

Solution 1.1

a)

The objectives of the IASB are:

- to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in the financial statements to help participants in the various capital markets of the world and other users of the information to make economic decisions
- to promote the use and rigorous application of those standards
- to work actively with national standard setters to bring about convergence of national accounting standards and International Financial Reporting Standards to high quality solutions.

b)

The IASB consists of fourteen individuals and has sole responsibility for setting accounting standards. The foremost qualification for IASB membership is technical expertise. The constitution requires the membership to comprise *at least*:

- five practicing auditors
- three preparers of financial statements
- three users of financial statements
- one academic

The publication of a Standard or Exposure Draft requires approval by eight of the IASB's fourteen members

c)

International Financial Reporting Standards are developed through a formal system of due process and broad international consultation that involves accountants, financial analysts and other users of financial statements, the business community, stock exchanges, regulatory and legal authorities and academics.

The formal due process usually involves the following steps:

- IASB staff review all the issues associated with the topic and consider the application of the IASB Framework to the issues
- Study of national accounting requirements
- Consulting the IASB Standards Advisory Council (SAC) about the advisability of adding the topic to the IASB's agenda
- Formation of an advisory group to give advice to the IASB on the project
- Publishing a discussion document for public comment
- Publishing an Exposure Draft and a Basis for Conclusions
- Consideration of all comments received
- Consideration of the possibility of holding a public hearing
- Approval and publishing of a Standard and a Basis for Conclusions

Solution 1.2

- Fair presentation is *achieved* by compliance with applicable IFRSs. This requires:
 - selecting and applying appropriate accounting policies
 - presenting information in a manner that provides relevant, reliable, comparable and understandable information
 - providing additional disclosures where the requirements in IFRSs are insufficient to meet users needs.(IAS 1, para 17)
- Inappropriate accounting treatments are not rectified either by disclosure of accounting policies used or by notes or explanatory material.
(IAS 1, para 18)
- In the extremely rare circumstances when management concludes that compliance with a requirement in an IFRS would be misleading that it would conflict with the objective of financial statements set out in the Framework, the entity shall depart from that requirement if the regulatory framework *requires, or otherwise does not prohibit*, such a departure:
 - that management has concluded that the financial statements fairly present the entity's financial position, financial performance and cash flows,
 - that it has complied in all material respects with applicable IFRSs except that it has departed from a standard in order 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 misleading in the circumstances and the treatment adopted, and
 - the financial effect of the departure on each item in the financial statements that would have been reported in complying with the requirement.(IAS 1, para 20)
- In the extremely 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 Framework, but the relevant regulatory framework *prohibits departure* from the requirement, the entity shall, to the maximum extent possible, reduce the perceived misleading aspects of compliance by disclosing:
 - the title of the IFRS in question, the nature of the requirement, and the reason why management has concluded that complying with that requirement is so misleading in the circumstances that it conflicts with the objective of financial statements set out in the Framework; and
 - for each period presented, the adjustments to each item in the financial statements that management has concluded would be necessary to achieve a fair presentation(IAS 1, para 23)

Solution 2.1

In order for financial statements to be reliable, they should:

- not include material error or bias;
- be a faithful representation;
- show the substance rather than the legal form of the transaction;
- be neutral;
- be prudent (but not to the extent that reserves become hidden); and
- be complete (within the confines of materiality and cost).

Solution 2.2

- The framework is not an International Financial Reporting Standard [paragraph 2 of framework].
- Faithful representation forms part of the discussion of reliable information (qualitative characteristic) of useful information as addressed in the framework.
- IAS 1 p13 states that fair presentation requires faithful representation of transactions and elements as defined in the framework.
- As a result, IAS 1, p13, therefore requires a user to incorporate the principles set out in the framework (although it is not an IFRS) as well as the definitions of the elements, so as to achieve fair presentation.

Solution 2.3

The qualitative characteristics are:

- Understandability;
- Comparability.
- Reliability; and
- Relevance;

Understandability

Since entities are allowed to use a variety of measurement models to report their financial information, understandability is impaired. For example, IAS 16 (Property, plant and equipment) allows the cost model or the revaluation model to be used for different classes of assets: users may not understand how different classes of property, plant and equipment can be measured using different measurement models. Conversely, IAS 39 (Financial instruments) allows the fair value model to be used for both 'financial assets at fair value through profit and loss' and 'financial assets available for sale': users may not necessarily understand how financial assets that are classified differently are measured in the same way.

Comparability

Comparability amongst similar entities is impaired by permitting choice between measurement models and further detracts from their understandability. For example, two similar entities may choose different models (i.e. one may choose to measure their non-current assets at cost less accumulated depreciation (cost model) and another entity may choose to measure them at fair value less accumulated depreciation (revaluation model)).

Reliability

With regard to IAS 16 (Property, plant and equipment), for example, the cost model may be argued to be more reliable than the revaluation model. On the other hand, it is unlikely to provide relevant values for the statement of financial position as the depreciated cost is unlikely to have any relevance to its true value.

Relevance

The fair value and revaluation models are more likely to produce relevant values, but may be criticized as being unreliable in the absence of active markets. The fair value and revaluation models aid comparability as similar assets with differing historical costs could be reported as the same value in the statement of financial position. It may, however, be noted that fair value accounting can also detract from comparability in extremely volatile markets.

Conclusion:

It can be seen that it is difficult to successfully meet all four qualitative characteristics.

Solution 2.4**a) Users and their information needs**

- *Investors.* The providers of risk capital and their advisers are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information which enables them to assess the ability of the entity to pay dividends.
- *Employees.* Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the entity to provide remuneration, retirement benefits and employment opportunities.
- *Lenders.* Lenders are interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due.
- *Suppliers and other trade creditors.* Suppliers and other creditors are interested in information that enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an entity over a shorter period than lenders unless they are dependent upon the continuation of the entity as a major customer.
- *Customers.* Customers have an interest in information about the continuance of an entity, especially when they have a long-term involvement with, or are dependent on, the entity.
- *Governments and their agencies.* Governments and their agencies are interested in the allocation of resources and, therefore, the activities of entities. They also require information in order to regulate the activities of entities, determine taxation policies and as the basis for national income and similar statistics.
- *Public.* Entities affect members of the public in a variety of ways. For example, entities may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the entity and the range of its activities.

b) Relationship between users and other investors

While all of the information needs of these users cannot be met by financial statements, there are needs which are common to all users. As investors are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

Solution 2.5**Statement of fact**

The credit entry represents equity.

Explanation**Introduction:**

An account with a credit balance is normally a liability, income or equity. The definitions of each of these elements will now be discussed.

Definition of a liability and discussion thereof

- a present obligation of the entity,
- as a result of past events,
- the settlement of which is expected to result in an outflow of economic benefits.

There is an essential difference between an equity participant and a financier. An equity participant (shareholder) invests money in a company for an indefinite period of time. He is considered to be a part owner, who never expects to be refunded the capital contributed. Instead, the shareholder hopes for dividend distributions and growth in the value of his share certificates through the success of the company. The financier (e.g. bank), on the other hand, *lends* money to the company for a defined period of time, meaning that as soon as the finance is received there is an obligation to repay this amount. (*This discussion was not required*).

Although there is a past event – the issue of shares – this event, in itself, does not create an associated present obligation. The transaction in question involves equity participants and accordingly, there exists no obligation to repay the amount of C120 000. By default, there will be no related settlements resulting in the outflow of future economic benefits. Both the share capital and the share premium are obviously not liabilities.

Definition of income and discussion thereof

- an increase in future economic benefits during the accounting period,
- in the form of inflows or enhancements of assets or decreases in liabilities,
- resulting in an increase in equity other than through contributions from equity participants.

There has been an inflow of assets during the period: an amount of C 120 000 in cash upon the issue of shares. But, the definition specifically excludes contributions from equity participants: therefore both the share capital and share premium cannot be considered to be income since it represents a contribution from equity participants.

Definition of equity and discussion thereof

- the residual interests in assets,
- after deducting all liabilities.

Since the transaction creates an asset of C120 000 (cash in bank) and does not create a liability at all (as explained in the discussion above), the residual interest resulting from the transaction is a net asset of C120 000 with the result that both the share capital and the share premium should therefore be treated as equity.

Please note:

*The required specifically referred to a 'discussion of the relevant definitions' whereas no reference was made to the discussion of the recognition criteria – this is the reason why the recognition criteria were not discussed here. Had the required not specified 'definitions' but rather required a discussion in terms of the 'Framework' in general, then a discussion of **both** definitions **and** recognition criteria would have been required.*

Solution 2.6**Definitions and recognition criteria:***Income definition:*

- There must be an increase in economic benefits during the accounting period
- in the form of inflows or the enhancement of an asset/s; or decrease in liabilities
- resulting in an increase in equity
- other than contributions from equity participants.

Liability definition:

- There must be a present obligation of the entity
- as a result of a past event
- the settlement of which is expected to result in an outflow of future economic benefits.

Recognition criteria for a liability:

A liability may only be recognised in the financial statements if:

- it is probable that future economic benefits will flow to/from the entity; and
- the element has a cost or value that can be reliably measured.

Recognition criteria for income:

Income may only be recognised in the financial statements if:

- there is a probable increase in future economic benefits through either an increase in assets or decrease in liabilities; and
- this increase can be measured reliably.

Discussion:

The bookkeeper is incorrect in the accounting treatment of the receipt since it does not meet the definition of 'income':

- although the cash received from the tenant is an increase in economic benefits during the accounting period (December 20X3); and
- the receipt has increased Hazyview Mall Ltd's assets (bank);
- there has been a simultaneous increase in liabilities since Hazyview Mall Ltd has an obligation to provide the tenant with occupation for January 20X4 or refund the C65 000;
- with the result that there has been no increase in equity (assets: 65 000 – liabilities: 65 000)

The receipt of C65 000 meets the definition of a liability:

- Hazyview Mall Ltd has a present obligation to provide the tenant occupation in January 20X4 or refund the C65 000;
- as a result of a past event, being the receipt of the C65 000;
- the settlement of which is expected to result in future economic benefits flowing from Hazyview Mall Ltd in the form of occupation rights or a refund of the cash received.

Solution 2.6 continued ...

Both the recognition criteria for the recognition of a liability have been met in that:

- the outflow of future economic benefits is probable (the tenant is a long-standing tenant and, as such, it is not expected that Hazyview Mall Ltd would fail to provide occupation to the tenant in January 20X4 or would cancel the lease agreement and not refund the cash)
- the value can be reliably measured (C65 000).

Conclusion:

The bookkeeper must treat the receipt as a current liability in the financial statements of Hazyview Mall Ltd as at 31 December 20X3.

The correcting journal entry is as follows:

	Debit	Credit
<i>31 December 20X3:</i>		
Rental income	65 000	
Rental income received in advance (L)		65 000
<i>Rent income received in advance</i>		

Solution 2.7

The accountant has debited an expense and credited a liability. Both of these elements will now be discussed in terms of the arguments presented by the accountant.

Definition of a liability

- a present obligation of the entity,
- arising from past events,
- the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Recognition criteria for a liability

- it must be probable that the future economic benefits will flow from the entity,
- the item must have a cost that can be reliably measured.

Definition of an expense

- Decreases in economic benefits,
- during the accounting period,
- in the form of outflows or depletions of assets or incurrence of liabilities,
- that result in decreases in equity, other than those relating to distribution to equity participants.

Recognition criteria for an expense

An expense may only be recognised in the financial statements if:

- there is a probable decrease in future economic benefits through either an decrease in assets or an increase in liabilities; and
- this decrease can be measured reliably.

Discussion of the definition of a liability

- Although a possible outflow of economic benefits would result in the event of a theft or other calamity, this outflow is not expected since:
- no past event has occurred: neither an insurance contract has been signed (requiring the payment of insurance premiums) nor has a calamity occurred (requiring a repair or replacement); and thus
- there is no present obligation (for an obligation to be a *present* obligation, there has to be a past event). Furthermore, there is no obligation as the company is not obliged, (legally or otherwise), to repair or replace any items damaged. An obligation derives from either a legal obligation or a constructive obligation (e.g. public expectations created through a public announcement). Neither a legal nor a constructive obligation exists here since there is simply an internal management decision that can obviously be rescinded.

Discussion of the recognition criteria for a liability

- It can be argued that the cost of C480 000 is reliably measured, as it represents the best estimate of the insurance expense based on past experience. Although the liability has been estimated based on past insurance contributions, the actual claims have historically been significantly less than the insurance premiums. This means that the C480 000 may be slightly overestimated but still acceptable on the grounds that this is a prudent approach.
- The outflow of economic benefits is, however, not probable since no past event has occurred; the outflow is only possible at this stage.

Solution 2.7 continued ...**Discussion of the definition of an expense**

- Although the possible loss represents a decrease in future economic benefits (e.g. through the destruction of a machine),
- this has not yet occurred and is therefore not 'during the accounting period'; and
- there is no outflow during the period (e.g. payment of insurance premiums), no depletion of assets (e.g. destruction of a machine) and no liability incurred (e.g. signing of an insurance contract or contract for repairs); and therefore
- there is no decrease in equity and therefore there is no expense.

Discussion of the recognition criteria for an expense

- Although there is an amount that may have been reliably measured (C480 000),
- there is no change to either assets or liabilities, and therefore there is no decrease in equity (future economic benefits) and therefore the recognition criteria are not met.

Conclusion

Since there is no liability (meeting neither the definition nor the recognition criteria), there can also be no expense and therefore the journal entry should be reversed.

Please note:

*The required specifically referred to a discussion in terms of the 'Framework': for this reason, the discussion involves **both** definitions **and** recognition criteria.*

Solution 2.8**Treatment of brands as an asset****Definition of an asset:**

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

Discussion of the definition

- Control - the brand is a resource that is controlled by the entity since it has been purchased by the entity and control will therefore be supported by legal documents.
- Past event - the past event is the signing of the purchase documents.
- Future economic benefits - future economic benefits are expected through increased sales resulting from the ownership of the brand.

The purchased brands therefore meet the definition of an asset.

Recognition criteria and discussion thereof:

- Cost / value must be reliably measured: since the brand is purchased, the cost is reliably measurable (C1 500 000) in terms of purchase documentation.
- Future economic benefits must be probable: Although the sales have doubled, which may be indicative of future trends, (probable future economic benefits), what portion of these future economic benefits stem from the C1 500 000 brand and what portion from other expenditure, such as an effective sales team, is difficult to measure reliably.

Conclusion:

Assuming that the increase in sales can be attributed to the new brand, and to a sufficient extent, it would suggest that there are probable future economic benefits that are expected from the brand. In such a case, the C1 500 000 should be capitalised and amortised against the future income

Please note:

Depending on time allocation in a test or examination, it may be prudent to also discuss the definition and recognition criteria of an expense as well (this was not discussed here since the required was not clear that both the asset and expense definitions and recognition criteria needed to be discussed and obviously a mark allocation was unavailable to guide the extent of the answer).

Solution 2.9**Introduction:**

The incentive payments represent a debit, therefore the treatment as an asset or an expense should be discussed.

Definition of an asset:

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

Recognition criteria for an asset:

- it must be probable that the future economic benefits will flow to the entity,
- the item must have a cost that can be reliably measured.

Discussion of the asset:

The contract acquired through the payment of the incentive:

- is a resource (right to receive cash from the members),
 - which is controlled by the entity (through a signed contract)
 - from a past event (the signing of the contract)
 - from which future economic benefits are expected to flow over the next 2 years (through membership fees).
-
- There is a probable inflow of future economic benefits since the customer is bound by a legal contract to pay monthly fees.
 - The amount of the fees are stipulated in the contract and are therefore reliably measurable.

The definition and recognition criteria of an asset are therefore met.

Definition of an expense:

It represents

- a decrease in economic benefits,
- during the accounting period,
- in the form of outflows (through a decrease in assets or an increase in liabilities),
- that result in decrease in equity (other than through distributions to equity participants).

Recognition criteria for an expense:

- there must be a probable decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen
- that can be measured reliably.

Discussion of the expense:

- The amount of the incentive payment is reliably measured since it would be stipulated in terms of the contract;
- The payment of the incentive payment is made in the accounting period, on which date
- There is a decrease in assets (bank);
- There is therefore a decrease in equity and therefore the payment could be expensed.

Solution 2.9 continued ...**Conclusion:**

The incentive payment meets both the definition of an asset and the definition of an expense (and related recognition criteria).

Since, however, the contract is a 2-year contract, thus meaning that income is expected over 2 years, the cost of the incentive payment should be recognised when the revenue is recognised. This requires the treatment of the payment as an asset that is amortised over the 2-year period.

The amortisation should not be over a 10-year period since this is based on research into European trends and not South African trends in which the loyalty of South Africans might prove vastly different:

- the research in Europe covers only a five year period, so the asset should be amortised over a period not longer than 5 years, otherwise the concept of prudence is not met (assuming that the results of the European research are equally applicable in South Africa);
- the club has only recently entered into the South African market and may not survive so to keep an asset in the statement of financial position for 10 years is not prudent (since the probability of future economic benefits becomes questionable);
- it is more prudent to amortise the asset faster (over 2-years) based on the uncertainties mentioned above;
- since the asset will be decreased over two years, the definition of an expense will be met in each of these two years – the expense will be reliably measured based on the amount by which the asset has decreased.

Note: if the customer is able to cancel the contract relatively easily, then the future economic benefits from signing up a customer are no longer probable (recognition criteria not met) and it would therefore be more prudent to treat the full incentive payment as an expense in the first year.

Solution 2.10**Definition of a liability**

- A present obligation of the entity
- Arising from past events
- The settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Discussion of a liability

- There is no past event at 31 March 20X4 since the event that would lead to an obligation is the declaration, which happened afterwards (13 April 20X4).
- There can be no present obligation at 31 March 20X4 since there is no past event.
- The settlement of the dividend will result in an outflow of economic benefits when the dividend payment is made.

Since the definition is not met in its entirety, a liability may not be recognized at the end of the financial year (31 March 20X4).

Definition of an expense

- A decrease in economic benefits during the accounting period
- in the form of outflows or depletions of assets or incurrences of liabilities
- that result in decreases in equity, other than distributions to equity participants.

Discussion of an expense

- At 31 March 20X4, there has been no increase in liabilities (see discussion above) or decrease in assets (no dividend payment was made on or before 31 March 20X4) and therefore there has been no decrease in economic benefits during the period.
- A dividend declaration should, in any event, never be included as an expense in the statement of comprehensive income as it represents a distribution to equity participants, which is expressly excluded from the definition of an expense.

Conclusion:

The journal entry made in the books of the 31 March 20X4 must be reversed as follows:

	Debit	Credit
<i>31 March 20X4</i>		
Dividend payable (liability)	xxx	
Dividend (expense)		xxx
<i>Reversal of previous dividend journal entry: no obligation at 31 March X4 and incorrect allocation to an expense account</i>		

The following dividend journal entry should then be processed on 13 April 20X4 instead.

	Debit	Credit
<i>13 April 20X4</i>		
Dividend (equity distribution)	xxx	
Dividend payable (liability)		xxx
<i>Dividend declared on 13 April 20X4: 0.15 x number of issued shares</i>		

Solution 2.11**Definition of an asset**

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

The river is a resource acquired by the entity from past events (the purchase of the farm) from which future economic benefits are expected to flow (the river promotes growth of the crops which in turn yield profits - cost savings on the water bill is also a future economic benefit to consider). There may be doubt as to whether the farm controls the river, since the river may run dry due to drought (which cannot be controlled by the farm) or due to a farm damming or polluting it upstream, etcetera. All these factors are effectively out of the control of the farmer.

Recognition criteria for an asset

- the cost should be reliably measurable,
- the future economic benefits should be probable

It may be argued that the future economic benefits that will flow from the use of the river are probable (e.g. cost savings in not having to pay the local council for water; and profits from the sale of crops) but the cost or value of the river cannot be reliably measured since it was purchased as part of the farm (as opposed to purchasing it as a separate item).

Conclusion

Although the river may meet the definition of an asset, (assuming there is sufficient control over the river) it may not be included as an asset in the statement of financial position since it does not meet the recognition criteria.

An alternative would be to revalue the entire land and buildings and in so doing include the value of the river in the land and buildings amount (i.e. the river will then be included in the valuation of the farm but would not be disclosed as a separate item due to the difficulty in measuring it as a separate item).

Solution 2.12

The Framework requires financial statements to reflect substance and economic reality of transactions over legal form. The issue in question is whether the inventory should be included as an asset in Minutemin's financial statements or in the manufacturer's financial statements.

The Framework's definition of an asset and the recognition criteria need to be applied to the situation.

Definition of an asset:

An asset is

- a resource, controlled by the entity,
- as a result of a past event,
- from which future economic benefits are expected to flow to the entity.

Discussion of the asset definition:

- Minutemin pays insurance in respect of the photocopy machines which indicates the risks and rewards of ownership have passed. There has never been an instance where the machines were returned to the manufacturer. All indications are that the photocopiers are controlled by the company.
- The past event is Minutemin taking possession of the machines.
- Future economic benefits are expected to flow from the sale of the machines and sale of photocopies.

All the elements of the definition of an asset are therefore met.

Recognition criteria for an asset:

The recognition criteria require an asset to be recognized when:

- it is probable that future economic benefits will flow to the entity and
- the asset has a cost or value that can be measured reliably.

Discussion of the asset's recognition criteria:

- It is probable that Minutemin will receive economic benefits from the sale of the inventory as inventory has never been returned to the manufacturer.
- The cost of the photocopiers can be reliably measured as it is determined when the photocopier is received by Minutemin.

The recognition criteria are both met.

Since both the asset definition and related recognition criteria are met, Minutemin must recognize the inventory as an asset in its books.

The journal entries would be as follows: (not required)

	Debit	Credit
Inventory	30 000	
Bank		3000
Accounts payable		27 000
<i>Purchase of inventory and payment of deposit</i>		
Accounts payable	27 000	
Bank		27 000
<i>Payment of balance owing upon sale of inventory</i>		
Cost of sales	30 000	
Inventory		30 000
<i>Inventory is expensed as it is sold</i>		

Solution 2.13**Introduction**

The main concern is whether the item should be treated as an asset or an expense depending on whether it meets the specific definitions and recognition criteria.

Treatment as an asset**Definition of an asset**

- Resource under control of the company
- Resulting from a past event
- From which future economic benefits are expected to flow to the company

Applying the asset definition to the plantation

- It is under the control of the company. The plantation is on company land and is being developed and maintained by the company.
- The past event is the development of the plantation.
- Future economic benefits: If the trees are harvested and the wood is sold, economic benefits will flow to the company. It can therefore be assumed that the plantation has been developed (and the costs incurred) with expected future economic benefits in mind.

Recognition criteria for an asset:

- The inflow of future economic benefits must be probable.
- The item must have a cost/value that can be measured with reliability.

Application of the recognition criteria to the plantation:

- As the period prior to expectation of the benefits is quite long, there is some uncertainty involved in the probability of the inflow of future economic benefits (e.g. drought, fire, market after 10 years, etc).
- The cost of developing the plantation can in this case be determined with accuracy since all costs have been provided for including both the original purchase cost of the land and the plantation costs to date.

Definition of an expense

- Expenses are decreases in economic benefits
- during the accounting period
- in the form of outflows or depletions of assets or incurrences of liabilities
- that result in decreases in equity,
- other than those relating to distributions to equity participants.

Solution 2.13 continued ...**Applying the expense definition to the plantation**

- In this case the cost to develop and maintain the plantation must be paid and can be seen as the outflow of an economic benefit through the depletion of an asset, being the bank account or an increase in liabilities if the amounts have not yet been paid.
- These outflows of economic benefits have all occurred before 31 December 20X2 and the outflows are therefore said to have occurred 'during the accounting period'.
- Since there has either been a decrease in assets or an increase in liabilities (or a decrease in assets *and* an increase in liabilities, assuming some amounts have not yet been paid), there will be a decrease in equity.

Since none of these outflows represent distributions to equity participants the outflows meet the definition of an expense.

Recognition criteria for an expense:

- There must be a probable decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen
- that can be measured reliably.

Applying the recognition criteria to the plantation:

- The decrease in future economic benefits is probable since the asset has been reduced already (e.g. cash in bank was reduced to make related payments);
- The C1.3 million is supported by documentation of payments and invoices and is therefore reliably measurable.

Since the recognition criteria relating to the expense are both met, the expense should be recognised.

Conclusion:

Assuming that the uncertainty regarding the probable inflow of future economic benefits is material, the definition of an asset is met but its recognition criteria are not. Conversely both the definition and related recognition criteria of an expense are met and therefore the journal entry showing the C1.3 million as an expense is correct. No adjustment is required.

Alternative conclusion:

Assuming that the uncertainty regarding the probable inflow of future economic benefits is not material, the costs can be said to comply with the definition and recognition criteria of an asset. The development and maintenance costs are integral to the sustainability of the asset. The capitalisation is justified based on the fact that these costs will generate future income. Without spending on development and maintenance the company may not realise the expected incomes (20% on costs), and although a long time will pass before the trees will result in any income, it is fair to assume that they were planted with the intention of earning a return over and above the costs incurred and thus the future economic benefits will be earned.

Therefore there are sufficient reasons for treating the costs as an asset.

Solution 2.14**a) Definitions:****i) Liability:**

- Present obligation of the entity
- As a result of a past event
- The settlement of which will result in an outflow of future economic benefits.

ii) Equity:

- The net increase in assets after deducting liabilities

iii) Expense:

- A decrease in economic benefits
- During the accounting period
- Through an increase in liabilities or decrease in assets
- Resulting in a decrease in equity, other than a distribution to equity participants.

b) Discussion: Recognition**i) Recognition of the initial issue of preference shares:***Liability:*

- Since Keeptrying Ltd's preference shares are compulsorily redeemable, they represent a present obligation of the entity.
- The past event is the issue of these shares on 1 January 20X3.
- The settlement of this obligation will result in an outflow of cash of C420 000 (in respect of the par value of the shares: C300 000, the premium: C30 000 and the annual dividends: C30 000 x 3 years = C90 000).

The preference shares therefore meet the definition of a liability.

Equity:

- Since bank (an asset) increased and
- preference shares (a liability) increased,
- there is no impact on equity.

The preference shares therefore have no impact on equity.

Solution 2.14 continued ...**b) Discussion: Recognition continued ...***ii) Recognition of the redemption of preference shares:**Expense:*

- A decrease in economic benefits: cash outflow
- During the accounting periods: 20X5
- Through an increase in liabilities or decrease in assets: decrease in bank
- Resulting in a decrease **in equity, other than a distribution to equity participants**:
 - Since the issue of the preference shares represents a liability, none of the payments to the preference shareholders represent distributions to equity participants.
 - Since the par value of the shares and premium on redemption are both committed to on the date that the preference shares are issued and are thus recognised as liabilities, the repayment of each represents a decrease in assets (decrease in the bank account) and a decrease in this preference share liability balance, with the result that there is no impact on the equity. These repayments are therefore not expenses.
 - The C300 000 paid is a settlement of the original liability
 - The C30 000 paid is a settlement of the premium that accrued over the 3 years.
 - Both the above payments thus decrease liabilities and, at the same time, decrease the assets (bank) with the result that the payments do not represent expenses.

The preference shares therefore have no impact on expenses.

c) Calculation: Measurement

- Liabilities should be recognised at the present value of the future obligation (future obligation is C420 000):
 - C318 762 at 31 December 20X4.
- The liability balance may be calculated as follows:

Effective interest rate table	Interest at 12,937%	Bank	Premium accrued	Preference share liability
				300,000
31/12/20X3	38,811	-30,000	8,811	308,811
			8,811	
31/12/20X4	39,951	-30,000	9,951	318,762
			18,762	
The rest of this table was not required:				
31/12/20X5	41,238	-30,000	11,238	330,000
			30,000	
31/12/20X5		-330,000	-30,000	0
			0	
	120,000	-420,000		

Solution 2.14 continued ...

d) Journals:

	Debit	Credit
1 January 20X4		
Retained earnings	8 811	
Premium accrued		8 811
<i>Correction: preference dividend & premium recognised as interest expense</i>		
1 January 20X4		
Preference share (equity)	300 000	
Preference share (liability)		300 000
<i>Correction: recognition of preference shares as a liability</i>		
31 December 20X4		
Finance charges	39 951	
Preference dividend		30 000
Premium accrued		9 951
<i>Correction: preference dividend & premium recognised as interest expense</i>		
31 December 20X4		
Preference share (liability)	318 762	
Current portion of preference share (liability)		318 762
<i>Correction: recognition of preference shares as a liability</i>		

Assuming that it was possible for the company to process correcting journals in the 20X3 records, the following correcting journal would be processed in 20X3 (below) instead of the correcting journal processed on 1 January 20X4 (above):

	Debit	Credit
31 December 20X3		
Finance charges	38 811	
Preference dividend		30 000
Premium accrued		8 811
<i>Correction: preference dividend & premium recognised as interest expense</i>		

Solution 2.15**Introduction:**

The issue surrounds whether an increase in the value of an asset should be recognised as income or recognised directly as an increase in equity.

Definitions:

Equity is defined as:

- The residual interest in the assets of the entity
- After deducting its liabilities.

Income is defined as:

- An increase in economic benefits
- During the accounting period
- That increases equity through either
- An increase in assets or a decrease in liabilities
- Other than through a contribution from equity participants.

Discussion:

Discussion of income definition:

- The value of the plant was re-measured to fair value and resulted in an increase in assets in the trial balance.
- Since the value of assets increased but liabilities remained the same, this resulted in an increase in equity.
- Although the revaluation occurred during the accounting period, this increase in economic benefits was not actually realised during the accounting period since it has not been sold.
- Although this item meets the framework definition of income, it is excluded from profit measurement. (IAS 1, paragraph 80)

Discussion of equity definition:

- Since the plant (an asset) has increased in value and
- since there is no concomitant increase in liabilities,
- equity will have increased.

Conclusion:

Equity has increased and the income definition has been met. However, the increase in the asset's value (since it is obviously not a liability in any way) is recognised directly in equity because it is excluded from the measurement of profit (IAS 1, paragraph 80).

IAS 1, paragraph 96 requires that the statement of changes in equity to disclose:

- profit or loss;
- income and expenses recognised directly in equity; and
- the total of the above two items.

This disclosure is necessary since it is important to consider all items of income and expense in assessing changes in an entity's financial position between two reporting dates.

Solution 2.16**Asset definition:**

- a resource controlled by the entity
- as a result of past events and
- from which future economic benefits are expected to flow to the entity.

Recognition criteria for an asset:

- the future economic benefits expected to flow to the entity must be probable; and
- the asset must have a cost or value that can be measured reliably.

Discussion:

- The increased customer awareness created through the advertising promotion could be argued to be a resource.
- The decision to undertake advertising promotions is within the control of the entity.
- There is a past event since the promotion took place before 31 December 20X8.
- The future economic benefits are expected to flow in through increased future sales.

- The cost can be reliably measured as the C2 000 000 has already been spent.
- The issue relates to the uncertainty of the *probability* of the future benefits. The company cannot control how the public will react to the advertising i.e. whether they will react positively, which will result in an increase in sales, or whether they will react negatively, which will result in a decrease in sales, or whether they are indifferent, which will result in no change to sales. This lack of control over the flow of future economic benefits and the difficulty in linking any future increase in the inflow of economic benefits directly to the advertising means that the probability criteria needed for recognition is not met.

So although the definition of an asset is met, the accountant may not capitalize the amount.

Solution 2.16 continued ...**Expense definition:**

- decreases in economic benefits
- during the accounting period
- in the form of outflows or depletions of assets or incurrence of liabilities
- that result in decreases in equity, other than those relating to distributions to equity participants.

Recognition criteria for an expense:

- Recognised in the statement of comprehensive income when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen
- that can be measured reliably.

Discussion:

- The advertising expense has been paid and can be seen as the outflow of an economic benefit through the depletion of an asset (bank account).
- The expenditure was approved by the board and paid prior to the year end; hence it occurs 'during the accounting period'
- The payment does not represent a distribution to equity participants and should be recognised as an expense.

The cost therefore meets the definition of an expense.

- The cost of the item can be reliably measured as there is an amount of C2 000 000 that has been paid.
- There is a decrease in future economic benefits as there has been a decrease in the asset bank.

The recognition criteria have also been met and therefore the expense should be recognised.

Conclusion:

The entire amount must be expensed in the financial statements for the year ended 31 December 20X8.

Solution 3.1**a) Components of a complete set of financial statements**

A complete set of financial statements comprises:

- a statement of financial position as at the end of the period;
- a statement of comprehensive income for the period;
- a statement of changes in equity for the period;
- a statement of cash flows for the period;
- notes, comprising a summary of significant accounting policies and other explanatory information;

and

- a statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

b) Reasons for the introduction of a statement of comprehensive income

The main objective of the International Accounting Standards Board in revising IAS 1 was to aggregate information in the financial statements on the basis of shared characteristics. With this in mind, the Board considered it useful to separate changes in equity of an entity during a period arising from:

- transactions with owners in their capacity as owners
- other changes in equity.

Consequently, the Board decided that all owner changes in equity should be presented in the statement of changes in equity, separately from non-owner changes in equity

All non-owner changes in equity (ie comprehensive income) are required to be presented in one statement of comprehensive income. Components of comprehensive income are not permitted to be presented in the statement of changes in equity.

Solution 3.2

Profit or loss is the total of income less expenses, excluding the components of other comprehensive income.

Other comprehensive income comprises items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other IFRSs.

The IFRS list the components of other comprehensive income:

- changes in a revaluation surplus
- actuarial gains and losses on defined benefit plans
- gains or losses on translating foreign operations
- gains and losses on re-measuring available-for-sale financial assets
- gains and losses on hedging instruments in a cash flow hedge (the effective portion).

Total comprehensive income is the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners.

Total comprehensive income comprises all components of 'profit or loss' and of 'other comprehensive income'.

Solution 3.3

- a) The presentation and classification of items should not change from one period to the next (e.g. accounting policies should be applied consistently).
- b) It is important in order to achieve comparability from one year to the next.
- c) A change in classification and presentation is acceptable when (IAS 1, paragraph 45):
 - It is apparent, following a significant change in the nature of the entity's operations or a review of its financial statements, that another presentation or classification would be more appropriate having regard to the criteria for the selection and application of accounting policies in IAS 8;
 - An IFRS requires a change in presentation.

IAS 1, paragraph 46, explains that a change in presentation will therefore only occur if:

- The revised presentation is likely to continue; and
- The revised presentation is reliable and more relevant.

Solution 3.4

The loss of C7 500 000 suffered by the company must be included in the determination of the profit or loss for the period.

The effects of an entity's various activities, transactions and other events differ in frequency, risk and predictability, and the disclosure of the elements of financial performance assists in the understanding of the financial performance achieved and in making projections of future results. Additional line items are included on the face of the statement of comprehensive income, and the descriptions used and the ordering of items are amended when it is necessary to explain the elements of financial performance. Factors considered include materiality and the nature and function of the components of income and expenses, (IAS 1, paragraph 85 and 86).

The nature and amount of items of income and expenses that are material shall be disclosed separately (IAS 1, paragraph 97).

An item is material if its omission or misstatement could influence the economic decisions of users (Framework, paragraph 30).

On the assumption that the nature or amount is considered material to the users of Full Stop Limited, the C7 500 000 used in cleaning the factory and replacing the plant and machinery would therefore need to be disclosed as an additional line item (either on the statement of comprehensive income or in the note describing profit before tax).

Solution 3.5

(a) An entity shall classify an asset as current when:

- it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle; or
- it holds the asset primarily for the purpose of trading; or
- it expects to realise the asset within twelve months after the reporting period; or
- the asset is cash or a cash equivalent (as defined in IAS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

An entity shall classify all other assets as non-current.

(b) An entity shall classify a liability as current when:

- it expects to settle the liability in its normal operating cycle, or
- it holds the liability primarily for the purpose of trading;
- the liability is due to be settled within twelve months after the reporting period; or
- the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period

An entity shall classify all other liabilities as non-current.

(c) The **operating cycle** of an entity is the time between the acquisition of assets entering into a process and their realisation in cash or an instrument that is readily convertible into cash (IAS 1, p68).

(d) Current asset (because inventory is sold within the normal course of an entity's operating cycle, even though this cycle is more than 12 months).

(e) Current liability (because the raising of this liability and its subsequent payment is part of the entity's operating cycle, even though this cycle is more than 12 months).

(f) When an entity supplies goods or services within a clearly identifiable operating cycle, separate classification of current and non-current assets and liabilities on the face of the statement of financial position provides **useful information** by distinguishing the net assets that are continuously circulating as working capital from those used in the entity's long-term operations. It also highlights assets that are expected to be realised within the current operating cycle, and liabilities that are due for settlement within the same period: a simple comparison of the two totals give a useful indication of the entity's relative liquidity (e.g. current ratio and acid-test ratio).

Solution 3.6

In terms of IAS 1 [para 69, (a) to (d)] an entity should classify its financial liabilities as current when;

- a) it expects to settle the liability in its normal operating cycle;
- b) it holds the liability primarily for the purpose of trading;
- c) the liability is due to be settled within twelve months after the reporting period; or
- d) the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period.

If an entity expects, and *has the discretion*, to refinance or roll over an obligation for at least twelve months after financial reporting date under an existing loan facility, it classifies the obligation as non-current, even if it would otherwise be due within a shorter period. However, when refinancing is not at the discretion of the entity (e.g. no agreement to refinance), the obligation is still classified as current. Therefore, an agreement to refinance, or reschedule payments, on a long-term basis that is completed after the financial reporting date (and before the financial statements are authorised for issue), cannot result in the obligation being classified as non-current.

Even though Kyoto Limited's loan had an original term of 5 years and the agreement to refinance was signed before the financial statements were authorised for issue, the loan must still be classified as 'current' in the statement of financial position at 30 June 20X8 because it was not yet signed as at reporting date.

As the agreement was signed before the financial statements were authorised for issue, however, a note detailing the extended repayment period could be included in the financial statements, if considered relevant.

Note, that had the original loan agreement included an option to refinance the loan for a further twelve months or more, then the loan could remain disclosed as 'non-current' on condition that this option was at the discretion of Kyoto Limited.

Solution 3.7
GARMIN LIMITED
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X1

	Ordinary share capital C	Preference share capital C	Share premium C	RE C	Total C
Balance 1/1/X1	120 000	100 000	50 000	X	270 000
Ordinary shares issued during the year	80 000		16 000		96 000
Preference shares issued during the year		50 000	25 000		75 000
Share issue expenses written off			(5 000)		(5 000)
Dividends				(X)	
Total comprehensive income				X	
Balance 31/12/X1	200 000	150 000	86 000	X	436 000

GARMIN LIMITED
EXTRACTS FROM THE NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X1
1. Share capital

Authorised	C
300 000 ordinary shares of C1 each	300 000
12% 100 000 preference shares of C1 each	100 000
10% 100 000 preference shares of C1 each	100 000
Issued	
200 000 ordinary shares of C1 (20X0: 120 000)	200 000
100 000 12% non-redeemable preference shares (20X0: 100 000)	100 000
50 000 10% non-redeemable preference shares (20X0: 0)	50 000

1 500 ordinary shares were issued to the managing director during the year at C1.20 per share.

Reconciliation of quantity of shares

	Ordinary	Preference
Balance 1/1/X1	120 000	100 000
Issued during year	80 000	50 000
Balance 31/12/X1	200 000	150 000

Solution 3.8

a)

ESKIMO LIMITED
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X8

	20X8
	C
ASSETS	
Non-current assets	310 000
Land and buildings	200 000
Equipment	60 000
Investments	50 000
Current assets	370 000
Inventories	120 000
Trade receivables	250 000
	680 000
EQUITY AND LIABILITIES	
Issued share capital and reserves	394 200
Non-current liabilities	
Bank loan	25 000
Current liabilities	260 800
Trade accounts payable	225 000
Current tax payable	12 800
Bank overdraft	8 000
Shareholders for dividends	15 000
	680 000

ESKIMO LIMITED
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X8

	Share capital	NDR	Retained earnings	Total
	C	C	C	C
Opening balance - 1/1/20X8 ⁽¹⁾	200 000	20 000	145 000	365 000
Shares issued during the year (20 000 X C2)	40 000			40 000
Dividends declared			(15 000)	(15 000)
Total comprehensive income			4 200	4 200
Closing balance - 31/12/20X8	240 000	20 000	134 200	394 200
Dividends per share 2007				XXX
Dividends per share 2008	(C15 000/ 120 000)			0.125

(1) Balancing: 240 000 – 40 000 = 200 000

Solution 3.8 continued ...

ESKIMO LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X8

	Notes	20X8 C
Revenue from sales		580 000
Cost of sales		(300 000)
Gross profit		280 000
Other income	(12 500 + 23 000) 2	35 500
Operating expenses	(250 000 + 25 000 + 25 000)	(300 000)
Finance costs		(9 500)
Profit before tax	3 & 4	6 000
Income tax expense		(1 800)
Profit for the period		4 200
<i>Other comprehensive income</i>		-
Total comprehensive income		4 200
Earnings per share	(C4 200/ 120 000)	0.035

ESKIMO LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X8

2 Other Income

Interest Income	12 500
Rent Income	23 000
	<hr/>
	35 500
	<hr/>

3. Analysis of expenses by function

Cost of sales	300 000
Cost of administration	25 000
Cost of distribution	25 000
Other costs	250 000
	<hr/>
	600 000
	<hr/>

4. Profit before tax

Profit before tax is stated after taking into account the following items:

- depreciation on equipment (40 000 – 25 000)	15 000
---	--------

Solution 3.8 continued ...

b)

If the dividends are proposed but not declared yet, there is no present obligation meaning that there is no liability and that the dividend may therefore not be recognised. The changes have been highlighted in bold.

ESKIMO LIMITED
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X8

	20X8 C
ASSETS	
Same as (a) above	680 000
EQUITY AND LIABILITIES	
Issued capital and reserves	409 200
Non-current liabilities	25 000
Bank loan	25 000
Current liabilities	245 800
Trade accounts payable	225 000
Current tax payable	12 800
Bank overdraft	8 000
	680 000

ESKIMO LIMITED
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X8

	Share capital C	NDR C	Retained earnings C	Total C
Opening balance - 1/1/20X8 ⁽¹⁾	200 000	20 000	145 000	365 000
Total comprehensive income			4 200	4 200
Shares issued during the year [20 000 X C2]	40 000			40 000
Closing balance - 31/12/20X8	240 000	20 000	149 200	409 200

(1) Balancing: 240 000 – 40 000 = 200 000

ESKIMO LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X8

	20X8 C
6. Dividends paid and proposed	
Dividends paid during the year	-
Dividends proposed during the year	15 000
	15 000

Solution 3.9**a) Journals**

Journal entries		
	Debit	Credit
31 December 20X3		
Rent income received in advance	5 000	
Rent income		5 000
Telephone payable	3 000	
Telephone/ Other expense		3 000
<i>Year-end accruals: opening balances reversed</i>		
Rent income	6 000	
Rent income received in advance		6 000
Telephone prepaid	4 000	
Telephone/ Other expense		4 000
<i>Year-end accruals: closing balances processed</i>		
Dividends declared	30 000	
Shareholders for dividends		30 000
<i>Final dividend declared on 31 December 20X3</i>		
Cost of sales	48 000	
Depreciation		48 000
<i>Correction: transfer of factory depreciation to cost of sales</i>		
<i>80 000 x 60% = 48 000</i>		

Solution 3.9 continued ...

b) Disclosure

TRAVEL BUG LIMITED		
STATEMENT OF COMPREHENSIVE INCOME		
FOR THE YEAR ENDED 31 DECEMBER 20X3		
		20X3
		C
Sales	(given)	480 000
Cost of sales	$(105\,000 + 80\,000 \times 60\%)$	(153 000)
Gross profit		327 000
Other income	$(170\,000 + 240\,000 + 50\,000 + 5\,000 - 6\,000)$	459 000
Distribution expenses	$(100\,000 - 3\,000 - 4\,000) \times 30\% + 80\,000 \times 30\%$	(51 900)
Administrative expenses	$(100\,000 - 3\,000 - 4\,000) \times 20\% + 80\,000 \times 10\%$	(26 600)
Other expenses	$(100\,000 - 3\,000 - 4\,000) \times 50\%$	(46 500)
Finance charges		(22 000)
		639 000
Income tax expense		136 590
Other comprehensive income		-
Total comprehensive income		502 410

Solution 3.10

a)

ABC LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 28 FEBRUARY 20X9

	Notes	20X9 C
Sales		300 000
Cost of sales		(142 500)
Gross profit		157 500
Other income		300 000
Administration expenses		(117 313)
Distribution expenses		(119 375)
Other expenses		(148 812)
Finance costs		(9 500)
Profit before tax	3	62 500
Tax		(6 000)
Profit for the period		56 500
<i>Other comprehensive income</i>		-
Total comprehensive income		56 500

ABC LIMITED
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 28 FEBRUARY 20X9

	Share capital C	NDR C	Retained earnings C	Total C
Opening balance - 1/3/20x8	36 500	2 500	100 250	139 250
Total comprehensive income			56 500	56 500
Transfers between reserves		50 000	(50 000)	-
Closing Balance - 28/2/20x9	36 500	52 500	106 750	195 750

ABC LIMITED
STATEMENT OF FINANCIAL POSITION
AS AT 28 FEBRUARY 20X9

	20X9 C
ASSETS	
Non-current assets	150 000
Land and buildings	80 000
Equipment	40 000
Vehicles	30 000
Current assets	282 500
Inventories	129 000
Trade receivables	150 000
Expenses prepaid	500
Cash and cash equivalents	3 000
	432 500

Solution 3.10 continued ...**EQUITY AND LIABILITIES**

Issued share capital and reserves	195 750
Non-current liabilities	52 750
Bank loan	52 750
Current liabilities	184 000
Trade and other payables (64 000 + 2 000)	66 000
Current tax payable	118 000
	432 500

Authors' note:

Accounts prepaid at year-end of C500 have been shown separately from trade receivables, whereas accounts payable at year-end of C2 000 has been combined with trade payables to form trade and other payables. The reason is that accounts payable and trade payables are both 'payables' whereas amounts prepaid and trade receivables are technically two different things. However, the fourth and fifth Schedules of the Companies Ordinance 1984 require the separate disclosure of each of these four items.

ABC LIMITED**NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X9****2. Analysis of expenses by function**

Cost of sales	(Given)	142 500
Administration expenses	(See working below)	117 313
Distribution expenses	(See working below)	119 375
Other expenses	(See working below)	148 812
		528 000

3. Profit before tax

Profit before tax is stated after taking into account the following items:

- depreciation on office equipment [100 000 x 30%]	30 000
- depreciation on vehicles [100 000 x 70%]	70 000

Workings for note 3: expense allocation by function

Expense allocation	Total	Administration	Distribution	Other
Salaries & wages (250 000 - 500 - 2 000)	247 500	92 813	61 875	92 812
Depreciation - equipment (100 000 x 30%)	30 000	15 000		15 000
Depreciation - vehicles (100 000 x 70%)	70 000		56 000	14 000
Rates	10 000	2 500	1 500	6 000
Electricity & water (25 000 + 2 000 + 1 000)	28 000	7 000		21 000
		117 313	119 375	148 812

Solution 3.10 continued ...**b)***Current ratio:*

Current assets: current liabilities

C282 500: C184 000

1.535: 1

Comment:

The current ratio has dropped below the required minimum of 1.8:1 and therefore half of the long-term loan from AB Bank becomes repayable immediately. This means that half of the loan needs to be reclassified as current. The only financial statement that will change is the statement of financial position. Only that section of the statement of financial position that changes is shown. The line-items that change have been shown in bold in the C column.

ABC LIMITED**EXTRACT FROM STATEMENT OF FINANCIAL POSITION****AS AT 28 FEBRUARY 20X9**

	20X9
<i>EQUITY AND LIABILITIES</i>	C
Issued capital and reserves	195 750
Non-current liabilities	26 375
Bank loan	26 375
Current liabilities	210 375
Short-term portion of bank loan	26 375
Trade accounts payable (64 000 + 2 000)	66 000
Current tax payable	118 000
	432 500

Solution 3.11

(a)

DURHAM LIMITED				
STATEMENT OF COMPREHENSIVE INCOME				
FOR THE YEAR ENDED 28 FEBRUARY 20X6				
		Note	C	
Revenue from sales			10 500 000	
Cost of goods sold	(7 500 000 + 12 000)		(7 512 000)	
Gross profit			2 988 000	
Distribution costs			(520 000)	
Administration expenses			(480 000)	
Other expenses	(600 000 + 30 000)		(630 000)	
Finance cost			(140 000)	
Profit before tax		3	1 218 000	
Income tax expense	(1 218 000 X 0.29) ^(comment 1)	4	(353 220)	
Profit for the period			864 780	
<i>Other comprehensive income</i>				
Revaluation of land and buildings			240 000	
Total comprehensive income			1 104 780	

Authors comment:

Comment 1: please note that to calculate the tax by simply multiplying the profit before tax by the standard tax rate is only possible if there are no permanent differences between the IFRSs and the tax legislation and there are no further taxes and no tax adjustments relating to prior years (such as under/over provisions of current tax in a prior year) etc.

(b)

DURHAM LIMITED				
STATEMENT OF CHANGES IN EQUITY				
FOR THE YEAR ENDED 28 FEBRUARY 20X6				
	Ordinary share capital C	Non- distributable reserve C	Retained earnings C	Total C
Balance at 01/03/X5	4 000 000	200 000	1 250 000	5 450 000
Total comprehensive income		240 000	864 780	1 104 780
Dividends			(100 000)	(100 000)
Issue of share capital	1 000 000			1 000 000
Balance at 28/02/X6	5 000 000	440 000	2 014 780	7 454 780

Solution 3.12 continued ...

(c)

DURHAM LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 28 FEBRUARY 20X6

1. Corporate information

...XXX...

2. Significant accounting policies**2.1 Statement of compliance**

These financial statements have been prepared in accordance with approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) as are notified under the Companies Ordinance, 1984, provisions of and directives issued under the Companies Ordinance, 1984. In case requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

2.2 Accounting convention

These financial statements have been prepared on the basis of historical cost convention except for certain assets that are measured at fair value as specified in their respective notes.

2.3 Property, plant and equipment

Land and buildings held for the use in the production or supply of goods or services, or for administration purposes, are stated in the statement of financial position at their revalued amounts, being the fair value at the date of revaluation, less any subsequent accumulated depreciation and subsequent impairment losses. Revaluations are performed with sufficient regularity that the carrying amounts do not differ materially from those that would be determined using fair values at the financial reporting date.

Depreciation is charged so as to write off the cost or valuation of assets, over their estimated useful lives using the straight line method. The estimated useful lives, residual values and depreciation method are reviewed at each year end, with the effect of any changes in estimate accounted for in a prospective basis.

2.4 Inventory

Inventories are stated at the lower of cost and net realizable value. Costs are assigned to inventories on a first-in-first-out basis. Net realizable values represent the estimated selling price for inventories less all estimated costs of completion and costs necessary to make the sale.

3. Profit before tax

The profit before tax has been computed after taking into account the following:

		20X6
Auditors remuneration		C
Fee for audit		20 000
Other services		3 000
Depreciation on buildings	(112 500 + 85 000)	197 500
Depreciation on equipment	(60 000 + 40 000)	100 000
Employee benefits expense	(270 000 + 342 000)	612 000
Write down of inventory to net realisable value	(62 000 – 50 000)	12 000
Impairment of equipment		30 000

4. Dividends of C150 000 have been declared on 15 March 20X6 but have not

been recognised as a distribution. The DPS amounts to C0.03 per share.

Solution 3.12**a)**

The amount of C350 000 paid to the auditors in respect of the consulting fees, the C1 800 000 relating to inventory being written off and the C300 000 loss sustained in respect of flood damage should be included in the determination of profit or loss for the period.

The effects of an entity's various activities, transactions and other events differ in frequency, risk and predictability, and the disclosure of the elements of financial performance assists in the understanding of the financial performance achieved and in making projections of future results. Additional line items are included on the face of the statement of comprehensive income, and the descriptions used and the ordering of items are amended when it is necessary to explain the elements of financial performance. Factors considered include materiality of the nature, function and or size of the elements, (IAS 1, paragraph 85 and 86).

The nature and amount of items of income and expenses that are material (i.e. where non-disclosure thereof may influence the decision making of the users) should be disclosed separately.

The inventory write off of C1 800 000 and the loss sustained in respect of the flood of C300 000 should therefore be disclosed as an additional line item on the statement of comprehensive income or in the note describing profit before tax.

Revaluation surplus is considered part of 'other comprehensive income' and is therefore not included in the determination of profit before taxation.

Solution 3.12 continued ...**b)**
SKY LIMITED
STATEMENT OF COMPREHENSIVE INCOME (DRAFT)
FOR THE YEAR ENDED 30 SEPTEMBER 20X9

	Note	C000s
Gross profit		6 700
Other income (2 150 – 900)	2	1 250
Other expenses	3	(5 408)
Profit before taxation		2 542
Income tax expense		(741)
Profit for the period		1 801
<i>Other comprehensive income</i>		-
Revaluation of land		900
Total comprehensive income		2 701

SKY LIMITED
EXTRACT FROM THE STATEMENT OF CHANGES IN EQUITY (DRAFT)
FOR THE YEAR ENDED 30 SEPTEMBER 20X9

	Note	Retained earnings C000s	NDR C000s
Balance at 30/9/20X8		10 110	-
Total comprehensive income		1 801	900
Ordinary dividend - paid	5	(240)	
Balance at 30/9/20X9		11 671	900

SKY LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 SEPTEMBER 20X9
1. Accounting policies**1.1 Statement of compliance**

These financial statements have been prepared in accordance with approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) as are notified under the Companies Ordinance, 1984, provisions of and directives issued under the Companies Ordinance, 1984. In case requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

1.1.1 Accounting convention

These financial statements have been prepared on the basis of historical cost convention except for certain assets that are measured at fair value as specified in their respective notes.

1.2 Revenue

Revenue is measured at the fair value of the consideration received or receivable net of VAT. Revenue consists of sales of goods, rendering of services, royalties, dividends and interest income.

2. Other income

	C000s
Income from subsidiary	450
- Dividends	260
- Interest	190

Income from other investments
 - Dividends from listed companies

800
<hr/> 1 250

Solution 3.12 continued ...

3. Other expenses classified by nature include the following amounts.

	C'000
Auditor's remuneration	438
- audit fee	88
- consulting fees	350
Technical fees (200 - 80)	120
Depreciation	620
Staff costs	(x + 80)
Loss on inventory written down	1 800
Loss arising from flood damage	300

c)

The following information is still required for proper disclosure:

- If the function method is to be used for the statement of comprehensive income, then the following information would also be required:
 - Cost of sales
 - Details as to how to allocate the other expenses of C5 408 000 to the other functions: distribution, administration and other;
 - Any other expense included in 'general expenses' that may require separate disclosure in terms of IAS 1, other IAS's, the Companies Act and materiality.
- If the nature method is to be used for the statement of comprehensive income, then the following information would also be required:
 - Details of the movement in inventory: increase or decrease in the opening and closing balances of inventory and purchases thereof etcetera
 - Any other expense included in 'general expenses' that may require separate disclosure in terms of IAS 1, other IAS's, the Companies Act and materiality.

Solution 3.13**a)**

MUSTARD SEED LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 28 FEBRUARY 20X5

	Note	C
Revenue from sales	2	8 422 500
Cost of goods sold (6 053 500 + 23 000)		(6 076 500)
Gross profit		2 346 000
Other income (140 200 + 62 800 + 67 000)	2	270 000
Distribution costs		(505 300)
Administration expenses		(436 000)
Other expenses		(48 000)
Finance cost		(12 000)
Profit before tax	3	1 614 700
Income tax expense	4	(471 850)
Profit for the period		1 142 850
<i>Other comprehensive income</i>		-
Total comprehensive income		1 142 850

b)

MUSTARD SEED LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 28 FEBRUARY 20X5

C**1. Accounting policies****Statement of compliance**

These financial statements have been prepared in accordance with approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) as are notified under the Companies Ordinance, 1984, provisions of and directives issued under the Companies Ordinance, 1984. In case requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

Basis of preparation

The financial statements have been prepared in the historical cost basis. These policies are consistent in all material respects with these applied in the previous years.

2. Revenue

Sales of goods	8 422 500
Rendering of services	140 200
Dividends received	62 800
	<hr/> 8 625 500

Solution 3.13 continued ...

MUSTARD SEED LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 28 FEBRUARY 20X5 (CONTINUED)

C

3. Profit before tax

The profit before tax has been computed after taking into account the following:

Auditors remuneration		
Fee for audit		25 000
Other services		4 000
Depreciation of fixtures, fittings and equipment	(82 000 + 68 000)	150 000
Employee benefits expense	(320 000 + 312 000)	632 000
Profit on disposal of fixtures, fittings and equipment		67 000
Write down of inventory to net realisable value	(75 000 – 52 000)	23 000

4. Income tax expense

Normal tax		471 850
Current		471 850
Deferred		-

Tax rate reconciliation

	%	
Tax on profit / applicable rate	30,00	484 410
Dividends received	(0.78)	(12 560)
Income tax expense / effective rate	29.22	471 850

5. Dividends declared

Dividends amounting to C20 000 (C0.02 per share) were declared by the directors after the financial reporting date and before the financial statements were authorised for issue.

Solution 3.15 continued ...**c) Presentation of borrowings**

- An entity shall classify a liability as current when:
 - it expects to settle the liability in its normal operating cycle;
 - it holds the liability primarily for the purpose of trading;
 - the liability is due to be settled within twelve months after the reporting period; or
 - the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period.

All other liabilities shall be classified as non-current. Based on this definition, it appears that the borrowings should be classified as a current liability at 28 February 20X5 as the amount of C100 000 is payable on 30 May 20X5.

- However, if an entity expects, and has the discretion, to refinance or roll over an obligation for at least twelve months after the financial reporting date under an existing loan facility, it classifies the obligation as non-current, even if it would otherwise be due within a shorter period. In this situation, Mustard Seed Limited has entered into an agreement to refinance the loan until 30 May 20X6 under the existing loan facility.
- The C100 000 should therefore be classified as a non-current liability on the statement of financial position at 28 February 20X5.

Workings

Tax computation	
Profit before tax	1 614 700
Less: Dividends received (to be taxed @ 10%)	(62 800)
	1 551 900
Corporate tax rate	30%
Tax	465 570
Add: tax on dividend income @ 10% (62 800 * 10%)	6280
	471 850

Solution 4.1

- a) Dividend income may be recognised by the persons holding the shares (i.e. the shareholders) on 31st December, being the date on which the right to receive the dividend is firmly established.
- b) Since value-added tax is an amount received on behalf of a third party (the relevant tax authority) the economic benefit does not flow to the entity receiving it. The value-added tax should therefore be shown as a liability (a present obligation expected to result in an outflow of economic benefits).
- c) According to IAS 18, revenue should be recognised at fair value of the consideration received/ receivable, where 'fair value' is calculated by deducting the amount of any trade discount given. (It is interesting to note that the same principles should be applied when purchasing goods and receiving trade discount: the cost of purchases should be recorded net of trade discount received).
- d) Entities granting cash discounts to customers should reduce the amount of revenue recognised on the date of sale.
- e) Settlement discounts allowed have to be estimated at the date of sale and the amount of the revenue reduced accordingly. This is consistent with the requirement of IAS 18 that revenue should be recognised at the fair value of the consideration receivable (IAS 18, paragraph 9).
- f) A sale of goods on an instalment-sale basis includes a financing perspective. On completion of the necessary documentation, the customer is able to take the purchased goods into his custody. The payment for these goods occurs over a period of time and the total of the instalments add up to an amount in excess of the normal cash sale price. The reason for this excess is the financing cost that the customer is expected to pay. The revenue that may be recognised on the date of the sale is the cash sale price. The balance is recognised as interest income on a time basis, using the effective interest rate method.
- g) The revenue from sale of goods should only be recognised when 'the significant risks and rewards of ownership' have been transferred from the seller to the buyer and therefore the risks and rewards are generally assumed to be transferred on delivery of the goods.

However assuming that the goods had been sent before year-end, but only arrived after year-end, whether or not the sale was made on a FOB or CIF basis would then become relevant. If the goods were transported to the buyer on a F.O.B. basis (free-on-board), as the goods are packed on board the ship, they become the property of the buyer. If the goods are shipped C.I.F. (customs, insurance and freight), the seller undertakes to ensure that the goods arrive intact. The question did not specify which method was adopted, so the assumption must be that the goods were shipped C.I.F. and that the risks and rewards are only transferred on the date of delivery. Therefore, no revenue should be recognised until after year-end.

Solution 4.1 continued...

- h) In a lay-by sale (otherwise known as a lay-away sale), the goods are retained in the possession of the seller until such time as the last payment is made by the buyer. It differs from an instalment sale in that there is no financing aspect included in this transaction and the customer is not legally obliged to purchase the goods. Therefore, revenue is generally recognised after the final payment is received and the relevant goods are on hand and ready to be delivered. However, if *past experience indicates* that most lay-by sales are successfully concluded, then the revenue may be recognised once a significant portion of the sales amount has been received by the seller.
- i) A bill and hold sale involves a customer purchasing an item that is to be delivered or collected some time in the future. The revenue from such a sale may only be recognised when the customer has been invoiced, the goods are ready for delivery and it is probable that the delivery will take place.
- j) This is a normal sale (not a bill and hold) since the delay was not requested by the customer. The sale may therefore be recognised only once the goods are delivered, (on 3rd March), being the date upon which the risks and rewards are transferred and managerial control and effective management ceases.
- k) Revenue from a sale that has 'gone bad' should still be shown as revenue on the date that the sale took place, with the amount considered unrecoverable shown separately as an expense (bad debt expense).

Solution 4.2

		Debit	Credit
Mr. Schumi: Cash discount			
2 January 20X7			
Bank	$200\,000 \times 90\%$	180 000	
Sales income			180 000
<i>Cash sale to Schumi (less 10% cash discount)</i>			
Mr. Frank: Trade discount and cash discount			
1 February 20X7			
Bank	$100\,000 \times 3 \times 90\% \times 90\%$	243 000	
Sales income			243 000
<i>Cash sale to Frank (less 10% trade and 10% cash discount)</i>			
Mr. Alonzi: Settlement discount			
1 March 20X7			
Accounts receivable	<i>Given</i>	150 000	
Finance income allowance	$150\,000 \times 5\%$		7 500
Sales income	$150\,000 \times 95\%$		142 500
<i>Credit sale to Alonzi (less 5% early settlement discount)</i>			
30 March 20X7			
Bank	$150\,000 \times 95\%$	142 500	
Accounts receivable			150 000
Finance income allowance		7 500	
<i>Receipt from Alonzi within settlement period</i>			
Ms Haki: Sale on normal credit terms *			
1 April 20X7			
Accounts receivable	<i>Given</i>	400 000	
Sales income			400 000
<i>Credit sale to Haki</i>			
31 May 20X7			
Bank	<i>Given</i>	400 000	
Accounts receivable			400 000
<i>Receipt from Haki</i>			
Mr. Rory: Rebate against expenses *			
1 May 20X7			
Accounts receivable	$10 \times 100\,000 \times 90\%$	900 000	
Sales income	$10 \times 100\,000 \times 100\%$		1 000 000
Rebate expense	$10 \times 100\,000 \times 10\%$	100 000	
<i>Credit sale to Rory less 10% rebate against customer selling costs</i>			
30 June 20X7			
Bank		900 000	
Accounts receivable			900 000
<i>Receipt from Rory</i>			

Solution 4.2 continued ...

		Debit	Credit
Mr. Burn: Rebate against selling price *			
<i>1 June 20X7</i>			
Accounts receivable	$10 \times 100\,000 \times 90\%$	900 000	
Sales income			900 000
<i>Credit sale to Burn less 10% rebate against selling price</i>			
<i>31 July 20X7</i>			
Bank		900 000	
Accounts receivable			900 000
<i>Receipt from Burn</i>			
Mr. Mechanic: Sale on extended credit term *			
<i>1 July 20X7</i>			
Accounts receivable		450 000	
Sales income			450 000
<i>Sale on extended credit terms to Mechanic</i>			
<i>31 August 20X7</i>			
Accounts receivable	$W1: 32\,946 \times 2 / 12$	5 491	
Interest income			5 491
<i>Interest income on sale on extended credit terms to Mechanic</i>			

W1: effective interest table	Interest income	Instalment received	Accounts receivable balance
Inception	7.32125%		450 000
End of year 1	32 946	(250 000)	232 946
End of year 2	17 054	(250 000)	0
	<u>50 000</u>	<u>(500 000)</u>	

Solution 4.3

<i>Transaction number 1:</i>	Debit	Credit
10 January 20X7		
Debtors	160 000	
Revenue: sales		144 535
Unearned finance income		15 465
<i>Recognition of sale of goods</i>		
Cost of sales	85 000	
Inventory		85 000
<i>Cost of goods sold</i>		
10 June 20X7		
Bank	160 000	
Debtors		160 000
<i>Payment received from debtor</i>		
Unearned finance income	15 465	
Revenue: finance income		15 465
<i>Recognition of finance income</i>		
Transaction number 2:		
10 January 20X7		
Bank	150 000	
Revenue received in advance ^{NOTE 1}		150 000
<i>Recognition of revenue received in advance</i>		
Cost of sales	76 000	
Inventory		76 000
<i>Cost of goods sold</i>		
10 October 20X7		
Revenue received in advance	150 000	
Revenue: sales		150 000
<i>Recognition of sale of goods</i>		
Bank	$150\,000 \times 3.5\% \times 9/12$	3 938
Deferred income		3 938
<i>Recognition of deferred interest income until conditions met</i>		
Deferred income	3 938	
Revenue: interest income		3 938
<i>Recognition of interest income once conditions met</i>		

Note 1: IAS 18.17 considers that only an insignificant risk of ownership is retained if a sale is made with a warranty attached, in which case the recognition criteria would be met and the revenue would be recognized. However, the same paragraph (IAS 18.17) states that if a reliable estimate of the provision for warranty is not possible, then the revenue may not be recognized. Since the company had no experience with such warranties, a reliable estimate of the provision for warranties was not possible and therefore the revenue is not able to be recognized.

Solution 4.4**a) Discussion: recognition and measurement****Introduction**

The receipt of the C225 000 represents revenue from services rendered. This revenue may only be recognised if all the criteria below are met.

Discussion: recognition of revenue

- The amount of revenue can be reliably measured:

The amount of revenue is C225 000 being the cash value of the maintenance plan.

- It is probable that the future economic benefits will flow:

The full C225 000 has been received in advance and therefore probability is assured.

- Stage of completion can be measured reliably:

Although the stage of completion cannot be determined accurately, it is possible to make a reliable estimate thereof.

There are three methods to choose from when estimating the stage of completion:

- Costs to date method
- Number of services method
- Surveys method (work certified method).

Since we do not know how many services will be required, the number of services method is not appropriate. Similarly, since we have not been provided with work certified by a surveyor (and such certification would be unlikely given the unspecified nature of the work to be performed), the surveys method would be inappropriate. We do have the costs incurred to date and the total expected costs for the contract and therefore this method would be the most appropriate. The reliability of these estimates is enhanced given that Mark's Maintenance Men has 10 year's of experience to draw on when making these estimates.

- Cost incurred and to be incurred can be reliably measured:

Costs already incurred are reliably measured (by their very nature) and the future costs may be reliably estimated since Mark's Maintenance Men Ltd has 10 year's experience to draw on in making these estimates.

Conclusion: recognition of revenue

Revenue from the maintenance contract may be recognised on a percentage completion basis over the 3-year period of the contract.

Solution 4.4 continued ...**a) Discussion: recognition and measurement continued ...****Discussion: measurement of revenue**

The receipt of the C225 000 met the criteria for recognition as revenue. The revenue must be recognised over the three-year period of the contract based on the percentage completion. The method used to determine the percentage completion must be the costs method.

W1. Estimated stage of completion: services performed	20X3	20X4	20X5
Costs incurred to date (to date!) <i>20X3: Given</i>	30 000	75 000	150 000
<i>20X4: 30 000 + 45 000</i>			
<i>20X5: 75 000 + 75 000</i>			
Total expected costs <i>Given</i>	150 000	150 000	150 000
Percentage completion to date <i>20X3: 30 000 / 150 000</i>	20%	50%	100%
<i>20X4: 75 000 / 150 000</i>			
<i>20X5: 150 000 / 150 000</i>			
W2. Revenue recognised based on stage of completion	20X3	20X4	20X5
Revenue recognised to date <i>225 000 x 20%</i>	45 000	112 500	225 000
<i>225 000 x 50%</i>			
<i>225 000 x 100%</i>			
Less revenue recognised in prior years	(0)	(45 000)	(112 500)
Revenue to be recognised in current year	45 000	67 500	112 500

W3. Alternative calculation (instead of W1 and W2):

(costs incurred in CY + costs incurred in PYs) / total expected costs x total revenue – revenue recognised in PYs

- 20X3: (30 000 + 0) / 150 000 x 225 000 – 0 = 45 000
- 20X4: (45 000 + 30 000) / 150 000 x 225 000 – 45 000 = 67 500
- 20X5: (75 000 + 75 000) / 150 000 x 225 000 – 45 000 – 67 500 = 112 500

For your information:

Please note that, technically speaking, receiving revenue at the beginning of the transaction period (upfront) leads to the receipt of finance and therefore interest expense should be recognised. The effect of this financing was given to be immaterial and therefore this complication has been ignored.

If the cash were to have been received at the end of 20X5, this transaction would have involved revenue from services and revenue from interest.

Solution 4.4 continued ...**b) Journals**

	Debit	Credit
20X3 Journals		
Bank	225 000	
Revenue		45 000
Revenue received in advance		180 000
<i>Amount received in 20X3</i>		
<hr/>		
Costs	XXX	
Creditor/ bank		XXX
<i>Costs incurred in 20X3</i>		
<hr/>		
20X4 Journals		
Revenue received in advance	67 500	
Revenue		67 500
<i>Revenue recognised in 20X4</i>		
<hr/>		
Costs	XXX	
Creditor/ bank		XXX
<i>Costs incurred in 20X4</i>		
<hr/>		
20X5 Journals		
Revenue received in advance	112 500	
Revenue		112 500
<i>Revenue recognised in 20X5</i>		
<hr/>		
Costs	XXX	
Creditor/ bank		XXX
<i>Costs incurred in 20X5</i>		
<hr/>		

Solution 4.5**a) Discussion*****Revenue: general discussion***

- Revenue is defined as the gross inflow of economic benefits during the period, arising in the course of ordinary activities of an entity, that result in increases in equity, other than increases relating to equity participants.
 - Revenue includes transactions and events relating to
 - the sale of goods,(the sale of the clusters, sale of the produce and curios)
 - the rendering of services,(fees from grape tasting)
 - interest, royalties and dividends (interest on the deposits)
 - Amounts collected on behalf of third parties, such as VAT are not economic benefits that flow to the entity and do not increase equity, and are excluded from revenue
 - Therefore, the VAT on the sale of the clusters, from the grape tasting and the sale of the curios must be excluded
- Revenue should be measured at the fair value of the consideration received or receivable.

The recognition criteria are applied separately to each transaction.

Revenue from the sale of goods

Revenue from the sale of goods should be recognised when all the following conditions have been satisfied:

- (a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
 - (b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
 - (c) the amount of revenue can be measured reliably;
 - (d) it is probable that the economic benefits associated with the transaction will flow to the entity; and
 - (e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.
- *Sale of clusters to buyers*

The 150 clusters:

- The revenue is reliably measured at C25 000 000 (C28 500 000 X 100/114).
- It is reasonable to assume that the cost to build each home is reliably measurable.
- The significant risks and rewards of ownership were transferred and managerial involvement and effective control ceased when legal title was transferred.
- Since transfer is usually only registered after payment has been effected, the flow of future economic benefits has probably already occurred (and there is no evidence to suggest that the inflow of economic benefits is not probable).

The revenue from these sales may therefore be recognised.

Solution 4.5 continued ...**a) continued ...**

The 25 clusters:

- The revenue is reliably measured at C5 000 000 (excluding VAT)
- It is reasonable to assume that the cost to build each home is reliably measurable.
- The significant risks and rewards of ownership have not yet been transferred and managerial involvement and effective control has not yet ceased since legal title has not yet transferred.
- Since only deposits have been received to date and since sales are generally made after bond approval, the inflow of economic benefits are not yet probable.

We can therefore only include the C25 000 000 in revenue for the current financial year in question (the C5 000 000 received will have to be recognised as a deposit liability).

- *Sales of curios to customers*
 - The revenue is reliably measured at C75 000 (C85 500 X 100/114).
 - The cost of the curios is reliably measurable at C38 500: invoiced price of C50 000 – C1 500 (stolen) – C10 000 (unsold stock on hand at year-end).
 - The significant risks and rewards of ownership were transferred and managerial involvement and effective control ceased when the curios were sold and taken by the customers.
 - Since curios are normally sold on a cash basis and since there is no information provided to the contrary, it is safe to assume that the inflow of future economic benefits are probable.

Revenue of C75 000 from these sales may therefore be recognised.

- *Sale of produce*
 - The revenue is reliably measured at C2 500 000 (excluding VAT).
 - The cost of the transaction would include the commission, which is reliably measurable at 10% of the selling price: $10\% \times 2\,500\,000 = 250\,000$; the cost would also include the cost of the actual produce sold, which it is safe to assume would be reliably measurable by Burnt Limited.
 - The significant risks and rewards of ownership would be transferred and managerial involvement and effective control would cease when the produce was sold and taken by the customers.
 - Since there is no information provided to the contrary, it is safe to assume that the inflow of future economic benefits is probable.

Revenue should therefore be recognised at an amount of C2 500 000 (net of VAT). The commission paid to the shopkeeper would be regarded as an expense, and not a reduction in revenue.

Revenue from the rendering of services

When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction should be recognised by reference to the stage of completion of the transaction at the the end of the reporting period. The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:

Solution 4.5 continued ...**a) continued ...**

- (a) the amount of revenue can be measured reliably;
 - (b) it is probable that the economic benefits associated with the transaction will flow to the entity;
 - (c) the stage of completion of the transaction at the end of the reporting period can be measured reliably; and
 - (d) the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.
- *Fees from grape tasting*
 - The revenue is reliably measured at C130 000 (C148 200 X 100/114).
 - It is safe to assume that the cost of the grape tasted would be reliably measurable by Burnt Limited.
 - Given the nature of grape tasting, the stage of completion would always be 'complete'
 - The flow of future economic benefits are probable since grape tasting would normally be paid for at the time of tasting (and no evidence has been provided to suggest that the inflow is not probable).

Revenue should be recognised at an amount of C130 000.

Revenue from the use by others of an entity's assets (interest)

Revenue arising from the use by others of entity assets yielding interest, royalties and dividends should be recognised when:

- (a) it is probable that the economic benefits associated with the transaction will flow to the entity; and
- (b) the amount of the revenue can be measured reliably.

- *Interest*

Interest should be recognised on a time proportion basis that takes into account the effective yield on the asset

Revenue from interest amounting to C2 500 will be included. In this instance only 50% of the interest for the two months accrues to Burnt Limited, as the other 50% will be paid to the purchaser on transfer of the property (C250 000 x 12% x 2/12 x 50%).

b) Revenue note disclosure**BURNT LIMITED****NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 MARCH 20X4**

		C
8. Revenue		
Sales to customers	(28 500 000 x 100/114 + 85 500 x 100/114 + 2 500 000)	27 575 000
Sales from services rendered	(148 200 X 100/114)	130 000
		<u>27 705 000</u>
Interest received	(250 000 x 12% x 2/12 x 50%)	2 500
Total revenue		<u>27 707 500</u>

Solution 4.6**Recognition of revenue from sale of consignment stock**

Revenue from the sale of goods may only be recognised when all of the following criteria are met:

- Significant risks and rewards of ownership are transferred from seller to buyer: although the rewards of ownership have been transferred to Gareth Ltd to the full extent of the C500 000 consignment sales made during the year, (since the profit on the future sale thereof will vest in Gareth Ltd), the risks of ownership remain with Mitch Ltd in respect of the C200 000 of the consignment sales that have not yet been sold at year-end (the goods will ultimately be returned to Mitch Ltd if they are not sold by Gareth Ltd).
- Seller retains neither continuing managerial involvement nor effective control over the goods sold: not met since Mitch Ltd dictates the retail selling price of the goods remaining in Gareth Ltd's shop, worth C200 000
- Amount of revenue can be reliably measured: this criteria is met since the consignment sales price was set at C500 000.
- Costs incurred and to be incurred can be reliably measured: the goods have already been manufactured and therefore the cost thereof would be known to Mitch Ltd.
- Probable that future economic benefits will flow to the seller: past experience seems to suggest that the consignment stock sold to Gareth Ltd *will* be sold to the public at which point Gareth Ltd will owe Mitch Ltd the consignment sales price, (there is no evidence that Gareth Ltd is a bad debt), and therefore, it could be argued that this criteria is met.

Conclusion

Only C300 000 of the consignment sales should be recognised as revenue, since not all recognition criteria for the C200 000 sales have been met.

Solution 4.7**Revenue from services rendered: estate agent's commission**

The estate agency has provided a service to the seller (Mr. Caveman) in finding a buyer for his property. The reward for this is the commission. Revenue from services rendered may be recognised when:

- *The amount of revenue can be reliably measured:*
The commission is reliably measured at C14 000.
- *The costs incurred to date and the costs expected to be incurred to complete the contract can be reliably measured:*
The costs incurred to date, it is assumed, may be reliably measured. In the case of an estate agency, most legal costs are borne by the seller (or purchaser in certain instances) and the costs of finding a buyer, in terms of petrol and vehicle maintenance costs, are borne by the individual estate agent rather than the estate agency. The costs incurred by an estate agency would therefore be of a general administrative nature (electricity, telephone, rental of premises etc) and include the percentage commission payable to the agent responsible for the sale (in this case C8 000).
- *The stage of completion can be reliably measured:*
The mandate was to find a purchaser and although this appears to have been achieved, the purchaser is not a confirmed purchaser until the expiry of the 3-month cooling off period. This criteria, it is argued, is not met.
- *It is probable that the future economic benefits will flow to the entity:*
The commission will only be probable once the 3-month cooling off period has expired and the purchaser has not backed out of the offer. Once this has happened, a firm of lawyers will deduct the commission from the funds collected from the purchaser on behalf of the seller and pay this over to the estate agency and therefore there would seldom be a bad debt.

Conclusion:

The commission of C14 000 should be recognised as revenue only once the 3-month cooling off period has expired and the purchaser has not backed out of the offer. No revenue should, therefore, be recognised in 20X3.

Solution 4.8**a) Discussion****Introduction:**

This contract involves revenue from services rendered. Interest has been ignored on the basis that the contract period appears to be relatively short since three of the fifteen floors were completed within one month – and these were the worst floors, suggesting that the entire contract will be completed very soon. Furthermore, no information has been provided when the contract price is to be paid: upfront (which would lead to interest expense for Jillianne Limited), at the end of the contract (which would lead to interest revenue) or piecemeal during the contract (which would probably not result in interest of any kind).

Recognition criteria for revenue from services rendered:

Revenue from services rendered should be recognised when all the following criteria are met:

- Revenue can be reliably measured
- The inflow of economic benefits is probable
- The stage of completion is reliably measurable.
- Costs can be reliably measured

The stage of completion can be measured using:

- Costs to date as a percentage of total costs to date;
- Work certified as a percentage of total contract price; or
- Physical inspection method.

Discussion:

- The revenue can be reliably measured since the contract price has been fixed at C30 000.
- The costs can be reliably measured since this has already been estimated based on past experience to be C18 000.
- The inflow is probable since Jillianne Ltd had many previous dealings with the hotel.
- The stage of completion can be reliably measured based on costs to date as a percentage of total costs to date: $C6\,000 / C18\,000 = 33\%$

The physical inspection approach using 3 floors/ 15 floors (20%) would *not* be the most appropriate since the 3 floors include the hotel's most damaged furniture and thus the company has done more than the 20% of the work to date. Similarly, the work certified method would obviously not be appropriate since not certifications have been provided.

Conclusion:

Therefore, $33\% \times C30\,000 = C10\,000$ should be recognised as revenue in the statement of comprehensive income of Jillianne Ltd for the year ended 31 December 20X4.

b) Journals

20X4 Journals	Debit	Credit
31 December 20X4		
Cost of services rendered	6 000	
Bank/ Creditor		6 000
<i>Cost of re-upholstery: first 3 floors of hotel</i>		
31 December 20X4		
Debtor	10 000	
Revenue from services rendered		10 000
<i>Revenue from re-upholstery: first 3 floors of hotel: $6\,000 / 18\,000 \times 30\,000$</i>		

Solution 4.9**a) Discussion****Introduction**

The issues to be discussed include the recognition and measurement of revenue, of which there are two types within the one sale agreement: sales revenue and interest revenue.

Sales revenue:*Recognition criteria:*

- The significant risks and rewards associated with ownership have been transferred from the seller to the buyer;
- Managerial involvement to the extent normally associated with ownership of an asset must have ceased, as should the effective control thereof;
- Revenue is reliably measurable;
- Costs related to the sale are reliably measurable; and
- It is probable that future economic benefits resulting from the sale will flow to the entity.

Discussion:

- The significant risks have been transferred from seller to buyer since Outdoors Limited (the buyer) is responsible for the insurance and transport as of 1 March 20X5; the rewards have been transferred from Caravan Limited to Outdoors Limited since Caravan Limited no longer has physical or legal possession of the caravans whereas Outdoors Limited now does.
- Managerial involvement and effective control by Caravan Limited has ceased evidenced by the fact that Caravan Limited has no physical control over the inventory and is no longer financially involved in the insurance thereof.
- Revenue is reliably measurable at the cash cost per caravan (net of the trade discount):
 $C50\,000 \times 10 \text{ caravans} = C500\,000$
- Costs are reliably measurable using a mark-up of 30% on cost: $C58\,500 / 130 \times 100 = C45\,000$

The recognition criteria for the recognition of revenue from the sale of the caravans are therefore all met on 1 March 20X5 and therefore revenue of C500 000 must be recognised on 1 March 20X5.

Interest revenue:

Since the caravans were sold on an instalment basis, there is effectively an interest revenue component to this transaction. The amount owing in respect of the sale on 1 March 20X5 is C500 000 and yet only C100 000 was received on this day. This means that the balance of C400 000 was effectively financed.

Interest revenue is recognised and measured using the effective interest rate method, apportioned on a time basis.

The interest rate used by Caravans Limited is 15%. The interest revenue to be recognised each year can therefore be calculated as follows:

Solution 4.9 continued ...**a) continued ...****W1: Effective interest rate table:**

	O/bal	Interest	Bank	C/bal
1 March 20X5	500 000		(100 000)	400 000
28 February 20X6	400 000	60 000	(200 000)	260 000
28 February 20X7	260 000	39 000	(299 000)	0
		99 000	(599 000)	

W2: Time apportionment:

20X5

Interest income: $60\,000 \times 10/12 = 50\,000$

20X6

Interest income first 2 months: $60\,000 \times 2/12 = 10\,000$ Interest income next 10 months: $39\,000 \times 10/12 = 32\,500$ Total = $10\,000 + 32\,500 = 42\,500$

20X7

Interest income first 2 months: $39\,000 \times 2/12 = 6\,500$

Solution 4.9 continued ...**b) Journals**

	Debit	Credit
Journals for year ended 31 December 20X5		
<i>1 March 20X5</i>		
Debtor	500 000	
Sales revenue		500 000
<i>Recognition of sale of 10 caravans at 50 000 each</i>		
<i>1 March 20X5</i>		
Cost of sales	450 000	
Inventory		450 000
<i>Cost of 10 caravans sold: 58 500 / 1.3 x 10 caravans</i>		
<i>1 March 20X5</i>		
Bank	100 000	
Debtors		100 000
<i>Receipt of deposit</i>		
<i>31 December 20X5</i>		
Debtors	50 000	
Interest revenue		50 000
<i>Interest income: for calculations, see part (a): W2: 20X5</i>		
Journals for year ended 31 December 20X6		
<i>28 February 20X6</i>		
Bank	200 000	
Debtors		200 000
<i>Receipt of instalment</i>		
<i>31 December 20X6</i>		
Debtors	42 500	
Interest revenue		42 500
<i>Interest income: for calculations, see part (a): W2: 20X6</i>		
Journals for year ended 31 December 20X7 (not required)		
<i>28 February 20X7</i>		
Debtors	6 500	
Interest revenue		6 500
<i>Interest income: for calculations, see part (a): W2: 20X7</i>		
<i>28 February 20X7</i>		
Bank	299 000	
Debtors		299 000
<i>Receipt of instalment</i>		

Solution 4.10

W1: Effective interest rate table

	Interest income	Service income	Instalment received	Debtor balance
1 January 20X6	10%			21 528 170
31 December 20X6	2 152 817	600 000	(10 000 000)	14 280 987
31 December 20X7	1 428 099	1 200 000	(10 000 000)	6 909 086
31 December 20X8	690 909	2 400 000	(10 000 000)	(6)
	<u>4 271 824</u>	<u>4 200 000</u>	<u>(30 000 000)</u>	<i>Rounding error</i>

		Debit	Credit
<i>1 December 20X6</i>			
Debtor	2 152 817 x 10 customers	21 528 170	
Sales			21 528 170
<i>Sale of 10 vehicles</i>			
<i>31 December 20X6</i>			
Debtor		2 752 817	
Interest income	W1		2 152 817
Service income	50 000 x 120% x 10		600 000
<i>Interest income and service income earned</i>			
Bank	(1 000 000 x 10)	10 000 000	
Debtor			10 000 000
<i>Receipt of instalment from debtors (10 customers)</i>			
<i>31 December 20X7</i>			
Debtor		2 628 099	
Interest income	W1		1 428 099
Service income	100 000 x 120% x 10		1 200 000
<i>Interest income and service income earned</i>			
Bank	(1 000 000 x 10)	10 000 000	
Debtor			10 000 000
<i>Receipt of instalment from debtors (10 customers)</i>			
<i>31 December 20X8</i>			
Debtor		3 090 909	
Interest income	W1		690 909
Service income	200 000 x 120% x 10		2 400 000
<i>Interest income and service income earned</i>			
Bank (1 000 000 x 10)		10 000 000	
Debtor			10 000 000
<i>Receipt of instalment from debtors (10 customers)</i>			

Solution 4.11**a) Discussion****Introduction:**

This transaction involves two types of revenue:

- Revenue from the sale of goods
- Interest revenue

Discussion: revenue from sale of goods

The revenue from the sale of the machine may only be recognised when all the following criteria are met:

- The significant risks and rewards of ownership are transferred to the buyer.
The significant risks and rewards are transferred on the date of delivery: 30 November 20X3, when the risks are transferred to the buyer (costs of insurance, maintenance and repairs were then for the account of the customer) and all rewards from the use of the machine will be earned by the buyer. Although the buyer requested that the machine be delivered as soon as possible, the delivery was delayed since the required factory machine was not in stock and due to inefficiencies in the ordering system.
- The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold.
Managerial involvement and effective control by Roger Ltd ceased on 30 November 20X3 when delivery was accepted by the customer and the insurance over the machine was cancelled.
- The amount of revenue can be reliably measured
The revenue from the sale is the fair value being the net cash selling price that was agreed to at the time of the transaction: C240 000 – C40 000 = C200 000
- It is probable that the economic benefits associated with the transaction will flow to the entity.
No evidence has been given to suggest that the customer may be a bad debt and furthermore, the customer is one of Roger Ltd's regular customers and therefore we can assume the inflow of future economic benefits to be probable.
- The costs incurred or to be incurred in respect of the transaction can be reliably measured.
The cost of the machine may be reliably measured based on the invoice price converted into the local currency plus all related and necessary costs of transport and insurance from the date of purchase from the foreign supplier to the date on which it became available for sale locally: C150 000 + C20 000 = C170 000.

Discussion: revenue from interest

Interest revenue should be recognised using the effective interest rate method over the period that the finance is offered. The interest may be calculated as follows:

Year	Opening balance	Interest (at 12.937%)	Instalment (given)	Closing balance
31/11/X4	200 000	25 874	(20 000)	205 874
31/11/X5	205 874	26 634	(20 000)	212 508
31/11/X6	212 508	27 492	(240 000)	0
		80 000	280 000	

The interest should be recognised as follows, measured on a proportionate time basis:

- 31/12/20X3: C25 874 x 1/12 = C2 156
- 31/12/20X4: C25 874 x 11/12 + C26 634 x 1/12 = C25 937
- 31/12/20X5: C26 634 x 11/12 + C27 492 x 1/12 = C26 705
- 31/12/20X6: C27 492 x 11/12 = C25 202

Solution 4.11 continued ...**a) continued ...****Conclusion:**

The revenue from the sale of the machine of C200 000 should be recognised on the date of the delivery, that is, 30 November 20X3 whereas the interest should be recognised over the three year period of the financing with C2 156 recognised in 20X3 and C25 937 in 20X4.

20X4 Journals are overleaf ...

Solution 4.11 continued ...

b) Journals

20X3 Journals	Debit	Credit
9 October 20X3		
Inventory	150 000	
Foreign creditor		150 000
<i>Purchase of a machine: risks and rewards transferred to Roger Ltd on 9 October</i>		
<i>Evidenced by: taking out insurance over goods purchased from this date</i>		
1 November 20X3		
Inventory	20 000	
Foreign creditor		20 000
<i>Costs relating to purchase of machine shipped to Roger Ltd's premises</i>		
<i>Purchase recognised on arrival of goods at Roger Ltd's premises</i>		
30 November 20X3		
Cost of transport and insurance expense	10 000	
Foreign creditor		10 000
<i>Cost of shipping the machine to the customer (selling cost):</i>		
<i>The date of sale is 30 November since the delay was our fault. if the delay had been at the customer's request, the date of sale would have been 1/11</i>		
Debtor	200 000	
Sale		200 000
<i>Sale of a machine (net of discounts: 240 000 – 40 000)</i>		
Cost of sales	170 000	
Inventory		170 000
<i>Cost of sale: 150 000 + 20 000 = 170 000</i>		
15 December 20X3		
Foreign creditor	180 000	
Bank		180 000
<i>Foreign creditor paid</i>		
31 December 20X3		
Debtor	(25 874 x 1/12)	2 156
Interest		2 156
<i>Interest earned on debtor's balance</i>		
Tax	6 647	
Current tax payable		6 647
<i>Tax on sale and interest less costs incurred:</i>		
<i>(200 000 + 2 156 – 170 000 – 10 000) x 30%</i>		

Solution 4.11 continued ...

b) Journals continued ...

20X4 Journals	Debit	Credit
30 November 20X4		
Bank	20 000	
Debtor		20 000
<i>First instalment received</i>		
31 December 20X4		
Debtor	25 937	
Interest		25 937
<i>Interest earned on debtor's balance (25 874 x 11/12) + (26 634 x 1/12)</i>		
Tax	7 781	
Current tax payable		7 781
<i>Tax on interest earned on interest income: 25 937 x 30%</i>		

c) Disclosure

ROGER LTD
EXTRACTS FROM STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X3

		20X3	20X2
	Note	C	C
Revenue from sales		320 000	100 000
Cost of sales	(50 000 + 170 000)	(220 000)	(60 000)
Gross profit		100 000	40 000
Other income	(80 000 + 60 000 + 92 156 + 10 000)	242 156	260 000
	(80 000 + 60 000 + 100 000 + 20 000)		
Other costs	(60 000 + 10 000)	(70 000)	(50 000)
Finance charges	(just the finance charges incurred)	(100 000)	(110 000)
Profit before tax		172 156	140 000
Income tax expense	(40 000 + 6 647)	(46 647)	(40 000)
Profit for the period		125 509	100 000
<i>Other comprehensive income</i>		-	-
Total comprehensive income		125 509	100 000

Solution 4.12

a)

Introduction and recognition criteria: sale of prepaid vouchers

The recognition criteria relating to revenue from the sale of goods (per IAS 18), given below, needs to be considered:

- The significant risks and rewards of ownership are transferred to the buyer.
- The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold.
- The amount of revenue can be reliably measured
- It is probable that the economic benefits associated with the transaction will flow to the entity.
- The costs incurred or to be incurred in respect of the transaction can be reliably measured.

Discussion

- The revenue is reliably measured: C30 000.
- The flow of economic benefits is probable: the cash has already been received.
- In the case of the unredeemed gift vouchers:
 - the revenue is reliably measured: C2 000
 - since the recipient of the certificate has not yet exchanged it for merchandise the cost of the merchandise is not known;
 - since the C2 000 vouchers have not been exchanged for goods, these goods are still in the possession of the seller, and therefore the risks and rewards have not yet transferred from the seller to the buyer and managerial involvement and effective control would also not have ceased.
- In the case of the redeemed vouchers:
 - the revenue is reliably measured: C28 000
 - since the recipient of the certificate has already exchanged it for merchandise the cost of the merchandise would be known;
 - since the vouchers to the value of C28 000 have already been exchanged for goods, the risks and rewards thereof have been transferred and managerial involvement and effective control would also have ceased.

Therefore, only the C28 000 in respect of redeemed vouchers may be recognised; the C2 000 received should be treated as a liability since it is a present obligation to a potential customer. The critical event relative to the recognition of the liability is the supply of the merchandise selected by the customer.

It should be noted that the assumption was made that the certificate could neither be converted into cash nor set-off against an outstanding amount.

b)

If the vouchers had expiry dates, the value of the expired vouchers would be recognised as revenue on expiry date, whereupon the cost of the merchandise would be zero. Until such time as the vouchers are recognised as revenue, they would be recognised as liabilities (income received in advance).

Solution 4.13**Part A: Instalment sale**

An installment sale involves two transactions:

- the sale and
- the financing of the sale.

An installment obligates the purchaser to complete all the payments since the purchaser has taken possession of the goods.

The revenue from the installment sale (C1 000 x 5 – interest revenue) may be recognised in the financial statements of Battleship Gallactica Limited when all of the recognition criteria have been met. The recognition criteria are met when:

- the *significant* risks and rewards of ownership have passed to the buyer: since the goods have been delivered, the risks and rewards have obviously passed;
- managerial involvement to *the extent normally associated with ownership and effective control* over the goods ceases: since the goods have been delivered, managerial involvement has ceased;
- the revenue can be reliably measured: C5 000 – interest calculated on the effective interest rate method;
- the costs are reliably measurable: using either the supplier invoice or working back from the selling price to the cost price by using either the entity's gross profit percentage or mark up; and
- it is probable that the economic benefits associated with the transaction will flow to the entity: no evidence to the contrary was provided.

The interest element included in the installments should be recognised over the period of the installment sale contract using the effective interest rate method.

Part B: Lay away sale

A lay away sale does not involve financing and, since the goods are not collected by the purchaser until all installments are paid, there is no obligation for the purchaser to complete all the payments.

The revenue from the lay away sale (C1 000 x 5) may be recognised in the financial statements of Battleship Gallactica Limited when the goods are delivered. However, if experience indicates that most such sales are consummated, revenue may be recognised when a significant deposit is received provided the goods are on hand, identified and ready for delivery to the buyer.

Solution 4.14**Introduction**

Revenue is defined by IAS 18 as:

- the gross inflows of economic benefits;
- during the period;
- arising in the course of ordinary activities of an entity;
- when those inflows result in increases in equity,
- other than increases relating to contributions from equity participants.

In terms of the contract C3 000 will be paid to Sporty Limited and meets the definition of revenue in that:

- the C3 000 is a gross inflow of economic benefits,
- the amount will be received/receivable in the current period,
- as a result of the ordinary activities of the gym (the gym's primary business is to provide the client with gym facilities), and
- the amount is not a contribution from the equity participants (not a sale of shares).

The selling of the gym contract should therefore be recognised as revenue in the financial statements of Sporty Limited.

The sale of a gym contract must be assessed in order to determine if it is either:

- A sale of goods;
- Rendering of services; or
- Royalties, interest or dividends.

The provision of gym facilities to gym members is a rendering of a service.

Revenue from the rendering of services is recognised when all the following criteria are met:

- the revenue can be reliably measured;
- the costs can be reliably measured (costs incurred to date and costs still to be incurred);
- it is probable that the economic benefits expected will flow to the entity; and
- the stage (percentage) of completion can be reliably measured.

A discussion of these recognition criteria is provided below:

- The revenue is stated in the contract as C3 420. This amount includes VAT. The revenue must be calculated as $C3\ 420 \times 100/114$. The revenue is therefore reliably measurable at C3 000, (with a VAT liability owing to the tax authority of C420).
- Since the gym has been opened for eleven months, there is sufficient past experience upon which to base a reliable estimate of the cost involved in providing these services.
- Since the contract price is paid before the services are provided, the inflow of economic benefits are not only probable but certain.
- The stage of completion in this case is the most difficult to estimate. The following are the three methods from which to choose:
 - surveys of work performed;
 - services already performed as a percentage of the total services to be performed; and
 - the costs incurred to date as a percentage of the total costs to be incurred.

Solution 4.14 continued ...

In the case of Sporty Limited none of the above methods would be appropriate. Although research has proven that the contracts would be used 80% in the first year, 15% in the second and 5% in the third year, the revenue should not be recognised in this pattern. Even if the client does not utilise the gym in the second and third year, the gym would still be obliged to make the service available to the user. According to IAS 18, 'when services are performed by an indeterminate number of acts over a specified period of time, revenue is recognised on a straight-line basis over the specified period unless there is evidence that some other method better represents the stage of completion. When a specific act is much more significant than any other acts, the recognition of revenue is postponed until the significant act is executed' (IAS 18, para 25). Since there is no one significant act, it would be appropriate to recognise the revenue evenly over the period of the contract.

Conclusion

The amount received is therefore revenue received in advance and should initially be recognised as a liability, and reversed evenly over the contract period to revenue: C1 000 per year. Where the contract is sold during a year, the C1 000 would have to be calculated on a pro-rata basis e.g. a sale on 1 October in the current year, would require the current year revenue to include $C1\,000 \times 3/12 = 250$.

Solution 4.15**a)**

- Warthogs Limited only retain an insignificant risk of ownership in that on average only 2% (2/100) of broomsticks are defective.
 - Warthogs is able to reliably/reasonable estimate repair and replacement costs thereby warranting the recognition of revenue at the date of sale.
 - An appropriate provision for repairs/ replacements in terms of the warranty contract should be recognised/raised at the date of sale.
- It is probable that there will be an inflow of economic benefits in the form of sales revenue (C750 per broomstick sold) which can be reliably measured in terms of the sales agreement.
- Warthogs is able to reliably measure the costs of each broomstick sold ($C750/125\% \times 100\% = C600$).
- Once the broomstick has been sold, Warthogs no longer has any managerial involvement in the use of the broomstick.

Therefore, since the recognition criteria for a sale are all met, Warthogs Limited should recognise revenue at the date of sale and recognise a warranty provision for the estimated repair/ replacement costs.

b)

The installation of the air-conditioning unit constitutes a significant portion of the sales price:

- The rewards of ownership have not been transferred to the buyer until the air-conditioning unit has been installed and is operational at the buyer's premises.
- The revenue is able to be reliably measured as it is stipulated in the sale agreement and it is probable that economic benefits will flow to the entity once the air-conditioning unit has been successfully installed.
- Warthogs Limited relinquishes managerial involvement in the air-conditioning unit only once the unit has been installed.
- The costs incurred by Warthogs to distribute and to install the unit can only be reliably measured once the unit has been installed. (Or: a reliable estimate of the costs that will be incurred by Warthogs Limited to distribute and install the unit is probably possible based on past experience).

Therefore, since all the recognition criteria for the sale will only be met on installation of the system, Warthogs Limited should only recognise revenue arising on the sale of an air-conditioning unit, once installation is complete.

Solution 4.15 continued . . .

c)

- Prior to the purchaser being awarded the contract, Warthogs retains a significant portion of the risks of ownership.
- Although the sales amount can be reliably measured there is uncertainty at the date of the sale surrounding the probability of the return (inflow of benefits) which is contingent on the purchaser being awarded the contract. This could have an impact on the measurement of the sales revenue if the contract is only awarded much later (i.e. the revenue may need to be measured at the present values of future sales revenue).
- Warthogs Limited will only relinquish managerial involvement in the lawnmower once the purchaser has been awarded the gardening contract.
- A reliable estimate of the cost of the lawnmower is probably possible based on past experience.

Therefore, since all the recognition criteria for the sale will only be met when it is certain that the purchaser will be granted the gardening contract, Warthogs Limited should only recognise the revenue when it is certain that the purchaser will be granted the gardening contract.

d)

- Since the newspapers have been sold on consignment and the number of newspaper sales to the public is not predictable, Warthogs Limited has not transferred the risks of ownership (i.e. the risk of the costs associated with producing the paper not being recouped).
- The amount of revenue can only be reliably measured once Warthogs knows the number of newspapers sold.
- Warthogs Limited will only relinquish managerial involvement in the newspapers once they have been sold to the public (all unsold newspapers will be returned to the Warthogs Limited).
- A reliable estimate of the cost of the newspapers is probably possible based on past experience.

Therefore, revenue should only be recognised when Warthogs is certain of the number of papers sold on their behalf. Prior to this stage the probability of an inflow of benefits is uncertain based on the unpredictability of newspaper sales.

Solution 4.16

a)

In terms of IAS 18 Revenue, in order to reflect the substance of the transaction it may be necessary to apply the recognition criteria to the separately identifiable components of a single transaction. The sale of a Caris 1600, including service plan, to Mr Nick has two separately identifiable components: one being the sale of the vehicle and the second being the sale of a service plan. Each component needs to be discussed and recognised separately.

The sale of the motor vehicle:

In order for revenue to be recognised on the sale of the vehicle to Mr Nick, all of the following conditions need to be met:

- The significant risks and rewards of ownership must be transferred. The significant risks and rewards of ownership are transferred to Mr Nick, the buyer on 1 April 20X6 when Mr Nick takes delivery of the vehicle. From this date Mr Nick is responsible for insuring and maintaining the vehicle and receives the rewards from the use of the vehicle.
- No management involvement or control over the vehicle must exist. Jabulani Motors retains neither continuing management involvement nor control over the vehicle once Mr Nick has taken delivery of the vehicle: Jabulani Motors no longer has physical possession of the vehicle and is no longer responsible for insuring the vehicle.
- The amount of revenue must be able to be reliably measured. The amount of revenue can be measured reliably as the price has been agreed to in Mr. Nick's signed offer to purchase. The revenue attributable to the sale of the vehicle is C142 220 (C147 500 – C5 280 ^{NOTE 1} relating to the service plan – see below for calculations).
- The inflow of economic benefits must be probable. This criteria is met since Mr Nick has entered into a loan agreement with Tafcat bank, which paid the full amount of C147 500 to Jabulani Motors on 1 April 20X6.
- The costs incurred must be reliably measurable. The costs incurred in respect of the transaction can be measured reliably since Jabulani Motors works on a standard 25% gross profit percentage: $C142\,220 / 100\% \times 75\% = C106\,665$

As all of the above conditions have been met Jabulani Motors Limited should recognise revenue from vehicle sales of C142 220.

NOTE 1: The revenue from the services of 5 280 would normally have been present valued and then this present value would have been deducted from the total price of 147 500. This was not done in this question since the question indicated that discounting should be ignored.

The sale of the service plan:

In terms of IAS 18, the outcome of the sale of the service plan can be measured reliably when all of the following conditions are met:

- The amount of revenue must be able to be reliably measured. The amount of revenue can be measured reliably as customers are usually charged C880 for a service and the plan either covers 5 years or 90 000km. This means that, at most, 6 services (90 000km/ 15 000km), would be performed. Therefore C5 280 (C880 x 6 services) of the total selling price would be attributable to the service plan.
- The inflow of economic benefits must be probable. It is probable that the economic benefits associated with the transaction will flow to the entity, given that Jabulani Motors received the full price of C147 500 (which includes the C5 280 for the services) from Tafcat Bank on date of sale (i.e. 1 April 20X6).
- The stage of completion must be able to be reliably measured. The stage of completion of the transaction can be measured reliably at the end of the reporting period based on the number of services performed to date as a percentage of 6 total services. Mr. Nick's first service was performed in August 20X6, which means that at 30 September 20X6, the percentage complete is 16.7% (or 1/6).

Solution 4.16 continued ...**a) continued ...**

- The costs incurred and the costs to complete the transaction must be reliably measurable. The costs incurred for the transaction and the costs to complete the transaction can be measured reliably as Jabulani Motors marks up the cost of parts and labour on services by 33 1/3% and the selling price (C880) of a service is known. This means that the cost of the service must be C660 ($880 / 133\% \times 100\%$), and to complete the remaining service will cost, at most C3 300 (5 remaining services \times 660).

Revenue in respect of the service plan must be measured using the percentage completion method, using the number of services performed to date as an indicator of the percentage completed. The revenue should therefore be recognised as follows:

- The revenue for one service should be recognised in the financial statements at 30 September 20X6: C880 ($5\,280 \times 1/6$);
- the balance of the service revenue must be deferred as a liability (and presented as a current liability) until the remaining services have been performed or the 5 year period has expired: C4 400 (5 remaining services \times 880).

Note: the receipt of the 147 500 on date of sale, including an amount for services, suggests that there is an element of financing and that interest expense should therefore be recognised. The question has indicated that the effects of discounting should be ignored thus this complication was ignored.

Solution 4.16 continued ...

b)

JABULANI MOTORS LIMITED
EXTRACT FROM STATEMENT OF COMPREHENSIVE INCOME
FOR YEAR ENDED 30 SEPTEMBER 20X6

		Notes	C
Revenue	Sales: $C142\,220 \times 100$ + Services: 70 400 (W1)	3	14 292 400
Cost of sales and services	$C14\,222\,000 / 100\% \times 75\% +$ $C70\,400 / 133.3\% \times 100\%$		10 719 300

W1: $(5\,280 \times 100 \times 20\% \times 1/6) + (5\,280 \times 100 \times 30\% \times 2/6)$ and W2: $880 \times 6 \text{ services} = 5\,280$

JABULANI MOTORS LIMITED
EXTRACT FROM STATEMENT OF FINANCIAL POSITION
AS AT 30 SEPTEMBER 20X6

		C
<i>EQUITY AND LIABILITIES</i>		
Current liabilities *		
Service revenue received in advance	$C5\,280 \times 100 - 70\,400$	457 600

* the services could be earned over a period of 5 years or could be earned over a shorter period if the driver completes the 90 000 km maximum mileage before the 5 year limit. A more prudent approach would be to assume that the liability is a current liability rather than a long-term liability.

JABULANI MOTORS LIMITED
EXTRACT FROM NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 SEPTEMBER 20X6

		C
3. Revenue		
Revenue comprises:		
Sales of motor vehicles	$100 \times 142\,220$	14 222 000
Servicing of motor vehicles	$100 \times 20\% \times 5\,280 \times 1/6 + 100 \times 30\% \times 5\,280 \times 2/6$	70 400
		<u>14 292 400</u>

Solution 4.17

a)

Introduction

The issue is whether the amounts received should be treated as revenue (income earned in the current period) or as a liability (income received in advance). The nature of the revenue *could* be seen as either a sale of goods (in this case the cards) or the rendering of a service. In this case, it is argued that the most important/ significant aspect of the transaction is the rendering of a service by Born 2 Speak rather than the sale of a mere plastic card.

The revenue recognisable must be subject to the recognition criteria in IAS 18, 'Revenue'. The recognition of a liability must be as per The Framework.

Revenue

Revenue is defined in IAS 18 as:

- Gross inflows of economic benefits,
- During the year,
- Arising from ordinary activities,
- Resulting in increases in equity other than an increase arising from contributions of equity participants.

According to The Framework, income (including revenue) can only be recognised when the increase in economic benefits:

- is probable and
- can be measured reliably.

Although there has legally/ technically been a 'sale', revenue will be recognised as 'revenue from services' (since the resultant ability to use the card to make calls for 3 months, being a provision of a service, is the most significant aspect to the 'sale' transaction). The revenue from such 'sale' transactions must therefore be recognised based on the recognition criteria relevant to 'provision of services' transactions.

As per IAS 18, the revenue should be measured by reference to the stage of completion, once the outcome of the transaction can be estimated reliably.

The revenue recognition criteria for services rendered are as follows:

Revenue should be reliably measured

Revenue is measured in terms of the selling price per card (excluding VAT) multiplied by the number of cards sold.

Probable that economic benefits will flow to the entity

Because the amount is paid in advance, the economic benefits have already flowed to the entity.

Stage of completion must be reliably measured

This will relate to the extent to which users have utilised the services that they were entitled to.

- For Airtime cards, this can be calculated over the 3 month life.
- For Call cards, this can be based on experience, past usage or a computerised check.

Solution 4.17 continued ...**a) continued ...***Reliable measurement of costs*

It is reasonable to assume that the entity will be able to reliably measure the cost of its cards and its services.

Liability

The portion of amounts received to date that relate to services not yet rendered, should be recognised as a liability, being income received in advance.

A liability is defined in The Framework as:

- A present obligation of the entity
- As a result of a past event
- That will result in the outflow of economic benefits.

For a liability to be recognised, The Framework sets out recognition criteria as follows:

- the outflow of economic benefits must be probable; and
- the cost should be measured reliably.

Discussion:

- The obligation exists as the company has to provide services to the purchasers of the cards.
- The past event was the sale of the cards by the company which creates the obligation of service.
- The outflow of economic benefits will be in the form of resources used by the entity when providing the service in respect of its obligations.
- Reasonable to assume that outflow of benefits are probable and can be reliably measured.

Tax consequences – assuming that income received in advance is taxed in the year of receipt while accounted for in the books on an accrual basis, a temporary difference and therefore deferred tax would arise on this transaction.

VAT consequence – the VAT is received on behalf of the tax authorities and is thus not included as part of the income.

Conclusion

The proceeds can be divided into revenue and a liability. The revenue is earned from the rendering of a service and as a portion of the receipt complies with that definition, that portion of the receipt should be recognised as revenue.

The accrual basis of accounting requires the recognition of the effects of transactions when they occur (and to the period to which they relate) and not as cash is received or paid.

The portion of cash received for which a service is still to be rendered should therefore be recognised as a liability: the entity has an obligation to provide a service in respect of the coverage to be provided.

Solution 4.17 continued ...

b)

	Dr	Cr
Bank/ Debtors (A)	15 686 400	
Revenue (I)		12 980 000
Revenue received in advance		780 000
Output VAT (L)		1 926 400
<i>Cash received over the year</i>		
Commission expense	1 311 404	
Input VAT (A)	183 596	
Liability/ Bank		1 495 000
<i>Cash paid over the year</i>		

Workings

W1: Number of cards sold	Airtime cards (units)	Call cards (units)
Amount sent to retailers	100 000	60 000
Unsold at retailers	10 000	500
Therefore, total cards sold to customers	90 000	59 500

W2: Revenue generated by 'sales'	Total receipts (including VAT)	VAT liability	Total revenue	Revenue Recognised in 20X2	Revenue received in advance (L)
Airtime cards	90 000 x C114; 10 260 000 x 14/114; 10 260K – 1 260K;	10 260 000	1 260 000	9 000 000	^(a) 8 500 000
Call cards	59 500 x C91.20 5 426 400 x 14/114 5 426 400 – 666 400	5 426 400	666 400	4 760 000	^(b) 4 480 000
		15 686 400	1 926 400		12 980 000
					780 000

Airtime cards

Of the 90 000 airtime cards sold to customers, the entity still has to render services in respect of the cards sold in November and December. Since research indicates that most sales occur at the beginning of the month and that usage is constant over the three month service period, almost all airtime cards sold in October would have expired by year end. The amount of service to be provided can be calculated by dividing the number of cards by 3 to obtain a monthly figure based on the facts that sale occurs at the beginning of the month and usage is even over the 3 months:

- In respect of November's sales, only one month of service is owed as at December. This can be calculated as: $(3000/3) \times 1 = 1\,000$.
- In respect of December sales, two months service is owed at year end date. This can be calculated as: $(6000/3) \times 2 = 4000$
- By adding the units of service owed, we come to a total of 5 000 units still owed at year end. The sales of 90 000 cards should therefore be recognised as follows:
- 85 000 $(90\,000 - 5\,000)$ cards should be recognised as revenue: $C100 \times 85\,000 = C8\,500\,000$;
- 5 000 cards should be recognised as a liability: $C100 \times 5\,000 = C500\,000$.

Note: The unit price is taken excluding VAT: $C100 = (C114 \times 100/114)$

Solution 4.17 continued ...**Workings continued ...****Call cards**

Of the 59 500 cards sold, the entity is only liable to provide a service on 1 000 cards to the extent of 100% and 5 000 cards to the extent of 50%. Therefore in total, an obligation exists for 3 500 units:

- $[1\,000 (1\,000 \times 100\%) + 2\,500 (5\,000 \times 50\%)]$.

The sales of 59 500 cards should therefore be recognised as follows:

- 56 000 cards (59 500 - 3 500) as revenue: $C80 \times 56\,000 = C4\,480\,000$;
- 3 500 cards as a liability at year-end: $C80 \times 3\,500 = C280\,000$.

Note: The unit price is taken excluding VAT: $C80 = (C91.20 \times 100/114)$

Summary

Airtime Cards	$100\,000 - 10\,000 = 90\,000 \times R100$	$=$	R9 000 000	R	85 000 x R100	=	R8 500 000
				L	5000 x R100	=	<u>R500 000</u>
							R9 000 000
Call cards	$60\,000 - 500 = 59\,500 \times R80$	$=$	R4 760 000	R	56 000 x R80	=	R4 480 000
				L	3 500 x R80	=	<u>R280 000</u>
							<u>R4 760 000</u>

Solution 4.18**a) Initial recognition and measurement**

IFRIC 13 paragraph 5 states that paragraph 13 of IAS 18 must apply to the accounting of loyalty points.

Loyalty points should be recognised as a separately identifiable component of the sales transaction in which they are granted. The fair value of the consideration received or receivable in respect of the initial sale shall be allocated between the award credits and the other components of the sale. Therefore, the recognition of the C1 000 must be split into two components, namely revenue attributable to the sale of the actual product and the revenue attributable to the awarding of loyalty points.

Revenue relating to the sale of the goods

To recognise an amount of sales revenue, the criteria per IAS 18 for sales transactions must be met:

- The risks and rewards of ownership must pass to the customer. The entity immediately transfers the good to the customer.
- The entity must retain neither managerial involvement usually associated with ownership nor effective control. The purchased goods are transferred to the customer on date of sale and there is no indication that management has any further involvement with the goods.
- The inflow of future economic benefits must be probable. All sales are cash sales and therefore there is no risk that the inflow is not probable.
- The amount of revenue can be reliably measured – The components of the actual sale of the product can be calculated by netting off the calculation of revenue attributable to the loyalty points, from the total revenue of the sale.
- The costs incurred/to be incurred must be reliably measurable. The costs appear to be reliably measurable since the entity uses an efficient standard costing system.

The entity must *recognise* the revenue attributable to the sale of the product since all recognition criteria are met.

The *measurement* of the revenue from the sale of the actual product is calculated as the amount after deducting the revenue from the sale of the points. The revenue from the sale of the points would be measured as follows:

- Number of points x value per point = C1 000 / C10 x C1 = C100

The revenue from the sale of the actual goods is therefore measured as follows:

- Total revenue – revenue from sale of points = C1 000 – C100 = C900.

Revenue attributable to the loyalty points.

IFRIC 13 states that if the entity supplies the awards itself (as in Naty Ltd's case), it must recognise the consideration allocated to award credits as revenue when awards credits are redeemed and it fulfils its obligations to supply awards. The amount of revenue recognised is based on the number of award credits that have been redeemed in exchange for awards, relative to the total number expected to be redeemed.

Solution 4.18 continued ...**b) Journal entries for sale in part (a)**

	Debit	Credit
30 November 20X8		
Bank	1 000	
Revenue (actual sale of good)		900
Unearned income (loyalty award)		100
<i>Initial recognition of the sale</i>		

Workings

Sale = C1 000

C10 = 1 loyalty point

Therefore C1 000 = 100 loyalty points

Therefore C100 of the sale is attributable to the loyalty award

Therefore C900 of the sale is attributable to the actual sale of the good.

c) Journal entries for 20X8

	Debit	Credit
31 December 20X8		
Unearned income (loyalty award)	50 000	
Revenue (loyalty award)		50 000
<i>Recognition of revenue relating to the loyalty points redeemed</i>		

Workings

C1 000 000 total sales

C10 = 1 loyalty point

Therefore C1 000 000 = 100 000 loyalty points (1 000 000/100)

And 1 loyalty point has a FV of C1

Therefore 100 000 points = C100 000

Total points estimated to be redeemed = 80% = 0.8 x 100 000 = 80 000

Therefore % redeemed in 20X8 = 40 000/80 000 = 50%

Therefore total revenue recognised relating to loyalty points awarded =
0.5 x C100 000 = C50 000

Solution 4.18 continued ...**d) Journal entries for 20X9**

20X9 Journals	Debit	Credit
31 December 20X9		
Unearned income (loyalty award)	40 000	
Revenue (loyalty award)		40 000
<i>Recognition of revenue relating to the loyalty points redeemed</i>		

Workings

Total points estimated to be redeemed = 90% = $0.9 \times 100\,000 = 90\,000$

Therefore % redeemed in 20X9 = $81\,000/90\,000 = 90\%$ {81 000 = 41 000 + 40 000}

Therefore total revenue recognised relating to loyalty points awarded =

$0.9 \times \text{C}100\,000 = \text{C}90\,000$

But C50 000 was recognised in the 20X8 year

Therefore C40 000 should be recognised in the 20X9 year {90 000 – 50 000}

Solution 4.19

All of the above scenario's deal with the sale of goods. From the information provided it is clear to see that the both the criteria of reliably measuring cost (C12 000) and revenue (C15 600) are met. The three scenario's below focus on the *other* criteria.

Customer A

- The customer paid the amount in full and thus the flow of economic benefits is certain.
- The customer also has taken delivery of the goods and *rewards* have transferred to him.
- The issue, which requires special attention here, is the passing of the *risks* of ownership and whether Retail Therapy's management is still involved in the transaction.

IAS 18.16 provides examples of where significant risks may be retained by the entity. One of the examples listed involves the presence of a warranty provision. IAS 18.17 explains that revenue should be recognised if the risk of ownership is insignificant and that the risk is 'insignificant' if the seller can reliably estimate future returns and recognise a liability for returns based on previous experience.

Retail Therapy should therefore recognise this revenue since:

- A sale has been made with a warranty (being a risk that ownership will be retained), but
- Past experience is available to draw on in order to reliably estimate the warranty provision (therefore this risk of ownership being retained is deemed to be insignificant).

No provision would, however, be recognised in the case of customer A since past experience indicates that this customer never returns goods and that goods are never faulty: therefore no return is expected.

Customer B

- The customer has taken delivery of the goods and thus risks and rewards have been transferred to him, Retail Therapy's management is also no longer involved and no longer has effective control over the goods. Retail Therapy now has a right to receive payment from customer B.

The issue that requires more deliberation is whether or not it is probable that the economic benefits associated with the transaction will flow to Retail Therapy.

As the customer was known to have a criminal record for fraud and no creditworthiness test was done, there is significant uncertainty that the future economic benefits will flow in. This means that:

- No asset may be recognised (the recognition criteria are not met); and
- Revenue may not be recognised (the recognition criteria are not met).

For practical purposes though, a journal entry must be passed in order that a debtor's statement is generated from the accounting system (debtors statements are normally automatically generated from the debtors account and therefore, if we do not debit this account, no statement will be posted to the customer and therefore, would be failing as a business to recover the money owed to it).

The following journal is suggested (the net effect is that the debtors balance in the statement of financial position is nil and revenue is not recognised, thus complying with both the Framework and IAS 18).

Solution 4.19 continued ...

	Debit	Credit
Debtors	15 600	
Unrecognisable debtors allowance (-'ve asset)		15 600
<i>Sale to customer B (fraud crime): uncertain inflow of FEBS. Revenue to be recognised when received.</i>		

Customer C

- The customer, at the time of the sale, was expected to fulfil his obligation to pay in full based on the fact that he was a reliable and long standing customer and therefore the flow of economic benefits was reasonably certain.
- The customer had taken delivery of the goods and therefore risks and rewards had been transferred.

It would thus have been appropriate, according to IAS18, to recognise revenue at this stage.

IAS 18.18 states that when an uncertainty arises about the collectibility of an amount already included in revenue, this uncollectible must be recognized as an expense and not an adjustment to revenue.

It is thus clear that the C15 600 owing by this customer must be written off as a bad or doubtful debt expense, depending on the company's assessment of the probability of recoverability. Either one of the following journals would then be appropriate:

	Debit	Credit
Doubtful debt expense	15 600	
Doubtful debts allowance (-'ve asset)		15 600
<i>Customer C has skipped the country and therefore the recoverability is in question</i>		

OR

	Debit	Credit
Bad debt expense	15 600	
Debtors		15 600
<i>Customer C has skipped the country and therefore the recoverability is not expected: balance owing is written-off</i>		

Solution 5.1

The case in this question is therefore possible if the provisional payments during the year exceeded the final tax calculated, resulting in a debtor being raised on the statement of financial position, while at the same time the tax authority assessed the taxation due as being greater than that calculated and provided by the company, resulting in an under-provision. This under-provision will now have to be paid in the current year (i.e. the year in which the tax assessment is received). The accounting entry will have to be a debit to taxation in the statement of comprehensive income and a credit to bank or creditors.

Solution 5.2

(a) Ledger accounts

CURRENT TAX PAYABLE/ RECEIVABLE					
20X1			20X1		
		C			C
30 June	Bank	26 000	31 Dec	Taxation	56 000
31 Dec	Bank	28 000			
31 Dec	Balance	2 000			
		<u>56 000</u>			<u>56 000</u>
20X2			20X2		
16 May	Bank (underpayment)	2 000	1 Jan	Balance ⁽¹⁾	2 000
30 June	Bank	29 000	31 Dec	Taxation	58 000
31 Dec	Bank	30 000	31 Dec	Balance	1 000
		<u>61 000</u>			<u>61 000</u>
20X3			20X3		
1 Jan	Balance ⁽²⁾	1 000	19 May	Taxation (under-prov)	1 500
19 June	Bank (underpayment)	500			
30 June	Bank	31 000	31 Dec	Taxation	65 000
31 Dec	Bank	31 500			
31 Dec	Balance	2 500			
		<u>66 500</u>			<u>66 500</u>
20X4			20X4		
18 April	Taxation (over-prov)	200	1 Jan	Balance ⁽³⁾	2 500
18 May	Bank (underpayment)	2 300			
30 June	Bank	33 000	31 Dec	Taxation	67 400
31 Dec	Bank	34 000			
31 Dec	Balance	400			
		<u>69 900</u>			<u>69 900</u>
20X5			20X5		
			1 Jan	Balance ⁽⁴⁾	400

TAXATION EXPENSE					
20X1			20X1		
		C			C
31 Dec	Current tax payable	56 000	31 Dec	Retained earnings	56 000
20X2			20X2		
31 Dec	Current tax payable	58 000	31 Dec	Retained earnings	58 000
20X3			20X3		
19 May	Current tax payable	1 500	31 Dec	Retained earnings	66 500
31 Dec	Current tax payable	65 000			
		<u>66 500</u>			<u>66 500</u>
20X4			20X4		
31 Dec	Current tax payable	67 400	18 April	Current tax payable	200
		<u>67 400</u>	31 Dec	Retained earnings	67 200
					<u>67 400</u>

Balance at	01/01/X2 ⁽¹⁾	01/01/X3 ⁽²⁾	01/01/X4 ⁽³⁾	01/01/X5 ⁽⁴⁾
Provide	56 000	58 000	65 000	67 400
Pay	54 000	59 000	62 500	67 000
	<u>2 000</u>	<u>(1 000)</u>	<u>2 500</u>	<u>400</u>

Solution 5.2 continued..

(b) Disclosure in the annual financial statements

MISTY RIDGE LIMITED
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X1

	Note	20X4 C	20X3 C	20X2 C	20X1 C
Current liabilities					
Current tax payable		400	2 500	0	2 000
Current assets					
Current tax receivable		0	0	1 000	0

MISTY RIDGE LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X4

	Note	20X4 C	20X3 C	20X2 C	20X1 C
Income tax expense	14	67 200	66 500	58 000	56 000

MISTY RIDGE LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X4

	20X4 C	20X3 C	20X2 C	20X1 C
14 Taxation				
Normal tax				
Current tax				
- for the current year	67 400	65 000	58 000	56 000
- under/ (over)-provision in a prior year	(200)	1 500	0	0
Income tax expense	67 200	66 500	58 000	56 000

Solution 5.2 continued..

Workings

	20X1	20X2	20X3	20X4
Assessment	56 000	59 500	64 800	
Provided	56 000	58 000	65 000	
Under/(over) provision	-	1 500	(200)	
Assessment	56 000	59 500	64 800	
Total payments	54 000	59 000	62 500	
Amount owing	2 000	500	2 300	
Provided	56 000	58 000	65 000	67 400
Total payments	54 000	59 000	62 500	67 000
Statement of financial position liability (asset)	2 000	(1 000)	2 500	400

Solution 5.3

Part A

- a) First provisional payment: $(C40\,000 \times 30\%) / 2 = C6\,000$
- b) Second provisional payment: $C50\,000 \times 30\% - C6\,000 = C9\,000$
- c) Tax expense in SOCI: $C40\,000 \times 30\% = C12\,000$
- d) Closing balance in the Current tax payable account:
 $C0 + C12\,000 \text{ (credit)} - C6\,000 \text{ (debit)} - C9\,000 \text{ (debit)} = C3\,000 \text{ (debit – current asset)}$
- e) Underprovision of tax expense in 20X9: *[tax per assessment – tax expense provided for]:*
 $C14\,000 - C12\,000 = C2\,000 \text{ (underprovision)}$
- f) Refund owing by the tax authorities: *[tax per assessment – total payments made to the tax authorities]:*
 $C14\,000 - C6\,000 - C9\,000 = C1\,000 \text{ (refund)}$

Workings

Current tax payable			
Description	C	Description	C
Bank	6 000	Tax expense	12 000
Bank	9 000	Balance	3 000
	15 000		15 000
Balance	3 000	Tax expense	2 000
	1 000	Balance	1 000
			3 000

	C	C
Assessment	14 000	14 000
Provided / provisional payments	12 000	15 000
Under / (over) provision / amount owing by / (to) us	2 000	(1 000)

Solution 5.3 continued...

Part B

- a) First provisional payment: $(C40\,000 \times 30\%) / 2 = C6\,000$
- b) Second provisional payment: $C30\,000 \times 30\% - C6\,000 = C3\,000$
- c) Tax expense in SOCI: $C40\,000 \times 30\% = C12\,000$
- d) Closing balance in the current tax payable account:
 $C0 + C12\,000 \text{ (credit)} - C6\,000 \text{ (debit)} - C3\,000 \text{ (debit)} = C3\,000 \text{ (cr: current liability)}$
- e) Underprovision of tax expense in 20X9: *[tax per assessment – tax expense provided for]*
 $C14\,000 - C12\,000 = C2\,000 \text{ (underprovision)}$
- f) Amount owing to the tax authorities: *[tax per assessment – total payments made to the tax authorities]*
 $C14\,000 - C6\,000 - C3\,000 = C5\,000$

Workings

Current tax payable			
Description	C	Description	C
Bank	6 000	Tax expense	12 000
Bank	3 000		
Balance	3 000		
	12 000		12 000
		Balance	3 000
Balance	5 000	Tax expense	2 000
	5 000	Balance	5 000

	C	C
Assessment	14 000	14 000
Provided / provisional payments	12 000	9 000
Under / (over) provision / amount owing by / (to) us	2 000	5 000

Solution 5.3 continued...

Part C

- a) First provisional payment: $(C40\,000 \times 30\%) / 2 = C6\,000$
- b) Second provisional payment: $C15\,000 \times 30\% - C6\,000 = C0$ (not required because the total payment required is C4 500 and there is already an overpayment of C1 500)
- c) Tax expense in SOCI: $C40\,000 \times 30\% = C12\,000$
- d) Closing balance in the current tax payable account:
 $C0 + C12\,000 \text{ (credit)} - C6\,000 \text{ (debit)} - C0 = C6\,000 \text{ (credit: current liability)}$
- e) Overprovision of tax expense in 20X9: *[tax per assessment – tax expense provided for]*
 $C10\,000 - C12\,000 = C2\,000 \text{ (overprovision)}$
- f) Amount owing to the tax authorities: *[tax per assessment – total payments made to the tax authorities]*
 $C10\,000 - C6\,000 - C0 = C4\,000$

Workings

Current tax payable			
Description	C	Description	C
Bank	6 000	Tax expense	12 000
Balance	6 000		
	12 000		12 000
Tax expense	2 000	Balance	6 000
Balance	4 000		
	6 000		6 000
		Balance	4 000

	C	C
Assessment	10 000	10 000
Provided / provisional payments	12 000	6 000
Under / (over) provision / amount owing by / (to) us	(2 000)	4 000

Solution 5.4

Please note that the journals and the t-accounts have been interspersed to assist you in your understanding. Under test and exams conditions it would be more time efficient to show all the journal entries followed by the T-accounts.

20X6 FINANCIAL YEAR**Journal entries**

	Debit	Credit
Current tax payable	4 000	
Bank		4 000
<i>Provisional tax payments in 20X6 in respect of 20X6 assessment</i>		
Income tax expense (statement of comprehensive income)	4 200	
Current tax payable		4 200
<i>Estimated income tax expense for the year</i>		

Ledger -accounts

Bank			
		Current tax payable	4 000
Current tax payable (L)			
Bank	4 000	Income tax expense	4 200
Balance (c/d)	200		
	<u>4 200</u>		<u>4 200</u>
		Balance (b/d)	200
Income tax (e)			
Current tax payable	<u>4 200</u>	Profit and loss	<u>4 200</u>

Financial statements
WAK LIMITED
EXTRACT FROM STATEMENT OF FINANCIAL POSITION
AS AT 28 FEBRUARY 20X6

	20X6 C
EQUITY AND LIABILITIES	
Current liabilities	
Current tax payable	200

WAK LIMITED
EXTRACT FROM STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 28 FEBRUARY 20X6

	20X6 C
Profit before tax	12 000
Income tax expense	(4 200)
Profit for the period	<u>7 800</u>
<i>Other comprehensive income</i>	-
Total comprehensive income	<u>7 800</u>

Solution 5.4 continued....

20X7 FINANCIAL YEAR

Journal entries: First step – deal with the 20X6 assessment

	Debit	Credit
Income tax expense	400	
Current tax payable		400
<i>Underprovision of 20X6 taxation expense</i>		
Current tax payable	600	
Bank		600
<i>Payment with return made in respect of overpayment in 20X6</i>		

Journals: Second step – current year entries

Current tax payable	5 000	
Bank		5 000
<i>Total of the first and second provisional payments made in 20X7 (these two payments would normally be processed as two separate entries on the dates on which the payments were actually made)</i>		
Income tax expense	5 320	
Current tax payable		5 320
<i>Estimated income tax expense for the year</i>		

Ledger-accounts:

Bank			
		Current tax payable	600
		Current tax payable	5 000
Current tax payable			
Bank	600	Balance (1/1/20X7)	200
Bank	5 000	Tax (underprovision – 20X6)	400
Balance	320	Tax expense	5 320
	<u>5 920</u>		<u>5 920</u>
		Balance	320
Income tax expense			
Current tax payable	400	Profit and loss	5 720
Current tax payable	5 320		
	<u>5 720</u>		<u>5 720</u>

Solution 5.4 continued....

Financial statements

WAK LIMITED
EXTRACT FROM STATEMENT OF FINANCIAL POSITION
AS AT 28 FEBRUARY 20X7

	20X7 C	20X6 C
Current liabilities		
Current tax payable	320	200

WAK LIMITED
EXTRACTS FROM STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 28 FEBRUARY 20X7

	Note	20X7 C	20X6 C
Profit before tax		15 200	12 000
Income tax expense	3	(5 720)	(4 200)
Profit for the period		9 480	7 800
<i>Other comprehensive income</i>		-	-
Total comprehensive income		9 480	7 800

WAK LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 28 FEBRUARY 20X7

	20X7 C	20X6 C
3. Taxation		
Normal tax		
Current tax	5 720	4 200
Current tax	5 320	4 200
Under provision in a previous year	400	-
Deferred	-	-
	5 720	4 200
<i>Tax rate reconciliation</i>		
Applicable tax rate	35%	35%
Tax effects of profit before tax	5 320	4 200
Underprovision of current tax in a prior year	400	-
Income tax expense	5 720	4 200
Effective tax rate	37.6%	35%

The effective tax rate is higher than the applicable tax rate due to:

- the under-provision of tax in the prior year.

Solution 5.4 continued....

20X8 FINANCIAL YEAR

	Debit	Credit
Current tax payable	495	
Income tax expense		495
<i>Overprovision of 20X7 taxation expense</i>		
Bank	175	
Current tax payable		175
<i>Refund received from the tax authorities in respect of overpayment in X7</i>		
Current tax payable	5 950	
Bank		5 950
<i>Total of the first and second provisional payments made in 20X8 (these two payments would normally be processed as two separate entries on the dates on which the payments were actually made)</i>		
Income tax expense (Statement of comprehensive income)	5 845	
Current tax payable (Statement of financial position)		5 845
<i>Estimated income tax expense for the year</i>		

Ledger accounts

Bank			
Current tax payable	175	Current tax payable	5 950
Current tax payable/ receivable			
Overprovision in 20X7	495	Balance (1/1/20X8)	320
Bank	5 950	Tax	5 845
		Bank	175
		Balance	105
	<u>6 445</u>		<u>6 445</u>
Balance	105		
Income tax expense			
Current tax payable (CT for CY)	5 845	Current tax payable (overprovision)	495
		Profit and loss	5 350
	<u>5 845</u>		<u>5 845</u>

Financial statements

WAK LIMITED
EXTRACT FROM STATEMENT OF FINANCIAL POSITION
AS AT 28 FEBRUARY 20X8

	20X8	20X7
Current liabilities	C	C
Current tax payable	-	320
Current assets		
Current tax receivable	105	-

Solution 5.4 continued....

WAK LIMITED
EXTRACT FROM STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 28 FEBRUARY 20X8

	20X8 C	20X7 C
Profit before tax	16 700	15 200
Income tax expense	(5 350)	(5 720)
Profit for the period	11 350	9 480
<i>Other comprehensive income</i>	-	-
Total comprehensive income	9 480	7 800

WAK LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 28 FEBRUARY 20X8 (EXTRACTS)

	20X8 C	20X7 C
3. Taxation		
Normal tax		
Current tax	5 350	5 720
- Current year	5 845	5 320
- Under/ (over) provision – previous year	(495)	400
Deferred	-	-
Income tax expense	5 350	5 720
<i>Tax rate reconciliation</i>		
Applicable tax rate	35%	35%
Tax effects of profit before tax	5 845	5 320
Under/ (over) provision – prior year	(495)	400
Income tax expense	5 350	5 720
Effective tax rate	32.0%	37.6%

The effective tax rate is higher than the applicable tax rate due to:

- the over-provision of tax in the prior year.

Authors' note:

Notice that the effective rate is reduced below the applicable rate of tax of 35% in 20X8 (due to the over-provision of the 20X7 tax expense, which is adjusted in 20X8) whereas the effective rate is greater than the applicable rate of tax in 20X7 (due to the 20X6 under-provision of the tax expense, which is adjusted in 20X7).

Solution 5.5

a) Tax expense note

BIG BLUE LIMITED NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 20X3			
		20X3	20X2
		C	C
5 Taxation			
Normal tax			
Current tax	20X2: 87 000 – 0	83 650	87 000
- current year	20X3: 84 750 – 1 100		
	20X2: balancing (87 000 + - 0); W1	84 750	87 000
	20X3: balancing (83 650 + 1 100) W1		
- prior year under/ (over) provision	20X2: first year of operations	(1 100)	-
	20X3: 87 000 – 85 900		
Deferred		-	-
Income tax expense	given	83 650	87 000
<i>Tax rate reconciliation:</i>			
Applicable tax rate		30%	30%
Tax effects of:			
Profit before tax	20X2: 290 000 x 30%;	90 000	87 000
	20X3: 300 000 x 30%		
Exempt capital profit	20X3: 13 000 x 30%	(3 900)	
Exempt dividend income	20X3: 5 000 x 30%	(1 500)	
Non-deductible fine	20X3: 500 x 30%	150	
Prior year over-provision of current tax	per above	(1 100)	
Income tax expense	given	83 650	87 000
Effective tax rate	20X3: 83 650 / 300 000	27.88%	30%
	20X2: 87 000 / 290 000		

The effective tax rate is lower than the applicable tax rate due to:

- Exempt capital profit and dividends earned
- the over-provision of tax in the prior year.

Solution 5.5 continued . . .

b) Statement of financial position

**BIG BLUE LIMITED
STATEMENT OF FINANCIAL POSITION
AT 31 DECEMBER 20X3**

		20X3	20X2
		C	C
Current liabilities			
Current tax payable: normal tax	20X3: 5 000 (o/b) + 83 650 (CT) - 80 000 (pmts)	8 650	5 000
W 1 current normal tax	20X3	20X2	
Profit before tax	300 000	290 000	
Less capital profit	(13 000)		
Less dividend received	(5 000)		
Add fine	500		
Taxable income	282 500	290 000	
Current normal tax @30%	84 750	87 000	

Solution 5.6**a) Calculations****1. Calculation of capital gain on sale of building***Proceeds:*

Carrying amount on date of sale (given)	280 000
Profit on sale (given)	100 000
	<u>380 000</u>

Taxable Capital Profit

<i>Sales proceeds</i>	380 000
<i>Sales proceeds for tax purpose</i>	300 000
<i>Less: Tax base</i>	<u>(280 000)</u>
<i>Taxable profit</i>	<u>20 000</u>

2. Calculating the taxable profits and current tax

Profit before tax (given)	500 000
Less exempt income:	
Dividend income	(10 000)
Accounting capital profits	(100 000)
Taxable capital gain	20 000
Add non-deductible expenses:	
Donations	50 000
Fines	<u>30 000</u>
Taxable profit	<u>490 000</u>

Current tax (C490 000 x 30%)	147 000
Add: Tax on dividend income @ 10% (10 000*10%)	<u>1 000</u>
	<u>148 000</u>

b) Disclosure

ZAC LTD
EXTRACT FROM STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31ST DECEMBER 20X2

	Note	20X2
		C
Profit before tax		500 000
Income tax expense	4	<u>(148 000)</u>
Profit for the period		352 000
<i>Other comprehensive income</i>		<u>-</u>
Total comprehensive income		<u>352 000</u>

Solution 5.6 continued....

ZAC LTD
EXTRACTS FROM NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X2

4. Taxation

	20X2
	C
Normal tax	148 000
Current tax	148 000
Deferred tax(no temporary differences)	-
Income tax expense	159 000
<i>Tax rate reconciliation:</i>	
Applicable tax rate	30%
Tax effects of	
Profits before tax (C500 000 x 30%)	150 000
Exempt capital profit (C80 000 x 30%)	(24 000)
Exempt dividend income (C10 000 x 20%)	(2 000)
Non-deductible donations (C50 000 x 30%)	15 000
Non-deductible fines (C30 000 x 30%)	9 000
Income tax expense	148 000
Effective tax rate (148 000/ 500 000)	29.6%

The effective tax rate is higher than the applicable tax rate due to:

- Exempt capital profit and dividends earned taxed at lower rate

Workings

	CA	TB
Selling price	380 000	380 000
Carrying amount	280 000	280 000
Profit	100 000	100 000
Capital profit / Capital gain (X 50% = 40 000)	80 000	80 000
Non-capital profit / Recoupment	20 000	20 000

Solution 5.7**a) Calculations****1. Calculating the taxable profits and current tax**

Profit before tax (given)	250 000
Less Dividend income	(12 000)
Add Donations (permanent difference)	8 000
	<hr/> 246 000
Temporary Differences	29 000
Add income received in advance (closing balance)	24 000
Less prepaid expense (closing balance)	(10 000)
Add back depreciation	40 000
Less capital allowance	(25 000)
	<hr/> 275 000
Taxable income	<hr/> 275 000
Tax at 30% (275 000 x 30%)	82 500
Tax on dividend income (12 000 * 10%)	1 200
Current tax	<hr/> 83 700

For the purpose of this exercise, deferred taxation was not required. The deferred taxation figure may, however, be calculated by, multiplying the temporary differences into tax rate

		X 0.30
Temporary Differences (see above)	29 000	8 700

The journal entries for the processing of the current and deferred taxation would be as follows:

	Debit	Credit
Taxation expense	83 700	
Current tax payable (liability)		83 700
<i>Processing of the current taxation expense</i>		
Deferred taxation (asset)	8 700	
Taxation expense		8 700
<i>Journalising the deferred taxation expense</i>		

Solution 5.7 continued ...

b) Disclosure

WAC LTD
EXTRACTS FROM STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X1 (EXTRACTS)

	Note	20X1 C
Profit before tax		250 000
Income tax expense	4	<u>75 000</u>
Profit for the period		175 000
<i>Other comprehensive income</i>		<u>-</u>
Total comprehensive income		<u>175 000</u>

WAC LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X1

4. Taxation	20X1 C
Normal tax	75 000
Current	<div style="border: 1px solid black; padding: 2px;">83 700</div>
Deferred (not required)	<div style="border: 1px solid black; padding: 2px;">(8 700)</div>
	<u>75 000</u>

Tax rate reconciliation:

	C	%
Tax effects of:		
Profits before tax / Applicable tax rate (250 000 x 30%)	75 000	30
Dividend income taxed at lower rate (C12 000 x 20%)	(2 400)	(0.9)
Non-deductible donations (C8 000 x 30%)	<u>2 400</u>	<u>0.9</u>
Income tax expense / Effective tax rate	<u>75 000</u>	<u>30</u>

Solution 5.8

a) Journals

	Debit	Credit
1.		
Inventories	200 000	
Bank/ creditors		200 000
<i>Purchase of inventories for C200 000 (no VAT included)</i>		
2.		
Inventories	28 947	
Current tax payable: VAT	4 053	
Bank/ Creditors		33 000
<i>Purchase of inventories for C33 000 (including VAT: C33 000 x 14/114)</i>		
3a.		
Bank/ debtors	800	
Sales		702
Current tax payable: VAT		98
<i>Sale of goods (including VAT of C800 x 14/114)</i>		
3b.		
Cost of Sales	xxx	
Inventories		xxx
<i>Insufficient information</i>		
4a.		
Bank/ debtors	12 000	
Sales		10 526
Current tax payable: VAT		1 474
<i>Sale of goods (including VAT of C12000 x 14/114)</i>		
4b.		
Cost of Sales	xxx	
Inventories		xxx
<i>Insufficient information</i>		
5.		
Electricity and water	368	
Current tax payable: VAT	52	
Bank		420
<i>Payment of electricity and water (including VAT of C420 x 14/114)</i>		
6.		
Telephone	167	
Current tax payable: VAT	23	
Bank		190
<i>Payment of telephone (including VAT of C190 x 14/114)</i>		
7.		
Salaries	28 000	
Current tax payable: employees tax		8 000
Bank		20 000
<i>Paid net salaries of C20 000 and owe C8 000 to the tax authorities</i>		

Solution 5.8 continued

	Debit	Credit
8.		
Current tax payable: employees tax	11 000	
Bank		11 000
<i>Paid employees' tax to the tax authorities</i>		
9.		
Bank	5 000	
Current tax payable: VAT		5 000
<i>Receipt of VAT refund from the tax authorities</i>		
10.		
Bank/ income receivable	12 000	
Dividend income		12 000
<i>Dividend income earned</i>		
11a.		
Retained earnings	18 000	
Shareholders for dividends		18 000
<i>Dividends declared</i>		
11b.		
Shareholders for dividends	18 000	
Bank		16 200
Withholding tax payable		1 800

b)

BG LIMITED
EXTRACT FROM STATEMENT OF COMPREHENSIVE INCOME
FOR THE MONTH ENDED 31 MARCH 20X9

	20X9
	C
Sales (702+10 526)	11 228
Cost of sales	xxx
Electricity and water	368
Telephone	167
Other Income	12 000
Salaries	28 000-
Profit before tax	xxx
Income tax expense	xxx
Profit for the period	xxx
<i>Other comprehensive income</i>	xxx
Total comprehensive income	xxx

Solution 5.8 continued ...

BG LIMITED
EXTRACT FROM STATEMENT OF FINANCIAL POSITION
AS AT 31 MARCH 20X9

	20X9
	C
ASSETS	
Non-current assets	
Vehicles (O/balance + 5 000 + 120 000)	xxx
Current assets	
Inventories [O/balance + 200 000 + 28 947 – cos (A) – cos (B)]	xxx
Trade debtors and other receivables	xxx
Bank	xxx
EQUITY AND LIABILITIES	
Non-current liabilities	
XYZ Bank (X + 5 000 + 120 000)	xxx
Current liabilities	
Trade and other payables	xxx
Current tax payable: VAT (2000+4053-98-1474+52+23-5000)	444
Current tax payable: (6 000 + 8 000 – 11 000) + 1 800	4 800
Current tax payable: Secondary tax on companies	750

BG LIMITED
EXTRACT FROM STATEMENT OF CHANGES IN EQUITY
FOR THE MONTH ENDED 31 MARCH 20X9

	Retained earnings	Total
	C	C
Opening balance: 1/3/20X8	xxx	xxx
Total comprehensive income	xxx	xxx
Dividends paid	(18 000)	(18 000)
Closing balance: 31/3/20X9	xxx	xxx

Solution 5.9**a) Statement of comprehensive income**

PEACH LIMITED			
EXTRACT FROM THE STATEMENT OF COMPREHENSIVE INCOME			
FOR THE YEAR ENDED 31 MAY 20X6			
		Note	C
Gross profit	(Balancing: 115 000 + 2 000 + 40 000 – 8 000)		149 000
Other income			
Dividends received			8 000
Other expenses			(40 000)
Finance costs			(2 000)
Profit before taxation			115 000
Income tax expense	(37 450 + 1 500 + 2 125)	12	(39 750)
Profit for the period			75 250
<i>Other comprehensive income</i>			-
Total comprehensive income			75 250

b) Statement of financial position

PEACH LIMITED		
EXTRACTS FROM THE STATEMENT OF FINANCIAL POSITION		
AS AT 31 MAY 20X6		
ASSETS		C
Current assets		
Current tax receivable	(43 000 – 37 450 – 800 – 1 500)	3 250
EQUITY AND LIABILITIES		
Current liabilities		
Shareholders for dividends		10 000

c) Taxation note

PEACH LIMITED			
EXTRACT FROM THE NOTES TO THE FINANCIAL STATEMENTS			
FOR THE YEAR ENDED 31 MAY 20X6			
12. Taxation			C
Normal tax			
Current tax	(calculation 1)		38 250
Under provision prior years	(given)		1 500
Income tax expense			39 750
<i>Tax rate reconciliation</i>		%	
Tax expense on profit before tax/ applicable rate		35.00	40 250
Exempt dividend	(8 000 x 25%/115 000)	(1.74)	(2 000)
Under provision	(1 500 / 115 000)	1.30	1 500
Income tax expense as reported / effective rate	(39 750 / 115 000)	34.56	39 750

Solution 5.9

Workings:

W1. Tax computation

Profit before taxation
Less: Dividend income to be taxed @ 10%

Dividend income taxed @ 10%
Taxable profit

		X 0.35	
	115 000		
	(8 000)		
	<hr/>		
	107 000	37 450	Dr TE
	10 000	800	
	<hr/>	<hr/>	
	127 000	38 250	Cr CTP

Solution 5.10

(a)

CARIBBEAN LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 28 FEBRUARY 20X7

	Notes	20X7 C
Revenue		12 000 000
Cost of sales	(7 100 000 + 80 000)	(7 180 000)
Operating expenses	(3 480 000 + 150 000)	(3 630 000)
Other income		150 000
Finance costs		(240 000)
Profit before tax	4	1 100 000
Income tax expense	5	(319 000)
Profit for the period		781 000
<i>Other comprehensive income</i>		
Revaluation surplus		800 000
Total comprehensive income		1 581 000

(b)

CARIBBEAN LIMITED
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 28 FEBRUARY 20X7

	Ordinary share capital C	Share premium C	NDR C	Retained earnings C	Total C
Balance at 01/03/X6	2 500 000	-	-	1 424 200	3 924 200
Total comprehensive income			800 000	781 000	1 581 000
Issue of share capital	500 000	1 500 000			2 000 000
Share issue expenses		(150 000)			(150 000)
Balance at 28/02/X7	3 000 000	1 350 000	800 000	2 205 200	7 355 200

(c)

CARIBBEAN LIMITED
EXTRACTS FROM STATEMENT OF FINANCIAL POSITION
AS AT 28 FEBRUARY 20X7

	Note	C
ASSETS		
Current assets		
Inventories		1 720 000
Trade and other receivables	(980 000 + 15 000)	925 000
Cash and cash equivalents		2 059 200
		4 779 200
EQUITY AND LIABILITIES		

Current liabilities

Borrowings		2 000 000
Trade and other payables	(400 000 + 20 000)	420 000
Current tax payable	(319 000 – 200 000)	119 000
		<u>2 539 000</u>

(d)

**CARIBBEAN LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 28 FEBRUARY 20X7**

1. Statement of compliance

These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 198, provisions of and directives issued by under the Companies Ordinance, 1984. In case the requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

2. Accounting policies

2.1 Basis of preparation

The financial statements have been prepared in the historical cost basis except for the revaluation of certain non-current assets. These policies are consistent in all material respects with these applied in the previous years.

3 Share capital

Authorised

10 000 000 ordinary shares of C0.50 each

C

Issued

6 000 000 ordinary shares of C0.50 each

Reconciliation of quantity of shares

Balance 1/3/X6 3 000 000

Issued during year

Qty

Balance 28/2/X7 5 000 000

1 000 000

6 000 000

4. Profit before tax

The profit before tax has been computed after taking into account the following:

Auditors remuneration		110 000
Depreciation of property, plant and equipment		210 000
Employee benefits expense		1 800 000
Write down of inventory to net realisable value	(1 800 000 - 1 720 000)	80 000
Profit on sale of plant		150 000

5. Income tax expense

Current normal tax	319 000
Income tax expense	<u>319 000</u>

Tax rate reconciliation

Applicable tax rate 29%

Tax effects of

Profit before tax (1 100 000 X 0.29) 319 000

Income tax expense	319 000
Effective tax rate	29%

6. Dividends of C300 000 have been declared on 25 March 20X7 but have not been recognised as a distribution. The DPS amounts to C0.05 per share.
-

Solution 5.10 continued ...

Workings

W1. Calculation of accounting / tax profit on sale of plant

	Accounting	Tax
Selling price	330 000	330 000
Carrying amount / tax base	(180 000)	(180 000)
Gain on sale of asset	<u>150 000</u>	<u>150 000</u>

W2. Current tax computation

Profit before tax		1 100 000
Accounting gain on sale of asset		(150 000)
Taxable gain on sale of asset		<u>150 000</u>
Taxable profit		<u>1 100 000</u>
Current tax payable	(1 100 000 X 0.29)	<u>319 000</u>

Solution 5.11

W 1. Calculation of current normal tax	Year 1	Year 2	Year 3
	C	C	C
Profit before tax	300 000	400 000	450 000
• Add donations	40 000	0	0
• Less capital profit on sale of vehicle <i>Given</i>	(50 000)	0	0
• Add taxable capital gain on sale of vehicle	15 000	0	0
• Less capital profit on sale of machine <i>[80-(70-15-15)]</i>			(40 000)
• Add taxable capital gain on sale of machine <i>[80-(70-25-25)]</i>			60 000
	305 000	400 000	470 000
• Add income received in advance: c/bal	20 000	10 000	40 000
• Less income received in advance: o/bal	0	(20 000)	(10 000)
• Less expenses prepaid: c/bal	(30 000)	(40 000)	(20 000)
• Add expenses prepaid: o/bal	0	30 000	40 000
• Add depreciation	0	15 000	15 000
• Less tax depreciation	0	(25 000)	(25 000)
Taxable profit	295 000	370 000	510 000
Current normal tax at 30%	88 500	111 000	153 000

W2 Calculation of over/ under estimates of current normal tax	Year 1	Year 2	Year 3
	C	C	C
Current normal tax estimated (see working 1)	88 500	111 000	153 000
Current normal tax assessed (given)	94 000	114 500	not yet assessed
(Over)-estimated/ under-estimated	5 500	3 500	unknown
Assessment received in year 2 so journalised in:	Year 2		
Assessment received in year 3 so journalised in:		Year 3	

W3 Calculation of whether a payment with return or refund is due	Year 1	Year 2	Year 3
	C	C	C
<i>Extracts from the current tax payable account</i>			
Current normal tax charge (working 1) (Credit)	(88 500)	(111 000)	(153 000)
Less provisional payments made (given) Debit	60 000	70 000	100 000
(Under)/ over-estimate of current normal tax Debit/ (Credit)	0	(5 500)	(3 500)
Balance owing: payment with return or (refund)	(28 500)	(46 500)	(56 500)
Payments with returns or refunds paid in:	year 2	year 3	year 4

Solution 5.11 continued ...

Journals	Debit	Credit
<i>Year 1</i>		
Current tax payable: normal tax	60 000	
Bank		60 000
Provisional tax payments (this is the total of the 2 provisional payments - these would normally each be journalised separately)		
Tax expense	88 500	
Current tax payable: normal tax		88 500
Current normal tax estimated for year 1 (see working 1)		
<i>Year 2</i>		
Current tax payable: normal tax	70 000	
Bank		70 000
Provisional tax payments (this is the total of the 2 provisional payments - these would normally each be journalised separately)		
Tax expense	111 000	
Current tax payable: normal tax		111 000
Current normal tax estimated for year 2 (see working 1)		
Tax expense	5 500	
Current tax payable: normal tax		5 500
Current normal tax under-estimated in year 1 (see working 2)		
Current tax payable: normal tax	28 500	
Bank		28 500
Payment with return made in respect of year 1 (see working 3)		
<i>Year 3</i>		
Current tax payable: normal tax	100 000	
Bank		100 000
Provisional tax payments (this is the total of the 2 provisional payments - these would normally each be journalised separately)		
Tax expense	153 000	
Current tax payable: normal tax		153 000
Current normal tax estimated for year 3 (see working 1)		
Tax expense	3 500	
Current tax payable: normal tax		3 500
Current normal tax under-estimated in year 2 (see working 2)		
Current tax payable: normal tax	46 500	
Bank		46 500
Payment with return made in respect of year 2 (see working 3)		

Solution 5.12

a) Current normal tax calculation

Current taxation (and deferred taxation adjustment)		30%			
Profit before tax	885 000				
<i>Permanent differences:</i>					
Less dividend income (exempt income)	(60 000)				
Add non deductible items fines	1 000				
Add non deductible items VAT penalty	6 000				
<i>Temporary differences:</i>					
Add depreciation- office equipment	110 000				
Less Tax depreciation - office equipment	(80 000)				
Add depreciation- machinery $(600\,000 - 0) \times 25\%$	150 000				
Less Tax depreciation- machinery $(600\,000 \times 20\%)$	(120 000)				
Less income received in advance: opening balance	(6 500)				
Add income received in advance: closing balance	7 500				
Add provision for leave pay	50 000				
Add taxable gain on sale of machine (W1.4)	60 000				
Less non capital profit (W1.3)	(150 000)				
Add expense prepaid: opening balance	3 000				
Less expenses prepaid: closing balance	(6 000)				
Taxable profit and current normal tax	850 000	255 000	Dr	TE	Cr
				CTP	

W1 Machinery

W1.1 Machine carrying amount

Cost: 1/1/20X6	600 000
Accumulated depreciation $(600\,000 - 0) \times 25\% \times 3$	(450 000)
Carrying amount: 31/12/20X8	150 000

W1.2 Machine tax base

Cost: 1/1/20X6	600 000
Accumulated tax depreciation $(600\,000 \times 20\% \times 3)$	(360 000)
Tax base: 31/12/20X8	240 000

W1.3 Machine proceeds on sale

Profit on sale (Given: all non-capital because the proceeds did not exceed cost price)	150 000
Carrying amount (W1.1)	150 000
Proceeds	300 000

W1.4 Taxable gain on sale of machine

Proceeds (W1.3: 300 000)	300 000
Less tax base (W1.2)	(240 000)
Taxable gain on sale of machine	60 000

Solution 5.12 continued ...

b) Journal entries

	Debit	Credit
Taxation expense: normal tax	255 000	
Current tax payable: normal tax		255 000
<i>Current tax for the year</i>		
Current tax payable: normal tax	200 000	
Bank		200 000
<i>Payments made to the tax authorities during the year</i>		
Current tax payable: normal tax	20 000	
Tax expense: normal tax		20 000
<i>Over provision of normal tax in 20X7</i>		
Income received in advance (L)	6 500	
Rent income		6 500
<i>Reversal of opening balance to income</i>		
Rent income	7 500	
Income received in advance (L)		7 500
<i>Portion of rent received in advance (for 20X9)</i>		
Insurance expense	3 000	
Prepaid expense (A)		3 000
<i>Reversal of opening prepaid insurance</i>		
Prepaid expense (A) W1	6 000	
Insurance expense		6 000
<i>Amount of insurance prepaid (for 20X9)</i>		
Leave pay expense	50 000	
Provision for leave pay (L)		50 000
<i>Leave paid to staff at 31 December 20X8</i>		

Solution 5.13

a) Current normal tax calculation

Current taxation (and deferred taxation adjustment)	30%	
Profit before tax	535 000	
<i>Permanent differences:</i>		
Add non deductible items: Donation	30000	
<i>Temporary differences:</i>		
Add depreciation – plant and machinery (given)	190 000	
Add impairment – machinery (given)	20 000	
Less tax depreciation (given)	(170 000)	
Less income received in advance- O/B (given)	(8900)	
Add income received in advance: C/B (given)	5500	
Less expense prepaid C/B (given)	(17 000)	
Add expense prepaid O/B (given)	18000	
Add: Accrued expenses – opening balance	4 000	
Less: Accrued expenses – closing balance	(11 000)	
Less: Tax loss on sale of plant (W1)	(170 000)	
Less: Accounting gain on sale of plant (W1)	(30 000)	
Less: Accounting gain on sale of machine (W2)	(120 000)	
Add: Tax gain on sale of machine (W2)	110 000	
Taxable profit and current normal tax	<u>385 600</u>	115 680 Dr TE Cr CTP

W1 Plant

Plant: carrying amount

Proceeds	<i>Given</i>	230 000
Profit on sale of plant	<i>All non-current profit because SP less than CP</i>	<u>(30 000)</u>
Carrying amount		200 000

Tax gain / loss on plant

Proceeds limited to cost	<i>Given: 230 000, cost is 800 000 so not limited</i>	230 000
Less tax base	<i>800 000- 400 000</i>	<u>(400 000)</u>
Tax Loss		170 000

W2 Machinery

Accounting gain / loss

Accounting profit	120 000
Carrying amount	<u>80 000</u>
Sales proceeds	200 000

Tax gain / loss

Sales proceeds (from above)	200 000
Less: tax base	<u>(90 000)</u>
Taxable gain	110 000

Solution 5.13**b) Journal entries**

	Debit	Credit
1 September 20X5		
Current tax payable: normal tax	11 350	
Bank		11 350
<i>Payment of outstanding balance</i>		
31 December 20X5		
Current tax payable: normal tax	90 000	
Bank		90 000
<i>Payment of first provisional payment (600 000x0,3 ÷2)</i>		
30 June 20X6		
Current tax payable: normal tax	31 500	
Bank		31 500
<i>Payment of second provisional payment (405 000x0,3 – 90 000)</i>		
Tax expense	99 780	
Current tax payable: normal tax		99 780
<i>Recording of current year tax expense</i>		

Solution 6.1

a) Calculations

Current taxation (and deferred taxation adjustment)		30%	
Accounting profit	100 000		
<i>Permanent differences:</i>			
- capital profits (exempt income)	(50 000)		
+ donations (non-deductible expenses)	30 000		
Taxable accounting profits	80 000	24 000	Dr Tax expense
<i>Temporary differences:</i>			
- expenses prepaid closing balance	(40 000)	12 000	Cr Deferred tax
Taxable income	40 000	12 000	Cr CTP

Deferred taxation calculation (Balance sheet approach)

	Carrying amount	Tax base	Temporary difference	Deferred tax	Balance/ adjustment
Balance: 1 March 20X0	0	0	0	0	
Adjustment				(12 000)	dr TE; cr DTL
Balance: 28 February 20X1	40 000	0	(40 000)	(12 000)	L

b) Ledger-accounts

Taxation				Current tax payable/ receivable			
Description	C	Description	C	Description	C	Description	C
Current tax payable/ receivable	12 000					Taxation	12 000
Deferred tax	12 000						
		Profit & Loss	24 000	Balance c/d	12 000		
	24 000		24 000		12 000		12 000
						Balance b/d	12 000

Deferred tax			
Description	C	Description	C
		Taxation	12 000
Balance c/d	12 000		
	12 000		12 000
		Balance b/d	12 000

Solution 6.1 continued ...

c) Disclosure

LOOK LIMITED
EXTRACT FROM NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 28 FEBRUARY 20X1

	20X1 C
3. Taxation	
Normal tax	
Current tax	12 000
Deferred tax	12 000
Income tax expense	<u>24 000</u>
<i>Tax rate reconciliation:</i>	
	C %
Tax effects of:	
Profit before tax / applicable rate (100 000 x 30%)	30 000 30
Exempt capital profits (50 000 x 30%)	(15 000) (15)
Non-deductible expenses (30 000 x 30%)	9 000 9
Income tax expense / effective rate	<u>24 000 24</u>

d) Journals

GENERAL JOURNAL		
	Debit	Credit
Tax expense	12 000	
Current tax payable: normal tax		12 000
<i>Current normal taxation estimated for 20X1</i>		
Tax expense	12 000	
Deferred taxation: normal tax		12 000
<i>Deferred normal taxation estimated for 20X1</i>		

e) Statement of comprehensive income disclosure

LOOK LIMITED
EXTRACT FROM STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 28 FEBRUARY 20X1

	Note	20X1 C
Profit before tax		100 000
Income tax expense	3	<u>(24 000)</u>
Profit for the period		76 000
<i>Other comprehensive income</i>		-
Total comprehensive income		<u>76 000</u>

Solution 6.1 continued ...

f) Statement of financial position disclosure

LOOK LIMITED

EXTRACTS FROM STATEMENT OF FINANCIAL POSITION

AS AT 28 FEBRUARY 20X1

	Note	20X1 C
<i>EQUITY AND LIABILITIES</i>		
Non-current liabilities		
Deferred taxation		12 000
Current liabilities		
Current tax payable: Normal taxation		12 000

Solution 6.2**a) Journals**

	Debit	Credit
20X7		
Tax expense	100 000	
Current tax payable: normal tax		100 000
Current normal taxation estimated for 20X7		
Tax expense	800	
Deferred taxation: normal tax		800
Deferred normal taxation adjustment estimated for 20X7		
Depreciation: equipment	48 000	
Accumulated depreciation: equipment		48 000
Depreciation on equipment: 20X7		
20X8		
Tax expense	116 000	
Current tax payable: normal tax		116 000
Current normal taxation estimated for 20X8		
Deferred taxation: normal tax	3 200	
Tax expense		3 200
Deferred normal taxation adjustment estimated for 20X8		
Current tax payable: normal tax	100 000	
Bank		100 000
Payment of current normal taxation charged for 20X7		
Depreciation: equipment	48 000	
Accumulated depreciation: equipment		48 000
Depreciation on equipment: 20X8		

b) Disclosure**EYE LIMITED****EXTRACT FROM STATEMENT OF FINANCIAL POSITION
AT 30 JUNE 20X8**

	Note	20X8 C	20X7 C
Non-current assets			
Equipment		288 000	336 000
Non-current liabilities			
Deferred tax	15	8 752	11 952
Current liabilities			
Current tax payable		116 000	100 000

EYE LIMITED**EXTRACT FROM STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEARS ENDED 30 JUNE 20X8**

	Note	20X8 C	20X7 C
Profit before tax	10	282 000	252 000
Income tax expense	11	(112 800)	(100 800)
Profit for the period		169 200	151 200
<i>Other comprehensive income</i>		-	-
Total comprehensive income		169 200	151 200-

Solution 6.2 continued ...

EYE LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 30 JUNE 20X8

	20X8 C	20X7 C
1. Accounting policies		
1.1 Statement of compliance		
These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 198, provisions of and directives issued by under the Companies Ordinance, 1984. In case the requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.		
1.2 Basis of preparation		
The financial statements have been prepared in the historical cost basis except for the revaluation of certain non-current assets. These policies are consistent in all material respects with these applied in the previous years.		
1.3 Equipment		
Equipment held for the use in the production or supply of goods or services, or for administration purposes, are stated in the statement of financial position at their costs less any subsequent accumulated depreciation and subsequent impairment losses.		
Depreciation is charged so as to write off the cost or valuation of assets, over their estimated useful lives using the straight line method. The estimated useful lives, residual values and depreciation method are reviewed at each year end, with the effect of any changes in estimate accounted for in a prospective basis.		
1.4 Deferred taxation		
Deferred tax is provided using the balance sheet liability method, on all the temporary differences at the balance sheet date between the tax base of assets and liabilities and their carrying amounts for financial reporting purposes.		
Deferred tax asset are recognized for all deductible temporary differences, carry forward of unused tax losses, to the extent that is probable that future taxable profit will be available against which the deductible temporary difference, unused tax losses and tax credits can be utilized.		
Carrying amount of deferred tax asset is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that the related tax benefit will be realized. Deferred tax is calculated at the rates that are expected to apply to the period when differences reverse based on the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.		
10. Profit before tax is arrived at after charging:		
Depreciation	48 000	48 000
11. Taxation		
Normal tax		
Current tax	116 000	100 000
Deferred tax	(3 200)	800
Income tax expense	<u>112 800</u>	<u>100 800</u>

15. Deferred taxation liability

Deferred tax was caused by temporary differences relating to:

- Equipment

8 752

11 952

Solution 6.2 continued ...

Workings

W1. Current normal tax	20X8	40%		20X7	40%	
Profit before tax	282 000	112 800	Dr TE	252 000	100 800	Dr TE
Temporary differences	8 000	3 200	Dr DT	(2 000)	800	Cr DT
Depreciation	48 000			48 000		
Tax depreciation	(40 000)			(50 000)		
Taxable profit	290 000	116 000	Cr CTP	250 000	100 000	Cr CTP

W2. Deferred tax: property, plant and equipment	Carrying amount	Tax base	Temporary difference	Deferred tax bal/ adj	
30/06/X6 Balance	384 000	356 120	(27 880)	(11 152)	L
	(48 000)	(50 000)	(2 000)	(800)	Cr
30/06/X7 Balance	336 000	306 120	(29 880)	(11 952)	L
	(48 000)	(40 000)	8 000	3 200	Dr
30/06/X8 Balance	288 000	266 120	(21 880)	(8 752)	L

Solution 6.3

a) Calculation of profit before tax

	Total	20X2	20X1
Cash received		110 000	10 000
- cash received in advance (closing balance)		(0)	(10 000)
+ cash received in advance (opening balance) (now recognised)		10 000	0
Profit before tax	120 000	120 000	0

b) Calculation of taxable profits and current normal tax

Profit before tax (see (a) above)	120 000	0
+ cash received in advance (closing balance)	0	10 000
- cash received in advance (opening balance) (taxed in prior year)	(10 000)	(0)
Taxable income	120 000	110 000

Current tax at 30% of taxable profits	36 000	33 000	3 000
---------------------------------------	--------	--------	-------

c) Calculation of actual effective rate of tax over the 2 years

Taxation	36 000	33 000	3 000
Profit before tax	120 000	120 000	0

Effective rate of tax (the effective rate of tax is 30% over the two years but each year the effective rate appears distorted!) 30% 28% Not possible

Comment:

The reason for the distortion shown above (i.e. the difference between the effective tax rate and the standard tax rate of 30%) is that the tax on the C10 000 rent received in 20X1 is recognised in 20X1 whereas this rent income is only recognised in 20X2. If one recognised the tax expense in the same period that the related income was recognised (i.e. both recognised in 20X2), then matching would be achieved. See below:

Profit before tax	120 000	0
Tax (120 000 x 30%) (0 x 30%) (current and deferred!)	(36 000)	0
Profit after tax	84 000	84 000

Effective rate of tax per year 30% n/a

The profit after tax and the effective rate of tax makes more sense now that the taxes have been matched to the profits.

d) Ledger-accounts

Taxation				Current tax payable/ receivable			
Description	C	Description	C	Description	C	Description	C
20X1						20X1	
CTP ¹	3 000	Deferred tax ²	3 000			Taxation ¹	3 000
20X2						20X2	
CTP ³	33 000					Taxation ³	33 000
Deferred tax ⁴	3 000						
	36 000						

Solution 6.3 continued ...

Deferred tax			
<i>Description</i>	<i>C</i>	<i>Description</i>	<i>C</i>
20X1		20X2	
Taxation ²	3 000	Taxation ⁴	3 000

- 1) Current tax owing to the tax authorities in 20X1 must be recognised as a liability.
- 2) The tax expense caused by income that will only be recognised in the future should be deferred and recognised in the future instead. This tax is treated as a deferred tax asset and is much the same as a prepaid expense in that it is tax to be paid before it is incurred (the accountant believes that this tax is only incurred once the related income is earned).
- 3) Current tax owing to the tax authorities in 20X2 must be recognised as a liability.
- 4) The tax expense, the recognition of which was previously deferred to a future year (i.e. deferred tax), should now be recognised since the income has now been recognised (i.e. the deferred tax asset balance should now be reversed and recognised as an expense).

e) Disclosure

PHOBIE LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 20X2

4. Taxation	20X2	20X1
	C	C
Normal tax		
Current tax	33 000	3 000
Deferred tax	3 000	(3 000)
Income tax expense	<u>36 000</u>	<u>0</u>

f) Journals

	Debit	Credit
20X1		
Bank	10 000	
Rent income received in advance		10 000
Rent received		
Tax expense	3 000	
Current tax payable: normal taxation		3 000
Current normal taxation estimated for 20X1		
Deferred taxation: normal	3 000	
Tax expense		3 000
Deferred normal taxation adjustment estimated for 20X1		
20X2		
Bank	110 000	
Rent income		110 000
Rent received		
Rent income received in advance	10 000	
Rent income		10 000
Rent received in advance opening balance reversed in 20X2		
Tax expense	33 000	
Current tax payable: normal tax		33 000
Current normal taxation estimated for 20X2		
Tax expense	3 000	
Deferred taxation: normal tax		3 000

Deferred normal taxation balance reversed in 20X2

Solution 6.4

a) Discussion

Definition of a liability

- A present obligation
- Of the entity
- As a result of a past event
- The settlement of which is expected to result in an outflow of future economic benefits.

Definition of an expense

- Decrease in economic benefits
- During the accounting period
- In the form of decrease in assets or increase in liabilities resulting in a decrease in equity
- Other than through a distribution to equity participants.

Recognition criteria

- A reliable estimate must be possible.
- The outflow of future economic benefits must be probable.

Discussion: liability

- The event is the earning/ receiving of the taxable profits: since the profits on which the tax is calculated were earned/ received before 31 December 20X3, the event is a past event.
- Since there is a past event, there is a present obligation as at 31 December 20X3.
- Since the taxable profits were earned by the entity, the tax thereon is a legal obligation of the entity.
- The settlement of the obligation will result in an outflow of cash.

Discussion: recognition criteria

- A reliable estimate is possible since the Income Tax Ordinance is available to the public to use in the estimate thereof/ the auditors, who are professionals in this area, have already calculated the estimated tax.
- The outflow is probable since it has either already been pre-paid via the provisional payment system/ or will have to be paid since it is a legislative requirement!

Discussion: expense

- The decrease in economic benefits is the tax outflow expected in relation to the profits made (i.e. a decrease in profits).
- The profits arose in 20X3 and therefore the tax arose in 20X3 and thus it is a decrease in economic benefits during the accounting period 20X3.
- Since there has been an increase in liabilities without an equal increase in assets, equity will decrease.
- The tax payable on the profits is not a distribution to equity participants.

Conclusion

Since both the liability and expense definitions and the related recognition criteria have been met, the current tax liability and related tax expense should be processed.

Solution 6.4 continued ...

b) Journals

	Debit	Credit
Tax expense	80 000	
Current tax payable (L)		80 000
<i>Current normal tax for 20X3</i>		
Tax expense	7 000	
Current tax payable (L)		7 000
<i>Under-provision of current normal tax in 20X2</i>		
Tax expense	10 000	
Deferred tax (L)		10 000
<i>Deferred tax adjustment for 20X3: 60 000 (L) – 50 000 (L)</i>		

Solution 6.5

a) Deferred tax working paper

	Carrying amount	Tax base	Temporary difference	Deferred tax	
Property, plant & equipment:					
Balance – 28/02/20X1	145 000	115 000	(30 000)	(9 000)	L
Movement				(1 500)	Cr DT; Dr TE
Balance – 28/02/20X2	120 000 ⁽¹⁾	85 000	(35 000)	(10 500)	L
Rent received in advance:					
Balance – 28/02/20X1	(2 000)	0	2 000	600	A
Movement				900	Dr DT; Cr TE
Balance – 28/02/20X2	(5 000)	0	5 000	1 500	A
Interest income receivable:					
Balance – 28/02/20X1	0	0	0	0	
Movement				0	
Balance – 28/02/20X2	20 000	20 000	0	0	

(1) $115\,000 - 30\,000 = 85\,000$

Deferred tax summary	Property, plant and equipment	Rent received in advance	Income receivable	Total	
Balance – 28/02/20X1	(9 000)	600	0	(8 400)	L
Movement (<i>balancing</i>)	(1 500)	900	0	(600)	Cr DT; Dr TE
Balance – 28/02/20X2	(10 500)	1 500	0	(9 000)	L

b) Current normal tax calculation

		20X2 C	X 30%	
Profit before tax		100 000		
Permanent differences		0		
		100 000	30 000	Normal tax
Movement in temporary differences		(2 000)	600	Deferred tax
Add depreciation	145 000 – 120 000	25 000		
Less tax depreciation	Given	(30 000)		
Add rent received in advance c/ balance	Will be taxed in 20X2	5 000		
Less rent received in advance o/ balance	Was taxed in 20X1	(2 000)		
Taxable profits		98 000	29 400	Current tax

Solution 6.5 continued ...

c) Ledger accounts

Taxation				Deferred tax			
Description	C	Description	C	Description	C	Description	C
Current tax payable/ receivable ⁴	29 400	Profit and loss	30 000	Balance c/f ²	9 000	Balance b/f ¹	8 400
Deferred tax ³	600					Taxation ³	600
	30 000		30 000		9 000		9 000
						Balance b/f ²	9 000

Current tax payable/ receivable			
Description	C	Description	C
Balance c/f	39 400	Balance b/f	10 000
	39 400	Taxation ⁴	29 400
			39 400
		Balance b/f	39 400

- 1) 9 000 – 600: see workings in part (a): (opening balance of deferred tax)
- 2) 10 500 – 1 500: see workings in part (a): (closing balance of deferred tax)
- 3) 9 000 – 8 400: see workings in part (a): (deferred tax adjustment)
- 4) Current tax for 20X2

d) Disclosure

BLUE CHEESE LIMITED
EXTRACT FROM STATEMENT OF FINANCIAL POSITION
AS AT 28 FEBRUARY 20X2

	Notes	20X2 C	20X1 C
Non-current assets			
Property, plant and equipment		120 000	145 000
Current assets			
Interest receivable		20 000	0
Non-current liabilities			
Deferred tax	10	9 000	8 400
Current liabilities			
Current tax payable		39 400	10 000
Income received in advance		5 000	2 000

e) Deferred tax note disclosure

BLUE CHEESE LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X2

	20X2 C	20X1 C
10. Deferred taxation asset / (liability)		
The deferred tax balance comprises temporary differences caused by:		
• Property, plant and equipment	(10 500)	(9 000)
• Income received in advance	1 500	600
	(9 000)	(8 400)

Solution 6.5 continued ...

f) Discussion

Plant and equipment

- The carrying amount of the plant and equipment represents the amount that will be recovered in the form of economic benefits that will flow to the entity in future periods.
- The tax base of the plant and equipment is the amount that will be deductible for tax purposes against the future taxable economic benefits.
- As the carrying amount of the plant and equipment exceeds its tax base, the amount of the taxable economic benefits will exceed the amount that will be allowed as a deduction for tax purposes. This difference is a taxable temporary difference and the obligation to pay the resulting income taxes in future periods is recognised as a deferred tax liability.

Rent received in advance

- The carrying amount of the rent received in advance represents the obligation to provide services in future periods.
- The tax base of the rent received in advance is the carrying amount of the liability, less any amount of the revenue that will not be taxable in future periods. In other words, the tax base represents the portion of the future economic benefits (past cash receipt) that will be taxable in a future period.
- As the rent received in advance was not recognised as income for accounting purposes but was taxed in the current period, the tax base is zero (C5 000 – C5 000) (i.e. no portion of the income received in advance account will be taxable in the future). This gives rise to a deductible temporary difference and the tax 'pre-paid' is a deferred tax asset.

Interest income receivable

- The carrying amount of the interest income receivable represents the amount that will be recovered in the form of economic benefits that will flow to the entity in future periods.
- The tax base of interest income receivable is equal to its carrying amount if the economic benefits will not be taxable in future periods. Since all the interest income is taxed in the current year, no portion of the amount receivable will be taxed in the future: the tax base is therefore equal to its carrying amount (carrying amount: 20 000 – portion to be taxed in the future: 0).
- The tax authority taxes interest income on accrual basis and thus the interest income receivable is taxed in the current year (year of accrual). The accountant recognises income in the same year (the year of accrual). There is thus no temporary difference and no deferred tax.

Solution 6.6

a) Deferred tax calculation

Deferred tax computation	CA	TB	TD	DT	DT A/ L or DT adjustment
Property, plant and equipment					
Balance - 1/1/20X3	355 000	290 000	(65 000)	(19 500)	DTL
Depreciation/ tax depreciation	(35 000)	(25 000)	10 000	3 000	Dr DT; Cr TE
Balance - 31/12/20X3	320 000	265 000	(55 000)	(16 500)	DTL
Year-end accruals					
Balance - 1/1/20X3	(15 000)	0	15 000	4 500	DTA
- Income received in advance	(15 000)	0	15 000	4 500	
- Expenses prepaid	0	0	0	0	
Movement				900	Dr DT; Cr TE
Balance - 31/12/20X3	(18 000)	0	18 000	5 400	DTA
- Income received in advance	(28 000)	0	28 000	8 400	
- Expenses prepaid	10 000	0	(10 000)	(3 000)	
Total deferred tax balance at				C	
- 1/1/20X3				(15 000)	DTL
- 31/12/20X3				(11 100)	DTL

b) Calculation of current normal income tax

Current tax computation			
Profit before tax	300 000		
Adjust for permanent differences			
Less dividend income	(5 000)		
Taxable accounting profits	295 000	88 500	Dr TE
Adjust for movement in temporary differences	13 000	3 900	Dr DT
Add depreciation	35 000		
Less tax depreciation	(25 000)		
Add income received in advance closing balance	28 000		
Less income received in advance opening balance	(15 000)		
Less expenses prepaid closing balance	(10 000)		
Taxable profit	308 000	92 400	Cr CTP
Add: Tax on dividend income @ 10%	5 000	500	
		92 900	

Solution 6.6 continued . . .

c) Journal entries

	Debit	Credit
Tax expense	92 900	
Current tax payable		92 900
<i>Current normal income tax for 20X3</i>		
Deferred taxation	3 900	
Tax expense		3 900
<i>Deferred normal income tax adjustment for 20X3</i>		

d) Disclosure

FISH LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X3

	20X3 C	20X2 C
6. Deferred taxation asset/ (liability)		
The deferred tax balance is caused by temporary differences relating to:		
• Property, plant and equipment	(16 500)	(19 500)
• Expenses prepaid	(3 000)	0
• Income received in advance	8 400	4 500
	<u>(11 100)</u>	<u>(15 000)</u>

Solution 6.7

Part A

a) Calculating the taxable profits and current tax	20X3	20X2	20X1
	C	C	C
Profit before taxation and depreciation (given)	200 000	200 000	200 000
Depreciation:			
• First plant (20X1, 20X2 & 20X3: 200 000 x 20%)	(40 000)	(40 000)	(40 000)
• Second plant (20X2 & 20X3: 500 000 x 20%)	(100 000)	(100 000)	0
Profit before taxation	60 000	60 000	160 000
Adjust for permanent differences:	0	0	0
Taxable accounting profits	60 000	60 000	160 000
Adjust for temporary differences:			
+ depreciation	140 000	140 000	40 000
- tax depreciation: first plant (20X1, 20X2 & 20X3: 200 000 / 4 yrs)	(50 000)	(50 000)	(50 000)
- tax depreciation: second plant (20X2 & 20X3: 500 000 / 4 yrs)	(125 000)	(125 000)	0
Taxable profits	25 000	25 000	150 000
Tax rate	35%	35%	35%
Current tax	8 750	8 750	52 500

b) Calculation of deferred taxation using the income statement approach

Current tax (<i>taxable profits x 35%</i>)	8 750	8 750	52 500
Tax expense (<i>taxable accounting profits x 35%</i>)	21 000	21 000	56 000
Deferred tax charge (<i>movement in temporary differences x 35%</i>)	12 250	12 250	3 500

Summary of deferred tax effect on deferred tax in the statement of financial position (not required)

1/1/20X1	Opening balance	0	Given
20X1	Deferred tax charge (calculation b)	<u>3 500</u>	Cr DTL; Dr TE
1/1/20X2	Opening balance at 35%	3 500	Liability
20X2	Deferred tax charge (calculation b)	<u>12 250</u>	Cr DTL; Dr TE
1/1/20X3	Opening balance at 35%	15 750	Liability
20X3	Deferred tax charge (calculation b)	<u>12 250</u>	Cr DTL; Dr TE
31/12/20X3	Closing balance at 35%	<u>28 000</u>	Liability

c) Current and deferred tax journals	20X3	20X2	20X1
	Dr/ (Cr)	Dr/ (Cr)	Dr/ (Cr)
01-Jan			
Tax expense	8 750	8 750	52 500
Current tax payable (liability)	(8 750)	(8 750)	(52 500)
<i>Recording estimated current taxation owing</i>			
31-Dec			
Tax expense/ (income)	12 250	12 250	3 500
Deferred tax asset/(liability)	(12 250)	(12 250)	(3 500)
<i>Recording current year's deferred tax charge</i>			

Solution 6.7 continued ...

Part A continued ...

d) Calculation of deferred tax using the balance sheet approach

		Carrying amount	Tax base	Temporary differences	Deferred taxation
1.1.20X1	Opening balance	0	0	0	0
	First plant - cost	200 000	200 000	0	0
30.6.20X1	Second plant - cost	500 000	500 000	0	0
	Depreciation	(40 000)	(50 000)	(10 000)	(3 500)Dr TE Cr DT
31.12.20X1	Balance at 35%	660 000	650 000	(10 000)	(3 500)Liability
	Depreciation - first plant	(40 000)	(50 000)	(10 000)	(3 500)Dr TE Cr DT
	Depreciation - second plant	(100 000)	(125 000)	(25 000)	(8 750)Dr TE Cr DT
31.12.20X2	Balance at 35%	520 000	475 000	(45 000)	(15 750)Liability
	Depreciation - first plant	(40 000)	(50 000)	(10 000)	(3 500)Dr TE Cr DT
	Depreciation - second plant	(100 000)	(125 000)	(25 000)	(8 750)Dr TE Cr DT
31.12.20X3	Balance at 35%	380 000	300 000	(80 000)	(28 000)Liability

Solution 6.7 continued ...

Part B

	20X3 C	20X2 C	20X1 C
a) Calculating the taxable profits and current tax			
Profit before taxation and depreciation (given)	200 000	200 000	200 000
Depreciation:			
• First plant (20X1, 20X2 & 20X3: 200 000 x 30%)	(40 000)	(40 000)	(40 000)
• Second plant (20X2 & 20X3: 500 000 x 20%)	(100 000)	(100 000)	0
Profit before taxation	60 000	60 000	160 000
Adjust for permanent differences:	0	0	0
Taxable accounting profits	60 000	60 000	160 000
Adjust for temporary differences:			
+ depreciation	140 000	140 000	40 000
- tax depreciation (20X1: 200K/ 4 years) (20X2 & 20X3: 200K/ 4 years + 500K/ 4 years)	(175 000)	(175 000)	(50 000)
Taxable profits	25 000	25 000	150 000
Tax rate	35%	45%	40%
Current tax	8 750	11 250	60 000

b) Calculation of deferred taxation using the income statement approach

Current tax (taxable profits x 35/45/40%)	8 750	11 250	60 000
Tax expense (taxable accounting profits x 35/45/40%)	21 000	27 000	64 000
Deferred tax charge (balancing) or (temporary differences x tax rate)	12 250	15 750	4 000

Summary of deferred tax effect on deferred tax in the statement of financial position (not required)

1/1/20X1	Opening balance	0	Given
20X1	Deferred tax charge (calculation b)	4 000	Cr DT
1/1/20X2	Opening balance at 40%	4 000	Liability
	Increase in rate (4 000/ 40% x 5%)	500	Cr DT
	Opening balance restated at 45%	4 500	
20X2	Deferred tax charge (calculation b)	15 750	Cr DT
1/1/20X3	Opening balance at 45%	20 250	Liability
	Decrease in rate (20 250/ 45% x 10%)	(4 500)	Dr DT
	Opening balance restated at 35%	15 750	
20X3	Deferred tax charge (calculation b)	12 250	Cr DT
31/12/20X3	Closing balance at 35%	28 000	Liability

	20X3 Dr/ (Cr)	20X2 Dr/ (Cr)	20X1 Dr/ (Cr)
c) Current and deferred tax journals			
01-Jan Tax expense	8 750	11 250	60 000
Current tax payable (liability)	(8 750)	(11 250)	(60 000)
<i>Recording estimated current taxation owing</i>			
01-Jan Tax expense/ (income)	(4 500)	500	n/a
Deferred tax asset/(liability)	4 500	(500)	n/a
<i>Recording effect of rate change on opening balance of deferred taxation</i>			
31-Dec Tax expense/ (income)	12 250	15 750	4 000
Deferred tax asset/(liability)	(12 250)	(15 750)	(4 000)
<i>Recording current year's deferred tax charge</i>			

Solution 6.7 continued ...

Part B continued ...

d) Calculation of deferred tax using the balance sheet approach

		Carrying amount	Tax base	Temporary differences	Deferred taxation
1.1.20X1	Opening balance	0	0	0	0
	First plant - cost	200 000	200 000	0	0
30.6.20X1	Second plant	500 000	500 000	0	0
	Depreciation	(40 000)	(50 000)	(10 000)	(4 000)Dr TE Cr DT
31.12.20X1	Balance at 40%	660 000	650 000	(10 000)	(4 000)Liability
	Rate change: 40% to 45%				(500) Dr TE Cr DT
	Balance restated at 45%	660 000	650 000	(10 000)	(4 500)
	Depreciation - first plant	(40 000)	(50 000)	(10 000)	(4 500)Dr TE Cr DT
	Depreciation - second plant	(100 000)	(125 000)	(25 000)	(11 250)Dr TE Cr DT
31.12.20X2	Balance at 45%	520 000	475 000	(45 000)	(20 250)Liability
	Rate change: 45% to 35%				4 500Cr TE Dr DT
	Balance restated at 35 %			(45 000)	(15 750)
	Depreciation - first plant	(40 000)	(50 000)	(10 000)	(3 500)Dr TE Cr DT
	Depreciation - second plant	(100 000)	(125 000)	(25 000)	(8 750)Dr TE Cr DT
31.12.20X3	Balance at 35%	380 000	300 000	(80 000)	(28 000)Liability

Solution 6.8

Part A

a) Statement of comprehensive income disclosure

HOBBIT LIMITED EXTRACT FROM STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X1			
		Note	C
Profit before tax	(497 000 – 5 000 + 6 000 – 10 000 + 20 000)		508 000
Income tax expense	(147 300 – 1 200)	3	146 100
Profit for the period			361 900
Other comprehensive income			-
Total comprehensive income			361 900

b) Statement of financial position disclosure

HOBBIT LIMITED EXTRACT FROM STATEMENT OF FINANCIAL POSITION AT 31 DECEMBER 20X1			
		20X1	20X0
<i>EQUITY AND LIABILITIES</i>	<i>Note</i>	<i>C</i>	<i>C</i>
Non-current liabilities			
Deferred taxation	10	10 800	12 000

c) Note disclosure

HOBBIT LIMITED EXTRACT FROM NOTES TO THE FINANCIAL STATEMENTS AT 31 DECEMBER 20X1			
3. Taxation		20X1	
Normal Tax		C	
- Current	W1	147 300	
- Deferred		(1 200)	
Income tax expense		146 100	
<i>Tax rate reconciliation</i>		%	C
Tax effects of:			
• Profit before tax / Applicable rate	508 000 x 30%	30.0	152 400
• Income not subject to tax	30 000 x 30%	(1.8)	(9 000)
• Expenses disallowed for tax	9 000 x 30%	0.5	2 700
Tax expense / effective rate	146 100 / 508 000	28.7	146 100

The effective tax rate is lower than the applicable tax rate due to:

- Exempt income.
- Disallowed expense.

10. Deferred taxation asset/ (liability)			
		20X1	20X0
The deferred tax balance is caused by temporary differences relating to:		C	C
- Plant	W3	(10 500)	(12 000)
- Prepaid expenses	W3	(1 800)	0
- Income received in advance	W3	1 500	0
		(10 800)	(12 000)

Solution 6.8 continued ...

Part A continued ...

Workings

1. Normal tax computation	C	X 0.30	
Profit before tax	508 000		
Permanent differences:			
- Dividend income (not taxable)	(30 000)		
+ Fines (not deductible)	9 000		
Taxable accounting profits	487 000	146 100	Total tax expense
Temporary differences:	4 000	1 200	Cr TE Dr DT
+ Rent received in advance closing balance	5 000		
- Rates prepaid closing balance	(6 000)		
+ Depreciation (155 000 * - 120 000)	35 000		
- Tax depreciation (115 000 - 85 000)	(30 000)		
Taxable income	491 000	147 300	Dr TE Cr CTP

* where CA: 155 000 = DTL: 12 000 / 30% + TB: 115 000

3. Calculation of deferred taxation (balance sheet approach)	CA	TB	TD	DT @ 30%	
Property, plant & equipment:					
Balance – 1/1/20X1	155 000	115 000	(40 000)	(12 000)	Liability
Movement (balancing)				1 500	Dr DT Cr TE
Balance – 31/12/20X1	120 000	85 000	(35 000)	(10 500)	Liability
Rent received in advance:					
Balance – 1/1/20X1	0	0	0	0	
Movement (balancing)				1 500	Dr DT Cr TE
Balance – 31/12/20X1	(5 000)	0	5 000	1 500	Asset
Prepaid rates expense:					
Balance – 1/1/20X1	0	0	0	0	
Movement (balancing)				(1 800)	Dr TE Cr DT
Balance – 31/12/20X1	6 000	0	(6 000)	(1 800)	Liability
Advertising payable:					
Balance – 1/1/20X1	0	0	0	0	
Movement (balancing)				0	
Balance – 31/12/20X1	(10 000)	(10 000)	0	0	
Interest income receivable:					
Balance – 1/1/20X1	0	0	0	0	
Movement (balancing)				0	
Balance – 31/12/20X1	20 000	20 000	0	0	

Solution 6.8

Part B

a) Statement of comprehensive income disclosure

HOBBIT LIMITED			
EXTRACT FROM STATEMENT OF COMPREHENSIVE INCOME			
FOR THE YEAR ENDED 31 DECEMBER 20X1			
	Note	20X1 C	
Profit before tax	(497 000 – 5 000 + 6 000 – 10 000 + 20 000)	508 000	
Taxation	3	(143 100)	
Profit for the period		364 900	
Other comprehensive income		-	
Total comprehensive income		364 900	

b) Statement of financial position disclosure

HOBBIT LIMITED			
EXTRACT FROM STATEMENT OF FINANCIAL POSITION			
AS AT 31 DECEMBER 20X1			
<i>EQUITY AND LIABILITIES</i>	Note	20X1 C	20X0 C
Non-current liabilities			
Deferred taxation	10	10 800	12 000

c) Note disclosure

HOBBIT LIMITED			
EXTRACT FROM NOTES TO THE FINANCIAL STATEMENTS			
FOR THE YEAR ENDED 31 DECEMBER 20X1			
3. Taxation		20X1 C	
Normal tax			
- Current	W1	144 300	
- Deferred		(1 200)	
- current year temporary differences	W3.4	1 800	
- rate change	W3.4	(3 000)	
Income tax expense		143 100	
Tax rate reconciliation	%	C	
Tax effects of:			
• Profit before tax / Applicable rate	508 000 x 30%	30.0	152 400
• Income not subject to tax	30 000 x 30%	(1.8)	(9 000)
• Expenses disallowed for tax	9 000 x 30%	0.5	2 700
• Rate change	Above	(0.6)	(3 000)
Tax expense / effective rate	143 100/ 508 000	28.1	143 100
10. Deferred taxation asset/ (liability)		20X1 C	20X0 C
The deferred tax balance is caused by temporary differences relating to:			
- Plant	W3.1	(10 500)	(12 000)
- Income received in advance	W3.2	1 500	0
- Prepaid expenses	W3.3	(1 800)	0
		(10 800)	(12 000)

Solution 6.8 continued ...

Part B continued ...

Workings

W1. Normal tax computation		C	X 0,30	
Profit before tax	<i>Per SOCIE</i>	508 000		
Permanent differences:				
- Dividend income (not taxable)	<i>Given</i>	(30 000)		
+ Fines (not deductible)	<i>Given</i>	9 000		
Taxable accounting profits		487 000	146 100	Tax expense
Temporary differences:		(6 000)	(1 800)	Dr TE Cr DT
Add rent received in advance:		5 000		
c/bal				
Less rates prepaid: c/bal		(6 000)		
Add depreciation	<i>(145 000* – 120 000)</i>	25 000		
Less tax depreciation	<i>(115 000 – 85 000)</i>	(30 000)		
Taxable income		481 000	144 300	Dr TE Cr CTP

* where CA: 145 000 = DTL: 12 000 / 40% + TB: 115 000

W3. Calculation of deferred taxation (balance sheet approach)

	CA	TB	TD	DT	
W3.1 Property, plant & equipment:					
Balance – 1/1/20X1	145 000 (2)	115 000	(30 000) (1)	(12 000)	Liability @ 40%
Rate change (decrease)				3 000	Dr DT Cr TE
Balance – 1/1/20X1 restated				(9 000)	Liability @ 30%
Movement (balancing)				(1 500)	Cr DT Dr TE
Balance – 31/12/20X1	120 000	85 000	(35 000)	(10 500)	Liability @ 30%
W3.2 Rent received in advance:					
Balance – 1/1/20X1	0	0	0	0	
Movement (balancing)				1 500	Dr DT Cr TE
Balance – 31/12/20X1	(5 000)	0	5 000	1 500	Asset @30%
W3.3 Prepaid rates expense:					
Balance – 1/1/20X1	0	0	0	0	
Movement (balancing)				(1 800)	Cr DT Dr TE
Balance – 31/12/20X1	6 000	0	(6 000)	(1 800)	Liability @ 30%
W3.4 Summary DT:					
	PPE	IRIA	EPP	Total	
Balance – 1/1/20X1	(12 000)	0	0	(12 000)	L
Movement: rate change		<i>12 000 / 40% x 10%:</i>		3 000	Dr DT Cr TE
Movement: other		<i>10 800 – (12 000 – 3000):</i>		(1 800)	Cr DT Dr TE
Balance – 31/12/20x1	(10 500)	1 500	(1 800)	(10 800)	L

(1) $12\,000 / 40\% = 30\,000$

(2) $115\,000 + 30\,000 = 145\,000$ (Add the temporary differences since the DT balance was a liability)

Solution 6.9

Part A

a) Calculation of deferred taxation using the balance sheet approach

	Carrying amount	Tax base	Temporary differences	Deferred taxation
20X2 Opening balance	0	0	0	0
Plant - cost	500 000	500 000	0	0
Depreciation 20X2	(100 000)	(250 000)	(150 000)	(60 000)Cr DT Dr TE
20X2 Closing balance	400 000	250 000	(150 000)	(60 000)Liability
Depreciation 20X3	(100 000)	(150 000)	(50 000)	(20 000)Cr DT Dr TE
20X3 Closing balance	300 000	100 000	(200 000)	(80 000)Liability
Depreciation 20X4	(100 000)	(100 000)	0	0
20X4 Closing balance	200 000	0	(200 000)	(80 000)Liability
Depreciation 20X5	(100 000)	0	100 000	40 000Dr DT Cr TE
20X5 Closing balance	100 000	0	(100 000)	(40 000)Liability
Depreciation 20X6	(100 000)	0	100 000	40 000Dr DT Cr TE
20X6 Closing balance	0	0	0	0 Liability

b) Calculation of taxable profits/ current tax

	20X5	20X4
Profit before tax	150 000	120 000
<i>Permanent differences</i>	0	0
Taxable accounting profits	150 000	120 000
<i>Temporary differences:</i>		
+ depreciation	100 000	100 000
- tax depreciation	0	100 000
Taxable profit	250 000	120 000
Tax rate	40%	40%
Current tax	100 000	48 000

c) Journal entries

	20X6 Dr/ (Cr)	20X5 Dr/ (Cr)	20X4 Dr/ (Cr)	20X3 Dr/ (Cr)	20X2 Dr/ (Cr)
Taxation expense		100 000	48 000		
Current tax payable (liability)	not required	(100 000)	(48 000)	not required	not required
<u>Current normal tax estimated</u>					
Taxation expense	(40 000)	(40 000)	N/A	20 000	60 000
Deferred taxation	40 000	40 000	N/A	(20 000)	(60 000)
<u>Deferred tax adjustment</u>					

Solution 6.9 continued ...

Part B

a) Calculation of deferred taxation using the balance sheet approach

	Carrying amount	Tax base	Temporary differences	Deferred taxation
20X2 Opening balance	0	0	0	0
Plant purchased	500 000	500 000	0	0
Depreciation 20X2	(100 000)	(250 000)	(150 000)	(60 000)Cr DT Dr TE
20X2 Closing balance	400 000	250 000	(150 000)	(60 000)Liability
Depreciation 20X3	(100 000)	(150 000)	(50 000)	(20 000)Cr DT Dr TE
20X3 Closing balance	300 000	100 000	(200 000)	(80 000)Liability
Depreciation 20X4	(100 000)	(100 000)	0	0
20X4 Closing balance	200 000	0	(200 000)	(80 000)Liability
Depreciation 20X5	(100 000)	(0)	100 000	80 000Dr DT Cr TE
CA of asset sold	(100 000)	(0)	100 000	
20X5 Closing balance	0	0	0	0

b) Calculation of taxable profits and current normal tax

	20X5	20X4
Profit before tax	150 000	120 000
Adjust for permanent differences	0	0
Taxable accounting profits	150 000	120 000
+ depreciation	100 000	100 000
- tax depreciation	0	(100 000)
- profit on sale (proceeds: 100 000 – CA: 100 000)	0	n/a
+profit on sale (tax)	100 000	n/a
Taxable profits	350 000	120 000
Tax rate	40%	40%
Current tax	140 000	48 000

c) Journals

	20X5 Dr/ (Cr)	20X4 Dr/ (Cr)	20X3 Dr/ (Cr)	20X2 Dr/ (Cr)
31 Dec Taxation expense	140 000	48 000	Not required	Not required
Current tax payable (liability)	(140 000)	(48 000)		
<i>Recording current tax</i>				
31 Dec Taxation expense	(80 000)	n/a	20 000	60 000
Deferred tax asset/(liability)	80 000	n/a	(20 000)	(60 000)
<i>Recording deferred tax</i>				

Solution 6.9 continued

Part B continued ...

d) Disclosure

MAKE LIMITED**EXTRACT FROM STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X5**

	Note	20X5 C	20X4 C
Profit before taxation		150 000	120 000
Income tax expense	3	(60 000)	(48 000)
Profit for the period		90 000	72 000
<i>Other comprehensive income</i>		-	-
Total comprehensive income		90 000	72 000

MAKE LIMITED**EXTRACT FROM STATEMENT OF FINANCIAL POSITION
AT 31 DECEMBER 20X5**

	20X5 C	20X4 C
ASSETS		
Non-current assets		
Property, plant and equipment	0	200 000
EQUITY AND LIABILITIES		
Non-current liabilities		
Deferred taxation	0	80 000

MAKE LIMITED**EXTRACT FROM NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X5**

	20X5 C	20X4 C
1. Accounting Policies		
1.1 Deferred taxation		
Deferred tax is provided using the balance sheet liability method, on all the temporary differences at the balance sheet date between the tax base of assets and liabilities and their carrying amounts for financial reporting purposes.		
Deferred tax asset are recognized for all deductible temporary differences, carry forward of unused tax losses, to the extent that is probable that future taxable profit will be available against which the deductible temporary difference, unused tax losses and tax credits can be utilized.		
Carrying amount of deferred tax asset is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that the related tax benefit will be realized. Deferred tax is calculated at the rates that are expected to apply to the period when differences reverse based on the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.		
3. Taxation		
Normal tax		
Current tax	140 000	48 000

Deferred tax	(80 000)	0
Income tax expense	60 000	48 000

Authors' comment:

*There is no rate reconciliation since there are no permanent differences or any other reconciling items.
There is no permanent difference on the sale since the proceeds did not exceed the original cost.*

3. Deferred tax liability

The deferred tax balance comprises temporary differences relating to:

• Property, plant and equipment	0	80 000
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Solution 6.10

a)

ROOT LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X6

		20X6 C
7. Tax expense	<i>Calculations</i>	
Current		
- current year	<i>See working 1</i>	80 600
- overprovision for the prior year	<i>48 000 – 52 000</i>	(4 000)
Deferred	<i>16 500 L + 900 A</i>	(17 400)
		<u>59 200</u>
<i>Rate reconciliation</i>		
Standard/ applicable tax rate		30%
Tax effect of:		
Profit before tax	<i>344 000 x 30%</i>	103 200
Dividend income taxed at lower rate	<i>200 000 x 30%</i>	(40 000)
Over-provision of current tax	<i>Per above</i>	(4 000)
		<u>59 200</u>
Effective tax rate	<i>59 200/ 344 000</i>	17.2%

b)

ROOT LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER

		20X6 C
Profit before tax		344 000
Tax	7.	<u>59 200</u>
Profit for the year		284 800
<i>Other comprehensive income</i>		-
Total comprehensive income		<u>284 800</u>

Solution 6.10 continued ...

Workings

W1: Calculation of current normal tax		
Profit before tax		344 000
Less accounting profit on sale		(100 000)
Add taxable profit on sale		150 000
Less dividend income (to be taxed @ 10%)		(200 000)
Add depreciation		150 000
Less tax depreciation		(270 000)
Add income received in advance closing balance		130 000
Less income received in advance opening balance		(10 000)
Less expenses prepaid closing balance		(7 000)
Add expenses prepaid opening balance		15 000
Taxable profits		<u>202 000</u>
Current normal tax	(202 000 x 30%)	60 600
Add: Tax on dividend @ 10%	(200 000 x 10%)	20 000
		<u>80 600</u>

Solution 6.11

a)

	Debit	Credit
Current tax payable: NT	4 000	
Tax expense (current normal)		4 000
<i>Over-provision of current tax expense in 20X5: given</i>		
Tax expense (normal tax)	57 600	
Current tax payable: NT		57 600
<i>Current normal tax payable: given</i>		
Deferred tax: NT	17 400	
Tax expense (normal tax)		17 400
<i>Deferred normal tax adjustment: W1</i>		

b)

TREE LIMITED
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X6

		20X6	20X5
		C	C
Non-current liabilities			
Deferred tax	<i>Given</i>	0	16 500
Current liabilities			
Income received in advance	<i>Given</i>	123 000	0
Current tax payable: NT	<i>O/bal: 6 000 – payments: 30 000 + current NT for 20X6: 57 600 – overprovision in 20X5: 4 000</i>	29 600	6 000
Non-current assets			
Property, plant and equipment	<i>Given</i>	150 000	1 000 000
Deferred tax	<i>W1</i>	900	0
Current assets			
Expenses prepaid	<i>Given</i>	0	5 000

TREE LIMITED
NOTES TO THE FINANCIAL STATEMENTS
AT 31 DECEMBER 20X6

8. Deferred tax asset/ (liability) note		20X6	20X5
		C	C
The deferred tax balance is caused by temporary differences relating to:			
Property, plant and equipment	<i>W1</i>	(36 000)	(15 000)
Income received in advance	<i>W1</i>	36 900	0
Expenses prepaid	<i>W1</i>	0	(1 500)
		900	(16 500)

Solution 6.11 continued ...

Workings

W1: Deferred tax calculation

	CA	TB	TD	DT	
PPE					
O/ balance ^{Note 1}	1 000 000	950 000	(50 000)	(15 000)	L (16 500 – 1 500)
Movement				(21 000)	Cr DT Dr TE
C/ balance	150 000	30 000	(120 000)	(36 000)	DTL
IRIA					
O/ balance	0	0	0	0	A
Movement				36 900	Dr DT; Cr TE
C/ balance	(123 000)	0	123 000	36 900	DTA
EPP					
O/ balance	5 000	0	(5 000)	(1 500)	L
Movement				1 500	Dr DT; Cr TE
C/ balance	0	0	0	0	
Total					
O/ balance	<i>Given; 15 000L + 0 + 1 500L</i>			(16 500)	DTL
Movement	<i>21 000L - 36 900A – 1500A</i>			17 400	Dr DT Cr TE
C/ balance	<i>36 000L + 36 900A + 0</i>			900	DTA

Note 1 The opening balances for TB, TD and DT are all balancing figures, calculated as follows:

- 1st calc the o/bal of DT caused by PPE: $16\,500 - 1\,500 - 0 = 15\,000$ (credit)
- 2nd calc the related TDs: $15\,000 / 30\% = 50\,000$ (credit)
- 3rd calc the related TB of PPE using the following equation:

$$\text{TB} - \text{CA} = \text{TD}; \text{ therefore:}$$

$$\text{TB} - 1\,000\,000 = -50\,000$$

$$\text{TB} = 1\,000\,000 - 50\,000 = 950\,000$$

Solution 6.12

(a)

BEAN LIMITED
STATEMENT OF FINANCIAL POSITION
AT 30 JUNE 20X7

		20X7	20X6
		C	C
Non-current liabilities			
Deferred tax	W1 [X7: 52 200 (L) – 5 800 (A)]	46 400	17 400

(b)

BEAN LIMITED
STATEMENT OF FINANCIAL POSITION
AT 30 JUNE 20X7

		20X7	20X6
		C	C
Current liabilities			
Current tax payable	W4	19 300	5 900

(Not required for answer)

BEAN LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 JUNE 20X7

		20X7	20X6
		R	R
Profit before taxation		700 000	520 000
Income tax expense	(X6: 151 900 – 8 700 – 2 900) (X7: 168 300 + 29 000 + 14 200)	(207 500)	(140 300)
Profit for the period		492 500	379 700
<i>Other comprehensive income</i>		-	-
Total comprehensive income		492 500	379 700

Solution 6.12 continued...

(c)

BEAN LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 JUNE 20X7
1 Accounting policies**Statement of compliance**

These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 1984, provisions of and directives issued by under the Companies Ordinance, 1984. In case the requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

Basis of preparation

The financial statements have been prepared in the historical cost basis except for the revaluation of certain non-current assets. These policies are consistent in all material respects with these applied in the previous years.

Deferred tax

Deferred tax is provided using the balance sheet liability method, on all the temporary differences at the balance sheet date between the tax base of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred tax asset are recognized for all deductible temporary differences, carry forward of unused tax losses, to the extent that is probable that future taxable profit will be available against which the deductible temporary difference, unused tax losses and tax credits can be utilized.

Carrying amount of deferred tax asset is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that the related tax benefit will be realized. Deferred tax is calculated at the rates that are expected to apply to the period when differences reverse based on the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.

Equipment

Plant and equipment is stated at cost less accumulated depreciation and accumulated impairment losses. Depreciation is charged so as to write off the cost of assets over their estimated useful lives using the straight line method. The estimated useful lives, depreciation methods and residual values are reviewed at each year end, with the effect of any change in estimate accounted for on a prospective basis.

		20X7 C	20X6 C
4 Taxation			
Normal tax	W2	168 300	151 900
Deferred tax	W1	29 000	(8 700)
Under / (over) provision	W3	10 200	(2 900)
Taxation expense		<u>207 500</u>	<u>140 300</u>
<i>Tax rate reconciliation</i>			
Tax expense on profit	(X7: 700 000 X 0.29) (X6: 520 000 X 0.29)	203 000	150 800
Dividend income exempt	(X7: 30 000 X 0.19) (X6: 40 000 X 0.19)	(5 700)	(7 600)
Under / (over) provision		10 200	(2 900)
		<u>207 500</u>	<u>140 300</u>
Effective tax rate	(X7: 207 500 / 700 000) (X6: 140 300 / 520 000)	29.64%	29.98%

Solution 6.12 continued...

(d)

BEAN LIMITED		
STATEMENT OF CASH FLOWS		
FOR THE YEAR ENDED 30 SEPTEMBER 20X7		
		C
Cash flows from operating activities		
Cash receipts from customers	(184 000 + 3 500 000 – 14 000 – 196 000)	3 474 000
Cash paid to suppliers and employees	W5	<u>(2 929 000)</u>
<i>Cash generated from operations</i>		545 000
Investment income received		30 000
Taxation paid	W4 (20 100 + 146 000)	<u>(166 100)</u>
<i>Net cash inflow from operating activities</i>		408 900

Solution 6.12 continued...

Workings

W1. Deferred tax computation

		CA	TB	TD	DT X29%	
Equipment						
01/07/X4	Cost	900 000	900 000			
30/06/X5	Depreciation / tax allowance (900 000 X 0.10) / (900 000 X 0.20)	(90 000)	(180 000)			Dr TE Cr DT 26 100
		810 000	720 000	90 000	26 100	L
30/06/X6	Depreciation / tax allowance (900 000 X 0.10) / (900 000 X 0.20)	(90 000)	(180 000)			Dr DT Cr TE 8 700
		720 000	540 000			
	Impairment	(120 000)	-			
		600 000	540 000	60 000	17 400	L
30/10/X6	Depreciation / tax allowance (600 000 / 60m X 4m) / (900 000 X 0.20)	(40 000)	(180 000)			Dr TE Cr DT 40 600
		560 000	360 000	200 000	58 000	L
	Loss on sale / Recoupment	(60 000)	140 000	(200 000)	(58 000)	Dr DT Cr TE 58 000
30/06/X7		500 000	500 000	-	-	
Expenses paid in advance						
30/06/X6	Rent paid in advance	0	0	0	0	Dr TE Cr DT 52 200
30/06/X7	Rent paid in advance (270 000 X 4/6)	180 000	0	180 000	52 200	L
Income received in advance						
30/06/X6	Rent received in advance	0	0	0	0	Dr DT Cr TE 5 800
30/06/X7	Rent received in advance	20 000	0	20 000	5 800	A

Solution 6.12 continued...

W2 Current tax computation

	20X7			20X6		
Profit before tax	700 000			520 000		
Less:						
Dividend income (to be taxed @ 10%)	(30 000)			(40 000)		
Depreciation	40 000			90 000		
Impairment				120 000		
Tax allowance	(180 000)			(180 000)		
Loss on sale	60 000					
Tax gain on sale	140 000					
Rent prepaid	(180 000)					
Rent received in advance	20 000					
	570 000	165 300	Cr CTP	510 000	147 900	Cr CTP
Dividend income	30 000	3 000		40 000	4 000	
		<u>168 300</u>			<u>151 900</u>	

W3 Under / over provision and payment with return

20X6 year

20X5 normal assessed tax	132 200	132 200
20X5 normal tax provided / provisional payments	135 100	130 000
Overprovision / Balance owing on assessment	<u>2 900</u>	<u>2 200</u>

20X7 year

20X6 normal assessed tax	162 100	162 100
20X6 normal tax provided / provisional payments	151 900	142 000
Underprovision / Balance owing on assessment	<u>10 200</u>	<u>20 100</u>

W4 Current tax payable

Current tax payable			
<i>Description</i>	<i>C</i>	<i>Description</i>	<i>C</i>
Tax expense (o/p 20X5)	2 900	Balance (01/07/X5)	5 100
Bank (Balance owing 20X5)	2 200	Tax expense (20X6)	151 900
Bank (p/p 20X6)	142 000		
Balance	9 900		
	<u>157 000</u>		<u>157 000</u>
Bank (Balance owing 20X6)	20 100	Balance (30/06/X6)	9 900
Bank (p/p 20X7)	146 000	Tax expense (u/p 20X6)	10 200
Balance	22 300	Tax expense (20X7)	168 300
	<u>185 400</u>		<u>188 400</u>
		Balance (30/06/X7)	22 300

Solution 6.12 continued...

W5. Cash paid to suppliers and employees

Sales	3 500 000
Profit before tax	700 000
COS + net expenses	<u>2 800 000</u>
<i>Elimination of items shown separately on face of statement of cash flows</i>	
Dividends received	30 000
<i>Elimination of non-cash items</i>	
Bad debts	(14 000)
Depreciation	(40 000)
Loss on sale of equipment	(60 000)
<i>Elimination of the effects of accrual accounting</i>	
Increase in inventory	125 000
Increase in accounts payable	(72 000)
Increase in expenses pre-paid	180 000
Increase in income received in advance	<u>(20 000)</u>
	<u>2 929 000</u>

Solution 6.13**a) Journals**

		Debit	Credit
Tax expense	W1	742 350	
Current tax payable			742 350
<i>Current normal tax estimated</i>			
Tax expense	W2.4	1 650	
Deferred tax			1 650
<i>Deferred normal tax</i>			
Current tax payable	Given	5 000	
Tax expense			5 000
<i>Overprovision of 20X1 normal tax</i>			

b) Note disclosure

UNIVERSAL FITNESS LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X2

			C
4. Taxation	W1		
Normal tax			
Current tax			
• Current tax for 20X7	W1		742 350
• Overprovision of current tax in 20X6	Given		(5 000)
Deferred tax	W2.6		1 650
Tax expense			<u>739 000</u>
<i>Tax rate reconciliation</i>		%	
Tax on profit at applicable rate	W1: 2 350 000 X 0.30	30	705 000
Non-deductible donations	20 000 X 0.30	0.26	6 000
Dividend income	15 000 X 0.20	(0.13)	(4 500)
Exemption on administration building	120 000 X 0.30	1.53	36 000
Overprovision of current tax in 20X6	Per above	(0.21)	(5 000)
Tax expense		31.45	<u>739 000</u>

The effective tax rate is higher than the applicable tax rate due to:

- Non-deductible expenses; and

Comment: the rate reconciliation need not be provided in percentages and currency. You may choose which method to present. My suggestion would be as a currency as this is less time-consuming.

10 Deferred tax asset or (liability)

Equipment	W2.3	(79 800)
Unearned income	W2.4	19 125
Prepaid expenses	W2.5	<u>(7 500)</u>
	W2.6	<u>(68 175)</u>

Solution 6.13 continued ...

Workings

W1 Current normal tax computation			x30%
Profit before tax	(2 410 000 + 15 000 – 75 000)	2 350 000	705 000
+ Donations		20 000	
+ Depreciation on administration building		120 000	
- Dividends received: to be taxed @ 10%		(15 000)	
+ Depreciation on equipment	Given	170 000	
- Tax allowance	Given	(188 000)	
- Unearned income: o/ balance	Recognised as income in 20X7, but already taxed in 20X6	(26 250)	
+ Unearned income: c/ balance	Taxable in 20X7, to be recognised as income in 20X8	63 750	
- Prepaid expenses: c/ balance	Deductible in 20X7, to be recognised as expense in 20X8	(25 000)	
Taxable income		2 469 500	740 850 Cr CTP
Dividend received to be taxed @ 10%		15 000	1 500
			742 350

W2 Deferred normal tax computation					
	CA	TB	TD	DT	
W2.1 Land					
31/12/X6	2 470 000	0	(2 470 000)	0	Exempt
	0	0	0	0	
31/12/X7	2 470 000	0	(2 470 000)	0	Exempt
W2.2 Admin buildings					
31/12/X6	1 720 000	0	(1 720 000)	0	Exempt
	(120 000)	0	120 000	0	Exempt
31/12/X7	1 600 000	0	(1 600 000)	0	Exempt
W2.3 Equipment					
31/12/X6	(1) 800 000	(2) 552 000	(248 000)	(74 400)	Liability
	(3) (170 000)	(3) (188 000)	(18 000)	(5 400)	Cr DT
31/12/X7	(3) 630 000	(4) 364 000	(266 000)	(79 800)	Liability
W2.4 Unearned income					
31/12/X6	(26 250)	0	26 250	7 875	Asset
				11 250	Dr DT
31/12/X7	(63 750)	0	63 750	19 125	Asset
W2.5 Prepaid expenses					
31/12/X6	0	0	0	0	
				(7 500)	Cr DT
31/12/X7	25 000	0	(25 000)	(7 500)	Liability
W2.6 Summary of deferred tax					C
Proof of deferred tax at 31/12/X6 as per question	Given or 74 400 – 7 875			(66 525)	Liability
Deferred tax at 31/12/X7	79 800 – 19 125 + 7 500			(68 175)	Liability
Movement: increase in deferred tax liability	Dr TE; Cr DT			(1 650)	Cr DT

(1) 630 000 + 170 000 = 800 000

- (2) 800 000 – 248 000 (minus because temporary differences were taxable)
- (3) Given
- (4) Given

Solution 6.14

a)

Journal entries

		Debit	Credit
Rent received in advance		10 000	
Rent income			10 000
<i>Reversal of opening balance of rent received in advance</i>			
Rent income		8 000	
Rent received in advance			8 000
<i>Creation of closing balance of rent received in advance</i>			
Expense account		15 000	
Expense prepaid			15 000
<i>Reversal of opening balance of expense prepaid</i>			
Expense prepaid		7 000	
Expense account			7 000
<i>Creation of closing balance of expense prepaid</i>			
Current tax payable: normal tax	Assessed: 48 000 – Expensed:	4 000	
Tax expense (current normal)	52 000 = 4 000 overprovided		4 000
<i>Over-provision of current tax expense in 20X5</i>			
Tax expense (normal tax)	W1	60 000	
Current tax payable: NT			60 000
<i>Current normal tax payable</i>			
Tax expense (normal tax)	42 000 (A) – 22 800 (A)	19 200	
Deferred tax: NT			19 200
<i>Deferred normal tax adjustment</i>			

Solution 6.14 continued ...

a) continued ...

**W1: Current normal
tax**

	C	Tax X 30%
Profit before tax	494 000	
Less: Dividend income	(200 000)	
<i>Permanent differences</i>	(64 000)	
Add: Accounting gain on sale of vehicle	(100 000)	
Tax profit on sale of vehicle	150 000	
Accounting depreciation	150 000	
Less: Tax allowance	(270 000)	
Income received in advance		
Opening balance	(10 000)	
Closing balance	8 000	
Prepaid expenses		
Opening balance	15 000	
Closing balance	(7 000)	
Taxable income	230 000	69 000

Solution 6.14 continued ...

b)

RAINY LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X6

		20X6 C
Revenue	<i>Sales 800 000</i>	800 000
Other income	<i>Dividend income 200 000 + Rent 50 000 + PoS 100 000 + Accruals 10 000 – 8 000</i>	352 000
Cost of sales		(300 000)
Distribution costs	<i>150 000 + (80 000 – 7 000 + 15 000) x 30%</i>	(176 400)
Administration costs	<i>(80 000 – 7 000 + 15 000) x 20%</i>	(17 600)
Other costs	<i>(80 000 – 7 000 + 15 000) x 50%</i>	(44 000)
Finance costs	<i>Given</i>	(120 000)
Profit before tax		494 000
Tax	7.	(77 700)
Profit for the year		416 300
<i>Other comprehensive income</i>		-
Total comprehensive income		416 300

c)

RAINY LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X6
7. Tax expense note

		20X6 C
Normal tax		
Current		
- current year	<i>W1 (in part a)</i>	69 000
- overprovision for the prior year	<i>52 000 – 48 000; or per the journal</i>	(4 000)
Deferred	<i>42 000A – 22 800A; or per the journal</i>	19 200
		84 200

Rate reconciliation

Standard/ applicable tax rate		30%
Tax effect of:		
Profit before tax	<i>494 000 x 30%</i>	148 200
Exempt dividend income	<i>200 000 x 30%</i>	(60 000)
Over-provision of current tax	<i>Per above</i>	(4 000)
		84 200
Effective tax rate	<i>84 200 / 494 000</i>	17.04%

Solution 6.15

W1. Calculation of current normal tax

	20X3 C	20X2 C	20X1 C
Profit before tax	30 000	20 000	14 000
Dividend Income	(10 000)	(10 000)	(10 000)
Temporary differences (PPE)	(8 000)	(4 000)	(14 000)
Assessed tax loss brought forward	(4 000)	(10 000)	0
Taxable profit/ (tax loss)	8 000	(4 000)	(10 000)
Current normal tax at 30%	2 400	0	0
Add: Tax on dividend income @ 10% (10 000 x 10%)	1 000	1 000	1 000
	3 400	1 000	1 000

W2. Calculation of deferred normal tax

	Carrying amount (SOFP) (a)	Tax base (IAS 12) (b)	Temporary difference (b) – (a) (c)	Deferred tax at 30% (c) x 30% (d)	Deferred tax balance/ adjustment
W2.1 PPE					
Balance: 1 Jan 20X1	70 000	90 000	20 000	6 000	Asset
Movement	(6 000)	(20 000)	(14 000)	(4 200)	Cr DT Dr TE
Balance: 31 Dec 20X1	64 000	70 000	6 000	1 800	Asset
Movement	(16 000)	(20 000)	(4 000)	(1 200)	Cr DT Dr TE
Balance: 31 Dec 20X2	48 000	50 000	2 000	600	Asset
Movement	(12 000)	(20 000)	(8 000)	(2 400)	Cr DT Dr TE
Balance: 31 Dec 20X3	36 000	30 000	(6 000)	(1 800)	Liability

W2.2 Tax loss

Balance: 1 Jan 20X1	0	0	0	0	
Movement				3 000	Dr. DT Cr. TE
Balance: 31 Dec 20X1	0	10 000	10 000	3 000	Asset
Movement	0			(1 800)	Cr. DT Dr. TE
Balance: 31 Dec 20X2	0	4 000	4 000	1 200	Asset
Movement	0			(1 200)	Cr. DT Dr. TE
Balance: 31 Dec 20X3	0	0	0	0	

W2.3 Summary of deferred tax on:

	PPE	Tax loss	Total	
Balance: 1 January 20X1	6 000	0	6 000	
Movement	(4 200)	3 000	(1 200)	Cr. DT Dr. TE
Balance: 31 December 20X1	1 800	3 000	4 800	Asset
Movement	(1 200)	(1 800)	(3 000)	Cr. DT Dr. TE
Balance: 31 December 20X2	600	1 200	1 800	Asset
Movement	(2 400)	(1 200)	(3 600)	Cr. DT Dr. TE
Balance: 31 December 20X3	(1 800)	0	(1 800)	Liability

Solution 6.15 continued ...

Journals 20X1

	Debit	Credit
Tax expense W2.1	4 200	
Deferred tax: NT – PPE (L)		4 200
<i>Deferred tax adjustment due to temporary differences PPE (20X1)</i>		
Deferred tax: NT – loss (A) W2.2	3 000	
Tax expense: NT		3 000
<i>Deferred tax adjustment due to tax loss created (20X1)</i>		
Tax Expense	1 000	
Current tax payable		1 000
<i>Current normal tax payable 20X1</i>		

Journals 20X2

Tax expense: NT W2.1	1 200	
Deferred tax: NT – PPE (L)		1 200
<i>Deferred tax adjustment due to temporary differences: PPE (20X2)</i>		
Tax expense: NT W2.2	1 800	
Deferred tax: NT – loss (A)		1 800
<i>Deferred tax adjustment due to tax loss partially utilised (20X2)</i>		
Tax Expense	1 000	
Current tax payable		1 000
<i>Current normal tax payable 20X2</i>		

Journals 20X3

Tax expense: NT W2.2	2 400	
Deferred tax: NT – PPE (L)		2 400
<i>Deferred tax adjustment due to temporary differences: PPE (20X3)</i>		
Tax expense: NT W2.2	1 200	
Deferred tax: NT – loss (A)		1 200
<i>Deferred tax adjustment: remaining tax loss utilised (20X3)</i>		
Tax expense: NT W1	3 400	
Current tax payable: NT		3 400
<i>Current normal tax payable 20X3</i>		

Liquid limited

Notes to the financial statements

For the year ended 31 December 20X3

	20X3 C	20X2 C	20X1 C
3. Taxation expense			
Normal taxation expense			
• Current W1	3 400	1 000	1 000
• Deferred W2.3	3 600	3 000	1 200
• Tax loss (created)/ used	1 200	1 800	(3 000)
• Other temporary differences	2 400	1 200	4 200
	7 000	4 000	2 200
<i>Tax rate reconciliation</i>			
Applicable tax rate	30%	30%	30%
Tax effects of:			
Profit/ (loss) before tax (20X3: 30 000 x 30%) (20X2: 20 000 x 30%) (20X1: 14 000 x 30%)	9 000	6 000	4 200
Permanent differences (20X1 - 20X3: 10 000 x 20%)	(2 000)	(2 000)	(2 000)
Tax expense per the statement of comprehensive income	7 000	4 000	2 200

Effective tax rate	(20X3: 7 000/ 30 000) (20X2: 4 000/ 20 000) (20X1: 2 200 / 14 000)	23.33%	20.00%	15.71%
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5. Deferred tax asset/ (liability)

The deferred tax balance comprises tax on the following types of temporary differences:

• Property, plant and equipment	W2.3	(1800)	600	1 800
• Tax loss	W2.3	0	1 200	3 000
		<u>(1 800)</u>	<u>1 800</u>	<u>4 800</u>

Solution 6.16

This is the solution to the question as it stands in the book (i.e. no DTA is to be recognised at all)

W1. Calculation of current normal tax

	20X3	20X2	20X1
	C	C	C
Profit before tax	30 000	20 000	14 000
Less: Dividend income	(10 000)	(10 000)	(10 000)
Less: Temporary differences (PPE)	(8 000)	(4 000)	(14 000)
Assessed tax loss brought forward	(4 000)	(10 000)	0
Taxable profit/ (tax loss)	8 000	(4 000)	(10 000)
Current normal tax at 30%	2 400	0	0
Add: Tax on dividend income @ 10%	1 000	1 000	1 000
	3 400	1 000	1 000

W2. Calculation of deferred normal tax

	Carrying amount (SOFPI) (a)	Tax base (IAS 12) (b)	Temporary difference (b) – (a) (c)	Deferred tax at 30% (c) x 30% (d)	Deferred tax balance/ adjustment
W2.1 PPE					
Balance: 1 Jan 20X1	70 000	90 000	20 000	6 000	Asset
Movement	(6 000)	(20 000)	(14 000)	(4 200)	Cr DT Dr TE
Balance: 31 Dec 20X1	64 000	70 000	6 000	1 800	Asset
Movement	(16 000)	(20 000)	(4 000)	(1 200)	Cr DT Dr TE
Balance: 31 Dec 20X2	48 000	50 000	2 000	600	Asset
Movement	(12 000)	(20 000)	(8 000)	(2 400)	Cr DT Dr TE
Balance: 31 Dec 20X3	36 000	30 000	(6 000)	(1 800)	Liability

W2.2 Tax loss

Balance: 1 Jan 20X1	0	0	0	0	
Movement				3 000	Dr DT Cr TE
Balance: 31 Dec 20X1	0	10 000	10 000	3 000	Asset
Movement	0			(1 800)	Cr DT Dr TE
Balance: 31 Dec 20X2	0	4 000	4 000	1 200	Asset
Movement	0			(1 200)	Cr DT Dr TE
Balance: 31 Dec 20X3	0	0	0	0	

W2.3 Summary

	PPE			Tax loss			Total		
	Total (a)	Recognised (b)	Unrecognised (c)	Total (d)	Recognised (e)	Unrecognised (f)	Total (g)	Recognised (h)	Unrecognised (i)
O/ balance 20X1	6 000	0	6 000	0	0	0	6 000		6 000
Movement	(4 200)	0	(4 200)	3 000	0	3 000	(1 200)		(1 200)
C/ balance 20X1	1 800	0	1 800	3 000	0	3 000	4 800		4 800
Movement	(1 200)	0	(1 200)	(1 800)	0	(1 800)	(3 000)		(3 000)
C/ balance 20X2	600	0	600	1 200	0	1 200	1 800		1 800
Movement	(2 400)	(1 800)	(600)	(1 200)	0	(1 200)	(3 600)	(1 800)	(1 800)
C/ balance 20X3	(1 800)	(1 800)	0	0	0	0	(1 800)	(1 800)	0

Please note: when the unrecognised portion of a DTA is reduced (see columns c and f), this means that some of what was previously unrecognised is now recognised (i.e. see column c: 6 000 DTA relating to PPE was initially not recognised, but by the end of 20X1, the portion that was unrecognised was only 1 800: this therefore means that 4 200 was recognised – see journals).

Solution 6.16 continued ...

Journals 20X1		Debit	Credit
Tax expense	W2.1	4 200	
Deferred tax			4 200
<i>DTA reversed due to temporary differences reversing: PPE (20X1) ^{NOTE 1}</i>			
Deferred tax	W2.3: column (c)	4 200	
Tax expense			4 200
<i>DTA recognised now that it was used (i.e. reversed – jnl above): PPE (20X1)</i>			
Deferred tax : tax loss	W2.2	3 000	
Tax expense			3 000
<i>DTA created: tax loss created (20X1)</i>			
Tax expense	W2.3: column (f)	3 000	
Deferred tax: tax loss			3 000
<i>DTA not to be recognised: reversal of above entry: tax loss (20X1)</i>			
Tax expense		1 000	
Current tax payable			1 000
<i>Current tax payable 20X1</i>			
Journals 20X2			
Tax expense	W2.1	1 200	
Deferred tax			1 200
<i>DTA reversed due to temporary differences reversing: PPE (20X2) ^{NOTE 1}</i>			
Deferred tax	W2.3: column (c)	1 200	
Tax expense			1 200
<i>DTA recognised now that it was used (i.e. reversed – jnl above): PPE (20X2)</i>			
Tax expense	W2.2	1 800	
Deferred tax			1 800
<i>DTA reduces due to tax loss partially used (20X2) ^{NOTE 1}</i>			
Deferred tax : tax loss	W2.3: column (f)	1 800	
Tax expense			1 800
<i>DTA recognised now that it was used (i.e. jnl above): tax loss (20X2)</i>			
Tax expense		1 000	
Current tax payable			1 000
<i>Current tax payable 20X2</i>			
Journals 20X3			
Tax expense	W2.1	2 400	
Deferred tax			2 400
<i>DTA reversed and a DTL created due to temporary differences reversing: PPE (20X3) ^{NOTE 1}</i>			
Deferred tax	W2.3: column (c)	600	
Tax expense			600
<i>DTA recognised now that it was used (i.e. the remaining previously unrecognised asset of 600 reversed – included in jnl above): PPE (20X3)</i>			
Tax expense	W2.2	1 200	
Deferred tax			1 200
<i>DTA reduces due to remaining tax loss being used (20X3) ^{NOTE 1}</i>			
Deferred tax : tax loss	W2.3: column (f)	1 200	
Tax expense			1 200
<i>DTA recognised now that it was used (i.e. jnl above): tax loss (20X3)</i>			
Tax expense	W1	3 400	

Current tax payable	3 400
<i>Current tax payable 20X3</i>	

NOTE 1: The journal is processed showing that a DTA asset was reversed (see W2.1 & W2.2). The problem is that since the company did not want to recognise deferred tax assets, the original 6 000 DTA on PPE and the original 3 000 DTA on the tax loss that are reversed were *not recognised* in the first place! This is the reason for the next journals where the part of the DTA that is reversing is now quickly recognised. The effect is nil on the balances, but these journals are necessary since disclosure of this movement is required.

Solution 6.16 continued ...

Reflection Limited

Notes to the financial statements

For the year ended 31 December 20X3

		20X3 C	20X2 C	20X1 C
15. Taxation expense				
Normal taxation				
• Current		3 400	1 000	1 000
• Deferred		1 800	0	0
- Temporary differences – current year	Jnls	2 400	1 200	4 200
- Tax loss – current year (arose)/ used	Jnls	1 200	1 800	(3 000)
- Current year DTA <i>not</i> recognised: tax loss ^{12.81 (e)}	Jnls	0	0	3 000
- Prior year unrecognised DTA now recognised:				
- Tax loss (because used) ^{12.80 (e)}	Jnls	(1 200)	(1 800)	0
- Temporary differences (because reversed) ^{12.80 (e)}	Jnls	(600)	(1 200)	(4 200)
Tax expense per the statement of comprehensive income		5 200	1 000	1 000
<i>Tax rate reconciliation</i>				
Applicable tax rate		30%	30%	30%
Tax effects of:				
Profit before tax	(20X3: 30 000 x 30%) (20X2: 20 000 x 30%) (20X1: 14 000 x 30%)	9 000	6 000	4 200
Permanent differences (20X1 - 20X3: 10 000 x 20%)		(2 000)	(2 000)	(2 000)
Current year DTA not recognised: tax loss ^{12.81 (e)} <i>Per above</i>		0	0	3 000
Prior year unrecognised DTA now recognised:				
- Tax loss (because used) ^{12.80 (e)} <i>Per above</i>		(1 200)	(1 800)	0
- Temporary differences (because reversed) ^{12.80 (e)} <i>Per above</i>		(600)	(1 200)	(4 200)
Tax expense per the statement of comprehensive income		5 200	1 000	1 000
Effective tax rate	(5 200 / 30 000, 1 000 / 20 000, 1 000 / 14 000,	17.33%	5.00%	7.14%

5. Deferred tax asset/ (liability)

The deferred tax balance comprises tax on the following types of temporary differences:

• Property, plant and equipment	W2.3	(1 800)	0	0
• Tax loss	W2.3	0	0	0
		(1 800)	0	0

Solution 6.16 ADAPTED

ADAPTATION: the question is adapted as follows:

- there is insufficient evidence for Reflection Limited to realise deferred tax assets created by its tax losses, although deferred tax assets on deductible temporary differences may be recognised.

W1. Calculation of current normal tax

	20X3	20X2	20X1
	C	C	C
Profit before tax	30 000	20 000	14 000
Less: Dividend to be taxed @10%	(10 000)	(10 000)	(10 000)
Temporary differences (PPE)	(8 000)	(4 000)	(14 000)
Assessed tax loss brought forward	(4 000)	(10 000)	0
Taxable profit/ (tax loss)	8 000	(4 000)	(10 000)
Current normal tax at 30%	2 400	0	0
Tax on dividend income @ 10%	1 000	1 000	1 000

W2. Calculation of deferred normal tax

	Carrying amount (SOFPI) (a)	Tax base (IAS 12) (b)	Temporary difference (b) – (a) (c)	Deferred tax at 30% (c) x 30% (d)	Deferred tax balance/ adjustment
W2.1 PPE					
Balance: 1 Jan 20X1	70 000	90 000	20 000	6 000	Asset
Movement	(6 000)	(20 000)	(14 000)	(4 200)	Cr DT Dr TE
Balance: 31 Dec 20X1	64 000	70 000	6 000	1 800	Asset
Movement	(16 000)	(20 000)	(4 000)	(1 200)	Cr DT Dr TE
Balance: 31 Dec 20X2	48 000	50 000	2 000	600	Asset
Movement	(12 000)	(20 000)	(8 000)	(2 400)	Cr DT Dr TE
Balance: 31 Dec 20X3	36 000	30 000	(6 000)	(1 800)	Liability

W2.2 Tax loss

Balance: 1 Jan 20X1	0	0	0	0	
Movement				3 000	Dr DT Cr TE
Balance: 31 Dec 20X1	0	10 000	10 000	3 000	Asset
Movement	0			(1 800)	Cr DT Dr TE
Balance: 31 Dec 20X2	0	4 000	4 000	1 200	Asset
Movement	0			(1 200)	Cr DT Dr TE
Balance: 31 Dec 20X3	0	0	0	0	

W2.3 Summary

	PPE			Tax loss			Total		
	Total (a)	Recognised (b)	Unrecognised (c)	Total (d)	Recognised (e)	Unrecognised (f)	Total (g)	Recognised (h)	Unrecognised (i)
O/ balance 20X1	6 000	6 000	0	0	0	0	6 000	6 000	0
Movement	(4 200)	(4 200)	0	3 000	0	3 000	(1 200)	(4 200)	3 000
C/ balance 20X1	1 800	1 800	0	3 000	0	3 000	4 800	1 800	3 000
Movement	(1 200)	(1 200)	0	(1 800)	0	(1 800)	(3 000)	(1 200)	(1 800)
C/ balance 20X2	600	600	0	1 200	0	1 200	1 800	600	1 200
Movement	(2 400)	(2 400)	0	(1 200)	0	(1 200)	(3 600)	(2 400)	(1 200)
C/ balance 20X3	(1 800)	(1 800)	0	0	0	0	(1 800)	(1 800)	0

Solution 6.16 ADAPTED continued ...

Journals 20X1		Debit	Credit
Tax expense	W2.1	4 200	
Deferred tax			4 200
<i>DTA reversed due to temporary differences reversing: PPE (20X1)</i>			
Deferred tax : tax loss	W2.2	3 000	
Tax expense			3 000
<i>DTA created: tax loss created (20X1)</i>			
Tax expense	W2.3: column (f)	3 000	
Deferred tax: tax loss			3 000
<i>DTA not to be recognised: reversal of above entry: tax loss (20X1)</i>			
Tax expense		1 000	
Current tax payable			1 000
<i>Current tax payable 20X1</i>			
Journals 20X2			
Tax expense	W2.1	1 200	
Deferred tax			1 200
<i>DTA reversed due to temporary differences reversing: PPE (20X2)</i>			
Tax expense	W2.2	1 800	
Deferred tax			1 800
<i>DTA reduces due to tax loss partially used (20X2) ^{NOTE 1}</i>			
Deferred tax : tax loss	W2.3: column (f)	1 800	
Tax expense			1 800
<i>DTA recognised now that it was used (i.e. jnl above): tax loss (20X2)</i>			
Tax expense		1 000	
Current tax payable			1 000
<i>Current tax payable 20X2</i>			
Journals 20X3			
Tax expense	W2.1	2 400	
Deferred tax			2 400
<i>DTA reversed and a DTL created due to deductible temporary differences reversing and taxable temporary differences arising: PPE (20X3)</i>			
Tax expense	W2.2	1 200	
Deferred tax			1 200
<i>DTA reduces due to remaining tax loss being used (20X3) ^{NOTE 1}</i>			
Deferred tax : tax loss	W2.3: column (f)	1 200	
Tax expense			1 200
<i>DTA recognised now that it was used (i.e. jnl above): tax loss (20X3)</i>			
Tax expense	W1	3 400	
Current tax payable			3 400
<i>Current tax payable 20X3</i>			

NOTE 1: The journal is processed showing that a DTA asset was reversed (see W2.1 & W2.2). The problem is that since the company did not want to recognise deferred tax assets on the tax loss, the parts of the original 3 000 DTA on the tax loss that are reversed were *not recognised* in the first place! This is the reason for the next journals where the part of the DTA that is reversing is now quickly recognised. The effect is nil on the balances, but these journals are necessary since disclosure of this movement is required.

Solution 6.16 ADAPTED continued ...

Reflection Limited

Notes to the financial statements

For the year ended 31 December 20X3

	20X3 C	20X2 C	20X1 C
15. Taxation expense			
Normal taxation			
• Current	2 400	1 000	1 000
• Deferred	2 400	1 200	4 200
- Temporary differences – current year	Jnls 2 400	1 200	4 200
- Tax loss – current year (arose)/ used	Jnls 1 200	1 800	(3 000)
- Current year DTA <i>not</i> recognised: tax loss ^{12.81 (e)}	Jnls 0	0	3 000
- Prior year unrecognised DTA now recognised:			
- Tax loss now used ^{12.80 (e)}	Jnls (1 200)	(1 800)	0
Tax expense per the statement of comprehensive income	5 800	2 200	5 200
<i>Tax rate reconciliation</i>			
Applicable tax rate	30%	30%	30%
Tax effects of:			
Profit before tax (20X3: 30 000 x 30%)	9 000	6 000	4 200
(20X2: 20 000 x 30%)			
(20X1: 14 000 x 30%)			
Permanent differences (20X1 - 20X3: 10 000 x 20%)	(2 000)	(2 000)	(2 000)
Current year DTA not recognised: tax loss ^{12.81 (e)} <i>Per above</i>	0	0	3 000
Prior year unrecognised DTA now recognised:			
- Tax loss ^{12.80 (e)} <i>Per above</i>	(1 200)	(1 800)	0
Tax expense per the statement of comprehensive income	5 800	2 200	5 200
Effective tax rate (20X3: 5 800 / 30 000)	19.33%	11.00%	37.14%
(20X2: 2 200 / 20 000)			
(20X1: 5 200 / 14 000)			

5. Deferred tax asset/ (liability)

The deferred tax balance comprises tax on the following types of temporary differences:

• Property, plant and equipment	W2.3 column b	(1 800)	600	1 800
• Tax loss	W2.3 column e	0	0	0
	W2.3 column h	(1 800)	600	1 800

Solution 6.17

W1. Calculation of current normal tax

	20X3	20X2	20X1
	C	C	C
Profit before tax	(20 000)	(10 000)	10 000
Less: Dividend income (to be taxed as a separate block of income)	(20 000)	(20 000)	(20 000)
Assessed tax loss brought forward	(140 000)	(110 000)	(100 000)
Taxable profit/ (tax loss)	(180 000)	(140 000)	(110 000)
Current normal tax at 30%	0	0	0
Tax on dividend @ 10%	2 000	2 000	2 000
Total current tax	2 000	2 000	2 000

	Carrying amount (SOFP)	Tax base (IAS 12)	Temporary difference (b) – (a)	Deferred tax at 30% (c) x 30%	Deferred tax balance/ adjustment
	(a)	(b)	(c)	(d)	
W2.1 Tax loss					
Balance: 1 Jan 20X1	0	0	100 000	30 000	Asset
Movement				3 000	Dr.DT Cr.TE
Balance: 31 Dec 20X1	0	110 000	110 000	33 000	Asset
Movement	0			9 000	Dr.DT Cr. TE
Balance: 31 Dec 20X2	0	140 000	140 000	42 000	Asset
Movement	0			12 000	Dr.DT Cr. TE
Balance: 31 Dec 20X3	0	180 000	180 000	54 000	Asset

W2.2 Summary

	Other temporary differences			Tax loss			Total		
	Total	Recognised	Unrecognised	Total	Recognised	Unrecognised	Total	Recognised	Unrecognised
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
O/ balance 20X1	0	0	0	30 000	30 000	0	30 000	30 000	0
Movement	0	0	0	3 000	3 000	0	3 000	3 000	0
C/ balance 20X1	0	0	0	33 000	33 000	0	33 000	33 000	0
Derecognise (1)					(33 000)	33 000		(33 000)	33 000
Movement	0	0	0	9 000	0	9 000	9 000	0	9 000
C/ balance 20X2	0	0	0	42 000	0	42 000	42 000	0	42 000
Re-recognise (2)					33 000	(33 000)		33 000	(33 000)
Recognise (3)					9 000	(9 000)		9 000	(9 000)
Movement	0	0	0	12 000	12 000	0	12 000	12 000	0
C/ balance 20X3	0	0	0	54 000	0	0	54 000	0	0

- (1) Write-down of an asset – derecognising the asset
- (2) Write-back of an asset – re-recognising the asset that was derecognised in a prior year
- (3) Recognising a deferred tax asset that had not been recognised before

Solution 6.17 continued ...

Journals		20X3	20X2	20X1
Deferred tax : tax loss	W2.1	12 000	9 000	3 000
Tax expense		(12 000)	(9 000)	(3 000)
<i>Deferred tax adjustment: tax loss created</i>				
Tax expense	W2.2	0	33 000	0
Deferred tax: tax loss		0	(33 000)	0
<i>Write-down of prior year DTA since future profitability is now in question (only in 20X2)</i>				
Tax expense	W2.2	0	9 000	0
Deferred tax: tax loss		0	(9 000)	0
<i>DTA reversed: Current year deferred tax asset is not to be recognised since profitability is in question (only in 20X2)</i>				
Deferred tax : tax loss	W2.2	33 000	0	0
Tax expense		(33 000)	0	0
<i>Write back of previously written down DTA: sufficient profitability is now expected such that the tax loss will be able to be used</i>				
Deferred tax: tax loss	W2.2	9 000	0	0
Tax expense		(9 000)	0	0
<i>Prior year DTA now recognised for the first time: sufficient profitability is now expected such that the tax loss will be able to be used</i>				
Current tax		2 000	2 000	2 000
Current tax payable		(2 000)	(2 000)	(2 000)
<i>Current tax payable for the years 20X1, 20X2 and 20X3</i>				

Solution 6.17 continued...

Beans Limited

Notes to the financial statements

For the year ended 31 December 20X3

	20X3 C	20X2 C	20X1 C
15. Taxation expense			
Normal taxation			
• Current	2 000	2 000	2 000
• Deferred	(54 000)	33 000	(3 000)
- Temporary differences – current year ^{80 (c)}	Jnls 0	0	0
- Tax loss – current year	Jnls (12 000)	(9 000)	(3 000)
- Current year DTA not recognised:		9 000	
- Tax loss ^{81 (e)}			
- Prior year recognised DTA written down/(back):	Jnls (33 000)	33 000	0
- Tax loss ^{80 (g)}			
- Prior year unrecognised DTA now recognised:	(9 000)	0	0
- Tax loss ^{80 (f)}			
	(52 000)	35 000	(1 000)
<i>Tax rate reconciliation</i>			
Applicable tax rate	30%	30%	30%
Tax effects of:			
Profit before tax	(20 000 x 30%) (10 000 x 30%) (10 000 profit x 30%)	(6 000)	(3 000)
Permanent differences	20 000 x 20% (each year)	(4 000)	(4 000)
Current year deferred tax asset not recognised:			
- Tax loss ^{81 (e)} Per above	0	9 000	0
Prior year recognised DTA written down/(written back):			
- Tax loss ^{80 (g)} Per above	(33 000)	33 000	0
Prior year unrecognised deferred tax asset now recognised:			
- Tax loss ^{80 (f)} Per above	(9 000)	0	0
Tax expense per the statement of comprehensive income	(52 000)	35 000	(1 000)
Effective tax rate	(52 000 tax income / 20 000 loss) (35 000 expense / 10 000 loss) (1 000 tax income / 10 000 profit)	260%	-350%
			-10%

5. Deferred tax asset/ (liability)

The deferred tax balance comprises tax on the following types of temporary differences:

• Tax loss	54 000	0	33 000
	54 000	0	33 000

Solution 6.18 ADAPTED

Adaptation:

This question has been adapted by adding the following requirements:

- c) Calculate the total tax expense recognised in 20X8
- d) Calculate the adjustment to the deferred tax liability account caused by temporary differences arising in 20X8.
- e) Calculate the adjustment to the deferred tax liability account caused by the rate change.
- f) Calculate the total deferred tax expense recognised in 20X8.
- g) Calculate the total tax expense recognised in 20X8.
- h) List the items that would appear as reconciling items in the tax expense note's rate reconciliation.

a) Deferred tax balance

W1.1 PPE	CA	TB	TD	DT	
Balance: 1/1/20X8 (at 29%)	700 000	680 000	(20 000)	(5 800)	L
Rate change (1)				(200)	Cr DT Dr TE
Balance: 1/1/20X8 (at 30%)				(6 000)	
Building: sold	(120 000)	(130 000)	(10 000)	(3 000)	Cr DT Dr TE
Plant: revaluation surplus (2)	10 000	0	(10 000)	(3 000)	Cr DT Dr RS
Plant: depreciation (3) (4)	(12 000)	(0)	12 000	3 600	Dr DT Cr TE
Other: depreciation (given)	(50 000)	(35 000)	15 000	4 500	Cr DT Dr TE
Balance: 31/12/20X8	528 000	515 000	(13 000)	(3 900)	L

(1): $5\,800 / 29\% \times 1\% = 200$ (increase in the balance)(2): $FV: 60\,000 - CA: 50\,000 = 10\,000$ (3): $FV: 60\,000 / RUL: 5\text{ years} = 12\,000$

(4): Tax deductions on plant are nil: a nil tax base means that 100% of the cost has already been deducted

W2 Expense prepaid	CA	TB	TD	DT	
Balance: 1/1/20X8 (at 29%)	0	0	0	0	
Rate change				0	
Balance: 1/1/20X8 (at 30%)					
Movement	30 000	0	(30 000)	(9 000)	Cr DT Dr TE
Balance: 31/12/20X8	30 000	0	(30 000)	(9 000)	L

W3 Deferred tax balance A/(L)	PPE	Expense Prepaid	Total	
Balance: 1/1/20X8 (at 29%)	(5 800)	0	(5 800)	L
Rate change	(200)	0	(200)	Cr DT Dr TE
Revaluation surplus	(3 000)	0	(3 000)	Cr DT Dr RS
Other temporary differences	5 100	(9 000)	(3 900)	Cr DT Dr TE
Balance: 31/12/20X8	(3 900)	(9 000)	(12 900)	L

Solution 6.18 ADAPTED continued ...

b) Current normal tax calculation

Current taxation (and deferred taxation adjustment)		30%	
Profit before tax	<i>Given</i>	650 000	
<i>Permanent differences:</i>			
Less Dividend income (to be taxed as separate lock of income)		(20 000)	
<i>Temporary differences:</i>			
Add depreciation	$50\,000 + (50\,000 + 10\,000) / 5$	62 000	
Less tax depreciation	<i>Given</i>	(35 000)	
Add loss on sale	<i>SP ltd to CP: 100 000 – CA: 120 000</i>	20 000	
Less scrapping allowance	<i>SP ltd to CP: 100 000 – TB: 130 000</i>	(30 000)	
Less expenses prepaid	<i>c/ Given</i>	(30 000)	
balance			
Taxable profit and current normal tax		617 000	185 100 Dr TE Cr CTP
Add: Dividend income to be taxed @ 10%		20 000	2 000
Total current tax			187 100

c) Current normal tax expense recognised

Current tax for current year	<i>(b) above</i>	187 100
Current tax for prior year - overprovided		(6 500)
• Assessed tax: 20X7	$650\,000 \times 29\%$	188 500
• Estimated current tax: 20X7	<i>Given</i>	195 000
Total current normal tax expense		180 600

d) Deferred tax adjustment due to temporary differences arising in 20X8

Deferred tax adjustments on temporary differences arising in 20X8, recognised in:		
• Other comprehensive income	<i>Cr DT Dr RS: working (a)</i>	3 000
• Profit or loss	<i>Cr DT Dr TE: working (a)</i>	3 900
Total adjustment to the DTL account due to 20X8 temporary differences arising in 20X8		6 900

e) Deferred tax adjustment due to rate change (temp. differences arising before 20X8)

Deferred tax rate change adjustment recognised in:		
• Other comprehensive income	<i>N/A: no opening balance reval surplus</i>	0
• Profit or loss	<i>Cr DT Dr TE: working (a)</i>	200

f) Deferred tax expense recognised

Deferred tax <i>expense</i> (i.e. only those adjustments recognised in <i>profit or loss</i>), due to:		
• Temporary differences arising in 20X8	<i>Working (d) above: Cr DT Dr TE:</i>	3 900
• Rate change (prior temporary differences)	<i>Working (e) above: Cr DT Dr TE:</i>	200

Solution 6.18 ADAPTED continued ...

g) Tax expense

Normal tax

Current

		180 600
• Current year	<i>Working (b) above: Dr TE Cr CTP</i>	187 100
• Prior year overprovision	<i>Working (c) above: Cr TE Dr CTP</i>	(6 500)

Deferred

		4 100
• Current year temporary differences	<i>Working (d) above: Dr TE Cr DT</i>	3 900
• Rate change (prior year td's)	<i>Working (e) above: Dr TE Cr DT</i>	200

Secondary tax

0

Tax expense (on face of statement of comprehensive income)

184 700

h) Reconciling items

The items that would cause the effective rate of tax to differ from the standard rate of tax include:

• Dividend income	$20\,000 \times 20\%$	4 000
• Rate change		200
• Overprovision		(6 500)

Solution 6.19

a)

Part A: Journals

Date	Account names	Debit	Credit
1 Jan X4	Revenue received in advance: 1 Jan 20X4	5 000	
	Revenue from services		5 000
	<i>Reversal of opening balance of revenue received in advance</i>		
1 Jan X4	Rent expense	20 000	
	Rent expense prepaid: 1 Jan 20X4		20 000
	<i>Reversal of opening balance of rent expense prepaid</i>		
31 Dec X4	Revenue from services	15 000	
	Revenue received in advance: 31 Dec 20X4		15 000
	<i>The recognition of revenue received in advance deferred to future years</i>		
31 Dec X4	Rent expense prepaid: 31 Dec 20X4	30 000	
	Rent expense		30 000
	<i>The recognition of rent prepaid as an expense is deferred to future years</i>		
29 Dec X4	Dividend declared	20 000	
	Dividends payable		20 000
	<i>Final dividend declared on 29 December 20X4</i>		
<i>Note to student: you would now need to calculate profit before tax (you should normally do this as part of your SOCI to save you time later: no SOCI was asked for in this question so it was done as a working instead). After doing this, calculate taxable profits and current normal tax. Only then are you able to do the tax journals.</i>			
31 Dec X4	Tax expense W1	333 500	
	Current tax payable: normal tax		333 500
	<i>Current normal tax estimated for 20X4</i>		
31 Dec X4	Tax expense Assessment: 120 000 - Expensed: 110 000	10 000	
	Current tax payable: normal tax		10 000
	<i>Current normal tax in 20X3 was underprovided</i>		
31 Dec X4	Tax expense W3.4	29 250	
	Deferred tax: normal tax		29 250
	<i>Increase in opening balance of deferred normal tax - rate changed from 30% to 40%</i>		
31 Dec X4	Deferred tax: normal tax W3.4	1 000	
	Tax expense		1 000
	<i>Adjustment of deferred tax balance owing to current year movement in temporary differences</i>		

Solution 6.19 continued ...

W1 Current normal tax calculation

Profit before tax	W4	810 000
Less: dividend income (taxed @ 10%)	Given	(5 000)
Add: donations made	Given	25 000
Less: accounting profit on sale	Given	(25 000)
Add: taxable gain	Given	7 500
Less: income received in advance (O/B)	Given	(5 000)
Add: income received in advance (C/B)	Given	15 000
Add: rent expense prepaid (C/B)	Given	20 000
Less: rent expense prepaid (O/B)	Given	(30 000)
Add: depreciation	Given	50 000
Less: tax depreciation	Given	(30 000)
Taxable profit		832 500
Current normal tax	(832 500 X 40%)	333 000
Tax on dividend income @ 10%	(5 000 X 10%)	500
		<u>333 500</u>

W3. Deferred tax calculation:	Carrying amount	Tax base	Temporary difference	Deferred tax bal/ adj
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W3.1 Income received in advance

01/01/X8	Balance	(5000)	0	5 000	1500	A
	Rate change (30% - 40%)				500	
	Movement	(10 000)	0	10 000	4 000	
31/12/X8	Balance	(15 000)	0	15 000	6 000	A

W3.2 Rent expense prepaid

01/01/X8	Balance	20 000	0	(20 000)	(6 000)	L
	Rate change (30% - 40%)				(2 000)	
	Movement	10 000	0	(10 000)	(4 000)	
01/01/X8	Balance	30 000	0	(30 000)	(12 000)	L

W3.3 Property, plant and equipment

01/01/X8	Balance (work backwards)	1 155 000	877 500	(277 500)	(83 250)	L
	Rate change (30% - 40%)				(27 750)	
	Depreciation/tax depreciation	(1) (50 000)	(1) (30 000)	20 000	8 000	
	Sale of plant: carrying amt	(1) (30 000)	(2) (47 500)	(17 500)	(7 000)	
01/01/X8	Balance	1 075 000	800 000	(275 000)	(110 000)	L

(1) Given

(2) W5

W3.4 Summary

Opening balance (1 500 – 6 000 – 83 250)		(87 750)	L
Rate change (500 – 2 000 – 27 750)	Cr DT Dr TE	(29 250)	
Movement (4 000 – 4 000 + 8 000 – 7 000)	Dr DT Cr TE	1 000	
Closing balance (6 000 – 12 000 – 110 000)		<u>(116 000)</u>	L

W4 Profit before tax

Revenue from services	<i>(1 510 000 + Accrual adjustments: 5 000 – 15 000)</i>	1 500 000
Dividend income		5 000

Solution 6.19 continued ...

Profit on sale of plant		25 000
Depreciation		(50 000)
Donations		(25 000)
Finance charges		(55 000)
Other expenses	<i>(600 000 + Accrual adjustments: 20 000 – 30 000)</i>	(590 000)
Profit before tax		<u>810 000</u>

W5 Tax base of plant sold

Proceeds	<i>CA: 30 000 + PoS: 25 000</i>	55 000
Less: capital profit	<i>Given</i>	<u>(7 500)</u>
Tax base		<u>47 500</u>

Solution 6.20

SOZORSTED LIMITED
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X4

	Notes	20X4 C
ASSETS		
Non current assets		
Property, plant and equipment	W3.1	1 075 000
Current assets		
Inventory	Given	400 000
Debtors	Given	30 000
Expenses prepaid	20 000 – 20 000 + 30 000	30 000
		<u>1535 000</u>
LIABILITIES AND EQUITY		
Equity		
Issued share capital and reserves	Per SOCIE	1 073 500
Non current liabilities		
Deferred tax	W 3.4	87 000
Loan liabilities	Total liabilities 150 000 – 20X3 DT: 132 000	18 000
Current liabilities		
Creditors	Given	40 000
Income received in advance	5 000 - 5 000 + 15 000	15 000
Dividends payable	Per journal: final dividend declared but unpaid	20 000
Current tax payable: normal tax		271 500
Bank overdraft	Given	10 000
		<u><u>1 535 000</u></u>

SOZORSTED LIMITED
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X4

		Share Capital C	Retained Earnings C	Total C
Opening balance	Given	200 000	320 000	520 000
Total comprehensive income	Per SOCI		583 500	583 500
Less dividend declared	10 000 + 20 000		(30 000)	(30 000)
Closing balance		200 000	873 500	1 073 500

SOZORSTED LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X4

	Notes	20X4 C
Revenue	1 510 000 + Accrual adj's: 5 000 – 15 000	1 500 000
Add: other income	(25 000 + 5 000)	30 000
Less: expenses	50 000 + 25 000 + 600 000 + Accrual adj's: 20 000 – 30 000	(665 000)
Less: finance costs		(55 000)
Profit before tax	10	810 000
Less taxation	Tax note 11	(266 500)
Profit for the year		583 500
Other comprehensive income		0
Total comprehensive income		<u><u>583 500</u></u>

Solution 6.20 continued ...

SOZORSTED LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X4
20X4
C
10. Profit before tax

Profit before tax is stated after taking into account the following disclosable items:

- Depreciation on plant 50 000

11. Tax expense

Normal tax

- Current		271 500
- current year	W 1	261 500
- prior year under/ (over) provision	(1)	10 000
- Deferred		(45 000)
- Current year movement	W 3.4	(12 000)
- Rate change on prior year balance	W 3.4	(33 000)

Tax expense on face of statement of comprehensive income

266 500

(1): Assessment for 20X3: 120 000 – Estimated provision in 20X3: 110 000

Rate reconciliation

Standard tax rate 30%

Tax effect of:

Profit before tax	810 000 x 30%	243 000
Less exempt dividend income	5 000 x 20%	(1 000)
Add non-deductible donation	25 000 x 30%	7 500
Current tax: prior year under-provision	Per above	10 000
Deferred tax: rate change	Per above	(33 000)

Tax expense on face of statement of comprehensive income

226 500

Effective tax rate 226 500 / 810 000 27.96 %

15. Deferred tax asset / (liability)**20X4****20X3**

The deferred tax balance is caused by the following

		C	C
• Property, plant and equipment	W 3.1	(82 500)	(126 000)
• Income received in advance	W 3.2	4 500	2 000
• Expenses prepaid	W 3.3	(9 000)	(8 000)
		(87 000)	(132 000)

Solution 6.20 continued ...

Workings

W1 Current normal tax	Calculations	20X4 C
Profit before tax	<i>Per SOCI</i>	810 000
Less dividend income (to be treated as a separate block of income)	<i>Given</i>	(5 000)
Less: accounting profit on sale		(25 000)
Add: tax profit on sale		45 000
Add non deductible donations	<i>Given</i>	25 000
Add income received in advance (c/bal)	<i>Given</i>	15 000
Less income received in advance (o/bal)	<i>Given</i>	(5 000)
Less expenses prepaid (c/bal)	<i>Given</i>	(30 000)
Add expenses prepaid (o/bal)	<i>Given</i>	20 000
Add depreciation	<i>Given</i>	50 000
Less tax depreciation	<i>Given</i>	(30 000)
Taxable profits		870 000
Current normal tax	<i>Taxable profit x 30%</i>	261 000
Add: Tax on dividend income @10%	<i>(5 000 x 0.1)</i>	500
Total current tax		261 500

Solution 6.20 continued ...

Workings continued ...

W 3 Deferred tax	CA	TB	TD	DT	
W3.1 Property, plant and equipment					
Opening balance (balancing)	1 155 000	840 000	(315 000)	(126 000)	L € 40%
Purchases (cost)	0	0			
Sales (carrying amount)	(30 000)	(10 000)			
Depreciation/ tax depreciation	(50 000)	(30 000)			
Closing balance	1 075 000	800 000	(275 000)	(82 500)	L € 30%
W3.2 Income received in advance					
Opening balance	(5 000)	0	5 000	2 000	A € 40%
Movement					
Closing balance	(15 000)	0	15 000	4 500	A € 30%
W3.3 Expenses prepaid					
Opening balance	20 000	0	(20 000)	(8 000)	L € 40%
Movement					
Closing balance	30 000	0	(30 000)	(9 000)	L € 30%
W3.4 Summary					
	PPE	IRIA	EPP	Total	
Opening balance at 40%	(126 000)	2 000	(8 000)	(132 000)	L
Rate change (rate decreased)	Debit DT; Credit TE	$132\,000 / 40\% \times 10\%$		33 000	
Opening balance restated 30%				(99 000)	
Current year movement in TD's	Debit DT; Credit TE	$99\,000 - 87\,000$		12 000	
Closing balance 30%	(82 500)	4 500	(9 000)	(87 000)	L

Solution 7.1

- a.) i) Accounting policies are specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements (IAS 8,p5).
- ii) A change in accounting policy shall be made if:
- it is required by IFRS or Interpretation; or
 - it results in more reliable and relevant presentation in the financial statements, financial position or financial performance of the entity.

Accounting policies are the principles upon which the presentation of the financial statements are based and therefore applying changes to these accounting policies cannot be made prospectively as it will compromise the comparability and consistency of the financial statements.

A change in accounting policy is therefore applied retrospectively with all prior period comparatives in the set of financial statements being restated and based upon the new policy. All prior periods not given as comparatives must also be adjusted, but with the cumulative effect on the opening balance of retained earnings disclosed as a single adjustment.

Where adjustments to prior periods are impracticable to determine (i.e. the company cannot apply it after making every reasonable attempt to do so), the application of a prospective adjustment may be appropriate.

- b.) i) A change in accounting estimate is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present value status of, and the expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from the new information or new developments and, accordingly, are not correction of errors (IAS 8, p5).
- ii) A change in accounting estimate relates to the change in the present status of expected future benefits and obligations associated with assets and liabilities. Due to accounting estimates relating to future benefits, a retrospective change would not be appropriate.

The effect of a change in accounting estimate shall therefore be recognised prospectively by including it in profit or loss in

- the period of the change, if that change affects that period only; i.e. the current period; or
- the period of the change and in future periods, if the change affects both.

(IAS 8.36)

To the extent that a change in accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it shall be recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change (IAS 8.37).

- c.) i) Errors are omissions from, and misstatements in, the entity's financial statements, and preparation thereof, arising from a failure to use, or misuse, of reliable information that was available or reasonably expected to have been obtained and taken into account.
- ii) IAS 8 requires that all material prior period errors are to be corrected retrospectively in the financial statements authorised for issue after their discovery.

Material omissions or misstatements of items are material if they could, individually or collectively; influence the economic decision that users make on the basis of the financial statements (IAS 8.5).

Prior period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

- was available when the financial statements for those periods were authorised for issue; and
- could reliably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

iii) In order to understand how errors are accounted for we shall break them down into three key areas, namely:

- Errors in the current financial year
- Immaterial errors made in the previous financial years
- Material errors occurring in previous financial years

All errors that occurred during the current year, whether material or immaterial, are adjusted in the current year.

If an error in the previous period is immaterial, it should also be corrected in the current year.

An entity shall correct material prior period errors as this means that previous financial statements that were published were incorrect and therefore need to be restated. Material prior period errors shall be corrected retrospectively.

A prior period error shall be corrected by retrospective restatement except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the error. When it is impracticable to determine the cumulative effect, at the beginning of the current period, of the error on all prior periods, the entity shall restate the comparative information to correct the error prospectively from the earliest date (IAS 8, p43–45).

Solution 7.2

a)

A change in the method of depreciation from the residual balance method to the straight line method is a change in accounting estimate. It may not be recognised as a change in accounting policy as the policy to depreciate the asset has not changed. It is merely the method of estimating depreciation that has changed.

The depreciation method used must reflect the pattern in which the asset's future economic benefits are expected to be consumed (IAS 16, p60).

When there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method of depreciation must be changed to reflect the changed pattern (e.g. from the residual balance method to the straight line method). Such a change must be accounted for as a change in an accounting estimate in accordance with IAS 8 (IAS 16, p61).

The change in accounting estimate must be applied prospectively. This prospective adjustment may be made using either the reallocation method or the cumulative catch-up method.

b)

A change from the weighted average method to the first-in-first-out method is generally taken to be a change in accounting policy although there is an argument that suggests it could be accounted for as a change in estimate.

Arguments for a change in accounting policy

Accounting policies are specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements (IAS 8, p5).

IAS 8, p35 states that a change in a measurement basis is a change in an accounting policy.

Inventory is valued at the lower of cost and net realisable value. This is referred to in IAS 2 as the measurement basis used for inventory. This is therefore a policy (the basis used in preparing the inventory balance for inclusion in the financial statements).

Part of this measurement basis is the determination of cost. IAS 2 requires that cost be determined according to one of the cost formulae:

- Weighted average
- First-in-first-out
- Specific identification

A change from the weighted average method to the FIFO method of valuing inventory is therefore a change in the cost formula used. Since the cost formula used is simply a part of the measurement basis for inventory, this represents a partial change in the measurement basis – and therefore a change in accounting policy.

Arguments in favour of a change in accounting estimate

A change in accounting estimate is defined as an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present value status of, and the expected future benefits and obligations associated with, assets and liabilities (IAS 8, p5).

A change from weighted average to first-in-first-out method reflects a change in the pattern in which the future economic benefits embodied in inventory are to be expensed.

IAS 8.35 states that when it is difficult to distinguish a change in accounting policy from a change in accounting estimate, the change is treated as a change in accounting estimate. Since there appears to be a lack of consensus regarding whether or not the change from weighted average to first-in-first-out method is a change in policy or change in estimate, this paragraph suggests that it should be accounted for as a change in estimate.

Solution 7.3

a)

CLUEDO LIMITED

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 MARCH 20X4 (EXTRACTS)

1. Accounting policies

1.1 Statement of compliance

These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 198, provisions of and directives issued by under the Companies Ordinance, 1984. In case the requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

1.2 Basis of preparation

The financial statements have been prepared on the historical cost convention. The principal accounting policies are set out below. These policies are consistent in all material respects with those applied in the previous year.

1.3 Non-current assets

Equipment is depreciated using the straight-line method at 10% p.a. This represents a change in estimate, as disclosed in notes 2 and 3.

2. Profit before tax

	20X4	20X3
	C	C
Profit before tax is arrived at after deducting		
Depreciation - equipment	50 000	100 000
- original estimate	100 000	
- change in estimate (note 3)	(50 000)	

3. Change in estimate

The company changed the estimated useful life of the forensic equipment from six to ten years.

The (increase)/ decrease caused by the change in estimate is as follows:	C
• Current profits (before tax)	(50 000)
• Future profits (before tax)	50 000

Solution 7.3 continued ...

b)

i) Depreciation journal:

	Debit	Credit
Depreciation	50 000	
Accumulated depreciation: equipment		50 000
<i>Depreciation of equipment</i>		

ii) Adjustment to depreciation journal:

	Debit	Credit
Accumulated depreciation: equipment	50 000	
Depreciation		50 000
<i>Adjustment to depreciation of equipment</i>		

c)

	Debit	Credit
Tax expense	15 000	
Deferred tax		15 000
<i>Deferred tax resulting from change in estimated depreciation W2</i>		

Workings

W1	Change in accounting estimate (RAM)		Original estimate	Revised estimate	Difference
01/04/X1	Cost	<i>Given</i>	600 000		
31/03/X3	Accum. depreciation	<i>(600 000 / 6 x 2 years)</i>	(200 000)		
31/03/X3	Carrying amount		400 000	400 000	
	<i>Remaining useful life</i>	<i>(6 – 2 yrs) (10 – 2 yrs)</i>	<i>4 years</i>	<i>8 years</i>	
31/03/X4	Depreciation	<i>(400 000/ 4) (400 000/ 8)</i>	(100 000)	(50 000)	
31/03/X4	Carrying amount		300 000	350 000	50 000
Future yrs	Depreciation		(300 000)	(350 000)	(50 000)
Final	Carrying amount	<i>Residual value</i>	0	0	0

W2	Carrying amount	Tax base	Temporary difference	Deferred tax	Adjustment/ balance
Deferred tax					
Balance: 1/4/20X1	0	0	0	0	
Purchase	600 000	600 000			
Depreciation (/6)	(100 000)	(100 000)			
Balance: 31/3/20X2	500 000	500 000	0	0	
Depreciation	(100 000)	(100 000)			

(/5)					
Balance:	400 000	400 000	0	0	
31/3/20X3					
Depreciation	(50 000)	(100 000)	(50 000)	(15 000)	Cr DT; Dr
(/8)					TE
Balance:	350 000	300 000	(50 000)	(15 000)	L
31/3/20X3					

Solution 7.4

Part a)

i) Disclosure:

DREAMCOAT LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X6 (EXTRACTS)

2 Profit before taxation

Profit before taxation is stated after taking the following (income)/ expenses into account:

		20X6	20X5
		C	C
Depreciation on vehicles	W1	1 000	900
• original estimate	W1	900	
• change in estimate	W1	3 100	

3 Change in accounting estimate

The residual value of vehicles was changed from C1 000 to C600.

	20X6
	C
The (increase)/ decrease caused by the change is as follows:	
• current profits (before tax)	100
• future profits (before tax)	300

ii) Depreciation journal:

	Debit	Credit
Depreciation	1 000	
Accumulated depreciation: vehicle		1 000
<i>Depreciation of vehicle</i>		

iii) Adjustment to depreciation journal:

	Debit	Credit
Depreciation	100	
Accumulated depreciation: vehicle		100
<i>Adjustment to depreciation of vehicle</i>		

Workings:

W1	Change in accounting estimate (RAM)	Was	Is	Adjustment
	Date	Calculations		
Cost	1/1/20X0		10 000	
Accum. depreciation	31/12/20X5	(10K – 1K) / 10yrs x 6yrs	(5 400)	
Carrying amount	31/12/20X5		4 600	4 600
Residual value			(1 000)	(600)
Depreciable amount			3 600	4 000
Remaining useful life		10 – 6 years	4 years	4 years
Depreciation		current year adjustment	(900)	(1 000)
Carrying amount	31/12/20X6	cumulative adjustment	3 700	3 600
Depreciation:	future	(CA: 3 700 – RV: 1 000)	(2 700)	(3 000)
		(CA: 3 600 – RV: 600)		
Carrying amount:	future final	residual value	1 000	600
				(400)

Solution 7.4 continued ...

Part b)

i) Disclosure:

DREAMCOAT LIMITED**NOTES TO THE FINANCIAL STATEMENTS****FOR THE YEAR ENDED 31 DECEMBER 20X6 (EXTRACTS)****2 Profit before taxation**

Profit before taxation is stated after taking the following (income)/ expenses into account:

		20X6	20X5
		C	C
Depreciation on vehicles	W1	775	900
• original estimate	W1	900	
• change in estimate	W1	3 (125)	

3 Change in accounting estimate

The residual value of vehicles was changed from C1 000 to C1 500.

	20X6
	C
The (increase)/ decrease caused by the change is as follows:	
• current profits (before tax)	(125)
• future profits (before tax)	(375)

ii) Depreciation journal:

	Debit	Credit
Depreciation	775	
Accumulated depreciation: vehicle		775
<i>Depreciation of vehicle</i>		

iii) Adjustment to depreciation journal:

	Debit	Credit
Accumulated depreciation: vehicle	125	
Depreciation		125
<i>Adjustment to depreciation of vehicle</i>		

Workings:

W1	Change in accounting estimate (RAM)		Was	Is	Adjustment
	Date	Calculations			
Cost	1/1/20X0		10 000		
Accum. depreciation	31/12/20X5	(10K – 1K) / 10yrs x 6yrs	(5 400)		
Carrying amount	31/12/20X5		4 600	4 600	
Residual value			(1 000)	(1 500)	
Depreciable amount			3 600	3 100	
Remaining useful life			4 years	4 years	
Depreciation		current year adjustment	(900)	(775)	125
Carrying amount	31/12/20X6		3 700	3 825	125
Depreciation:	future	(CA: 3 700 – RV: 1 000)	(2 700)	(2 325)	375
		(CA: 3 825 – RV: 1 500)			
Carrying amount:	future final	residual value	1 000	1 500	500

Solution 7.4 continued ...

Part c)

i) Disclosure:

DREAMCOAT LIMITED.

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 20X6 (EXTRACTS)

2 Profit before taxation

Profit before taxation is stated after taking the following (income)/ expenses into account:

		20X6 C	20X5 C
Depreciation on vehicles	W1	(0)	900
• original estimate	W1	900	
• change in estimate	W1	3 (900)	

3 Change in accounting estimate

The residual value of vehicles was changed from C1 000 to C5 000.

	20X6 C
The (increase)/ decrease caused by the change is as follows:	
• current profits (before tax)	(900)
• future profits (before tax)	(2 700)

ii) Depreciation journal:

	Debit	Credit
No journal would be processed.		

iii) Adjustment to depreciation journal:

iii) Adjustment to depreciation journal:	Debit	Credit
Accumulated depreciation: vehicle	900	
Depreciation		900
<i>Adjustment to depreciation of vehicle</i>		

Workings:

W1	Change in accounting estimate (RAM)	Was	Is	Adjustment
	Date	Calculations		
Cost	1/1/20X0		10 000	
Accumulated depreciation	31/12/20X5	$(10K - 1K) / 10\text{yrs} \times 6\text{yrs}$	(5 400)	
Carrying amount	31/12/20X5		4 600	4 600
Residual value			(1 000)	(5 000)
Depreciable amount			3 600	(400)
Remaining useful life		10 – 6 years	4 years	4 years
Depreciation		current year adjustment	(900)	*(0)
Carrying amount	31/12/20X6		3 700	4 600
Depreciation:	future	(CA: 3 700 – RV: 1 000)	(2 700)	(0)
		(CA: 5 000 – RV: 5 000)		2 700
Carrying amount:	future final	residual value	1 000	4 600
				3 600

- * According to IAS 16, depreciation must cease when the residual value is greater than or equal to the carrying amount. Depreciation will resume when the residual amount drops below the carrying amount IAS 16, p 54.

Solution 7.5

**MERIDIAN LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X6**

		Note	20X6 C	20X5 C
Revenue	<i>Given</i>		800 000	650 000
Profit before tax	<i>(329 000 – 28 800)</i>	4	300 200	236 000
Income tax expense	<i>(131 600 – 28 800 x 40%) or (112 080 + 8 000 + 1 875)</i>	6	(120 080)	(94 400)
Profit for the period			180 120	141 600
<i>Other comprehensive income</i>			0	0
Total comprehensive income			180 120	141 600

**MERIDIAN LIMITED
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X6**

	Retained earnings C
Balance 31/12/20X4	(40 000)
Total comprehensive income: 20X5	141 600
Dividends	(10 000)
Balance 31/12/20X5	91 600
Total comprehensive income: 20X6	180 120
Dividends	(15 000)
Balance 31/12/20X6	256 720

Solution 7.5 continued ...

MERIDIAN LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X6

1. Accounting policies**1.1 Statement of compliance**

These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 198, provisions of and directives issued by under the Companies Ordinance, 1984. In case the requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

1.2 Basis of preparation

The financial statements have been prepared on the historical cost convention. The principal accounting policies are set out below. These policies are consistent in all material respects with those applied in the previous year.

1.3 Non-current assets

Plant is depreciated using the straight-line method over its remaining useful life of three years. This represents a change in estimate, as disclosed in note 4 and 5.

4. Profit before tax

	20X6	20X5
	C	C
Profit before tax is arrived at after deducting:		
Depreciation - plant	80 000	64 000
- original estimate	51 200	
- change in estimate (note 5)	28 800	

5. Change in estimate

The company changed the method of estimating depreciation on plant from the reducing balance to the straight-line method and changed the estimated residual value from C0 to R16 000.

	20X6
	C
The (increase)/ decrease caused by the change in estimate is as follows:	
• Current profits (before tax)	28 800
• Future profits (before tax)	(44 800)

6. Taxation expense

	20X6	20X5
	C	C
Normal tax		
- Current tax	20X6 (given – unchanged) or (W3)	112 080
- Deferred tax	20X6 [19 520 – (28 800x40%)] or (W2)	8 000
Tax expense	120 080	94 400

Tax rate reconciliation:

	20X6	20X5
	C	C
Applicable tax rate	40%	40%
N Tax effects of:		
Profit before tax	(20X5: 236 000 x 40%) (20X6: 300 200 x 40%)	120 080
Tax expense	120 080	94 400
Effective tax rate	(20X5: 94 400/ 236 000)	40.00%

(20X6: 120 080 / 300 200)

Solution 7.5 continued...

Workings

W1 Change in estimate – re-allocation method

There are two estimates that have changed:

- The estimated residual value has been changed (from C0 to R16 000); and
- The estimated pattern of consumption of the asset/ method of depreciation (from reducing balance method to straight-line method).

	Date	Calculations	Was	Is	Difference
Cost	1/1/20X3		500 000		
Depreciation	20X3	(500 000 x 0.20)	(100 000)		
Carrying amount	31/12/20X3		400 000		
Depreciation	20X4	(400 000 x 0.20)	(80 000)		
Carrying amount	31/12/20X4		320 000		
Depreciation	20X5	(320 000 x 0.20)	(64 000)		
Carrying amount	31/12/20X5		256 000	256 000	
		<i>Residual value</i>	0	(16 000)	
		<i>Depreciable amount</i>	256 000	240 000	
		<i>Rate or remaining useful life</i>	20%	3 years	
Depreciation	20X6	(256 000 x 0.20) (240 000 / 3)	(51 200)	(80 000)	(28 800)
Carrying amount	31/12/20X6		204 800	176 000	(28 800)
Depreciation	future	(CA: 256 000 – RV: 0) (CA: 176 000 – RV: 16 000)	(204 800)	(160 000)	44 800
Carrying amount	future/ final		0	16 000	16 000

W2 Calculation of deferred tax (not required)	Carrying amount	Tax base	Temporary difference	Deferred tax	
01/01/20X3 opening balance	0	0	0	0	
purchase	500 000	500 000	0	0	
depreciation/ wear & tear	(100 000)	(200 000)	(100 000)	(40 000)	
31/12/20X3 closing balance	400 000	300 000	(100 000)	(40 000)	L
depreciation/ wear & tear	(80 000)	(100 000)	(20 000)	(8 000)	
31/12/20X4 closing balance	320 000	200 000	(120 000)	(48 000)	L
depreciation/ wear & tear	(64 000)	(100 000)	(36 000)	(14 400)	
31/12/20X5 closing balance	256 000	100 000	(156 000)	(62 400)	L
depreciation/ wear & tear	(80 000)	(100 000)	(20 000)	(8 000)	
31/12/20X6 closing balance	176 000	0	(176 000)	(70 400)	L

W3 Tax computation (not required)		20X6			20X5		
			Tax x 40%	Journal entry		Tax x 40%	Journal entry
Profit before tax	<i>Per SOCI</i>	300 200	120 080	Dr TE	236 000	94 400	Dr TE
Temporary differences	<i>:Deferred tax</i>	(20 000)	8 000	Cr DT	(36 000)	14 400	Cr DT
+Depreciation		80 000			64 000		
-Tax allowances		(100 000)			(100 000)		
Taxable income	<i>:Current tax</i>	280 200	112 080	Cr CTP	200 000	80 000	Cr CTP

Solution 7.6**a) Journals**

Adjusting journal:	Debit	Credit
Depreciation	50 000	
Vehicles: accumulated depreciation		50 000
<i>Adjustment to depreciation of vehicles</i>		

For your interest:

Had no entries for depreciation yet been passed in 20X5, the correct journal entry would have been:

Correct depreciation journal:	Debit	Credit
Depreciation	125 000	
Vehicles: accumulated depreciation		125 000
<i>Depreciation of vehicles</i>		

b) Note disclosure

MILD LIMITED.
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X5 (EXTRACTS)

1. Accounting Policies**1.1 Statement of compliance**

These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 198, provisions of and directives issued by under the Companies Ordinance, 1984. In case the requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

1.2 Basis of preparation

The financial statements have been prepared on the historical cost convention. The principal accounting policies are set out below. These policies are consistent in all material respects with those applied in the previous year.

1.3 Depreciation

Vehicles are depreciated over 6 years using the straight-line method. This represents a change in estimate (see notes 2 and 3).

2. Profit before tax

Profit before tax is stated after taking into account the following items:

	20X5	20X4
	C	C
Depreciation	125 000	75 000
• original estimate	75 000	
• change in estimate	50 000	

3. Change in estimate

The company changed the estimated useful life of vehicles from 8 years to 6 years.

The (increase)/ decrease caused by the change in estimate is as follows:

20X5
C

- | | |
|-------------------|----------|
| • current profits | 50 000 |
| • future profits | (50 000) |

Solution 7.6 continued ...

c) Statement of comprehensive income – revised using the reallocation method

MILD LIMITED STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X5			20X5 C	20X4 C
Profit before taxation	(20X5: 500K-50K)	2	450 000	650 000
Taxation expense	(20X5: 180K – 50K x 30%)		165 000	300 000
Profit for the year			285 000	350 000
Other comprehensive income			0	0
Total comprehensive income			285 000	350 000

d) Statement of financial position – revised using the reallocation method

MILD LIMITED STATEMENT OF FINANCIAL POSITION AT 31 DECEMBER 20X5 (EXTRACTS)			20X5 C	20X4 C
	Workings	Notes		
ASSETS				
Property, plant and equipment	20X5: W1 = 'is' column 20X4: W1 = 'was' column	20	250 000	375 000

Workings

W1	Change in accounting estimate (RAM)		Was	Is	Adjustment
	Date	Calculations			
Cost:	1/1/20X2	given	600 000		
Accumulated depreciation:	31/12/20X4	was: 600 000 / 8yrs x 3yrs	(225 000)		
Carrying amount:	31/12/20X4		375 000	375 000	
Remaining useful life		was: 8 – 3; Is: 6 – 3	5 yrs	3 yrs	
Depreciation:	20X5	was: 375 000 / 5 yrs x 1 yr is: 375 000 / 3yrs x 1yr	(75 000)	(125 000)	(50 000)
Carrying amount:	31/12/20X5		300 000	250 000	(50 000)
Depreciation:	future	(CA: 300 000 – RV: 0) (CA: 250 000 – RV: 0)	(300 000)	(250 000)	50 000
Carrying amount:	future final	residual value	0	0	0

Solution 7.6 ADAPTATION

ADAPTATION of the question:
Repeat parts (a) – (d) assuming that the cumulative catch-up method is used to account for changes in accounting estimates.

a) Journals**Workings**

W1	Change in Accounting Estimate (CCUM)		Was	Is	Adjustment
	Date	Calculations			
Cost:	1/1/20X2	<i>given</i>	600 000	600 000	
Accumulated depreciation:	31/12/20X4	<i>was: 600 000 / 8yrs x 3yrs</i>	(225 000)	(300 000)	(75 000) <i>Extra deprec</i>
		<i>is: 600 000 / 6 yrs x 3yrs</i>			
Carrying amount:	31/12/20X4		375 000	300 000	
<i>Remaining useful life</i>		<i>was: 8 – 3; Is: 6 – 3</i>	<i>5 yrs</i>	<i>3 yrs</i>	
Depreciation:	20X5	<i>was: 375 000 / 5yrs</i>	(75 000)	(100 000)	(25 000) <i>Extra deprec</i>
		<i>is: 300 000 / 3 yrs</i>			
Carrying amount:	31/12/20X5	<i>cumulative adjustment</i>	300 000	200 000	(100 000)
Depreciation:	future	<i>(CA: 300 000 – RV: 0)</i> <i>(CA: 200 000 – RV: 0)</i>	(300 000)	(200 000)	100 000 <i>Less deprec</i>
Carrying amount:	future final	<i>residual value</i>	0	0	0

Adjusting journal

	Debit	Credit
Depreciation	100 000	
Accumulated depreciation: vehicles		100 000
<i>Adjustment to depreciation of vehicles</i>		

For your interest: Had no entries for depreciation yet been passed in 20X5, the correct journal entry would have been:

	Debit	Credit
Depreciation	175 000	
Accumulated depreciation: vehicles		175 000
<i>Depreciation of vehicles</i>		

b) Note disclosure

SPRING LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X5 (EXTRACTS)

1. Accounting Policies**1.1 Basis of preparation**

These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 198, provisions of and directives issued by under the Companies Ordinance, 1984. In case the requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

1.2 Depreciation

Vehicles are depreciated over 6 years using the straight-line method. This represents a change in estimate (see notes 3 and 4).

Solution 7.6 ADAPTATION continued ...**b) Note disclosure continued ...****3. Profit before tax**

Profit before tax is stated after taking the following items into account:

		20X5 C	20X4 C
Depreciation		175 000	75 000
• original estimate		75 000	
• change in estimate	4	100 000	

4. Change in accounting estimate

The company changed the estimated useful life of vehicles from 8 years to 6 years.

The (increase) / decrease caused by the change in estimate on profit before tax is as follows:

	20X5 C
• current profits	(100 000)
• future profits	100 000

c) Statement of comprehensive income – revised using the cumulative catch-up method
SPRING LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X5

			20X5 C	20X4 C
Profit before taxation	(20X5: 500K-100K)	2	400 000	650 000
Income tax expense	(20X5: 180K – 100K x 30%)		150 000	300 000
Profit for the period			250 000	350 000
Other comprehensive income			0	0
Total comprehensive income			250 000	350 000

Notice that when adjusting for a change in accounting estimate, there is no change to the prior year figures (the change is adjusted for prospectively). Notice that the tax amount is adjusted by the tax effect of the change in estimate adjustment (i.e. adjustment x tax rate). You must NEVER assume that tax will be 30% of 'profit before tax' because there may be permanent differences, STC and other reconciling items to be taken into consideration.

d) Statement of financial position – revised using the cumulative catch-up method
SPRING LIMITED
STATEMENT OF FINANCIAL POSITION
AT 31 DECEMBER 20X5 (EXTRACTS)

			20X5 C	20X4 C
ASSETS	Workings	Notes		
Property, plant and equipment	20X5: W1 = 'is' column 20X4: W1 = 'was' column	20	200 000	375 000

Solution 7.7

a)

PEAR LIMITED
EXTRACT FROM STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X6

		20X6 C	20X5 C Restated
Profit before tax	(20X6: 500 000 – 150 000) (20X5: 400 000 – 150 000)	350 000	250 000
Income tax expense	[20X6: 145 000 – (150 000 X 0,29)] [20X5: 116 000 – (150 000 X 0,29)]	(101 500)	(72 500)
Profit for the period		248 500	177 500
Other comprehensive income		0	0
Total comprehensive income		248 500	177 500

PEAR LIMITED
EXTRACT FROM THE STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X6

	Note	Retained earnings C
Balance: 01/01/X5 - restated		54 000
- As previously reported		(159 000)
- Correction of error	[600 000 – (600 000 / 4 yrs x 2 yrs)] x 0,71	213 000
Total comprehensive income - restated		177 500
Balance: 31/12/X5 - restated		231 500
- As previously reported		125 000
- Correction of error	[213 000 – (150 000 x 0,71)]	106 500
Total comprehensive income		248 500
Balance: 31/12/X6		480 000

Solution 7.7 continued ...

b)

PEAR LIMITED
EXTRACT FROM THE NOTES TO THE FINANCIAL STATEMENTS
AT 31 DECEMBER 20X6

		20X5 C	20X4 C
3 Correction of error			
.			
The company had incorrectly recorded the acquisition of a vehicle as an expense in a prior year. The effect of the correction of the error is as follows:			
Effect on the statement of comprehensive income			
Increase: depreciation	<i>(600 000 / 4 yrs)</i>	150 000	
Decrease: taxation expense	<i>(150 000 X 0,29)</i>	(43 500)	
Decrease: profit		<hr/> 106 500	
Effect on the statement of financial position			
Increase: property, plant and equipment	20X5: <i>[600 000 – (600 000 / 4 yrs X 3 yrs)]</i> 20X4: <i>[600 000 – (600 000 / 4 yrs X 2 yrs)]</i>	150 000	300 000
Increase: current tax payable	20X5: <i>[600 000 - (600 000/ 4 yrs X 3yrs)] X 0,29</i> 20X4: <i>[600 000 - (600 000/ 4 yrs X 2yrs)] X 0,29</i>	(43 500)	(87 000)
Increase: retained earnings	20X5: <i>(expense reversed 600 000 – amortisation to date 600 000 / 4 x 3yrs) x 71%</i> 20X4: <i>(expense reversed 600 000 – amortisation to date 600 000 / 4 x 2yrs) x 71%</i>	(106 500)	(213 000)

Solution 7.8**a) Journal**

	Debit	Credit
20X7		
Inventory	3 000	
Retained earnings		2 100
Current tax payable		900
<i>Correction of prior period error</i>		

Workings

The journal entry above can be understood by examining the journal entries that *would have been* processed if it were possible to post journal entries to each specific year affected.

	Debit	Credit
Year of inception to 20X5 (prior to the prior year)		
Inventory	2 000	
Cost of sales		2 000
<i>Inventory balance increased: 14 000 - 12 000</i>		
Tax expense	600	
Current tax payable		600
<i>Tax on increased profits: 2 000 x 30%</i>		
20X6 (prior year)		
Cost of sales	1 000	
Inventory		1 000
<i>Inventory balance increased: 15 000 - 14 000 = 1 000 increase</i>		
<i>But increased inventory by 2 000 in past years, therefore:</i>		
<i>1 000 - 2 000 increase in past years = 1 000 decrease</i>		
Current tax payable	300	
Tax expense		300
<i>Tax on decreased profits: 1 000 x 30%</i>		
20X7 (current year)		
Inventory	2 000	
Cost of sales		2 000
<i>Inventory balance increased: 18 000 - 15 000 = 3 000 increase</i>		
<i>But increased inventory by 1 000 in past years (2 000 - 1 000), therefore:</i>		
<i>3 000 - 1 000 increase in past years = 2 000 increase</i>		
Tax expense	600	
Current tax payable		600
<i>Tax on increased profits: 2 000 x 30%</i>		

Solution 7.8 continued

b)

HOT LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X7

		20X7 C	20X6 C Restated
Gross revenue		1 200 000	900 000
Cost of sales	<i>Journals: (20X7: 420 000 – 2 000) (20X6: 350 000 + 1 000) or W1</i>	(418 000)	(351 000)
Gross profit		782 000	549 000
Other costs (given)		(220 000)	(200 000)
Profit before tax		562 000	349 000
Income tax expense	<i>Journals: (20X7: 235 200 + 600) (20X6: 136 500 - 300) or W2</i>	(235 800)	(136 200)
Profit for the period		326 200	212 800
Other comprehensive income		0	0
Total comprehensive income		326 200	212 800

HOT LIMITED.
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X7 (EXTRACTS)

		Note	Retained earnings C
Opening balance: 1/1/20X6 - restated			68 900
- As previously reported (given)			67 500
- Correction of error	<i>(14 000 – 12 000) x 70% or W2 or Note: 700 + 700 or Journals: (2 000 – 600)</i>	4	1 400
Total comprehensive income: 20X6 restated	<i>213 500 – 700 or per statement of comprehensive income</i>		212 800
Opening balance: 1/1/20X7 - restated			281 700
- As previously reported (given)			281 000
- Correction of error	<i>(15 000 – 14 000) x 70% or W2 or per note or Journals: (1 400 – 1 000 + 300)</i>	4	700
Total comprehensive income: 20X7	<i>324 800 + 1 400 or per statement of comprehensive income</i>		326 200
Closing balance: 31/12/20X7			607 900

Solution 7.8 continued

b) continued ...

**HOT LIMITED.
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X7 (EXTRACTS)**

	Notes	20X7 C	20X6 C Restated	20X5 C Restated
ASSETS				
Inventory <i>Given</i>	25	18 000	15 000	14 000
EQUITY AND LIABILITIES				
Retained earnings <i>Per statement of changes in equity</i>		607 900	281 700	68 900

**HOT LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X7**
1. Accounting policies**1.1 Statement of compliance**

These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 198, provisions of and directives issued by under the Companies Ordinance, 1984. In case the requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

1.2 Basis of preparation

The financial statements have been prepared on the historical cost convention. The principal accounting policies are set out below. These policies are consistent in all material respects with those applied in the previous year.

1.3 Inventories

Inventories are stated at the lower of cost or net realisable value, with movements recorded on the first-in-first-out method. This represents a correction of error (see note 4).

4. Correction of error

The company had incorrectly recorded inventory movements using the weighted average method instead of the first-in-first-out method.

The effect of this correction is as follows:

Effect on the statement of comprehensive income	20X6 C	
<i>Increase/ (decrease) in expenses or losses</i>		
Increase in cost of sales	1 000	
Decrease in tax expense	(300)	
<i>(Increase)/ decrease in income or profits</i>		
Decrease in profit for the year	<u>700</u>	
Effect on the statement of financial position	20X6 C	20X5 C
<i>Increase/ (decrease) in assets</i>		
Increase in inventories	1 000	2 000
<i>(Increase)/ decrease in liabilities and equity</i>		

Increase in current tax payable	(300)	(600)
Increase in retained earnings	(700)	(1 400)

Solution 7.8 continued

b) continued ...

Workings

W1 Reconstruction of the inventory accounts	CY	PY	PPY
	Was	Was	Was
Opening balance (given) (PPY: always zero when starting a business)	14 000	12 000	0
Purchases (balancing figure) (PPY: assumed figure)	421 000	352 000	100 000
Closing balance (given)	(15 000)	(14 000)	(12 000)
Cost of sales (given)	420 000	350 000	88 000
	Is	Is	Is
Opening balance (given) (PPY: always zero when starting a business)	15 000	14 000	0
Purchases (per above working)	421 000	352 000	100 000
Closing balance (given)	(18 000)	(15 000)	(14 000)
Cost of sales (balancing figure)	418 000	351 000	86 000

Abbreviations: CY = current year; PY = prior year; PPY = prior to the prior year

W2 Effect of change on line items:	CY	PY	PPY
	Difference	Difference	Difference
Cost of sales increased/ (decreased)	(2 000)	1 000	(2 000)
Profit before tax (increased)/ decreased	(2 000)	1 000	(2 000)
Tax increased/ (decreased)	600	(300)	600
Profit for the year (increased)/ decreased	(1 400)	700	(1 400)
Inventory increased/ (decreased)	3 000	1 000	2 000
Current tax payable (increased)/ decreased	(900)	(300)	(600)
Closing retained earnings (increased)/ decreased	(2 100)	(700)	(1 400)

Abbreviations used:

CY: current year

PY: prior year

PPY: years prior to the prior year

Alternative workings (can replace W1 and W2):

Summary adjustments	Cumulative to	Profit for	Cumulative to	Profit for	Cumulative to
	20X7	20X7	20X6	20X6	20X5
WA (old)	15 000		14 000		12 000
FIFO (new)	18 000		15 000		14 000
	(3 000)	(2 000)	(1 000)	1 000	(2 000)
Tax	900	600	300	(300)	600
	(2 100)	(1 400)	(700)	700	(1 400)

Solution 7.8 continued

c)

HOT LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X7

		20X7 C	20X6 C Restated
Revenue		1 200 000	900 000
Cost of sales	<i>Journals: (20X7: 420 000 – 2 000) (20X6: 350 000 + 1 000) or W1</i>	(418 000)	(351 000)
Gross profit		782 000	549 000
Other costs	<i>Given</i>	(220 000)	(200 000)
Profit before tax		562 000	349 000
Income tax expense	<i>Journals or W2: (20X7: 235 200 + 600) (20X6: 136 500 - 300)</i>	(235 800)	(136 200)
Profit for the period		326 200	212 800
Other comprehensive income		0	0
Total comprehensive income		326 200	212 800

HOT LIMITED.
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X7 (EXTRACTS)

		Note	Retained earnings C
Opening balance: 1/1/20X6 - restated			68 900
- As previously reported	<i>Given</i>		67 500
- Change in accounting policy	<i>(14 000 – 12 000) x 70% or W2 or Note: 700 + 700 or Journals: (20X7: 2 000 – 600)</i>	4	1 400
Total comprehensive income: 20X6 restated	<i>213 500 – 700 or per Statement of comprehensive income</i>		212 800
Opening balance: 1/1/20X7 - restated			281 700
- As previously reported	<i>Given</i>		281 000
- Change in accounting policy	<i>(15 000 – 14 000) x 70% or W2 or per note or Journals: (1 400 – 1 000 + 300)</i>	4	700
Total comprehensive income: 20X7	<i>324 800 + 1 400 or per Statement of comprehensive income</i>		326 200
Closing balance: 31/12/20X7			607 900

Solution 7.8 continued

c) continued

HOT LIMITED.**STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X7 (EXTRACTS)**

	Notes	20X7 C	20X6 C Restated	20X5 C Restated
ASSETS				
Inventory	Given	25	18 000	15 000
EQUITY AND LIABILITIES				
Retained earnings	Per statement of changes in equity		607 900	281 700
				68 900

HOT LIMITED**NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X7****1. Accounting policies****1.1 Statement of compliance**

These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 198, provisions of and directives issued by under the Companies Ordinance, 1984. In case the requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

1.2 Basis of preparation

The financial statements have been prepared on the historical cost convention. The principal accounting policies are set out below. These policies are consistent in all material respects with those applied in the previous year, except the policy concerning the recording of inventory as detailed in note 4.

1.3 Inventories

Inventories are stated at the lower of cost or net realisable value, with movements recorded on the first-in-first-out method. This represents a change in accounting policy (see note 4).

4. Change in accounting policy

The company changed its policy of recording inventory movements using the weighted average method to the first-in-first-out method instead.

This gives relevant and more reliable information in that it better reflects the expected pattern of future economic benefits through usage and sale of inventory. The comparatives have been appropriately restated.

The effect of this change is as follows:

Effect on the statement of comprehensive income		20X7 C	20X6 C
<i>Increase/ (decrease) in expenses or losses</i>			
- Cost of sales		(2 000)	1 000
- Tax expense		600	(300)
<i>(Increase)/ decrease in income or profits</i>			
- Profit for the year		(1 400)	700
Effect on the statement of financial position		20X7 C	20X6 C
<i>Increase/ (decrease) in assets</i>			
- Inventories		3 000	1 000
			2 000

(Increase)/ decrease in liabilities and equity

- Current tax payable	(900)	(300)	(600)
- Retained earnings - closing	(2 100)	(700)	(1 400)

Solution 7.9

a)

Change in accounting estimate (RAM)			Was	Is	Difference
Cost	1/1/20X0		250 000		
	31/12/20X2	(250K - 5K)/10yrs x 3yrs	(73 500)		
Carrying amount	1/1/20X3		176 500	176 500	
Residual value			(5 000)	(10 000)	
Depreciable amount			171 500	166 500	
Remaining useful life		was: 10 - 3; is 15 - 3	7	12	
Depreciation	20X3		(24 500)	(13 875)	10 625
Carrying amount	31/12/20X3		152 000	162 625	
Depreciation	future		(147 000)	(152 625)	(5 625)
Carrying amount	future	residual value	5 000	10 000	5 000

b)

ORANGES LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X3

5. Change in accounting estimate

The residual value of machinery was increased (from C5 000 to C10 000) and the useful life was increased (from 10 years to 15 years).

The (increase)/ decrease caused by the change in estimate is as follows:

	20X3
	C
Current profits	(10 625)
Future profits	5 625
	<u>(5 000)</u>

6. Correction of material error

Cost of sales was incorrectly recognised as equipment during 20X1.

	20X2	
	C	
Effect on the statement of comprehensive income		
<i>Increase/ (decrease) in expenses or losses</i>		
- Depreciation	(30 000)	
- Tax expense $30\,000 \times 30\%$	9 000	
<i>(Increase)/ decrease in income or profits</i>		
- Profit for the year	<u>(21 000)</u>	
Effect on the statement of financial position	20X2	20X1
<i>Increase/ (decrease) in assets</i>	C	C
Property, plant and equipment $20X2: 300\,000 - (300\,000 \times 10\% \times 1.5 \text{ years})$	(255 000)	(285 000)
$20X1: 300\,000 - (300\,000 \times 10\% \times 0.5 \text{ years})$		
<i>(Increase)/ decrease in liabilities</i>		
Deferred tax liability $20X2: 255\,000 \times 30\%$	76 500	85 500
$20X1: 285\,000 \times 30\%$		
<i>(Increase)/ decrease in equity</i>		

Retained earnings	$20X2: [300\,000 - (300\,000 \times 10\% \times 1.5)] \times 70\%$ $20X1: [300\,000 - (300\,000 \times 10\% \times 0.5)] \times 70\%$ <i>OR balancing</i>	178 500	199 500
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Solution 7.9 continued ...

b) continued ...

ORANGES LTD
STATEMENT OF COMPREHENSIVE INCOME (EXTRACTS)
FOR THE YEAR ENDED 31 DECEMBER 20X3

		20X3	20X2
		C	Restated C
Profit before taxation	<i>Calculations</i> 20X3: 300 000 + 10 625 deprec estimate + 30 000 depr error corrected	340 625	280 000
Taxation expense	20X2: 250 000 + 30 000 depr error restatement 20X3: 80 000 + 3 188 + 9 000 20X2: 70 000 + 9 000	(92 188)	(79 000)
Profit for the year		248 437	201 000
Other comprehensive income		0	0
Total comprehensive income		248 437	201 000

ORANGES LTD
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X3

			Retained earnings C
Balance: 1/1/20X2 - restated			800 500
- As previously reported	<i>given</i>		1 000 000
- Correction of material error	(300 000 – 15 000) x 70% or note: 178 500 – (- 21 000)	6	(199 500)
Total comprehensive income: 20X2 - restated			201 000
Balance: 1/1/20X3 - restated			1 001 500
- As previously reported	1 000 000 + 180 000		1 180 000
- Correction of material error	199 500 – (30 000 x 70%) or note	6	(178 500)
Total comprehensive income: 20X3			248 437
Balance: 31/12/20X3			1249 937

Solution 7.9 continued ...

b) continued ...

ORANGES LTD		20X3	20X2	20X1
DRAFT EXTRACTS FROM THE STATEMENT OF FINANCIAL POSITION		C	C	C
AS AT 31 DECEMBER 20X3			Restated	Restated
Property, plant and equipment	<i>Draft SOFP adjusted by note/ jnl 20X1: 1 566 000 – 285 00: note 20X2: 1 391 500 – 255 000: note 20X3: 1 217 000 – 255 000: note + 30 000: correction of error jnl in CY + 10 625: change in estimate jnl in CY</i>	1 002 625	1 136 500	1 281 000
Retained earnings	<i>Statement of changes in equity</i>	1 249 937	1 001 500	800 500
Deferred tax liability	<i>Draft SOFP adjusted by note/ jnl 20X1: 170 000 – 85 500: note 20X2: 150 000 – 76 500: note 20X3: 140 000 – 76 500: note + 9 000: correction of error jnl in CY + 3 188: change in estimate jnl in CY</i>	75 688	73 500	84 500

Solution 7.9 continued ...

c)

	Debit	Credit
20X3		
Retained earnings (closing balance in 20X2)	178 500	
Equipment: cost		300 000
Equipment: accumulated depreciation	45 000	
Deferred tax	76 500	
<i>Correcting journal entry: effect on years before 20X3</i> <i>(see W1 for proof that the tax adjustment is DT not CTP)</i>		
Machinery: accumulated depreciation	10 625	
Depreciation		10 625
Taxation expense	3 187.50	
Deferred tax		3 187.50
<i>Adjusting journal entry (change in estimate)</i>		
Equipment accumulated depreciation	30 000	
Depreciation		30 000
Taxation expense	9 000	
Deferred tax		9 000
<i>Correcting journal entry: effect on 20X3</i>		

For interest sake, had one been able to process journals in the previous years of 20X2 and 20X1, the first 'correcting' journal entry shown in 20X3 above would have been replaced with entries made to the specific years affected as follows:

	Debit	Credit
20X1		
Cost of sales	300 000	
Equipment: cost		300 000
<i>Correcting journal entry: 20X1</i>		
Equipment: accumulated depreciation	15 000	
Depreciation		15 000
<i>Correcting journal entry: 20X1</i> <i>Reversal of depreciation on equipment:</i> <i>300 000 x 10% x 0.5 year</i>		
Deferred tax	85 500	
Taxation expense		85 500
<i>Correcting journal entry: tax effect on decreased profit in 20X1:</i> <i>(300 000 – 15 000) x 30%</i>		
20X2		
Equipment: accumulated depreciation	30 000	
Depreciation		30 000
<i>Correcting journal entry: 20X2</i> <i>Reversal of depreciation on equipment:</i> <i>300 000 x 10% x 1 years</i>		
Taxation expense	9 000	
Deferred tax		9 000
<i>Correcting journal entry: tax effect on increased profit in 20X2:</i> <i>30 000 x 30%</i>		

Solution 7.9 continued ...

c) continued ...

Workings

W1. Proof that the tax adjustment is a deferred tax adjustment

Deferred tax caused by equipment that did not exist	Carrying amount	Tax base	Temporary difference	Deferred tax	Balance or adjustment
Incorrect balances: 31/12/20X2 (300 000 - 300 000 x 10% x 1.5 yrs)	255 000	0	(255 000)	(76 500)	L
Correct balances: 31/12/20X2	0	0	0	0	
Adjustment required				<u>76 500</u>	Dr DT; Cr TE

Comment: This required deferred tax adjustment assumes that the correct figures had been submitted for tax purposes. In other words:

- a deduction for cost of sales of C300 000 had been claimed in 20X1 and
- a deduction of wear and tear had been claimed on the correct equipment cost of C1 200 000 in 20X1 and 20X2 (i.e. wear and tear was not claimed on the incorrect cost of C1 500 000).

Solution 7.10

a) Journals

		Debit	Credit
20X6			
Retained earnings	$300\,000 \times 70$	210 000	
VAT payable	<i>Given</i>		300 000
Current tax payable: income tax	$300\,000 \times 30\%$	90 000	
<i>Correction of error made in 20X5</i>			
Depreciation		60 000	
Vehicles: accumulated depreciation			60 000
<i>Change in estimated depreciation: W1 (90 000 – 30 000)</i>			
Deferred tax		18 000	
Tax expense			18 000
<i>Change in estimated depreciation: tax effect of decreased profits: 60 000 x 30%</i>			
Advertising expense		750 000	
Machine: cost			750 000
Machine: accumulated depreciation	$750\,000 \times 10\% \times 7/12$	43 750	
Depreciation			43 750
<i>Correction of error made in 20X6: reverse incorrectly capitalised advertising to expense and reverse related depreciation</i>			
Current tax payable: income tax		198 750	
Tax expense			198 750
<i>Correction of error made in 20X6: tax effect of decreased profit: [(750 000 x 20% x 7/12) - 750 000] x 30%</i>			
Deferred tax		13 125	
Tax expense			13 125
<i>Correction of error made in 20X6: Tax base was: $750\,000 - (750\,000 \times 20\% \times 7/12) = 662\,500$ Carrying amount was: $750\,000 - (750\,000 \times 10\% \times 7/12) = 706\,250$ DTL was: $(662\,500 - 706\,250) \times 30\% = 13\,125$; to be reversed</i>			

For interest sake, had one been able to process journals in the previous year of 20X5, the first 'correcting' journal entry in 20X6 above would have been replaced with the following entries in 20X5:

	Debit	Credit
20X5		
Revenue	300 000	
VAT payable		300 000
Current tax payable: income tax	90 000	
Tax expense		90 000
<i>Correction of error made in 20X5</i>		

Solution 7.10 continued ...

b) Disclosure

TRUTH LIMITED

STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X6

		Notes	20X6 C	20X5 C Restated
Revenue	(20X6: 3 810 000) (20X5: 2 600 000 – 300 000)	3	3 810 000	2 300 000
Other income			250 000	100 000
Cost of sales	(20X6: 2 280 000 + 143 750 – 43 750)	1	(2 380 000)	(1 260 000)
Distribution costs	(20X6: 30 000 + 60 000)		(90 000)	(30 000)
Administration costs			(150 000)	(150 000)
Other costs	(W3)		(1 316 250)	(470 000)
Profit before taxation		4	123 750	490 000
Income tax expense	(20X6: 252 000 – 198 750 – 13 125 – 18 000) (20X5: 207 000 – 90 000)	7	(22 125)	(117 000)
Profit for the period			101 625	373 000
Other comprehensive income			0	0
Total comprehensive income			101 625	373 000

Please note:

- 1) The machinery was used in the manufacturing process and depreciation thereon is therefore capitalised to inventory and ultimately expensed as cost of sales. Since no inventory was on hand at year end, all depreciation on machinery would have been expensed through cost of sales.
- 2) Since the vehicles are delivery vehicles, depreciation thereon is included in distribution costs.

TRUTH LIMITED

STATEMENT OF CHANGES IN EQUITY

FOR THE YEAR ENDED 31 DECEMBER 20X6 (EXTRACTS)

	Notes	Retained earnings C
Balance - 1 January 20X5		900 000
Total comprehensive income: 20X5 - restated		373 000
Balance - 31 December 20X5 - restated		1 273 000
- As previously reported		1 483 000
- Correction of error	6	(210 000)
Total comprehensive income: 20X6		101 625
Balance - 31 December 20X6		1 374 625

Solution 7.10 continued ...

b) Disclosure continued ...

TRUTH LIMITED.**NOTES TO THE FINANCIAL STATEMENTS****FOR THE YEAR ENDED 31 DECEMBER 20X6 (EXTRACTS)**

3 Revenue			
Revenue comprises:		20X6	20X5
		C	C
Sale of goods	X5: 2 600 000 – 300 000	3 810 000	2 300 000
4 Profit before taxation			
Profit before taxation is stated after taking the following (income)/ expenses into account:		20X6	20X5
		C	C
Directors' remuneration		150 000	150 000
Depreciation on machinery	W2 or 143 750 – 43 750	100 000	100 000
Depreciation on vehicles	W1	90 000	30 000
• original estimate	W1	30 000	
• change in estimate	W1	60 000	
Profit on expropriation of land (tax effect: nil)		(150 000)	
Loss on inventory destroyed in tornado (tax decreased by R39 000)		130 000	
Loss on sale of land (tax effect: nil)		200 000	0
5 Change in accounting estimate			
The rate of depreciation on vehicles was changed from 10% pa to 20% pa.		20X6	
		C	
The (increase)/ decrease in profits is as follows:			
• current profits before tax	W1	60 000	
• future profits before tax	W1	(60 000)	
6 Correction of error			
A VAT liability was erroneously recognised as revenue in 20X5.		20X5	
The effect of the correction is as follows:		C	
Effect on the statement of comprehensive income			
<i>Increase/ (decrease) in expenses or losses</i>			
Income tax expense		(90 000)	
<i>(Increase)/ decrease in income or profits</i>			
Revenue		300 000	
Profit		210 000	
Effect on the statement of financial position		20X5	20X4
<i>(Increase)/ decrease in liabilities and equity</i>		C	C
VAT payable		(300 000)	0
Income tax payable		90 000	0
Retained earnings		210 000	0

Solution 7.10 continued ...

b) Disclosure continued ...

TRUTH LIMITED

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 20X6 (EXTRACTS) CONTINUED ...

		20X6 C	20X5 C
7 Taxation expense			
Normal tax			
Current tax	W4	1 125	78 000
Deferred tax	W5: (20X6: 30K - 9K); (20X5: -30K-9K) or W4	21 000	39 000
Income tax expense	W4	<u>22 125</u>	<u>117 000</u>
<i>Tax rate reconciliation:</i>			
Applicable tax rate		30%	30%
Tax effects of:			
Profit before tax	(123 750 x 30%) (490 000 x 30%)	37 125	147 000
Profit on expropriation of land	(150 000 x 30%) (N/A)	(45 000)	0
Dividend income	(100 000 x 30%) (100 000 x 30%)	(30 000)	(30 000)
Loss on sale of land	(200 000 x 30%) (N/A)	60 000	0
Income tax expense		<u>22 125</u>	<u>117 000</u>
Effective tax rate	(22 125 / 123 750) (117 000 / 490 000)	17.9%	23.9%

Solution 7.10 continued ...

Workings

W1 Change in accounting estimate (RAM)			Was	Is	Difference
Cost	1/7/20X3		300 000		
Accum.	31/12/20X5 (was:		(75 000)		
Depreciation	300 000 x 10% x 2.5 yrs)				
Carrying amount	31/12/20X5		225 000	225 000	
Remaining useful life	(was: 10 yrs – 2.5 yrs)		7.5 yrs	2.5 yrs	
	(is: 5 yrs – 2.5 yrs)				
Depreciation	20X6 (was: 225 000 / 7.5)		(30 000)	(90 000)	(60 000)
	(is: 225 000 / 2.5)				extra depr
Carrying amount	31/12/20X6		195 000	135 000	
Depreciation: future	(CA: 195 000 – RV: 0)		(195 000)	(135 000)	60 000
	(CA: 135 000 – RV: 0)				less depr
Carrying amount: future final			0	0	0

W2 Correction of error in current year: depreciation – machinery			20X6	20X5
Depreciation - given			143 750	100 000
Depreciation on advertising:	(750 000 x 10% x 7/12)		(43 750)	0
			100 000	100 000

W3 Other expenses			20X6	20X5
Given			890 000	750 000
Depreciation on machinery	Cost of sales		(143 750)	(100 000)
Depreciation on vehicles	Distribution costs		(30 000)	(30 000)
Advertising			750 000	0
Directors remuneration	Administration costs		(150 000)	(150 000)
			1 316 250	470 000

W4 Current tax		20X6		20X5	
		x 0.30		x 0.30	
Profit before tax	123 750			490 000	
Permanent differences					
- Profit on expropriation of land	(150 000)				
- Dividend income	(100 000)			(100 000)	
+ Loss on sale of land	200 000				
	73 750	22 125 Dr TE		390 000	117 000 Dr TE
Temporary differences					
	(70 000)	21 000 Cr DT		(130 000)	39 000 Cr DT
+Depreciation (machines)	100 000			100 000	
+Depreciation (vehicles)	90 000			30 000	
- W+T allowance (machines) *	(200 000)			(200 000)	
- W+T allowance (vehicles) **	(60 000)			(60 000)	
Taxable profit / (loss)	3 750	1 125 Cr CTP		260 000	78 000 Cr CTP

* wear and tear on machines: 1 000 000 x 20%

** wear and tear on vehicles: 300 000 x 20%

Solution 7.10 continued ...

Workings continued ...

W5 Deferred taxation

	Carrying amount	Tax base	Temporary difference	Deferred taxation	
Machinery					
Cost 1/5/20X4	1 000 000	1 000 000	0	0	
Movement - 20X4	(66 667)	(133 333)	(66 667)	(20 000)	Cr DT Dr Tax
Balance 31/12/20X4	933 333	866 667	(66 667)	(20 000)	DTL
Movement - 20X5	(100 000)	(200 000)	(100 000)	(30 000)	Cr DT Dr Tax
Balance 31/12/20X5	833 333	666 667	(166 667)	(50 000)	DTL
Movement - 20X6	(100 000)	(200 000)	(100 000)	(30 000)	Cr DT Dr Tax
Balance 31/12/20X6	733 333	466 667	(266 667)	(80 000)	DTL

Calculation of depreciation (carrying amount column):

20X4:	1 000 000 x 10% x 8/12	66 667
20X5/6:	1 000 000 x 10%	100 000

Calculation of wear and tear (tax base column):

20X4:	1 000 000 x 20% x 8/12	133 333
20X5/6:	1 000 000 x 20%	200 000

	Carrying amount	Tax base	Temporary difference	Deferred taxation	
Vehicles					
Cost 1/7/20X3	300 000	300 000	0	0	
Movement - 20X3	(15 000)	(60 000)	(45 000)	(13 500)	Cr DT Dr Tax
Balances 31/12/20X3	285 000	240 000	(45 000)	(13 500)	DTL
Movement - 20X4	(30 000)	(60 000)	(30 000)	(9 000)	Cr DT Dr Tax
Balance 31/12/20X4	255 000	180 000	(75 000)	(22 500)	DTL
Movement - 20X5	(30 000)	(60 000)	(30 000)	(9 000)	Cr DT Dr Tax
Balance 31/12/20X5	225 000	120 000	(105 000)	(31 500)	DTL
Movement - 20X6	(90 000)	(60 000)	30 000	9 000	Dr DT Cr Tax
Balance 31/12/20X6	135 000	60 000	(75 000)	(22 500)	DTL

Calculation of the depreciation (carrying amount column):

20X3:	300 000 x 10% x 6/12	15 000
20X4/5:	300 000 x 10%	30 000
20X6:	per profit before tax note or W1: 225 000 – 135 000	90 000

Calculation of wear and tear (tax base column):

20X3:	300 000 x 20% (not apportioned for part of a year)	60 000
20X4/5/6:	300 000 x 20%	60 000

Solution 7.11

a)

Journals		Debit	Credit
20X1			
Amortisation expense	$(600\,000 / 15 - 600\,000 / 20)$	10 000	
Intangible asset: accumulated amortisation			10 000
Deferred tax	$10\,000 \times 30\% \text{ or } W1$	3 000	
Tax expense			3 000
<i>Correction of error: 20X1</i>			
20X2			
Amortisation expense	$(600\,000 / 15 - 600\,000 / 20)$	10 000	
Intangible asset: accumulated amortisation			10 000
Deferred tax	$10\,000 \times 30\% \text{ or } W1$	3 000	
Tax expense			3 000
<i>Correction of error: 20X2</i>			
20X3			
Amortisation	$(600\,000 / 15 - 600\,000 / 20)$	10 000	
Intangible asset: accumulated amortisation			10 000
Deferred tax	$10\,000 \times 30\% \text{ or } W1$	3 000	
Tax expense			3 000
<i>Correction of error: 20X3</i>			
20X4			
Amortisation	$(600\,000 / 15 - 600\,000 / 20)$	10 000	
Intangible asset: accumulated amortisation			10 000
Deferred tax	$10\,000 \times 30\% \text{ or } W1$	3 000	
Tax expense			3 000
<i>Correction of error: 20X4</i>			

One is often unable to process journals in the prior period, in which case the following journal entries would be required instead:

Journals		Debit	Credit
1 January 20X4			
Retained earnings	$(600\,000 / 15 - 600\,000 / 20) \times 70\% \times 3 \text{ yrs}$	21 000	
Intangible asset: accum. amortisation	$(600\,000 / 15 - 600\,000 / 20) \times 3 \text{ yrs}$		30 000
Deferred tax	$(600\,000 / 15 - 600\,000 / 20) \times 30\% \times 3 \text{ yrs}$	9 000	
<i>Correction of error: years prior to 20X4</i>			
31 December 20X4			
Amortisation	$(600\,000 / 15 - 600\,000 / 20) \times 1 \text{ yr}$	10 000	
Intangible asset: accumulated amortisation			10 000
Deferred tax	$10\,000 \times 30\% \times 1 \text{ yr}$	3 000	
Tax expense			3 000
<i>Correction of error: effect on 20X4</i>			

Solution 7.11 continued ...

b)

AUTUMN LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X4
5. Correction of Error

The Guppy Rights have been amortised over a period of 20 years instead of 15 years.

The effect of the correction on the prior year/s is as follows:

		20X3	
		C	
Effect on the statement of comprehensive income			
<i>Increase/ (decrease) in expenses or losses</i>			
- Amortisation	$600K / 20 - 600K / 15$	10 000	
- Tax expense	$10\,000 \times 30\%$	(3 000)	
<i>(Increase)/ decrease in income or profits</i>			
- Profit for the year	<i>Balancing</i>	7 000	
		20X3	20X2
		C	C
Effect on the statement of financial position			
<i>Increase/ (decrease) in assets</i>			
Intangible assets	$20X3: (600K / 20 - 600K / 15) \times 3 \text{ years}$	(30 000)	(20 000)
	$20X2: (600K / 20 - 600K / 15) \times 2 \text{ years}$		
<i>(Increase)/ decrease in liabilities and equity</i>			
Deferred tax liability	$20X3: 30\,000 \times 30\%$	9 000	6 000
	$20X2: 20\,000 \times 30\%$		
Retained earnings		21 000	14 000

AUTUMN LIMITED
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X4

	Note	Retained earnings
		C
Balance: 1 January 20X3 - restated		786 000
- As previously reported	given	800 000
- Correction of material error	per note: 21 000 – 7 000 or journals: (10 000 – 3 000) x 2 years 5	(14 000)
Total comprehensive income: 20X3 - restated	$270\,000 - 10\,000 + 3\,000 \text{ (jnl)}$	263 000
Balance: 1 January 20X4 - restated		1 049 000
- As previously reported	given	1 070 000
- Correction of material error	per note or journals: (10 000 – 3 000) x 3 years 5	(21 000)
Total comprehensive income: 20X4	$370\,000 - 10\,000 + 3\,000 \text{ (jnl)}$	363 000
Balance: 31 December 20X4		1 412 000

Solution 7.11 continued ...

b) continued ...

AUTUMN LIMITED		20X4	20X3	20X2
STATEMENT OF FINANCIAL POSITION		C	C	C
AS AT 31 DECEMBER 20X4			Restated	Restated
ASSETS	<i>comments/ calculations</i>			
Intangible assets	W1.2	440 000	480 000	520 000
LIABILITIES AND EQUITY				
Retained earnings	Per statement of changes in equity	1 412 000	1 049 000	786 000
Deferred taxation	W1.2	24 000	18 000	12 000

Solution 7.11 continued ...

Workings

W1 Deferred taxation proof (NOT REQUIRED)

Proof that effect on tax expense was a deferred tax adjustment (as opposed to current tax owing to the tax authorities).

It was not necessary to provide this working, because the tax authority is not interested in the rate at which you believe you should be amortising your asset (he simply grants a tax allowance, in this case, at 10% per annum).

Notice how you can pick up the new, revised balances for the statement of financial position from the 'should be' table.

W1.1: Was	CA	TB	TD	DT
1/1/20X1	0	0	0	0
	600 000	600 000	}	(9 000) cr DT dr TE
	(30 000)	(60 000)		
31/12/20X1	570 000	540 000	(30 000)	(9 000) L
	(30 000)	(60 000)		(9 000) cr DT dr TE
31/12/20X2	540 000	480 000	(60 000)	(18 000) L
	(30 000)	(60 000)		(9 000) cr DT dr TE
31/12/20X3	510 000	420 000	(90 000)	(27 000) L
	(30 000)	(60 000)		(9 000) cr DT dr TE
31/12/20X4	480 000	360 000	(120 000)	(36 000) L

W1.2: Should be	CA	TB	TD	DT
1/1/20X1	0	0	0	0
	600 000	600 000	}	(6 000) cr DT dr TE
	(40 000)	(60 000)		
31/12/20X1	560 000	540 000	(20 000)	(6 000) L
	(40 000)	(60 000)		(6 000) cr DT dr TE
31/12/20X2	520 000	480 000	(40 000)	(12 000) L
	(40 000)	(60 000)		(6 000) cr DT dr TE
31/12/20X3	480 000	420 000	(60 000)	(18 000) L
	(40 000)	(60 000)		(6 000) cr DT dr TE
31/12/20X4	440 000	360 000	(80 000)	(24 000) L

W1.3: Difference: journal adjustment to be made

The difference between the annual deferred tax adjustments that:

- WERE processed (9 000; cr deferred tax and dr tax expense) and
 - SHOULD HAVE BEEN processed (6 000; cr deferred tax and dr tax expense)
- shows that a difference of 3 000 (9 000 – 6 000) must be reversed *for each affected year*:
- Adjustment per affected year: (3 000; dr deferred tax and cr tax expense).

Solution 7.12

Part A

(a)	Debit	Credit
Equipment: cost	100	
Equipment: Accumulated depreciation		10
Deferred tax liability		3
Current tax liability		24
Retained earnings		63
Correcting journals: equipment expense one year ago		
	100	100
(b)		
Equipment: cost	100	
Repair expense		100
Depreciation	10	
Equipment: Acc Depreciation		10
Tax expense	27	
Deferred tax liability		3
Current tax liability		24
Correcting journals: equipment expense one year ago		
	137	137

Workings

Current normal tax	Was	S/B	Diff	
Profit before depreciation and repair	2 000	2 000		
Repair	(100)	0		
Depreciation	0	(10)		
Profit before tax	1 900	1 990		
Add back depreciation	0	10		
Less wear and tear	0	(20)		
Taxable profits	1 900	1 980		
	570	594	24	Dr. TE Cr. CTP

Deferred normal tax WAS	CA	TB	TD	DT	
O/bal 20X1	0	0	0	0	
purchase	0	0			
Depreciation/ w&t	0	0		0	
C/bal 20X1	0	0	0	0	
Deferred normal tax S/B	CA	TB	TD	DT	
O/bal 20X1	0	0	0	0	
purchase	100	100			
Depreciation/ w&t	(10)	(20)		(3)	Dr. TE Cr DT
c/bal 20X1	90	80	(10)	(3)	

Solution 7.12 continued . . .

Tax expense note	WAS	SHB
SA Normal tax		
- current	570	594
- deferred	0	3
	<u>570</u>	<u>597</u>
	30.0%	30.0%

Profit and loss			
Exp's (2)	xxx	Income (1)	xxx
	<u>xxx</u>		<u>xxx</u>
Tax exp (3)	570	Total b/f (PBT)	1 900
Total c/f	<u>1 330</u>		<u>1 900</u>
	<u>1 900</u>		<u>1 900</u>
RE (4)	1 330	Total b/f (PAT)	1 330
Total c/f	<u>0</u>		<u>1 330</u>
	<u>1 330</u>		<u>1 330</u>
		Total b/f	0

Profit and loss			
Exp's (2)	xxx	Income (1)	xxx
	<u>xxx</u>		<u>xxx</u>
Tax exp (3)	597	Total b/f (PBT)	1 990
Total c/f	<u>1 393</u>		<u>1 990</u>
	<u>1 990</u>		<u>1 990</u>
RE (4)	1 393	Total b/f (PAT)	1 393
Total c/f	<u>0</u>		<u>1 393</u>
	<u>1 393</u>		<u>1 393</u>
		Total b/f	0

Part B

(a)

Equipment: cost
 Equipment: Acc Depreciation
 Deferred tax liability
 Current tax liability
 Retained earnings

Debit	Credit
100	
	10
	0
	27
	63

Correcting journals: equipment expense one year ago

100	100
-----	-----

(b)

Equipment: cost
 Repair expense
 Depreciation
 Equipment: Acc Depreciation
 Tax expense
 Deferred tax liability
 Current tax liability

100	
	100
10	
	10
27	
	0
	27

Correcting journals: equipment expense one year ago

137	137
-----	-----

Solution 7.12 continued . . .

Current normal tax	Was	S/B	Diff	
Profit before depreciation and repair	2000	2000		
Repair	(100)	0		
Depreciation	0	(10)		
Profit before tax	1900	1990		
Add back depreciation	0	10		
Less wear and tear	0	(10)		
Taxable profits	1900	1990		
	570	597	27	Dr. TE Cr. CTP

Deferred normal tax WAS	CA	TB	TD	DT
O/bal 20X1	0	0	0	0
purchase	0	0		
Depreciation/ w&t	0	0		0
C/bal 20X1	0	0	0	0

Deferred normal tax SHB	CA	TB	TD	DT
O/bal 20X1	0	0	0	0
purchase	100	100		
Depreciation/ w&t	(10)	(10)		3
c/bal 20X1	90	90	0	3

Tax expense note	WAS	SHB
SA Normal tax		
- current	570	597
- deferred	0	0
	<u>570</u>	<u>597</u>
	30.0%	30.0%

Profit and loss account			
Exp's (2)	xxx	Income (1)	xxx
	<u>xxx</u>		<u>xxx</u>
Tax exp (3)	570	Total b/f (PB4T)	1 900
Total c/f	1 330		
	<u>1 900</u>		<u>1 900</u>
RE (4)	1 330	Total b/f (PAT)	1 330
Total c/f	0		
	<u>1 330</u>		<u>1 330</u>
		Total b/f	0

Profit and loss account			
Exp's (2)	xxx	Income (1)	xxx
	<u>xxx</u>		<u>xxx</u>
Tax exp (3)	597	Total b/f (PB4T)	1 990
Total c/f	1 393		
	<u>1 990</u>		<u>1 990</u>
RE (4)	1 393	Total b/f (PAT)	1 393
Total c/f	0		
	<u>1 393</u>		<u>1 393</u>
		Total b/f	0

Solution 7.12 continued . . .

Part C

	Debit	Credit
(a)		
Equipment: cost	100	
Equipment: Acc Depreciation		10
Deferred tax liability		27
Current tax liability		0
Retained earnings		63
Correcting journals: equipment expense one year ago		
	100	100
(b)		
Equipment: cost	100	
Repair expense		100
Depreciation	10	
Equipment: Acc Depreciation		10
Tax expense	27	
Deferred tax liability		27
Current tax liability		0
Correcting journals: equipment expense one year ago		
	137	137

Workings

Current normal tax	Was	S/B	Diff
Profit before depreciation and repair	2000	2000	
Repair	(100)	0	
Depreciation	0	(10)	
Profit before tax	1900	1990	
Add back repair	100		
Add back depreciation	0	10	
Less wear and tear	(10)	(10)	
Taxable profits	1990	1990	
	597	597	0

Solution 7.12 continued . . .

Deferred normal tax WAS	CA	TB	TD	DT	
O/bal 20X1	0	0	0	0	
Purchase	0	100			
Depreciation/ w&t	0	(10)		27	Dr. DT Cr.TE
C/bal 20X1	0	90	90	27	A

Deferred normal tax SHB	CA	TB	TD	DT	
O/bal 20X1	0	0	0	0	
Purchase	100	100			
Depreciation/ w&t	(10)	(10)		0	
c/bal 20X1	90	90	0	0	

Tax expense note	WAS	S/B
SA Normal tax		
- current	597	597
- deferred	(27)	0
	<u>570</u>	<u>597</u>
	30.0%	30.0%

Profit and loss account			
Exp's (2)	xxx	Income (1)	xxx
	xxx		xxx
Tax exp (3)	570	Total b/f (PB4T)	1 900
Total c/f	1 330		
	<u>1 900</u>		<u>1 900</u>
RE (4)	1 330	Total b/f (PAT)	1 330
Total c/f	0		
	<u>1 330</u>		<u>1 330</u>
		Total b/f	0

Profit and loss account			
Exp's (2)	xxx	Income (1)	xxx
	xxx		xxx
Tax exp (3)	597	Total b/f (PB4T)	1 990
Total c/f	1 393		
	<u>1 990</u>		<u>1 990</u>
RE (4)	1 393	Total b/f (PAT)	1 393
Total c/f	0		
	<u>1 393</u>		<u>1 393</u>
		Total b/f	0

Solution 8.1

a) The following situations will result in comparatives for earnings per share to be restated:

- A capitalisation issue or a share split (i.e. a *not for value* issue)
- A change in accounting policy or a correction of an error

With a **capitalisation issue or a share split** no new cash resources are available to the company. The number of shares increases resulting in a decrease in the EPS. Therefore, the comparative EPS must be restated to ensure that comparability is not lost. This adjustment applies not only to the prior period but to the figures of all previous periods that are presented as comparatives as well.

A **change in accounting policy or a correction of an error** gives rise to a prior year adjustment in terms of IAS 8. With a prior year adjustment it is necessary to restate the previous year's comparatives and the retained earnings at the beginning of the year. If the adjustment has an impact on the 'earnings' used for the earnings per share calculation, it will therefore be necessary to restate the earnings per share figure for the previous year.

b) IAS 33 requires earnings per share to be based on basic earnings, which is defined as the profit or loss for the period attributable to ordinary shareholders after deducting preference dividends. In terms of IAS 8, profit for the period should include all items of income and expense recognised in a period. The profit on sale of investments should be included in profit for the period and therefore should be included in basic earnings as well.

c) Dividends per share depends on the dividend payout policy of a company, and not necessarily on the size of its profits. It is not possible to judge a company's performance on its dividends declared. In new or expanding companies, for example, it would be irresponsible to adopt too high a dividend payout ratio. A low dividend per share in such cases would not necessarily reflect poor performance - management may just be retaining the profits in order to re-invest in the business. Earnings per share, on the other hand, is based on profit earned by the business regardless of whether such funds are being paid out to the owners or are being re-invested to increase the value of the business.

Profit after tax on its own does not tell shareholders the extent of the return on their investment. For example if two companies both reflect profit after taxation for the year of C100 000 but company A has 1 000 shares and company B has 2 000 shares, it cannot be said that a shareholder with one share in each of the companies has earned the same amount on each investment, even though the profits earned by each company are the same. The one share held in company A has yielded a C100 return whereas the one share in company B has only yielded a C50 return once the profits have been shared out amongst the owners. It is therefore more meaningful to look at earnings per share than at total earnings.

Solution 8.2

AUSSIE LIMITED
EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 SEPTEMBER 20X3

		Notes	20X3 C	20X2 C
Basic earnings / (loss) per share	443 500 / 420 000; (23 500) / 405 000	14	1,06	(0,06)

AUSSIE LIMITED
EXTRACTS FROM THE STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 30 SEPTEMBER 20X3

	C	C	C	Total C
Balances: 1/10/20X1				
Movement				
Balances: 30/9/20X2				
Movement				
Balances: 30/9/20X3				
Dividends per share : 20X3				0,25
Dividends per share : 20X2				0,00

AUSSIE LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 SEPTEMBER 20X3
14. Earnings per share

The calculation of basic earnings per share is based on profit / (loss) of C445 188 (20X2: loss of C25 188) and on the weighted average of 420 000 shares in issue (20X2: 405 000) after the capitalisation issue on 15 June 20X3. The earnings per share for 20X2 have been adjusted accordingly.

The calculation of headline earnings per share is based on earnings of C515 188 (20X2: C64 938) and a weighted average of 420 000 (20X2: 405 000) shares in issue after the capitalisation issue on 15 June 20X3. The headline earnings per share for 20X2 has been adjusted accordingly.

Reconciliation of profit to earnings

		20X3 C Net	20X2 C Net
Profit/(loss) for the period		475 000	(10 000)
Preference dividends	(13 500 + 18 000) (13 500)	(31 500)	(13 500)
Basic earnings		443 500	(23 500)

Solution 8.2 continued ...

Workings

W1: Number of equity shares		Actual	20X3	20X2
Balance 1 October X1		300 000	300 000	300 000
Cash issue 1 January X2	<i>(20X2: 50 000 X 9/12)</i>	50 000	50 000	37 500
		350 000	350 000	337 500
Capitalisation issue 15 June X3	<i>(20X2: 337,5K/ 350K X 70K) or (337,5K X 1/5)</i>	70 000	70 000	67 500
	<i>20X3: 350K/ 350K X 70K</i>			
Balance 30 September X2		420 000	420 000	405 000

Solution 8.3

MITCH LIMITED

**EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X1**

	Notes	20X1 C	20X0 C
Profit for the period		100 000	80 000
<i>Other comprehensive income</i>		-	-
Total comprehensive income		100 000	80 000
Basic earnings per ordinary share	20X1: 95 000 / 1 375 000 20X0: 75 000 / 1 000 000	0.0691	0.0750

MITCH LIMITED

**EXTRACTS FROM THE STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X1**

	Ordinary shares C	Preference shares C	Retained earnings C	Total C
Opening balance at 1/1/20X0	200 000	50 000	xxx	
Total comprehensive income			80 000	
Ordinary dividends			(6 000)	
Preference dividends			(5 000)	
Opening balance at 1/1/20X1	200 000	50 000	xxx	
Share issue	100 000			
Total comprehensive income			100 000	
Ordinary dividends			(10 000)	
Preference dividends			(5 000)	
Closing balance at 31/12/20X1	300 000	50 000	xxx	
20X1 Dividends per ordinary share	10 000 / 1 500 000			0.0060
20X0 Dividends per ordinary share	6 000 / 1 000 000			0.0067

MITCH LIMITED

**EXTRACTS FROM THE NOTES TO THE FINANCIAL STATEMENT
FOR THE YEAR ENDED 31 DECEMBER 20X1**

5. Earnings per share

The calculation of earnings per share is based on earnings of C95 000 (20X0: C75 000) and a weighted average of 1 375 000 ordinary shares (20X0: 1 000 000) in issue throughout the year.

Reconciliation of earnings

	20X1 C	20X0 C
Profit for the year	100 000	80 000
Preference dividends	(5 000)	(5 000)
Basic earnings	95 000	75 000

Workings

Weighted average number of shares (issue for value)

	Actual	20X1	20X0
Balance 1/1/X0	1 000 000	1 000 000	1 000 000
Cash issue 31/3/X1 (500 000 x 9/12)	500 000	375 000	-
	1 500 000	1 375 000	1 000 000

Solution 8.4

MILES LIMITED

EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X1

	Notes	20X1 C	20X0 C
Profit before tax		503 000	403 000
Income tax expense		(200 000)	(180 000)
Profit for the period		303 000	223 000
Other comprehensive income		-	-
Total comprehensive income		303 000	223 000
Basic earnings per ordinary share	20X1: 300 000* / 1 500 000 20X0: 220 000** / 1 500 000 *(303 000 - 3000) **(223 000 - 3000)	5	0,200 0,147

MILES LIMITED

EXTRACTS FROM THE STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X1

	Ordinary shares C	Preference shares C	Share premium C	Retained earnings C	Total C
Opening balance at 1/1/20X0	200 000	30 000	290 000	60 000	580 000
Total comprehensive income				223 000	223 000
Ordinary dividends				(30 000)	(30 000)
Preference dividends				(3 000)	(3 000)
Opening balance at 1/1/20X1	200 000	30 000	290 000	250 000	770 000
Capitalisation issue	100 000		(100 000)		0
Total comprehensive income				303 000	303 000
Ordinary dividends				(30 000)	(30 000)
Preference dividends				(3 000)	(3 000)
Closing balance at 31/12/20X1	300 000	30 000	190 000	520 000	1 040 000
20X0 Dividends per ordinary share	$30\,000 / 1\,000\,000$				0.030
20X1 Dividends per ordinary share	$30\,000 / 1\,500\,000$				0.020

Solution 8.4 continued ...

MILES LIMITED

EXTRACTS FROM THE NOTES TO THE FINANCIAL STATEMENT
FOR THE YEAR ENDED 31 DECEMBER 20X1

5. Earnings per share

Basic earnings per share

The calculation of earnings per share is based on earnings of C300 000 (20X0: C220 000) and 1 500 000 ordinary shares (20X0: 1 500 000) after adjusting for the capitalisation issue during 20X1.

Reconciliation of profit to earnings

	20X1 C Net	20X0 C Net
Profit/(loss) for the period	303 000	223 000
Preference dividends	(3 000)	(3 000)
Basic earnings	300 000	220 000

Workings

Number of shares (issue for no value)

	Actual	20X1	20X0
Balance 1/1/X0	1 000 000	1 000 000	1 000 000
Capitalisation issue 1/7/X1 <i>(1 000 000 / 2 x 1)</i>	500 000	500 000	500 000
	1 500 000	1 500 000	1 500 000

20X1: $500\,000 \times 1\,000\,000$ (20X1 balance) / 1 000 000 (actual)

20X0: $500\,000 \times 1\,000\,000$ (20X0 balance) / 1 000 000 (actual)

Solution 8.5

LOYAL LIMITED

EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X1

	Notes	20X1 C	20X0 C
Profit for the year		250 000	280 000
<i>Other comprehensive income</i>		0	0
Total comprehensive income		250 000	280 000
Basic earnings per ordinary share	20X1: 247 000 / 200 000 20X0: 277 000 / 200 000	5	1.235
			1.385

LOYAL LIMITED

EXTRACTS FROM THE STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X1

	Ordinary shares C	Preference shares C	Retained earnings C	Total C
Opening balance at 1/1/20X0	100 000	20 000	120 000	240 000
Total comprehensive income			280 000	280 000
Ordinary dividends			(12 000)	(12 000)
Preference dividends			(3 000)	(3 000)
Opening balance at 1/1/20X1	100 000	20 000	385 000	505 000
Total comprehensive income			250 000	250 000
Ordinary dividends			(10 000)	(10 000)
Preference dividends			(3 000)	(3 000)
Closing balance at 31/12/20X1	100 000	20 000	622 000	742 000
20X0 Dividends per ordinary share	20X0: 12 000 / 100 000			0,120
20X1 Dividends per ordinary share	20X1: 10 000 / 200 000			0,050

LOYAL LIMITED

EXTRACTS FROM THE NOTES TO THE FINANCIAL STATEMENT
FOR THE YEAR ENDED 31 DECEMBER 20X1

5. Earnings per share

Basic earnings per share

The calculation of earnings per share is based on earnings of C247 000 (20X0: C277 000) and 200 000 ordinary shares (20X0: 200 000) after adjusting for the share split during 20X1.

Reconciliation of earnings

	20X1 C	20X0 C
Profit for the year	250 000	280 000
Preference dividends	(3 000)	(3 000)
Basic earnings	247 000	277 000

Solution 8.5 continued ...**Workings**

Number of shares (issue for no value)	Actual	20X1	20X0
Balance 1/1/X0 and 1/1/X1	100 000	100 000	100 000
Share split 1/7/X1	100 000	100 000	100 000
Balance 31/12/X1 <i>(100 000 / 1 x 2)</i>	200 000	200 000	200 000

Solution 8.6

ROGER LIMITED
EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X8

	Notes	20X8 C	20X7 C	
Profit before tax		750 000	730 000	
Income tax expense		(400 000)	(300 000)	
Profit for the year		350 000	430 000	
<i>Other comprehensive income</i>		0	0	
Total comprehensive income		350 000	430 000	
Basic earnings per ordinary share	20X8: 318 000 / 829 897 20X7: 398 000 / 773 196	5	0.3832	0.5147

ROGER LIMITED
EXTRACTS FROM THE STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X8

	Ordinary shares C	Preference shares C	Share premium C	Retained earnings C	Total C
Opening balance at 1/1/20X7	375 000	400 000	0	200 000	975 000
Total comprehensive income				430 000	430 000
Ordinary dividends				(30 000)	(30 000)
Preference dividends				(32 000)	(32 000)
Opening balance at 1/1/20X8 ^(W3)	375 000	400 000	0	568 000	1 343 000
Rights issue (375K / 3 x 1) or (500K – 375K) [250K x (2.20 - 0.50)] = 450K	125 000		425 000		550 000
Total comprehensive income				350 000	350 000
Ordinary dividends				(40 000)	(40 000)
Preference dividends				(32 000)	(32 000)
Closing balance at 31/12/20X8	500 000	400 000	425 000	846 000	2 171 000
20X7 Dividends per ordinary share	30 000 / 750 000				0.04
20X8 Dividends per ordinary share	40 000 / 1 000 000				0.04

Solution 8.6 continued ...

**ROGER LIMITED
EXTRACTS FROM THE NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X8**

5. Earnings per share*Basic earnings per share*

The calculation of earnings per share is based on earnings of C318 000 (20X7: C398 000) and a weighted average of 829 897 ordinary shares (20X7: 773 196) after adjusting for the rights issue on 30th September 20X8.

<i>Reconciliation of profit to earnings</i>	20X8	20X7
	C	C
	Net	Net
Profit/(loss) for the period	350 000	430 000
Preference dividends	(32 000)	(32 000)
Basic earnings	<u>318 000</u>	<u>398 000</u>

Solution 8.6 continued ...

Workings

W1: Weighted average/ Adjusted number of shares

	20X8 weighted	20X7 adjusted
<i>Ordinary shares</i>		
Balance (1/1/20X8): W3	750 000	750 000
Rights issue: 20X7: 750 000 x 1.030927		773 196
20X8: 750 000 x 9/12 x 1.030927	579 897	
20X8: 1 000 000 x 3/12	250 000	
	829 897	0

Calculating the ex right factor share value:

FV of shares in issue + Amount received after rights issue

Total amount after rights issue

(750 000 x 2.50) + (250 000 x 2.20)

1 000 000

1 875 000 + 550 000

1 000 000

= 2 425 000

1 000 000

= 2.4250

Adjustment factor:

Fair value

Ex right value

= 2.50

2.4250

= 1.0309278

W2. Number of Shares (rights issue) - an alternative calculation

	Actual 20X8	Weighted average 20X8	Adjusted 20X7
Balance: 1/1/20X8 (<i>see working 3</i>)	750 000	750 000	750 000
Issue for value (i.e. effectively sold at market value) (750K / 3 x 1 x C2.2 / C2.5); (x 3/12)	220 000	55 000	0
	970 000	805 000	750 000
Issue for no value (i.e. effectively given away for free) (<i>see working 4</i>) or (250K – 220K); (30/ 970 x 805K); (30/ 970 x 750K)	30 000	24 897	23 196
Balance: 31/12/20X8 (C500 000 / 0.5)	1 000 000	829 897	773 196

Solution 8.6 continued ...**W3 Number of shares at beginning of the year**

the number of shares at year-end = $C500\,000 / C0.50 = 1\,000\,000$ shares

let X = the number of shares in issue at the beginning of the year

then :

$$X + X/3 \times 1 = 1\,000\,000 \text{ shares}$$

$$1.3333X = 1\,000\,000$$

$$X = 1\,000\,000/1.3333 = 750\,000 \text{ shares (at C0.50 per share = C375\,000)}$$

check:

$$750\,000 / 3 \times 1 = 250\,000 \text{ (issued through rights issue)}$$

opening balance + rights issue = balance at year-end

$$750\,000 + 250\,000 = 1\,000\,000 \text{ (at C0.50 per share = C500\,000)}$$

W4 Percentage increase in number of shares due to 'free' shares

using 'actual' figures: $30/970 \times 100 = 3.09278\%$

apply to 20X8: $805\,000 \times 3.09278\% = 24\,897$

apply to 20X7: $750\,000 \times 3.09278\% = 23\,196$

Solution 8.7

a)

ANNE LIMITED
EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X3

			20X3	20X2
		Note	C	C
Profit for the year			700 000	900 000
<i>Other comprehensive income</i>			0	0
Total comprehensive income			700 000	900 000
Basic earnings per share	(20X3: 500 000 / 63 462)	25	7.88	17.98
	(20X2: 700 000 / 38 943)			

If you wanted to show 2 years of comparatives in 20X3, then the 20X1 earnings per share would be calculated using 25 962 as the weighted average number of shares.

ANNE LIMITED
EXTRACTS FROM THE NOTES TO THE FINANCIAL STATEMENT
FOR THE YEAR ENDED 31 DECEMBER 20X3

25. Earnings per share

Basic earnings per share is calculated based on earnings of C500 000 (20X2: C700 000) and a weighted average number of shares of 63 462 (20X2: 38 943).

Reconciliation of earnings:

Reconciliation of profit to earnings

	20X3	20X2
	C	C
	Net	Net
Profit/(loss) for the period	700 000	900 000
Preference dividends	(200 000)	(200 000)
Basic earnings	500 000	700 000

Solution 8.7 continued

b)

ANNE LIMITED
EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X2

		20X2	20X1
	Note	C	C
Profit for the year		900 000	800 000
<i>Other comprehensive income</i>		0	0
Total comprehensive income		900 000	800 000
Basic earnings per share	(20X2: 700 000 / 22 500) (20X1: 600 000 / 15 000)	25	40.00

ANNE LIMITED
EXTRACTS FROM THE NOTES TO THE FINANCIAL STATEMENT
FOR THE YEAR ENDED 31 DECEMBER 20X2

25. Earnings per share

Basic earnings per share is calculated based on earnings of C700 000 (20X1: C600 000) and a weighted average number of shares of 22 500 (20X1: 15 000).

Reconciliation of profit to earnings

	20X2	20X1
	C	C
	Net	Net
Profit/(loss) for the period	900 000	800 000
Preference dividends	(200 000)	(200 000)
Basic earnings	700 000	600 000

Solution 8.7 continued

c)

ANNE LIMITED
EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X1

		20X1	20X0
	Note	C	C
Profit for the period		800 000	x
<i>Other comprehensive income</i>		0	x
Total comprehensive income		800 000	x
Basic earnings per share	(20X1: 600 000 / 15 000)	40.00	x

ANNE LIMITED
EXTRACTS FROM THE NOTES TO THE FINANCIAL STATEMENT
FOR THE YEAR ENDED 31 DECEMBER 20X1

25. Earnings per share

Basic earnings per share is calculated based on earnings of C600 000 (20X0: C...) and 15 000 shares in issue throughout the year (20X0: ...).

<i>Reconciliation of profit to earnings</i>	20X1 C Net	20X0 C Net
Profit/(loss) for the period	800 000	x
Preference dividends	(200 000)	x
Basic earnings	600 000	x

Solution 8.7 continued

Calculation of number of shares

		<u>Actual</u>	<u>20X3</u>	<u>20X2</u>	<u>20X1</u>
balance	20X0	10 000			10 000
issue: 30/6/X1	$10\,000 \times 6/12$	<u>10 000</u>			<u>5 000</u>
balance	20X1	20 000		20 000	15 000
issue: 30/9/X2	$10\,000 \times 3/12$	<u>10 000</u>		<u>2 500</u>	<u>0</u>
balance	20X2	30 000	30 000	22 500	15 000
rights issue: 30/6/X3	$30\,000 / 3 \times 2 = 20\,000$				
- for value	$20\,000 \times 10 / 15 \times 6/12$	<u>13 333</u>	<u>6 667</u>	<u>0</u>	<u>0</u>
		43 333	36 667	22 500	15 000
- for no value	$20\,000 - 13\,333$	<u>6 667</u>	<u>5 641</u>	<u>3 462</u>	<u>2 308</u>
	$(6\,667 / 43\,333) \times 36\,667; \times 22\,500; \times 15\,000$				
		50 000	42 308	25 962	17 308
split	$50\,000 / 2 \times 3 - 50\,000$	<u>25 000</u>	<u>21 154</u>	<u>12 981</u>	<u>8 654</u>
	$(25\,000 / 50\,000) \times 42\,308; \times 25\,962; \times 17\,308$				
balance	20X3 $50\,000 / 2 \times 3$	<u><u>75 000</u></u>	<u><u>63 462</u></u>	<u><u>38 943</u></u>	<u><u>25 962</u></u>

a) Earnings per share in 20X4 financial statements

THOMAS LTD			
STATEMENT OF COMPREHENSIVE INCOME			
FOR THE YEAR ENDED 31 DECEMBER 20X4			
	20X4	20X3	20X2
	C	C	C
Profit for the year	180 000	150 000	100 000
<i>Other comprehensive income</i>	0	0	0
Total comprehensive income	180 000	150 000	100 000

Chapter 8: Page 17

Solution 8.8 continued ...

a) continued ...

THOMAS LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X4

8. Earnings per share*Basic earnings per share*

Basic earnings per share is calculated based on earnings of C170 000 (20X3: C140 000 and 20X2: C90 000) and a weighted average number of shares after taking into account the share issues of 388 064 (20X3: 262 120 and 20X2: 141 687).

Headline of profits to earnings per share

	20X4		20X3	20X2
	C	C	C	C
	Net	Gross	Net	Net
Profit for the period	180 000		150 000	100 000
Preference dividends	(10 000)		(10 000)	(10 000)
Basic earnings	170 000		140 000	90 000

Solution 8.8 continued ...

b) Earnings per share in 20X3 financial statements

	20X3 C	20X2 C
<u>Basic earnings</u>	<u>140 000</u>	<u>90 000</u>
Number of shares	185 000	100 000
	0.757	0.900

c) Journal entries

Journals	Debit	Credit
Bank (10 000 x 6)	60 000	
Ordinary shares (10 000 x 1)		10 000
Share premium (balancing)		50 000
<i>Ordinary shares issued at C6 (market price of C9)</i>		
Share premium	15 000	
Bank		15 000
<i>Share issue expenses written off</i>		
Share premium (30K + 50K – 15K)	65 000	
Retained earnings (bal)	47 000	
Ordinary share capital (112 000 x C1)		112 000
<i>Capitalisation issue of ordinary shares using the rest of the share premium balance:</i>		
<i>112 000 (per table) x C1; or</i>		
<i>(100K + 170K + 10K) / 5 x 2 x C1</i>		
Preference dividends	10 000	
Preference shareholders/ Bank		10 000
<i>Preference dividends paid: per note or 50K x C2 x 10%</i>		

Solution 8.9

MATTHEW LIMITED

EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X1

	Notes	20X1 C	20X0 C
Profit for the period		320 000	290 000
<i>Other comprehensive income</i>		0	0
Total comprehensive income		320 000	290 000
Basic earnings per ordinary share	5	0.194	0.181
Basic earnings per participating preference share	5	2.325	2.111

MATTHEW LIMITED

EXTRACTS FROM THE STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X1

	Ordinary shares C	Participating preference shares C	Preference shares C	Retained earnings C
Opening balance at 1/1/20X0	700 000	20 000	90 000	xxx
Total comprehensive income				290 000
Participating preference dividend (w3)				(4 000)
Preference dividend (C90 000 x 5%)				(4 500)
Ordinary dividends				0
Opening balance at 1/1/20X1	700 000	20 000	90 000	xxx
Total comprehensive income				320 000
Rights issue	175 000			
Participating preference dividend (w3)				(8 000)
Preference dividend (C90 000 x 5%)				(4 500)
Ordinary dividends				(10 000)
Closing balance at 31/12/20X1	875 000	20 000	90 000	xxx
20X0 Dividends per ordinary share				0,000
20X1 Dividends per ordinary share		10 000 / 1 250 000		0,008
20X0 Dividends per participating preference share		4 000 / 40 000		0,100
20X1 Dividends per participating preference share		8 000 / 40 000		0,200

Solution 8.9 continued

**MATTHEW LIMITED
EXTRACTS FROM THE NOTES TO THE FINANCIAL STATEMENT
FOR THE YEAR ENDED 31 DECEMBER 20X1**

5. Earnings per share*Basic earnings per ordinary share*

The calculation of earnings per ordinary share is based on earnings of C222 500 (20X0: C201 071) and a weighted average 1 145 833 ordinary shares (20X0: 1 111 111) in issue throughout the year.

Basic earnings per participating preference share

The calculation of earnings per participating preference share is based on earnings of C93 000, including the fixed preference dividend of C4 000 (20X0: C84 429) and 40 000 (20X0: 40 000) participating preference shares in issue during the year.

Reconciliation of profits to earnings

	20X1	20X0
	C	C
Profit for the year	320 000	290 000
Less preference dividends (<i>the fixed portion</i>)	(8 500)	(8 500)
Basic earnings	311 500	281 500
- ordinary share	222 500	201 071
- participating preference share	89 000	80 429

Solution 8.9 continued

Workings

W1: Earnings split		20X1	20X0
Total		311 500	281 500
Ordinary shares	5/7	222 500	201 071
Participating preference shares	2/7	89 000	80 429

Let X = share of earnings belonging to ordinary shareholders

Then:

$X + 2/5X = \text{Earnings to be shared}$

$7/5X = \text{Earnings to be shared}$

$X = \text{Earnings to be shared} \times 5/7$

This means that the ordinary shares will get 5/7 of the earnings, leaving 2/7 for the participating preference shares.

W2: Total earnings belonging to participating preference shares

		20X1	20X0
Share of earnings	W1	89 000	80 429
Fixed dividend		4 000	4 000
		<u>93 000</u>	<u>84 429</u>

W3: Total dividend belonging to participating preference shares

		20X1	20X0
Fixed dividend		4 000	4 000
Participating dividend	(10 000 x 2/5)	4 000	0
		<u>8 000</u>	<u>4 000</u>

W4: Weighted average number of ordinary shares ... overleaf

Solution 8.9 continued

W4: Weighted average number of ordinary :

	Actual 20X1	Weighted 20X1	Adjusted 20X0
Balance: 1/1	1 000 000	0	1 000 000
Rights issue: 1/1 - 30/9	0	833 333	0
Adjust prior year (1000000 x 2)	1 000 000	833 333	1 111 111
Rights issue: 30/9 - 31/12	250 000	312 500	0
	1 250 000	1 145 833	1 111 111

Calculating the ex right factor share value:

FV of shares in issue + Amount receives after rights issue

Total amount after rights issue

$$\frac{(1000\ 000 \times 1.40) + (250\ 000 \times 0.70)}{1\ 250\ 000}$$

$$\frac{1\ 400\ 000 + 175\ 000}{1\ 250\ 000} = \frac{1\ 575\ 000}{1\ 250\ 000}$$

$$= 1.26$$

Adjustment factor:

$$\frac{\text{Fair value}}{\text{Ex right value}} = \frac{1.40}{1.26}$$

$$= 1.11$$

W4: Weighted average number of ordinary shares (AN ALTERNATIVE CALCULATION)

	Actual 20X1	Weighted 20X1	Adjusted 20X0
Balance: 1/1	1 000 000	1 000 000	1 000 000
For value: (a) (b) and (c) 20X1: 125 000 x 3/12	125 000	31 250	0
	1 125 000	1 031 250	1 000 000
For no value: (d) 20X1: 125 000 / 1 125 000 x 1 031 250	125 000	114 583	111 111
20X0: 125 000 / 1 125 000 x 1 000 000	1 250 000	1 145 833	1 111 111

- a) shares issued: $1\ 000\ 000 / 4 \times 1 =$ 250 000
- b) cash received: $1\ 000\ 000 / 4 \times 1 \times C0.70 =$ 175 000
- c) shares sold: $175\ 000 / C1.40 =$ 125 000
- d) shares given away: $250\ 000 - 125\ 000 =$ 125 000

Solution 8.10

HUBBARD LIMITED
EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 JUNE 20X6

	Notes	20X6 C	20X5 C
Revenue		500 000	400 000
Cost of inventory expense		(250 000)	(200 000)
Gross profit		250 000	200 000
Other income	(20X6: 7 000 + 3 000)	10 000	3 000
Other expenses		(110 000)	(103 000)
Profit before tax		150 000	100 000
Income tax expense	(20X6: 40 000 20X5: 35 000 – (10 000 x 35%))	(40 000)	(31 500)
Profit for the period		110 000	68 500
Other comprehensive income		0	0
Total comprehensive income		110 000	68 500
Earnings per share	10	0.2160	0.1565

HUBBARD LIMITED
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 30 JUNE 20X6

	Note	Non-distributable reserve C	Retained earnings C
Balance at 30/6/20X4		-	25 000
Total comprehensive income - restated			68 500
Ordinary dividend			(5 000)
Preference dividend			(4 000)
Balance at 30/6/20X5 as restated		-	84 500
- as previously reported			81 000
- correction of error (3 500 – 1 125)	11		3 500
Total comprehensive income			110 000
Ordinary dividend			(10 000)
Preference dividend			(2 000)
Transfer to NDR		7 000	(7 000)
Balance at 30/6/20X6		7 000	175 500
20X5 Dividends per share	10 000 / 500 000		0.02
20X6 Dividends per share	5 000 / 250 000		0.02

Solution 8.10 continued ...

HUBBARD LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 JUNE 20X6

10. Earnings per share*Basic earnings per share:*

The calculation of earnings per share is based on earnings of C106 500 (20X5: C65 625) and on the weighted average of 500 000 shares in issue (20X5: 425 000) after the share split on 1 January 20X6. Comparatives have been restated.

<i>Reconciliation of profit to earnings</i>	20X6	20X5
	C	C
	Net	Net
Profit for the period	110 000	68 500
Preference dividends	(2 000)	(2 000)
		250
Basic earnings	<u>108 000</u>	<u>66 500</u>

11. Error

Correction of deduction omitted from 20X5 tax calculation. Comparatives have been appropriately restated.

The effect of the correction is as follows:

	20X5
	C
Effect on the statement of comprehensive income	
<i>Increase/ (decrease) in expenses</i>	
Tax 3 500 – 1 125	(3 500)
<i>(Increase)/ decrease in income / profits</i>	
Profit for the year	<u>(3 500)</u>

Effect on the statement of financial position

(Increase)/ decrease in liabilities / equity

Current tax payable	3 500
Retained earnings	(3 500)

Solution 8.10 continued ...**Workings****W1: Shares in issue**

		Actual	20X6	20X5
01/07/04	Balance	200 000	200 000	200 000
31/03/X5	New issue (3/12)	50 000	50 000	12 500
30/06/05	Balance	250 000	250 000	212 500
01/01/X6	Share split (1 for 1)	250 000	250 000	212 500
30/06/X6	Balance	500 000	500 000	425 000

Solution 8.11

TRINI LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X8

	20X8	20X7
	C	C
Profit for the year	3 220 000	2 125 000
Other comprehensive income	-	-
Total comprehensive income	3 220 000	2 125 000
Basic earnings per share	11.50	9.78
Headline earnings per share	12.35	9.87
Dividend per share	0.803	0.4

TRINI LIMITED
EXTRACTS FROM THE NOTES TO THE FINANCIAL STATEMENT
FOR THE YEAR ENDED 31 DECEMBER 20X8
5. Earnings per share**Basic earnings per share**

The calculation of basic earnings per share is based on earnings of C 3 220 000 (20X7: C2 125 000) and a weighted average of 279 900 (20X7: 217 391) ordinary shares in issue during the year.

Reconciliation of earnings

	20X8	20X7
	C	C
Profit for the year	3 220 000	2 125 000
Basic earnings	3 220 000	2 125 000

Significant changes to the number of shares after the end of the reporting period

30 000 ordinary shares were issued at par value after 31 December 20X8

Solution 8.11 continued ...

Workings

Number of shares (issue for no value)

	Actual	20X8	20X7
Balance 1/1/X8	500 000	500 000	500 000
30 April 20X8 for value	125 000	83 333	-
	625 000	583 333	500 000
30 May 20X8 rights issue for value	93 750	54 688	-
	718 750	638 021	500 000
30 May 20X8 rights issue for no value	62 500	55 480	43 478
	781 250	693 501	543 478
31 Oct 20X8 share consolidation (5 to 2)	(468 750)	(416 101)	(326 087)
	312 500	277 400	217 391
30 Nov 20X8 for value issue	30 000	2 500	-
31 Dec 20X8 Basic shares	342 500	279 900	217 391

Earnings Calculation

	20X8	20X7
Basic earnings per share	3 220 000	2 125 000
	279 900	217391
=	11.50	= 9.78
Dividend per share	275 000	200 000
	342 500	500 000
=	0.803	= 0.4

Solution 8.12

SPROG LIMITED
EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X5

	20X5 C
Profit for the year	20 000 000
<i>Other comprehensive income</i>	0
Total comprehensive income	20 000 000
<i>Earnings per share:</i>	
Basic	$20\,000\,000 \div (10\% \times 1\,000\,000\,000)$ 0.20
Diluted basic	(W1) 0.14

Workings

W1: Dilutive earnings per share

$$\begin{aligned}
 \frac{\text{Revised earnings}}{\text{Revised shares}} &= \frac{20\,000\,000 + 1\,505\,000}{100\,000\,000 + 50\,000\,000} \\
 &= \frac{21\,505\,000}{150\,000\,000} \\
 &= \text{C0.1434}
 \end{aligned}$$

Solution 8.13

LASER LIMITED
EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X5

	20X5 C	20X4 C
Profit/ (loss) for the year	125 000	(50 000)
<i>Other comprehensive income</i>	0	0
Total comprehensive income	125 000	(50 000)
<i>Earnings per share:</i>		
Basic earnings $(W1) \div (W2)$	1.116	(0.495)
Diluted basic $(W1) \div (W3)$	1.052	(0.464)

Workings

W1: Basic and headline earnings	20X5	20X4
Profit for the year	125 000	(50 000)
Preference dividends	0	0
Basic Earnings	125 000	(50 000)

W2: Weighted number of shares	Date	Actual	20X5 Weighted/ Actual	20X4 Adjusted
Balance	1/1/20X4	100 000		100 000
Issue for value	30/11/20X4	12 000		1 000
Balance	31/12/20X4	112 000	112 000	101 000
Movement	20X5	0	0	0
Balance	31/12/20X5	112 000	112 000	101 000

W3: Dilutive number of shares				
Options (bonus/ free portion)		$25\,000 - (25\,000 \times 2.00) \div 2.75$ <i>Or</i> $25\,000 \times (2.75 - 2.00) \div 2.75$	=	6 818
Dilutive number of shares	20X4:	$(6\,818 + 101\,000)$	=	107 818
	20X5:	$(6\,818 + 112\,000)$	=	118 818

Solution 8.14

REBEL LIMITED
EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X5

		20X5	20X4
		C	C
Basic earnings per share	(W2) ÷ (W3)	0.2400	1.2000
Basic diluted earnings per share	(W4)	0.2237	1.0927

EXTRACTS FROM THE STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 30 JUNE 20X6

		Total
		C
Balance at 30/6/20X4		
Movement		
Balance at 30/6/20X5		
Movement		
Balance at 30/6/20X6		
20X4 Dividends per share		0.0000
20X5 Dividends per share	20X5: 0.03 + 0.05 + 0.02	0.1000

Solution 8.14 continued ...

Workings

W1: Calculation of incorrect basic earnings			
		20X5	20X4
Incorrect basic earnings per share	<i>given</i>	0,20	1,75
Incorrect number of shares	<i>given</i>	100 000 shares	20 000 shares
Incorrect basic earnings	$(0.2 \times 100\,000) (1.75 \times 20\,000)$	20 000	35 000

W2: Calculation of correct basic earnings			
		20X5	20X4
Incorrect basic earnings	<i>W1</i>	20 000	35 000
Preference shares dividends	<i>given</i>	(5 000)	(5 000)
Correct basic earnings		15 000	30 000

W3: Calculation of correct number of shares			
	Actual	Weighted 20X5	Weighted 20X4
1 January	20 000	20 000	20 000
30 June 20X5 Rights issue “for value” portion (6 months / 12 months)	60 000	30 000	0
Sub-total	80 000	50 000	20 000
“Not for value” portion (20 000 x 50 000 / 80 000) (20 000 x 20 000 / 80 000)	20 000	12 500	5 000
31 December	100 000	62 500	25 000

W4: Basic dilutive earnings per share			
		20X5	20X4
Diluted basic earnings	$(15\,000 + 100)$	C15 100	C30 050
(finance costs saved)	$(30\,000 + 100 \times 6/12)$		
Dilutive number of shares	$(62\,500 + 5\,000)$	67 500	27 500
(additional shares)	$(25\,000 + 5\,000 \times 6/12)$		
Dilutive basic earnings per share	$(15\,100 / 67\,500)$ $(30\,050 / 27\,500)$	C0.2237	C1.0927

Solution 8.15

DABCHICK LIMITED
EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X5

	20X5: Calculations	20X4: Calculations	Note	20X5 C	20X4 C
Profit for the year				200 000	135 000
Other comprehensive income				0	0
Total comprehensive income				200 000	135 000
<i>Earnings per share</i>					
Basic	200 000 / 329 166	135 000 / 268 966	15	0.6076	0.5019
Diluted basic	201 000 / 391 666	136 000 / 331 466	15	0.5132	0.4103

Solution 8.15 continued ...

DABCHICK LIMITED
EXTRACTS FROM THE NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X5
15. Earnings per share

The calculation of the following earnings per share are based on the following amounts

	20X5	
	Earnings	Weighted Average number of shares
Basic	200 000	329 166
Diluted basic	201 000	391 666

	20X4	
	Earnings	Weighted Average number of shares
Basic	135 000	268 966
Diluted basic	136 000	331 466

Reconciliation of profit for the year to earnings

	20X5		20X4	
	Gross C	Net C	Gross C	Net C
Profit for the year (after tax)		200 000		135 000
Less preference dividends		0		0
Basic earnings		200 000		135 000

Reconciliation of basic earnings to diluted basic earnings

	20X5 C	20X4 C
Basic earnings	200 000	135 000
Options	0	0
Preference shares	1 000	1 000
Diluted basic earnings	201 000	136 000

Reconciliation of basic number of shares to diluted number of shares

	20X5	20X4
Basic number of shares	329 166	268 966
Options	12 500	12 500
Preference shares	50 000	50 000
Diluted number of shares	391 666	331 466

Solution 8.15 continued ...

Workings

W1: Weighted number of shares		Actual	Weighted 20X5	Adjusted 20X4
1 January 20X4		250 000		250 000
30 Sept 20X4 Rights issue	$250\,000 / 5 \times 1 \text{ share} = 50\,000$			
• for value portion	$50\,000 \times C6 / C7.50 = 40\,000$ $40\,000 \times 3/12$	40 000		10 000
Subtotal:		290 000		260 000
• not for value portion	$50\,000 - 40\,000 = 10\,000$ $10\,000 / 290\,000 \times 260\,000$	10 000		8 966
1 January 20X5		300 000	300 000	268 966
31 May 20X5 for value	$50\,000 \times 7/12$	50 000	29 166	0
31 Dec		350 000	329 166	268 966

W2: Ranking of dilutive instruments		Ranking:		
Options	<i>No change to earnings</i> $(25\,000 \times 4) - (25\,000 \times 4 \times C7) / C8 = 12\,500$ <i>Or</i> $(25\,000 \times 4 \times (C8 - C7) / C8 = 12\,500$	+ 0 + 12 500	0.0000	1
Preference shares	<i>Dividends: 1 000</i>	+ 1 000 + 50 000	0.02	2

W3: 20X5 Test whether anti-dilutive				
Basic earnings per share		$\frac{200\,000}{329\,166}$	= 0.6076	
Options	$\frac{200\,000 + 0}{329\,166 + 12\,500} =$	$\frac{200\,000}{341\,666}$	= 0.5854	Dilutive
Preference shares	$\frac{200\,000 + 1\,000}{341\,666 + 50\,000} =$	$\frac{201\,000}{391\,666}$	= 0.5132	Dilutive

W4: 20X4 Test whether anti-dilutive				
Basic earnings per share		$\frac{135\,000}{268\,966}$	= 0.5019	
Options	$\frac{135\,000}{268\,966 + 12\,500} =$	$\frac{135\,000}{281\,466}$	= 0.4796	Dilutive
Preference shares	$\frac{135\,000 + 1\,000}{281\,466 + 50\,000} =$	$\frac{136\,000}{331\,466}$	= 0.4103	Dilutive

Solution 8.16

LATE NIGHT LIMITED
EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X5

	20X5: Calculations	20X4: Calculations	Note	20X5 C	20X4 C
Profit for the year				500 000	337 500
<i>Other comprehensive income</i>				0	0
Total comprehensive income				500 000	337 500
<i>Earnings per share</i>					
Basic	500 000 / 329 166	337 500 / 268 966	15	1.5190	1.2581
Continuing operations	447 500 / 329 166	337 500 / 268 966		1.3595	1.2581
Discontinued operations	52 500 / 329 166			0.1595	
Diluted basic	501 000 / 395 833	338 500 / 335 633	15	1.2657	1.0085
Continuing operations	448 500 / 395 833	338 500 / 335 633		1.1331	1.0085
Discontinued operations	52 500 / 395 833			0.1326	

Solution 8.16 continued ...

LATE NIGHT LIMITED
EXTRACTS FROM THE NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X5
15. Earnings per share

The calculation of the following earnings per share are based on the following amounts

	20X5	
	Earnings	Weighted Average number of shares
Basic	500 000	329 166
Diluted basic	501 000	395 833

	20X4	
	Earnings	Weighted Average number of shares
Basic	337 500	268 966
Diluted basic	338 500	335 633

Reconciliation of profit for the year to basic, headline and diluted headline earnings

	20X5		20X4	
	Gross	Net	Gross	Net
	C	C	C	C
Profit for the year (after tax)		500 000		337 500
Less preference dividends				0
Basic earnings		500 000		337 500

Reconciliation of earnings to diluted basic earnings

	20X5	20X4
	Basic	Basic
Earnings	500 000	337 500
Options	0	0
Preference shares (1 000)	1 000	1 000
Diluted basic earnings	501 000	338 500

Solution 8.16 continued ...

LATE NIGHT LIMITED
EXTRACTS FROM THE NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X5

15. Earnings per share continued ...

Reconciliation of basic number of shares to diluted number of shares

	20X5	20X4
Basic number of shares	329 166	268 966
Options	16 667	16 667
Preference shares	50 000	50 000
Diluted number of shares	395 833	335 633

Workings

W1: Weighted number of shares		Actual	Weighted 20X5	Adjusted 20X4
1 January 20X4		250 000		250 000
30 Sept 20X4 Rights issue	$250\,000 / 5 \times 1 \text{ share} = 50\,000$			
• for value portion	$50\,000 \times C6 / C7.50 = 40\,000$ $40\,000 \times 3/12$	40 000		10 000
Subtotal:		290 000		260 000
• not for value portion	$50\,000 - 40\,000 = 10\,000$ $10\,000 / 290\,000 \times 260\,000$	10 000		8 966
1 January 20X5		300 000	300 000	268 966
31 May 20X5 for value	$50\,000 \times 7/12$	50 000	29 166	0
31 Dec		350 000	329 166	268 966

W2: Ranking of dilutive instruments		Ranking:		
Options	No change to earnings $(25\,000 \times 4) - (25\,000 \times 4 \times C10) / C12 = 12\,500$	+ 0 + 16 667	0,0000	1
Preference shares	Dividends: 1 000 Or $(25\,000 \times 4 \times (C8 - C7) / C8 = 12\,500$	+ 1 000 + 50 000	0.02	2

Solution 8.16 continued ...

For your information:

IAS 33 requires the dilutive (or anti-dilutive) effect of potential ordinary shares to be determined with reference to control earnings (i.e. earnings from continuing operations)

Of the total profit for the year, R52 500 (after tax) was earned from a discontinued operation. When testing to determine whether the potential ordinary shares are dilutive, profit for the period excluding profit from discontinued operations is used.

The actual calculation of diluted earnings per share will include profit from discontinued operations. The total diluted earnings per share is then split into diluted earnings per share from continuing operations and diluted earnings per share from discontinued operations (see extracts from the financial statements above).

W3: 20X5 Test whether anti-dilutive

Basic earnings per share	(500 000-52 500)		<u>447 500</u> 329 166	= 1.3595	
Options	<u>447 500 + 0</u>		<u>447 500</u>	= 1.2940	Dilutive
[(12-10)/12]x25 000x4	329 166 + 16 667	=	345 833		
Preference shares	<u>447 500 + 1 000</u>		<u>448 500</u>	= 1.1331	Dilutive
	345 833 + 50 000	=	395 833		

W4: 20X4 Test whether anti-dilutive

Basic earnings per share			<u>337 500</u> 268 966	= 1.2548	
Options	<u>337 500</u>		<u>337 500</u>	= 1.1816	Dilutive
	268 966 + 16 667	=	285 633		
Preference shares	<u>337 500 + 1 000</u>		<u>338 500</u>	= 1.0085	Dilutive
	285 633 + 50 000	=	335 633		

Solution 8.17

**EARLY MORNING LIMITED
EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X5**

	20X5: Calculations	20X4: Calculations	Note	20X5 C	20X4 C
Profit for the year				500 000	337 500
Other comprehensive income				0	0
Total comprehensive Income				500 000	337 500
<i>Earnings per share</i>					
Basic	500 000 / 329 166	337 500 / 268 966	15	1.5190	1.2548
Continuing operations	447 500 / 329 166	337 500 / 268 966		1.3595	1.2548
Discontinued operations	52 500 / 329 166			0.1595	
Diluted basic	500 000 / 345 833	337 500 / 285 633	15	1.4458	1.1816
Continuing operations	447 500 / 345 833	337 500 / 285 633		1.2940	1.1816
Discontinued operations	52 500 / 345 833			0.1518	

Solution 8.17 continued ...

EARLY MORNING LIMITED
EXTRACTS FROM THE NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X5
15. Earnings per share

The calculation of the following earnings per share are based on the following amounts

		20X5	
		Earnings	Weighted Average number of shares
Basic		500 000	329 166
Diluted basic		500 000	345 833
		20X4	
		Earnings	Weighted Average number of shares
Basic		337 500	268 966
Diluted basic		337 500	285 633
<i>Reconciliation of profit for the year to basic</i>		20X5	20X4
		Net	Net
		C	C
Profit for the year (after tax)		500 000	337 500
Less preference dividends			0
Basic earnings		500 000	337 500

Reconciliation of earnings to diluted basic earnings

		20X5	20X4
		Basic	Basic
Earnings		500 000	337 500
Options		0	0
Preference shares (not adjusted for as anti-dilutive)			
Diluted basic earnings		500 000	337 500

Solution 8.17 continued ...

EARLY MORNING LIMITED
EXTRACTS FROM THE NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X5

15. Earnings per share continued ...

Reconciliation of basic number of shares to diluted number of shares

	20X5	20X4
Basic number of shares	329 166	268 966
Options	16 667	16 667
Preference shares (not adjusted for because anti-dilutive)		
Diluted number of shares	345 833	285 633

Workings

W1: Weighted number of shares		Actual	Weighted 20X5	Adjusted 20X4
1 January 20X4		250 000		250 000
30 Sept 20X4 Rights issue	$250\,000 / 5 \times 1 \text{ share} = 50\,000$			
• for value portion	$50\,000 \times C6 / C7.50 = 40\,000$ $40\,000 \times 3/12$	40 000		10 000
Subtotal:		290 000		260 000
• not for value portion	$50\,000 - 40\,000 = 10\,000$ $10\,000 / 290\,000 \times 260\,000$	10 000		8 966
1 January 20X5		300 000	300 000	268 966
31 May 20X5 for value	$50\,000 \times 7/12$	50 000	29 166	0
31 Dec		350 000	329 166	268 966

W2: Ranking of dilutive instruments		Ranking:		
Options	No change to earnings $(25\,000 \times 4) - (25\,000 \times 4 \times C10) / C12 = 16\,667$ Or $(25\,000 \times 4 \times (C12 - C10) / C12 = 16\,667$	+ 0 + 16 667	0.000	1
Preference shares	Dividends: 1 000	+ 1 000 + 1000	1.000	2

Solution 8.17 continued ...

For your information

IAS 33 requires the dilutive (or anti-dilutive) effect of potential ordinary shares to be determined with reference to control earnings (i.e. earnings from continuing operations)

Of the total profit for the year, R52 500 (after tax) was earned from a discontinued operation. When testing to determine whether the potential ordinary shares are dilutive, profit for the period excluding profit from discontinued operations is used.

The actual calculation of diluted earnings per share will include profit from discontinued operations. The total diluted earnings per share is then split into diluted earnings per share from continuing operations and diluted earnings per share from discontinued operations (see extracts from the financial statements above).

W3: 20X5 Test whether anti-dilutive

Basic earnings per share	(500 000-52 500)	<u>447 500</u>	= 1.3595	
		329 166		
Options	$\frac{447\,500 + 0}{329\,166 + 16\,667}$	$\frac{447\,500}{345\,833}$	= 1.2940	Dilutive
Preference shares	$\frac{447\,500 + 1\,000}{345\,833 + 500}$	$\frac{448\,500}{346\,333}$	= 1.2950	Anti-Dilutive

W4: 20X4 Test whether anti-dilutive

Basic earnings per share		<u>337 500</u>	= 1.2548	
		268 966		
Options	$\frac{337\,500}{268\,966 + 16\,667}$	$\frac{337\,500}{285\,633}$	= 1.1816	Dilutive
Preference shares	$\frac{337\,500 + 1\,000}{285\,633 + 500}$	$\frac{338\,500}{286\,133}$	= 1.1830	Anti-Dilutive

	20X8	20X7
	C	C
Profit after tax	650 000	550 000
Preference dividends (W10)	(24 000)	(24 000)
Earnings to be shared	626 000	526 000
Portion to participating preference shareholders (626000 / 12)	52 167	43 833
Portion to ordinary shareholders (626 000 / 12 x 11)	573 833	482 167
Basic earnings (ordinary shareholders)	573 833	482 167
Adjustments		
Finance costs (not tax allowable)	15 750	15 750
Diluted earnings	589 583	497 917

W10: Participating preference shares		24 000 (equity)
Convertible preference shares	=	15 750 (treated as finance costs)=
		39 750

Number of shares	Total	20X8	20X7
Balance 1 January 20X8	900 000	900 000	683 750
31 March 20X7 – for value issue		-	50 000
1 May 20X7 – acquisition of Happy Ltd		-	110 000
	900 000	900 000	843 750
30 September 20X8 - Share buy-back	(200 000)	(150 000)	-
Used in basic earnings calculations	700 000	750 000	843 750
Options	37 500	37 500	-
Contingent shares	25 000	25 000	- (not met)
Convertible preference shares	56 250	56 250	56 250
Used in diluted earnings calculations		868 750	900 000

	20X8	20X7
Basic earnings per share	573 833 / 750 000 = 0.7651	482 167 / 843 750 = 0.5716
Diluted earnings per share	589 583/ 868 750 = 0.6787	497 917/ 900 000 = 0.5532

	20X8	20X7
	C	C
Basic earnings per share	0.7651	0.5716
Diluted earnings per share	0.6787	0.5532

Solution 8.18 continued ...

Diluted earnings per share

Ranking in order of dilution		Ranking	
Options	0 / 37 500	0.00	1
Convertible preference shares	(15 750 + 1 969) / 56 250	0.315	2
Convertible debentures	11 200 / 11 429	0.98	3
Testing for whether dilutive or not:			
Basic earnings per share	573 833 / 750 000	0.765	
Adjust for:			
Notionally exercised options	(573 833 + 0) / (750 000 + 37 500)	0.72868	Dilutive
Notionally exercised options + convertible preference shares	(573 833 + 0 + 15 750) / (750 000 + 37 500 + 56 250)	0.6987	Dilutive
Options, preference shares and debentures	(589 583 + 11 200) / (843 750 + 11 429)	0.7025	Anti Dilutive

Convertible preference shares: $750\,000 \times C3 \times 7\% = 15\,750$

Solution 8.19

W1: Number of equity shares	Actual	20X8	20X7
Balance 1 Jan 08	350 000	350 000	350 000
31 Mar: <i>Capitalisation issue</i>	140 000	140 000	140 000
	490 000	490 000	490 000
30 Sept: <i>Issue for value</i>	50 000	12 500	0
	540 000	502 500	490 000
30 Oct Rights issue: for value	21 000	3 500	0
	561 000	506 000	490 000
Rights issue: not for value	9 000	8 118	7861
	570 000	514 118	497 861
30 November for value	10 000	834	0
31 December 20X8	580 000	514 952	497 861
Options – not for value	16 000	16 000	16 000
Convertible debentures	100 000	100 000	0
31 December Diluted shares		630 952	513 861

Earnings – Numerator

Profit after tax		550 000	400 000
Finance cost on preference share liability	Already deducted	0	0
Basic earnings		550 000	400 000

Diluted earnings

Basic earnings			
Finance cost		48 000	0
Tax saving due to finance cost lost	48 000x 30%	(14 400)	0
Diluted earnings		583 600	400 000

Diluted EPS

Ranking in order of dilution			Rank
Options	$0 \div 16\,000$	0	1
Convertible debentures	$(48\,000 - 14\,400) \div 100\,000$	0.336	2
Testing whether dilutive or not			
Basic earnings \div basic no. of shares = $550\,000 \div 514\,952 = \text{C } 1.0680$			

Adjust for

- Notionally exercised options $550\,000 \div (514\,952 + 16\,000) = 530\,952 = \text{C } 1.0359$ dilutive
- Notionally exercised options and converted debentures $(550\,000 + 48\,000 - 14\,400) \div (514\,952 + 16\,000 + 100\,000) = \text{C } 0.925$ dilutive

Solution 8.19 continued ...

LAMBSON, GOLDEN AND MYBURG LIMITED
EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 SEPTEMBER 20X3

	Notes	20X8 C	20X7 C
Basic earnings / (loss) per share	$550\,000 \div 514\,952$; $400\,000 \div 497\,861$	1.068	0.8034
Diluted basic earnings per share	$583\,600 \div 630\,952$; $400\,000 \div 513\,861$	0.925	0.778

14. Earnings per share

The calculation of basic earnings per share is based on profit / (loss) of C550 000 (20X7: C400 000) and on the weighted average of 514 952 shares in issue (20X2: 497 861) at the end of the year.

The calculation of diluted basic earnings per share is based on profit / (loss) of C583 600 (20X7: C400 000) and on the weighted average of 630 952 shares in issue (20X2: 513 861) at the end of the year.

Reconciliation of profit to earnings

		20X8 C Gross	C Net	20X7 C Gross	C Net
Profit/(loss) for the period			550 000		400 000
Preference dividends	<i>Already deducted from profit</i>		0		0
Basic earnings			550 000		400 000
Basic earnings			550 000		400 000
Debentures finance cost avoided		48 000	33 600		
Diluted basic earnings			583 600		400 000

Reconciliation of basic number of shares to diluted

Basic share	514 952	497 861
Notionally exercised options	16 000	16 000
Notionally converted debentures	100 000	0
Diluted number of shares	630 952	513 861

Solution 9.1

(a)

ST KITTS LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 28 FEBRUARY 20X7

	Notes	20X7 C
Revenue		12 000 000
Cost of sales	(7 100 000 + 80 000)	(7 180 000)
Operating expenses	(3 480 000 + 120 000)	(3 600 000)
Finance costs		(240 000)
Profit before tax	4	980 000
Income tax expense	5	(284 200)
Profit for the period		695 800
<i>Other comprehensive income</i>		
Revaluation surplus		800 000
Total comprehensive income		1 495 800

(b)

ST KITTS LIMITED
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 28 FEBRUARY 20X7

	Ordinary share capital C	Share premium C	NDR C	Retained earnings C	Total C
Balance at 01/03/X6	2 500 000	-	-	1 424 200	3 924 200
Total comprehensive income			800 000	695 800	1 495 800
Issue of share capital	500 000	1 500 000			2 000 000
Share issue expenses		(150 000)			(150 000)
Balance at 28/02/X7	3 000 000	1 350 000	800 000	2 120 000	7 270 000

(c)

ST KITTS LIMITED
(EXTRACT FROM) STATEMENT OF FINANCIAL POSITION AT 28 FEBRUARY 20X7

	Note	C
ASSETS		
Current assets		
Inventories		1 720 000
Trade and other receivables	(980 000 + 15 000)	925 000
Cash and cash equivalents		2 059 200
		4 779 200
EQUITY AND LIABILITIES		
Current liabilities		
Borrowings		2 000 000
Trade and other payables	(400 000 + 20 000)	420 000
Current tax payable	(284 200 – 200 000)	84 200
		2 504 200

(d)

ST KITTS LIMITED**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 28 FEBRUARY 20X7****1. Statement of compliance**

These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprises of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 198, provisions of and directives issued under the Companies Ordinance, 1984. In case the requirements differ, the provision of the Companies Ordinance, 1984 shall prevail.

2. Accounting policies**2.1 Basis of preparation**

The financial statements have been prepared using the historic cost basis, except for the revaluation of certain property, plant and equipment.

3 Share capital

Authorised	C
10 000 000 ordinary shares of C0.50 each	
Issued	
6 000 000 ordinary shares of C0.50 each	3 000 000
Reconciliation of quantity of shares	Qty
Balance 1/3/X6	5 000 000
Issued during year	1 000 000
Balance 28/2/X7	<u>6 000 000</u>

4. Profit before tax

The profit before tax has been computed after taking into account the following:

Auditors remuneration	110 000
Depreciation of property, plant and equipment	210 000
Employee benefits expense	1 800 000
Write down of inventory to net realisable value	(1 800 000 - 1 700 000)
	100 000

5. Income tax expense

Current normal tax	284 200
Income tax expense	<u>284 200</u>

Tax rate reconciliation:

Applicable tax rate	29%
Tax effects of	
Profit before tax	(980 000 X 0.29)
	284 200
Income tax expense	<u>284 200</u>
Effective tax rate	29%

- 6.** Dividends of C300 000 have been declared on 25 March 20X6 but have not been recognised as a distribution. The DPS amounts to C0.05 per share.

Solution 9.1 continued ...

Workings

W1 Calculation of accounting / tax profit on sale of plant

	Accounting	Tax
Selling price	330 000	330 000
Carrying amount / tax base	(180 000)	(180 000)
	<u>150 000</u>	<u>150 000</u>

W2. Current tax computation

Profit before tax		980 000
Current tax payable	(960 000 X 0,29)	278 400

Solution 9.2

WORLD LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 JUNE 20X2

	Note	20X2 C
Sales	2	84 986 750
Cost of sales		(24 602 000)
Gross profit		60 384 750
Income from subsidiaries (1 150 000 + 900 000)	2/4	2 050 000
Other income		
Royalty income	2	175 000
Investment income	2	430 000
Administrative & selling expenses (1 327 100 - 50 000)		(1 277 100)
Distribution expenses		(185 400)
Other operating expenses	3,6	(43 285 250)
Finance costs		(367 500)
Profit before tax		17 924 500
Income tax expense (5 054 850 + 200 000 - 450 000)	5	(4 604 850)
Profit for the period		13 319 650
Other comprehensive income		-
Total comprehensive income		13 319 650

NOTES TO FINANCIAL STATEMENTS
1. Accounting policies
1.1 Statement of compliance

These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprises of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 198, provisions of and directives issued under the Companies Ordinance, 1984. In case the requirements differ, the provision of the Companies Ordinance, 1984 shall prevail.

1.2 Basis or preparation

The financial statements have been prepared in the historical cost basis. These policies are consistent in all material respects with these applied in the previous years.

1.3 Revenue

Revenue is measured at the fair value of the consideration received or receivable net of VAT. Revenue consists of sales of goods, royalties, dividends and interest income.

2. Revenue and other income

	C
Sale of goods	84 986 750
Interest	430 000
Royalties	175 000
Dividend	1 150 000
	86 741 750

Solution 9.2 continued ...

3. Operating expenses

The operating expenses are calculated after taking into account the following:

Audit fees		237 500
- For audit		212 000
- Consulting		12 500
- Other expenses		13 000
Depreciation	$[2\,405\,000 + (250\,000 * 0.15 * 8 / 12)]$	2 430 000
Operating lease expenses		1 602 500
Staff costs	$[300\,000 + 26\,934\,000 + 2\,178\,720 (0.08 \times 27\,234\,000) + 1\,433\,530 + 32\,000 + 130\,000]$	31 008 250
Bad debts expense		975 000
Impairment of inventory		1 307 500

4. Income from subsidiaries

Dividends	1 150 000
Management fee	900 000
	<u>2 050 000</u>

5. Tax

Normal tax	
Current	4 754 250
Deferred	300 600
Overprovision in previous year	(450 000)
Income tax expense	<u>4 604 850</u>

Tax rate reconciliation

	C	%
Tax expense on profit / Applicable rate	5 377 350	30,00
Dividend income exempt	(345 000)	(1,92)
Donations disallowed	22 500	0,12
Overprovision in previous year	(450 000)	(2,51)
Income tax expense / Effective rate	<u>4 604 850</u>	25.69

Solution 9.2 continued ...

Workings

Other operating expenses		
Audit fees		237 500
Bad debt expense		1 180 000
Depreciations expense	(2 405 000 + 25 000)	2 430 000
Donations		75 000
Impairment of inventory		1 307 500
Maintenance of industrial plant	(2 465 000 - 250 000)	2 215 000
Operating lease expenses		1 602 500
Salaries expense		34 237 750
		<u>43 285 250</u>

Tax computation		X.30		
Profit before tax	17 924 500			
<i>Permanent differences</i>				
Dividend income	(1 150 000)			
Donations	75 000			
	<u>16 849 500</u>	5 054 850		
<i>Temporary differences</i>	(1 002 000)	300 600	Dr TE	Cr DT
Depreciation	2 430 000			
Tax allowance	(3 382 000)			
Prepaid expense	(50 000)			
Taxable income	15 847 500	4 754 250	Dr TE	Cr CTP

Solution 9.3

a)

Deferred taxation calculation

	CA	TB	TD		Rate	DT
Balance at 01/04/X3			1 000		35%	350
Rate change					-5%	(50)
					30%	300
Rates prepaid	40	0	40	Taxable		
Royalties in advance	(10)	0	(10)	Deductible		
Manufacturing plant	2 000	1 050	950	Taxable		
Motor vehicles	1 000	1 200	(200)	Deductible		
Computer equipment	500	300	200	Taxable		
Furniture	500	230	270	Taxable		
Balance at 31/03/X4	4 030	2 780	1 250			375

b)

**ELECTORAL LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 MARCH 20X4**

	Note	C'000s
Revenue from sales	2	7 500
Cost of sales		(7 500 - 2 000)
Gross profit		2 000
Other income	2	6 917
Distribution costs		(1 200)
Administration expenses		(1 000)
Other operating expenses		(2 807 + 25 - 40)
Finance costs		(250)
Profit before tax	3	3 675
Income tax expense	4	(1 057.5)
Profit for the period		2 616.5
<i>Other comprehensive income</i>		-
Total comprehensive income		2 617.5

NOTES TO THE FINANCIAL STATEMENTS AT 31 MARCH 20X4

2. Revenue and other income	C'000s
Sale of goods	7 500
Services rendered	5 000
Royalties received (10 000 X 12)	120
Interest received [(100 000 X 0,12) + 140 000]	152
Profit on sale of plant	110
Dividends received	
- listed (300 000 X 0,05)	15
- unlisted	20
Rent received	1 500
	6 917
Total revenue	14 417

Solution 9.3 continued ...

3. Profit before tax	C
Profit before tax includes	
Rent received	1 500
Audit fees	272
- fees for audit	250
- expenses	12
- services	10
Depreciation	900
Operating lease payments	600
Staff costs	1 800
Profit on sale of plant	110

4. Taxation	C
Normal tax	
Current	1 032.5
- current year	1 027.5
- underprovision prior year	5
Deferred	25
- current year	75
- rate change	(50)
	1057.5

Tax rate reconciliation

	C	%
Tax on profits / Standard rate	1 102.50	30.00
Underprovision prior year	5.00	0.14
Donations	6.00	0.17
Legal fees	1.50	0.04
Traffic fines	3.00	0.08
Dividends received	(10.50)	(0.29)
Rate change	(50.00)	(1.37)
Per statement of comprehensive income / Effective rate	1 057.5	28.78

Solution 9.3 continued ...

Workings

Calculation of current tax:

		X 0,30
Accounting profit	3 675	1 102.5
Accounting profit on sale of plant	(110)	
Tax gain on sale of plant	160	
Donations	20	
Legal fees	5	
Traffic fines	10	
Dividends received (Exempt)	(35)	
Depreciation	900	
Wear and tear	(1 165)	
Prepaid rates - 2003	25	
Prepaid rates - 2004	(40)	
Royalties in advance - 2003	(30)	
Royalties in advance - 2004	10	
Taxable income	3 425	1 027.5 Dr TE Cr CTP

Sale of plant

	Accounting	Tax
Selling price	360	360
CA / TB	250	200
Profit	110	160

Solution 9.4**a) Correcting journal entries**

	Debit	Credit
Retained earnings	438 425	
Current tax payable	179 075	
Accounts receivable		617 500
<i>Reversal of fraudulent sales and related commission</i>		

Alternative entries 1

Retained earnings	(650 000 X 0.71)	461 500	
Current tax payable	(650 000 X 0.29)	188 500	
Accounts receivable			650 000
<i>Reversal of fraudulent sales</i>			
Accounts receivable	(650 000 X 0.05)	32 500	
Current tax payable	(32 500 X 0.29)		9 425
Retained earnings	(32 500 X 0.71)		23 075
<i>Reversal of fraudulent commission</i>			

Alternative entries 2

Retained earnings	106 500	
Current tax payable	43 500	
Accounts receivable		150 000
<i>Reversal of fraudulent sales for 20X3 year</i>		
Accounts receivable	7 500	
Current tax payable		2 175
Retained earnings		5 325
<i>Reversal of fraudulent commission for 20X3 year</i>		
Retained earnings	355 000	
Current tax payable	145 000	
Accounts receivable		500 000
<i>Reversal of fraudulent sales for 20X4 year</i>		
Accounts receivable	25 000	
Current tax payable		7 250
Retained earnings		17 750
<i>Reversal of fraudulent commission for 20X4 year</i>		

Amortisation	34 483	
Accumulated amortisation		34 483
<i>Increased amortisation from change in estimate</i>		

Deferred tax	10 000	
Tax expense		10 000
<i>Tax effect of increased amortization</i>		

Solution 9.4 continued ...

b) Income statement and statement of changes in equity disclosure

MANGO LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X5

		20X5	Restated 20X4
		C	C
Revenue	(20X4: 5 400 – 500)	7 200 000	4 900 000
Cost of sales		(3 600 000)	(2 160 000)
Gross profit		3 600 000	2 740 000
Other income		550 000	300 000
Other expenses	(20X5: 880 + 34.483) / (20X4: 760 – 25)	(914 483)	(735 000)
Profit before tax		3 235 517	2 305 000
Income tax expense	(20X5: 960 550 – 10 000) / (20X4: 808 950 – 137 750)	(950 550)	(671 200)
Profit for the period		2 284 967	1 633 800
Other comprehensive income		-	-
Total comprehensive income		2 284 967	1 633 800
EPS	(20X5: 2 249 217/600 000) (20X4: 1 613 550/540 000)	3.74	2.99

MANGO LIMITED
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X5

	Ordinary share capital C	Share premium C	Preference share capital C	Retained earnings C	Total C
Balance at 01/01/20X4	400 000	200 000	350 000	477 907	1 427 907
As previously stated				579 082	579 082
Correction of error				(101 175)	(101 175)
Shares issued	100 000	100 000			200 000
Total comprehensive income as restated				1 633 800	1 633 800
Balance at 01/01/20X5	500 000	300 000	350 000	2 111 707	3 261 707
As previously stated				2 550 132	2 550 132
Correction of error				(438 425)	(438 425)
Capitalisation issue	100 000	(100 000)			
Profit for period				2 284 967	2 284 967
Dividends				(156 000)	(156 000)
- Ordinary				(100 000)	(100 000)
- Preference				(56 000)	(56 000)
Balance at 31/12/20X5	600 000	200 000	350 000	4 240 674	5 390 674

Solution 9.4 continued ...

MANGO LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X5

6. Earnings per share

The calculation of earnings per share is based on earnings of C 2 249 217 (20X4:C1 613 550) and on a weighted average of 600 000 (20X4:540 000) shares in issue after a capitalisation issue on 1 April 20X5. Comparatives have been restated.

Reconciliation of earnings:

		20X5	20X4
		C	C
		Gross	Net
Profit for period		2 284 967	1 633 800
Preference dividends	(20X5: 20 000+18 000)	<u>(38 000)</u>	<u>(18 000)</u>
Basic earnings		2 246 967	1 615 800

Workings

1. Fictitious sales

	20X3	20X4	Total	
Decrease in revenue	(150 000)	(500 000)	(650 000)	
Decrease in expenses (commission)	7 500	25 000	32 500	(5% X 650 000)
Decrease in profits/retained earnings	(142 500)	(475 000)	(617 500)	
Tax saving at 29%	41 325	137 750	179 075	
Net decrease	(101 175)	(337 250)	(438 425)	

Solution 9.4 continued ...

2. Change in estimate

Was			CA	TB	TD	DT (29%)	
01/04/X2	Cost		750 000	750 000			
01/04/X2	Accumulated	(750 000 X $\frac{33}{180}$ / *180)	(137 500)	(225 000)			
-		^(2yrs 9 mths)					
31/12/X4	depreciation	* (15 yrs) /					
	/ Tax allowance	(750 000 X 0.10 X 3)					
31/12/X4	Balance		612 500	525 000	87 500	25 375	DT L
01/01/X5	Depreciation	(750 000 X 12 / 180) /	(50 000)	(75 000)	25 000	7 250	Cr
-	/ tax allowance	(750 000 X 0.10)					
31/12/X5			562 500	450 000	112 500	32 625	DT L

Is			CA	TB	TD	DT (29%)	
31/12/X4	Balance		612 500	525 000	87 500	25 375	DTL
01/01/X5 -	Depreciation	(612 500 X 12 / *87)	(84 483)	(75 000)	(9 483)	2 750	Dr
31/12/X5	/ tax allowance	*(7yrs 3 mths) or (120 mths – 33 mths)					
			528 017	450 000	78 017	22 625	DTL

Increase in depreciation	(84 483 – 50 000)	34 483
Change in temporary differences	(112 500 – 78 017)	34 483
Decrease in deferred tax liability	(32 625 – 22 625) or (Was: 7 250 Cr / Is: 2 750 Dr)	10 000

3. Weighted average number of shares

	Total	20X5	20X4
Opening balance	400 000	400 000	400 000
Fresh issue – 1 July 04 (20X4: 100 000 X 6/12) (20X5: 100 000)	100 000		50 000
		100 000	
	500 000	500 000	450 000
Capitalisation issue (20X4: 450/5 = 90) (20X5: 500/5 = 100)	100 000		90 000
		100 000	
Total	600 000	600 000	540 000

Solution 9.5

a)

Correcting journals: computer glitch 20X6		Debit	Credit
Income from sale of widgets	(900 000/ 90% x 10%)	100 000	
Income from services rendered			100 000
Correction of error: service revenue recognised as sales revenue			
Royalties payable	(100 000 x 2%)	2 000	
Royalty expense			2 000
Decrease in royalties payable due to decrease in sales			
Tax expense	(2 000 x 30%).	600	
Current tax payable			600
Increase in tax payable due to decrease in royalty expense			

b)

	Interest at 17%	Instalments	Capital balance
1 July 20X4			662 876
30 June 20X5	112 689	(300 000)	475 565
30 June 20X6	80 846	(300 000)	256 411
30 June 20X7	43 590	(300 000)	1
	<u>237 125</u>	<u>(900 000)</u>	<i>Rounding error</i>

c)

	Interest at 7%	Instalments	Capital balance
1 July 20X4			787 295
30 June 20X5	55 111	(300 000)	542 406
30 June 20X6	37 968	(300 000)	280 374
30 June 20X7	19 626	(300 000)	0
	<u>112 705</u>	<u>(900 000)</u>	

d) (Working 1)

	Income type	@ 17%	@ 7%	Difference
20X4	sales	662 876	787 295	124 419
	interest	56 344 (112 689 x 6/12)	27 555 (55 111 x 6/12)	(28 789)
		<u>719 220</u>	<u>814 850</u>	<u>95 630</u>
20X5	interest	96 767 (112 689 x 6/12 + 80 846 x 6/12)	46 540 (55 111 x 6/12 + 37 968 x 6/12)	(50 227)
	cumulative prior effect	815 988	861 390	45 403
20X6	interest	62 218 (80 846 x 6/12 + 43 590 x 6/12)	28 797 (37 968 x 6/12 + 19 626 x 6/12)	(33 421)
	Cumulative effect	<u>878 206</u>	<u>890 187</u>	<u>11 982</u>
20X7	interest	21 795 (43 590 x 6/12)	9 813 (19 626 x 6/12)	(11 982)
		<u>900 001</u>	<u>900 000</u>	<u>0</u>

Solution 9.5 continued . . .

Correcting journals: discount rate		Debit	Credit
1 January 20X6			
Debtors	<i>See Working 1</i>	45 403	
Deferred tax	<i>(45 403 x 30%)</i>		13 621
Retained earnings	<i>(45 403 – 13 621)</i>		31 782
<i>Correction of error: effect on years prior to 20X6 owing to revenue measured using incorrect discount rate (17% instead of 7%)</i>			
<i>See Working 1</i>			
<hr/>			
31 December 20X6			
Deferred tax	<i>See above journal</i>	13 621	
Current tax payable			13 621
<i>Deferred tax becomes current tax payable when adjustment processed in 20X6 tax return</i>			
<i>Prior year adjustment to deferred tax recognised as current tax payable:</i>			
<hr/>			
Interest income		33 421	
Debtors			33 421
<i>Correction of error: effect on current year due to revenue measured using incorrect discount rate (17% instead of 7%)</i>			
<i>Interest income decreased (62 218 - 28 797) (see working 1)</i>			
<hr/>			
Current tax payable		10 026	
Tax expense			10 026
<i>Correction of error: effect on current year due to revenue measured using incorrect discount rate (17% instead of 7%)</i>			
<i>Decrease in tax due to decrease in income (33 421 x 30%)</i>			
<hr/>			

Solution 9.5 continued . . .

If it had been possible to process entries in the prior years journals, the journal dated 1 January 20X6 above would have been replaced as follows:

Correcting journals: discount rate		Debit	Credit
31 December 20X4			
Interest income	(56 344 – 27 555)	28 789	
Debtors	(balancing)	95 630	
Sales income	(787 295 – 662 876)		124 419
<i>Correction of error: effect of correction of error on revenue and interest income measurement: discount rate 17% instead of 7%</i>			
Tax expense	(95 630 x 30%)	28 689	
Deferred tax			28 689
Tax effect of the above entry			
31 December 20X5			
Interest income		50 227	
Debtors			50 227
<i>Correction of error: effect on 20X5 due to revenue measured using incorrect discount rate: 17% instead of 7%</i>			
<i>Interest income decreased (96 767 – 46 540) (see working 1)</i>			
Deferred tax		15 068	
Tax expense			15 068
<i>Correction of error: effect on current year due to revenue measured using incorrect discount rate: 17% instead of 7%</i>			
<i>Decrease in tax due to decrease in income (50 227 x 30%)</i>			

Solution 9.5 continued ...

e)

CHARTWELL LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X6

6. Correction of error

Revenue was measured using the incorrect discount rate.

<i>Net effect on statement of comprehensive income items</i>	<i>Comments/ calculations</i>	20X5 C
<i>Increase/ (decrease) in expenses or losses</i>		
- Tax	<i>Per journals</i>	(15 068)
<i>(Increase)/ decrease in income or profits</i>		
- Revenue from interest	<i>Per journals</i>	50 227
- Profit for the year	<i>Balancing</i>	<u>35 159</u>

Net effect on statement of financial position items

		20X5 C	20X4 C
<i>Increase/ (decrease) in assets</i>			
Debtors	<i>Per journals: 95 630 – 50 227</i>	45 403	95 630
<i>(Increase)/ decrease in liabilities</i>			
Deferred tax liability	<i>Per journals: 28 689 – 15 068</i>	(13 621)	(28 689)
<i>(Increase)/ decrease in equity</i>			
Retained earnings - closing	<i>Per journals: 66 941 – 50 227 + 15 068</i>	(31 782)	(66 941)

7. Revenue

		20X6 C	20X5 C
Revenue constitutes the following:			
Sales	<i>980 000 + 200 000 – 100 000 (a)</i>	1 080 000	xxx
Services rendered	<i>900 000 + 100 000 (a)</i>	<u>1 000 000</u>	xxx
		2 080 000	
Other income			
Dividend income		400 000	xxx
Interest income	<i>260 000 – 33 421 (d)</i>	<u>226 579</u>	xxx
		426 579	

f)

CHARTWELL LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X6

		20X6 C
Revenue	<i>Per note 7</i>	2 080 000
Cost of sales and services	<i>Given</i>	(1 500 000)
Distribution expenses	<i>200 000 x 30%</i>	(60 000)
Administration expenses	<i>200 000 x 20%</i>	(40 000)
Other expenses	<i>200 000 x 50% + 4 000 – 2 000 (a)</i>	(102 000)
Finance charges	<i>Given</i>	<u>(30 000)</u>
Other income		426 579
Profit before tax	<i>Balancing</i>	974 579
Income tax expense	<i>285 000 + 600 (a) – 10 026 (d)</i>	<u>(275 574)</u>
Profit for the period	<i>Balancing</i>	699 005

<i>Other comprehensive income</i>	-
Total comprehensive income	699 005

Solution 9.5 continued ...

g)

CHARTWELL LIMITED
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X6

	Share capital C	Share premium C	Retained earnings C	Total C
Balance: 1 January 20X5	200 000	78 000	78 741	356 741
- as previously reported (331 800 – 320 000)			11 800	
- correction of error (note 6) (Journals)			66 941	
Total comprehensive income: 20X5 – restated (320 000-50 227 + 15 068)			284 841	284 841
Balance: 1 January 20X6	200 000	78 000	363 582	641 582
- as previously reported (Given)			331 800	
- correction of error (note 6)			31 782	
Total comprehensive income: 20X6			699 005	699 005
Dividends declared			(50 000)	(50 000)
Balance: 31 December 20X6	200 000	78 000	1 012 587	1 290 587

h)

CHARTWELL LIMITED
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X6

		20X6 C	20X5 C	20X4 C
ASSETS				
Non-current assets	(Given)			
Property, plant and equipment		864 800	*	*
Current assets				
Trade receivables	[528 000 + 95 630 (d) – 50 227 (d) – 33 421 (d)]	539 982	3 245 403	2 495 630
Cash	(Given)	120 000	*	*
		1 524 782	*	*
EQUITY AND LIABILITIES				
Share capital and reserves				
Share capital		200 000	200 000	200 000
Share premium		78 000	78 000	78 000
Retained Earnings		1 012 587	363 582	78 741
Non-current liabilities				
Deferred tax	(Given)	15 000	333 621	328 689
Current liabilities				
Trade payables	(Given)	182 000	*	*
Current tax payable	[30 000 + 600 (a) + 13 621 (d) – 10 026(d)]	34 195	52 000	40 000
Royalty payable	(5 000 – 2 000)	3 000	*	*
		1 524 782	*	*

* Insufficient information to calculate number

Solution 10.1

KERSHAW LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 JUNE 20X4

1. Accounting policies**1.1 Statement of compliance**

These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standard Board as are notified under the Companies Ordinance, 1984, provisions of and directives issued under the Companies Ordinance, 1984. In case the requirements differ, the provisions or the directives of the Companies Ordinance, 1984 shall prevail.

1.2 Basis of preparation

The financial statements are prepared in accordance with the historical cost convention. The financial statements incorporate the following principle accounting policies, which are consistent in all material respects with those applied in the previous year.

1.2 Property, plant and equipment

No depreciation is provided on land. Fixtures and fittings are depreciated at 10% per annum using the reducing balance method. Buildings are depreciated at 2% per annum on the straight line method.

2. Property, plant and equipment

	Land	Buildings	Fixtures and fittings	Total
	C	C	C	C
Cost				
Balance 1/7/20X3	80 000	-	60 000	140 000
Constructed	-	50 000		50 000
Balance 30/6/20X4	80 000	50 000	60 000	190 000
Accumulated depreciation				
Balance 1/7/20X3	-	-	10 000	10 000
Current depreciation	-	-	5 000	5 000
Balance 30/6/20X4	-	-	15 000	15 000
Carrying amount				
1/7/20X3	80 000	-	50 000	130 000
30/6/20X4	80 000	50 000	45 000	175 000

Cost of land 1 January 20X2	80 000
Buildings erected thereon 30 June 20X4	50 000
	<hr/> 130 000

Calculation of current depreciation: $(60\,000 - 10\,000) \times 10\%$

Solution 10.2

TREASURE LIMITED
EXTRACT FROM STATEMENT OF FINANCIAL POSITION
AT 31 MARCH 20X3

	Note	C
ASSETS		
Non-current assets		
Property, plant and equipment		125 000
EQUITY AND LIABILITIES		
Non-current liabilities		
Debentures		96 000
Current liabilities		
Accounts payable		5 000

EXTRACT FROM THE NOTES TO THE FINANCIAL STATEMENTS

4. Non-current liability

	C
Unsecured	
Debentures	100 000
Debenture discount not yet written off	4 000
	<u>96 000</u>

100 000 C1 unsecured debentures bearing interest at 15%, redeemable at par on 1 April 20X8

5. Property, plant and equipment

	Land C	Buildings C	Total C
Cost			
Balance 1/4/20X2	-	-	-
Acquisitions	120 000	5 000	125 000
Balance 31/3/20X3	<u>120 000</u>	<u>5 000</u>	<u>125 000</u>
Accumulated depreciation			
Balance 1/4/20X2	-	-	-
Current depreciation	-	-	-
Balance 31/3/20X3	<u>-</u>	<u>-</u>	<u>-</u>
Carrying amount			
1/4/20X2	-	-	-
31/3/20X3	<u>120 000</u>	<u>5 000</u>	<u>125 000</u>

Solution 10.2 continued ...

6. Capital commitments

Contracted	[(20 000 X $\frac{3}{4}$) + 10 000]	25 000
Authorised but not yet contracted		120 000
Total authorised		<u>145 000</u>

The expenditure is to be financed partly by C1 15% debentures of C100 000 issued at 4% discount and partly out of cash generated by operations.

Workings

Amount contracted

Contracted: Clearing (20 000 x $\frac{3}{4}$)	15 000
Architect	10 000
	<u>25 000</u>

Building

Work done: 20 000 x $\frac{1}{4}$ = 5 000

Solution 10.3**Plant: journals**

	Debit	Credit
Depreciation – Plant	150 000	
Accumulated depreciation - Plant		150 000

Workings

			Original estimate	New estimate
01/10/X1	Cost	$(800 + 45 - 5)$	840 000	
30/09/X3	Accumulated depreciation	$[(840 - 40) / 5 \times 2]$	(320 000)	
			520 000	520 000
30/09/X4	Depreciation	[Same] $[(520 - 70) / 3]$	(160 000)	(150 000)
			360 000	370 000
Future years		(160×2) (150×2)	(320 000)	(300 000)
			40 000	70 000

Motor vehicle: journals

	Debit	Credit
Motor vehicle	270 000	
Bank		270 000
Depreciation – MV	45 000	
Accumulated depreciation - MV		45 000
Accumulated depreciation - MV	2 000	
Loss on de-recognition	10 000	
Motor vehicle		12 000
Motor vehicle – Tyres	24 000	
Bank		24 000
Depreciation – MV	21 500	
Accumulated depreciation - MV		21 500
Depreciation – Tyres	4 000	
Accumulated depreciation - Tyres		4 000
Repairs and maintenance	12 500	
Bank		12 500

Solution 10.3 continued . . .

Workings

01/10/X3	Cost		270 000
30/05/X4	Depreciation	(270 000 / 4 X 8/12)	(45 000)
			225 000
	De-recognition of old tyres	[12 000 – (12 000 / 4 X 8/12)]	(10 000)
	Recognition of new tyres		24 000
			239 000
30/09/X4	Depreciation		(25 500)
	MV	(215 000 / 40 X 4)	21 500
	Tyres	(24 000 / 24 X 4)	4 000
			213 500
	MV	(215 000 – 21 500)	193 500
	Tyres	(24 000 – 4 000)	20 000

Helicopter: journals

	Debit	Credit
Accumulated depreciation – Helicopter inspection	200 000	
Helicopter inspection		200 000
Helicopter inspection	240 000	
Bank		240 000
Depreciation – Helicopter airframe & interior	90 000	
Accumulated depreciation - Helicopter airframe & interior		90 000
Depreciation – Helicopter engine & blades	74 000	
Accumulated depreciation - Helicopter engine & blades		74 000
Depreciation - Helicopter inspection	80 000	
Accumulated depreciation - Helicopter inspection		80 000

Workings

		Airframe & interior	Engine & blades	Inspection
01/10/X0	Cost	900 000	400 000	200 000
01/10/X0 – 30/09/X3	Accumulated depreciation	(270 000)	(222 000)	(200 000)
30/09/X3	CA	630 000	178 000	-
01/10/X3	Inspection			240 000
30/09/X4	Depreciation	(90 000)	(74 000)	(80 000)
		540 000	104 000	160 000

Photocopy machine: journals

	Debit	Credit
Depreciation expense	53 333	
Accumulated depreciation: photocopy machine (280 000 – 40 000) / 3 years X 8/12		53 333

Solution 10.4

a) Journals

	Debit	Credit
<i>2 January 20X2</i>		
Cost: plant – engine	1 500 000	
Cost: plant – conveyor belt and fittings	2 000 000	
Cost: plant – outer structure	800 000	
Bank/ liability		4 300 000
<i>Purchase of bottling plant</i>		
<i>5 January 20X2</i>		
Cost: plant – engine	250 000	
Cost: plant – conveyor belt and fittings	250 000	
Cost: plant – outer structure	250 000	
Bank/ liability		750 000
<i>Delivery and installation: 1/3 allocated to each component</i>		
<i>16 January 20X2</i>		
Staff training (expense)	60 000	
Bank/ liability		60 000
<i>Staff training expensed (not a 'directly attributable cost' in bringing the plant to a location and condition that enabled it to be used as intended by management)</i>		
<i>19 January 20X2</i>		
Cost: plant – engine	11 000	
Cost: plant – conveyor belt and fittings	11 000	
Cost: plant – outer structure	11 000	
Bank/ liability		33 000
<i>Testing that plant fully operational: 1/3 allocated to each component</i>		
<i>21 January 20X2</i>		
Entertainment/ advertising (expense)	210 000	
Bank/ liability		210 000
<i>'Bottling plant launch party' expensed</i>		
<i>31 December 20X2</i>		
Depreciation	799 173	
Accumulated depreciation: plant – engine		231 183
Accumulated depreciation: plant – conveyor belt and fittings		259 073
Accumulated depreciation: plant – outer structure		308 917
<i>Depreciating each component of plant separately:</i>		
<i>Engine = (1 500 000 + 250 000 + 11 000 – 500 000) / 5 years x 11/12</i>		
<i>Conveyor belt etc = (2 000 000 + 250 000 + 11 000 – 0) / 8 years x 11/12</i>		
<i>Outer structure = (800 000 + 250 000 + 11 000 – 50 000) / 3 years x 11/12</i>		
<i>Depreciation starts from the date that the asset was available for use:</i>		
<i>1 February 20X2</i>		
<i>31 December 20X3</i>		
Depreciation	871 825	
Accumulated depreciation: plant – engine		252 200
Accumulated depreciation: plant – conveyor belt and fittings		282 625
Accumulated depreciation: plant – outer structure		337 000
<i>Depreciating each component of plant separately:</i>		
<i>Engine = (1 500 000 + 250 000 + 11 000 – 500 000) / 5 years</i>		
<i>Conveyor belt etc = (2 000 000 + 250 000 + 11 000 – 0) / 8 years</i>		
<i>Outer structure = (800 000 + 250 000 + 11 000 – 50 000) / 3 years</i>		

Solution 10.4 continued ...

b) Disclosure

ANCIENT WATERS LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X3

Date		Total	Land	Bottling plant
01/01/20X2	Net carrying amount	4 000 000	4 000 000	-
	Gross carrying amount	4 000 000	4 000 000	-
	Accumulated depreciation and impairment losses	-	-	-
	Additions	5 083 000	-	5 083 000
	Depreciation	(799 173)	-	(799 173)
31/12/20X2	Net carrying amount	8 283 827	4 000 000	4 283 827
	Gross carrying amount	9 083 000	4 000 000	5 083 000
	Accumulated depreciation and impairment losses	(799 173)	-	(799 173)
	Depreciation	(871 825)	-	(871 825)
31/12/20X3	Net carrying amount	7 412 002	4 000 000	3 412 002
	Gross carrying amount	9 083 000	4 000 000	5 083 000
	Accumulated depreciation and impairment losses	(1 670 998)	-	(1 670 998)

Land is shown at cost:

- Purchased on 5 December 20X0
- Purchase price: C4 000 000
- There have been no additions to this property since purchase date.

Comments:

- There is no journal entry allocating the operating loss incurred during March 20X2 (the excess expenses incurred over income earned) to the plant since this cost was incurred after the plant had been brought to a location and put into a condition that enabled it to be used as intended by management.
- Depreciation is calculated on each individual component separately.
- Depreciation begins when the asset is available for use as intended by management.
- Depreciation does not cease when the asset is temporarily idle.

Solution 10.5

JOURNALS OF UNWIND LTD	Debit	Credit
a) EQUIPMENT		
Repairs	30 000	
Bank		30 000
<i>Payment for repair</i>		
Equipment: accumulated depr & imp losses	9 000	
Impairment loss reversed		9 000
<i>Impairment of equipment after fire, reversed after repair: 114 000 – 105 000</i>		
Depreciation	19 000	
Equipment: accumulated depreciation		19 000
<i>Depreciation on equipment: 114 000/6</i>		
b) LIGHT AIRCRAFT		
Depreciation	10 000	
Aircraft bodywork: accumulated depreciation		10 000
<i>Depreciation on aircraft bodywork: 80 000 / 8</i>		
Depreciation	24 000	
Aircraft engines and propellers: accumulated depreciation		24 000
<i>Depreciation on aircraft engines etc: (200000-80000)/15000*3000</i>		
Depreciation	25 000	
Aircraft inspection: accumulated depreciation		25 000
<i>Depreciation on aircraft inspection: 100 000 / 4</i>		
Aircraft inspection: accumulated depreciation	100 000	
Aircraft inspection: cost		100 000
<i>Derecognition of aircraft inspection</i>		
Aircraft inspection: cost	150 000	
VAT input	21 000	
Bank		171 000
<i>Payment for major inspection of aircraft</i>		
c) VEHICLE		
Depreciation: vehicle	20 000	
Vehicles: accumulated depreciation		20 000
<i>Depreciation of vehicles (residual value R17 500)</i>		
<i>{[100000-(100000-10000)/4]-17500}/3 or W1</i>		
d) COMPUTER		
Depreciation: computer	7 500	
Computer: accumulated depreciation		7 500
<i>Depreciation of new computer from time available for use</i>		
<i>(50000-0)/5years x 9/12</i>		

W1: Change in estimate		Was	Is	Difference
Cost	1/1/20X3	100 000		
Accumulated depreciation	(100 000 - 10 000) / 4 x 1 year	(22 500)		
Carrying amount	31/12/20X3	77 500	77 500	
Residual value		(10 000)	(17 500)	
Depreciable amount		67 500	60 000	
Remaining useful life		3	3	
Depreciation	20X3	(22 500)	(20 000)	2 500
Carrying amount	31/12/20X3			
	(77 500 – 22 500); (77 500 – 20 000)	55 000	57 500	

Solution 10.6

	Debit	Credit
Year ended 31 December 20X4		
<i>2 January 20X4</i>		
Ship: cost: hull	10 000 000	
Ship: cost: engine room	9 000 000	
Ship: cost: major inspection	1 000 000	
Bank/ Liability		20 000 000
<i>Purchase of ship</i>		
<i>30 June 20X4</i>		
Depreciation: ship major inspection	1 000 000	
Ship: accumulated depreciation: major inspection		1 000 000
<i>Depreciation: ship components: previous major inspection depreciated to date of expiration</i>		
Ship: accumulated depreciation: major inspection	1 000 000	
Ship: cost: major inspection		1 000 000
<i>Derecognition of previous major inspection costs</i>		
Ship: cost: major inspection	6 000 000	
Bank		6 000 000
<i>Payment for major inspection performed 30 June 20X4</i>		
<i>31 December 20X4</i>		
Depreciation: medical waste disposal plant	2 800 000	
Medical waste disposal plant: accumulated depreciation		2 800 000
<i>Depreciation: medical waste disposal plant - given</i>		
Depreciation: ship	3 100 000	
Ship: accumulated depreciation: hull		1 000 000
Ship: accumulated depreciation: engine room		900 000
Ship: accumulated depreciation: major inspection		1 200 000
<i>Depreciation: ship hull (10 000 000 - 2 000 000) / 8 years</i>		
<i>Depreciation: ship engine room (9 000 000 / 1 000 000 miles x 100 000 miles)</i>		
<i>Depreciation: ship second major inspection (6 000 000 / 2.5 years x 6/12)</i>		
<i>Depreciation: ship components</i>		

Solution 10.6 ADAPTATION

ADAPTATION:

Please note that this is the solution to 10.6 if the question is adapted in the following way:

- The medical waste disposal plant must be dismantled at the end of its useful life
- The expected dismantling costs were C2 000 000 (future costs) on date of acquisition. An appropriate discount rate is 10%.
- This plant was bought on 1 July 20X3, has a total useful life of 5 years and a nil residual value.

Journals:

		Debit	Credit
Year ended 31 December 20X3			
<i>1 January 20X3</i>			
Plant: cost: physical structure	W1	12 758 158	
Bank/ Liability			12 758 158
<i>Purchase of medical waste disposal plant</i>			
Plant: cost: dismantling provision	W1	1 241 842	
Provision for dismantling			1 241 842
<i>Purchase of medical waste disposal plant :</i>			
• Capitalise future dismantling provision			
<i>31 December 20X3</i>			
Depreciation: plant		1 400 000	
Plant: accumulated depreciation: physical structure			1 275 816
Plant: accumulated depreciation: dismantling provision			124 184
<i>Depreciation: medical waste disposal plant – total given</i>			
• Physical structure: $(12\,758\,158 - 0) / 5 \text{ years} \times 6/12$			
• Dismantling costs: $(1\,241\,842 / 5 \text{ years}) \times 6/12$			
Finance costs	W3: $124\,184 \times 6/12$	62 092	
Provision for dismantling			62 092
<i>Unwinding of the discount on the present valued future dismantling</i>			
Year ended 31 December 20X4			
<i>2 January 20X4</i>			
Ship: cost: hull		10 000 000	
Ship: cost: engine room		9 000 000	
Ship: cost: major inspection		1 000 000	
Bank/ Liability			20 000 000
<i>Purchase of ship</i>			
<i>30 June 20X4</i>			
Depreciation: ship major inspection		1 000 000	
Ship: accumulated depreciation: major inspection			1 000 000
<i>Depreciation: ship components: previous major inspection depreciated to date of expiration</i>			
Ship: accumulated depreciation: major inspection		1 000 000	
Ship: cost: major inspection			1 000 000
<i>Derecognition of previous major inspection costs</i>			
Ship: cost: major inspection		6 000 000	
Bank			6 000 000
<i>Payment for major inspection performed 30 June 20X4</i>			

Solution 10.6 ADAPTATION continued ...

Journals continued ...

	Debit	Credit
<i>31 December 20X4</i>		
Depreciation: plant	2 800 000	
Plant: accumulated depreciation: physical structure		2 551 632
Plant: accumulated depreciation: dismantling provision		248 368
<i>Depreciation: medical waste disposal plant – total given</i>		
• <i>Physical structure: (12 758 158 – 0) / 5 years</i>		
• <i>Dismantling costs: (1 241 842 / 5 years)</i>		
Depreciation: ship	3 100 000	
Ship: accumulated depreciation: hull		1 000 000
Ship: accumulated depreciation: engine room		900 000
Ship: accumulated depreciation: major inspection		1 200 000
<i>Depreciation: ship hull (10 000 000 - 2 000 000) / 8 years</i>		
<i>Depreciation: ship engine room (9 000 000 / 1 000 000 miles x 100 000 miles)</i>		
<i>Depreciation: ship second major inspection (6 000 000 / 2.5 years x 6/12)</i>		
<i>Depreciation: ship components</i>		
Finance costs <i>W3: 124 184 x 6/12 + 136 603 x 6/12</i>	130 394	
Provision for dismantling		130 394
<i>Unwinding of the discount on the present valued future dismantling</i>		

Workings:

W1. Initial cost of acquisition: plant

Total initial cost:	<i>2 800 000 depreciation x 5 years + nil RV</i>	14 000 000
• Dismantling provision: PV 1/1/20X3	<i>W2</i>	1 241 842
• Paid for in cash	<i>Balancing: 14 000 000 – 1 241 842</i>	12 758 158

W2. Present value of future dismantling costs as at 1 January 20X3

Future cost:	<i>Given</i>	2 000 000
PV factor	<i>1/1.1⁵ OR 1/1.1 / 1.1 / 1.1 / 1.1 / 1.1</i>	0.620921
Present value on 1 January 20X3	<i>2 000 000 x 0.620921</i>	1 241 842

W3. Effective interest rate table

Calendar years:	Provision: opening balance	Finance costs	Provision: closing balance
20X3	W2	1 241 843	1 366 027
20X4		1 366 027	1 502 630
20X5		1 502 630	1 652 893
20X6		1 652 893	1 818 182
20X7		1 818 182	2 000 000
		<u>758 157</u>	

Solution 10.7

a) Journals

	Debit	Credit
Year ended 31 December 20X2:		
<i>1 February 20X2</i>		
Raw materials (asset)	500 000	
Bank/ liability		500 000
<i>Purchase of raw materials</i>		
<i>30 June 20X2</i>		
Cost: tarring vehicle (asset)	100 000	
Raw materials (asset)		100 000
<i>Raw materials used on the construction of the tarring vehicle</i>		
<i>30 September 20X2</i>		
Cost: tarring vehicle (asset)	20 000	
Bank/ liability		20 000
<i>Safety test performed before vehicle could be brought into use</i>		
<i>31 December 20X2</i>		
Depreciation – machinery (expense)	200 000	
Accumulated depreciation: machinery		200 000
<i>Depreciation of machinery</i>		
<i>31 December 20X2</i>		
Cost: tarring vehicle (asset)	50 000	
Depreciation - machinery (expense)		50 000
<i>Allocation of 25% of the depreciation on machinery to the construction of the tarring vehicle: 200 000 x 25%</i>		
<i>The labour costs paid over the course of 20X2 would have totalled:</i>		
Labour costs (expense)	300 000	
Bank		300 000
<i>Labour costs incurred during the year (these journals would obviously have been journalised as incurred rather than as one single journal entry)</i>		
<i>31 December 20X2</i>		
Cost: tarring vehicle (asset)	57 000	
Labour costs (expense)		57 000
<i>Allocation of 20% of labour costs (excluding 5% unnecessary wastage due to strike) to construction of tarring vehicle: 300 000 x 20% x 95%</i>		
<i>31 December 20X2</i>		
Depreciation – tarring vehicle	11 000	
Accumulated depreciation: tarring vehicle		11 000
<i>Tarring vehicle depreciated since first available for use:</i> <i>(100 000 + 20 000 + 50 000 + 57 000 – 7 000) / 5 years x 3/12</i>		

Solution 10.7 continued ...

b) Disclosure

ROADS INTERNATIONAL LTD
NOTES TO THE FINANCIAL STATEMENTS - 31 DECEMBER 20X2

4 Property, plant and equipment

	20X2
	C
Total net carrying amount:	
Other assets listed per classification	xxx
Tarring vehicle	216 000
	xxx
Tarring vehicle – self constructed asset	
Net carrying amount: 1 January	0
Gross carrying amount:	0
Accumulated depreciation and impairment losses:	0
Additions (100 000 + 20 000 + 50 000 + 57 000)	227 000
Depreciation (227 000 – 7 000) / 5 years x 3/12	(11 000)
Net carrying amount: 31 December	216 000
Gross carrying amount:	227 000
Accumulated depreciation and impairment losses	(11 000)

5 Profit before taxation

Profit before taxation is stated after taking into account the following separately disclosable items:

	20X2
	C
Depreciation - machinery	150 000
Total depreciation on machinery	200 000
Less capitalised to tarring vehicle	(50 000)
Depreciation – tarring vehicle	11 000

Solution 10.8

Issue a) Internal manufacture of Machine B

All costs necessarily incurred in bringing the asset 'to a location and condition for it to be capable of operating in a manner intended by management' should be capitalised.

This means that the following costs may not be capitalised (all other costs were correctly capitalised):

- The C20 000 materials destroyed – all unnecessary wastage is expressly not allowed to be capitalised per IAS 16
- Administration overheads of C70 000 – unless it can be proved that these costs were directly linked to the manufacture of the machine.

The capitalisation of the other costs is correct on the grounds that:

- Raw materials, labour and the depreciation of other machinery used in the manufacture of machine B would be classified as costs necessarily incurred in bringing the asset to a location and condition enabling it to be used.

Property, plant and equipment must be depreciated from the date on which it first becomes available for use and thus this machine should be depreciated from 1 May 20X0. This has obviously not been done since the carrying amount at year-end equals the cost of manufacture.

Issue b) Acquisition of a crane

A newly acquired asset should be brought into the accounting records at the fair value of the asset given away adjusted for cash and cash equivalents, where appropriate. Where this fair value is not available, or the fair value of the acquired asset is considered to be more clearly evident, the fair value of the newly acquired asset should be used instead (in this case, C400 000). The only time that the carrying amount of the asset given away may be used is if neither of the fair values was available or there was no economic substance to the transaction (i.e. the assets are very similar).

If the difference between the carrying amount (C500 000) and the available fair value (C400 000) is considered to be material, this will mean that either:

- the carrying amount of the crane that was given away should first be reduced to C400 000, being its true fair value (i.e. there is an impairment loss), or
- the carrying amount of the crane that was given away was a true reflection of its fair value (C500 000) and therefore a genuine loss on exchange of C100 000 (C500 000 – C400 000) was incurred. The new crane should then be recognised at C400 000, this fair value being considered to be more clearly evident.

Although costs necessarily incurred in bringing the asset to a location/ condition that enables it to be used must be capitalised, costs that are avoided may not be capitalised since they have not been incurred. The relocation costs that were avoided should, therefore, not be considered in the debate regarding the measurement of newly acquired crane.

Solution 10.8 continued . . .

If it is decided that the C500 000 carrying amount of the crane that was given away should be reduced to C400 000 (being a better reflection of its fair value) this reduction may be effected either as a change in depreciation (if it is believed that the useful life was shorter than originally estimated) or as an impairment loss (if it is found that there was an unexpected drop in the asset's recoverable amount). The respective journal entries would be as follows:

	Debit	Credit
<i>a change in estimated depreciation:</i>		
Depreciation	100 000	
Accumulated depreciation		100 000
<i>or</i>		
<i>an impairment loss:</i>		
Impairment loss	100 000	
Accumulated depreciation & impairment loss		100 000

Issue c): Repainting of the administration building.

The cost of painting would either be considered to be:

- subsequent expenditure: a replacement or renewal of a component; or
- Subsequent expenditure: other.

Paint would only be considered to be a separate component of the building if it is material and has a different useful life or a different pattern of economic benefits. If it were a separate component, then it would also need to meet the recognition criteria. It is submitted that since there is no definite cause and effect between the cost of the paint and the potential for future economic benefits to flow, the recognition criteria would not be met.

If it were to be argued that the paint was 'subsequent expenditure: other', the cost of the paint would only be capitalised if 'the standard of performance assessed immediately before the expenditure was made' is improved. It is submitted that the extra paint maintains the expected level of future economic benefits (thus avoiding an impairment rather than improving the asset) and should therefore be classified as 'maintenance costs' and be expensed.

Solution 10.9

a)

Residual value is defined as the estimated amount that the entity would *currently* obtain (at the financial reporting date) if the asset were already of the age and in the condition expected at the end of its useful life.

The C100 000 is the amount the entity expects to receive when the plant is five years old in two years time. However, the residual value is the estimated amount the entity would receive today if the asset were already five years old. Therefore, C70 000, which is the amount that a similar five year old asset realised recently is used as the residual value.

b)

The cost of an item of property, plant and equipment is recognised as an asset if:

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

An entity evaluates under this recognition principle all its property, plant and equipment costs at the time they are incurred, including costs incurred *initially* to acquire the item or costs incurred *subsequently* to add to, replace part of or service it.

The fact that the new ventilation system is only maintaining the existing level of ventilation in the factory is irrelevant. Probable future benefits will flow to the entity and the cost (C240 000) can be measured reliably.

The carrying amount of the component that is replaced by the new component should be derecognised.

c)

Depreciation of an asset begins when it is available for use, that is, when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

Depreciation must therefore commence from 1 August, when it was available for use. This is to reflect the consumption of the asset's service *potential* that occurs while the asset is held.

d)

Depreciation is recognised even if the fair value of the asset exceeds its carrying amount.

The future economic benefits are consumed irrespective if the fair value increases. Therefore, it is appropriate to depreciate the property in the current year. The purpose of depreciation is not the recognition of decreases in the value of property, plant and equipment; rather the purpose is to allocate the cost or revalued amount over its useful life.

Solution 10.9 continued ...

e)

Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item is required to be depreciated separately. It is therefore necessary to allocate the amount initially recognised in respect of an item of property, plant and equipment to its significant parts, including the inspection.

The cost of the existing inspection component needs to be recognised even though it was not identified on initial acquisition. The current market price of an inspection for a three year old aircraft, estimated at C750 000 is used as an indication of what the cost of the existing inspection component was when the item was acquired

Additional comments (not required as part of answer)

When a major inspection or overhaul cost is embedded in the cost of an item of property, plant and equipment, it is necessary to estimate the carrying amount of the component because the cost of the physical item itself should not include any amount attributable to the inspection or overhaul. The carrying amount of the component should be determined by reference to the current market price of such overhauls and not the expected future price

For example, entity P runs a merchant shipping business and has just acquired a new ship for C400. The useful life of the ship is 15 years, but it will be dry-docked every three years and a major overhaul carried out. At the date of acquisition the dry-docking costs for similar ships that are three years old is approximately C80. Therefore, the cost of the dry-docking component for accounting purposes is 80 and this amount would be depreciated over the three years to the next dry-docking. The remaining carrying amount, which may need to be split further into components, is C320. Any additional components would be depreciated over their own estimated useful lives.

Component accounting for inspection or overhaul costs is intended to be used only for major expenditure that occurs at regular intervals over the life of an asset. Costs associated with routine repairs and maintenance should be expensed as incurred.

The remaining portion of the component that is replaced by a new component should be derecognised. For example, P carries out the dry-docking of its ship after two years instead of three. The carrying amount of the overhaul at that date is C27 [$80 - (80 / 3)$]. The actual dry-docking costs are C100

The remaining carrying amount of the component that has been replaced should be written off immediately because the component effectively has been disposed of. However, it is submitted that the amount written off should be included in depreciation instead of being classified as a loss on disposal because the requirement is to depreciate each asset separately. The extra depreciation of C27 is in effect a revision of the estimated useful life of the dry-docking.

The actual dry-docking costs of C100 will be capitalised to the cost of the ship and depreciated over the expected period until the next dry-docking.

Solution 10.10

Issue A: Impairment tests

a)

It is incorrect not to test for impairment on the basis that all property, plant and equipment has been valued using the revaluation model. An impairment test involves an indicator review, which should be performed annually. The annual indicator review involves looking at both internal and external information and assessing whether there is any indication that the recoverable amount may be less than the carrying amount.

Only if there is an indication that the recoverable amount may be less than the carrying amount would a formal assessment (calculation) of the recoverable amount have to be made.

b)

If the recoverable amount is less than the carrying amount, the variables of depreciation first need to be reassessed (remaining useful life; residual value and depreciation method). If the difference between the recoverable amount and carrying amount are as a result of an outdated assessment of the variables of depreciation, the difference should be treated as a change in accounting estimate (IAS 8). If, however, the difference is not as a result of insufficient depreciation, then an impairment loss will have to be processed.

Issue B: Recoverable amount, Residual value and Net realisable value

The recoverable amount is used when performing the impairment test. It is only calculated if the indicator review suggests that the recoverable amount is less than the carrying amount. It is the greater of the:

- Fair value less costs to sell; and the
- Value in use.

If the recoverable amount is less than the carrying amount, an impairment loss is recognised by reducing the carrying amount of the asset to the recoverable amount.

The residual value is used when calculating depreciation. Depreciation is based on the depreciable amount, which is calculated as the cost less the residual value.

The residual value of the asset is the amount the entity would currently obtain from disposal of the asset, if the asset were already of the age and condition expected at the end of its useful life.

The residual value is measured at the date of acquisition of the asset and is reassessed at the end of each financial year.

The net realisable value is calculated when valuing inventories. It is calculated as the expected selling price less expected costs to complete less expected disposal costs.

If the net realisable value is less than the cost of inventory, the value of the inventory should be written down to its net realisable value on the basis that inventory should be disclosed at the lower of cost or net realisable value. The amount of the write-down is therefore the difference between the cost of the inventory and its net realisable value. This difference is recognised as an expense and disclosed in the statement of comprehensive income.

Solution 10.11**a) Initial cost**

	C
Purchase price (excluding VAT)	520 000
Delivery costs	18 000
Installation costs	12 000
	<u>550 000</u>

b) Objective of impairment test

The objective of IAS 36 is to ensure that an entity's assets are not overstated. If the *carrying amount* of an asset exceeds its *recoverable amount*, the carrying amount will not represent the future economic benefits to be derived from the asset and the asset is described as impaired. The recoverable amount is calculated as the higher of the assets' fair value less costs to sell and its value in use.

c) Test for impairment at 31 December 20X7

		C
Cost		550 000
Accumulated depreciation	[(550 000 – 50 000) X 0.10 X 5 yrs]	<u>(250 000)</u>
Carrying amount		300 000
Recoverable amount		280 000
Fair value less costs to sell	(270 000 – 15 000)	<div style="border: 1px solid black; padding: 2px;">255 000</div>
Value in use	(249 000 + 31 000)	<div style="border: 1px solid black; padding: 2px;">280 000</div>
Impairment		20 000

d) Disclosure at 31 December 20X7

WIEN LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X7

1. Accounting policies**1.1 Basis of preparation**

The financial statements are prepared in accordance with the historical cost convention. The financial statements incorporate the following principle accounting policies which conform to International Financial Reporting Standards. These policies are consistent in all material respects with those applied in the previous year.

1.2 Property, plant and equipment

Equipment is stated at cost less accumulated depreciation and impairment losses. Depreciation is provided at 10% per annum on the straight line basis.

Solution 10.11 continued . . .

2. Property, plant and equipment

		C
Net carrying amount at 31/12/X6		350 000
Gross carrying amount		550 000
Accumulated depreciation & impairment losses	$(550\,000 - 50\,000) \times 0.10 \times 4 \text{ years}$	(200 000)
Depreciation for the year		(50 000)
Impairment loss		(20 000)
Net carrying amount at 31/12/X7		280 000
Gross carrying amount		550 000
Accumulated depreciation & impairment losses	$(200\,000 + 50\,000 + 20\,000)$	(270 000)
3. Profit before tax		
Profit before tax includes the following		
• Depreciation		50 000
• Impairment loss		20 000

Solution 10.11 continued . . .

e) Reversal of impairment

Actual carrying amount	(280 000 – *92 000) *(230 000 [^] / 5 yrs remaining x 2 yrs) [^] (280 000 – 50 000)	188 000
Recoverable amount		198 000
Fair value less costs to sell		170 000
Value in use		198 000
Historical carrying amount	(550 000 – *350 000) *(500 000 [^] / 10 yrs x 7 yrs) [^] (550 000 – 50 000)	200 000
Reversal of impairment loss	(RA: 198 000 – ACA: 188 000) (notice that the reversal is not limited by the historical carrying amount since the recoverable amount is less than the historical carrying amount)	10 000

- C10 000 of the revaluation increase will be recognised as income as it reverses the impairment previously recognised as an expense. Separately disclose the reversal, together with the circumstances that led to reversal.
- The reassessment will have an impact on deferred taxation as the tax base of the equipment would not reflect the adjustments effected for accounting purposes.

Workings

		ACA	HCA
01/01/X3	Cost	550 000	550 000
31/12/X6	Accumulated depreciation	(200 000)	(200 000)
		350 000	350 000
31/12/X7	Depreciation	(50 000)	(50 000)
	Impairment	(20 000)	
		280 000	300 000
31/12/X8	Depreciation	(46 000)	(50 000)
		234 000	250 000
31/12/X9	Depreciation	(46 000)	(50 000)
		188 000	200 000

Solution 10.12**a) Initial measurement:**

Purchase price	30 000
Transport	7 000
Protective varnish	13 000
	<u>50 000</u>

b) Recoverable amount and impairment loss

Depreciable amount		
Cost	(above)	50 000
Residual value	(5 000 – 3 000)	<u>(2 000)</u>
		48 000
Carrying amount		
Cost		50 000
Accumulated depreciation	(48 000/ 3 X 6/12)	<u>(8 000)</u>
		42 000
Fair value less costs to sell		
Selling price	(7 000 X 2 boats)	14 000
Selling costs	(4 000 x 2 boats)	<u>(8 000)</u>
		6 000
Value in use		
NPV of usage	(Given)	30 000
NPV of residual amount	(Given)	<u>2 000</u>
		32 000
Recoverable amount		
Higher of fair value less costs to sell: 6 000 and value in use: 32 000		<u>32 000</u>
Impairment loss		
Carrying amount		42 000
Recoverable amount		<u>(32 000)</u>
		10 000

Solution 10.12 continued . . .

c) Journals – 20X0

	Debit	Credit
01 Jan X0 Boats: cost	30 000	
Bank/ Accounts payable		30 000
<i>Purchase of boats</i>		
Boats: cost	7 000	
Bank/ Accounts payable		7 000
<i>Unavoidable costs of transport</i>		
Boats: cost	13 000	
Bank/ Accounts payable		13 000
<i>Unavoidable costs of varnish</i>		
Advertising	10 000	
Bank/ Accounts payable		10 000
<i>Painting of boats in company colours</i>		
30 June X0 Depreciation	8 000	
Boats: accumulated depreciation		8 000
<i>Depreciation of boats</i>		
Impairment loss	10 000	
Boats: accumulated depreciation & impairment loss		10 000
<i>Impairment of boats following the accident</i>		

Journals – 20X1

03 July X0 Bank	25 000	
Insurance proceeds		25 000
<i>Receipt of insurance proceeds</i>		
Boats: accumulated depreciation & impairment loss	18 000	
Boats: cost (old)		50 000
Boats: cost (new)	33 000	
Bank (33 000 – 9 000)		24 000
Loss on trade-in [(50 000 – 18 000) – 9 000]	23 000	
<i>Trade-in of damaged boats for new boats</i>		
30 June X1 Depreciation	6 600	
Boats: accumulated depreciation & impairment loss		6 600
<i>Depreciation of new boats (33 000 X 20%)</i>		

Solution 10.13

Part A (Cost model)

a) Disclosure

WANDERERS LIMITED		
EXTRACT FROM STATEMENT OF COMPREHENSIVE INCOME		
FOR THE YEAR ENDED 30 JUNE 20X3		
	Note	C
Profit before tax (300 000 – 110 000 + 100 000)	2	290 000
Taxation	3	(87 000)
Profit for the period		203 000
<i>Other comprehensive income</i>		-
Total comprehensive income		203 000

WANDERERS LIMITED		
EXTRACT FROM STATEMENT OF FINANCIAL POSITION		
AT 30 JUNE 20X3		
	Note	C
Non-current assets		
Property, plant and equipment	4	320 000
Non-current liabilities		
Deferred tax	5	96 000

WANDERERS LIMITED		
EXTRACT FROM NOTES TO THE FINANCIAL STATEMENTS		
AT 30 JUNE 20X3		
		C
2 Profit before tax		
Profit before tax is stated after taking into account the following:		
Depreciation		110 000
Reversal of impairment		(100 000)
3 Taxation		
Normal tax		
- Current tax	W4	10 000
- Deferred tax	W2	77 000
Income tax expense		87 000

Solution 10.13 continued ...

4 Property, plant and equipment**Equipment**

Net carrying amount: 1 July 20X2	330 000
Cost	800 000
Less accumulated depreciation (20X1: depr 160 000 + imp loss 200 000 + 20X2: depr 110 000)	(470 000)
Depreciation	(110 000)
Reversal of impairment	100 000
Net carrying amount: 30 June 20X3	320 000
Cost	800 000
Less accumulated depreciation (470 000 + 20X3: depr 110 000 – imp rev 100 000)	(480 000)

Due to changes in technology, an impairment loss of C100 000 relating to equipment has been reversed during the period. The recoverable amount is based on the fair value less costs to sell, determined by market prices.

5 Deferred tax asset/ (Liability)

The deferred tax balance comprises temporary differences caused by:

- Property, plant and equipment (96 000)

b) Journal

	Debit	Credit
Accumulated depreciation and impairment losses	100 000	
Reversal of impairment loss		100 000
<i>Recording increase in recoverable amount (equipment carried under the cost model)</i>		

Solution 10.13 continued ...**Part B (Revaluation model, impairment in 20X1, revaluation increase in 20X3)****Journal entries at 30 June 20X1**

	Debit	Credit
Depreciation	160 000	
Equipment: accumulated depreciation and impairment losses		160 000
<i>Depreciation on equipment for the year (800 000 x 20%)</i>		
Impairment loss	200 000	
Equipment: accumulated depreciation and impairment losses		200 000
<i>Impairment to fair value less costs to sell (CA = 800 000 – 160 000 = 640 000 RA = 440 000 640 000 – 440 000 = 200 000)</i>		
Deferred tax	28 000	
Tax expense		28 000
<i>Deferred tax on temporary differences on depreciation and impairment (200 000 x 30% = 60 000 DTA + (266 667 – 160 000) x 30% = 32 000 DTL)</i>		

Journal entries at 30 June 20X3

	Debit	Credit
Depreciation	110 000	
Equipment: accumulated depreciation and impairment losses		110 000
<i>Depreciation for the period (440 000 / 4 = 110 000)</i>		
Equipment: accumulated depreciation and impairment losses	100 000	
Impairment loss reversed		100 000
<i>Reversal of impairment up to historical carrying amount (current carrying amount: 220 000 – historical carrying amount: 320 000)</i>		
Equipment: accumulated depreciation and impairment losses	480 000	
Equipment		480 000
<i>Set-off of accumulated depreciation and impairment losses against the cost account = 20X1 depreciation: 160 000 + 20X1 impairment: 200 000 + 20X2 depreciation: 110 000 + 20X3 depreciation: 110 000 – 20X3 impairment reversal: 100 000)</i>		
Equipment: cost	180 000	
Revaluation surplus		180 000
<i>Revaluation above historical carrying amount (historical carrying amount: 320 000 - fair value: 500 000)</i>		
Revaluation surplus	54 000	
Deferred tax		54 000
<i>Deferred tax on revaluation surplus (180 000 x 30%)</i>		
Tax expense	77 000	
Deferred tax		77 000
<i>Deferred tax on depreciation and impairment reversed versus tax allowances: [266 667 – (100 000 – 110 000)] x 30%</i>		

Solution 10.13 continued ...**Part C (Revaluation model, revaluation decrease in 20X1, revaluation increase in 20X3)****Journal entries at 30 June 20X1**

	Debit	Credit
Depreciation	160 000	
Equipment: accumulated depreciation and impairment losses		160 000
<i>Depreciation for the year (800 000 x 20%)</i>		
Equipment: accumulated depreciation and impairment losses	160 000	
Equipment		160 000
<i>Transfer of accumulated depreciation to cost account</i>		
Revaluation expense	200 000	
Equipment		200 000
<i>Revaluation of equipment to fair value (640 000 – 440 000 = 200 000)</i>		
Deferred tax	28 000	
Tax expense		28 000
<i>Deferred tax on temporary differences on depreciation and revaluation (200 000 x 30% = 60 000 DTA + (266 667 – 160 000) x 30% = 32 000 DTL)</i>		

Journal entries at 30 June 20X3

	Debit	Credit
Depreciation	110 000	
Equipment: accumulated depreciation and impairment losses		110 000
<i>Depreciation for the period (440 000 / 4 = 110 000)</i>		
Equipment: accumulated depreciation	220 000	
Equipment		220 000
<i>Set-off of accumulated depreciation against the cost account (20X2: 110 000 + 20X3: 110 000)</i>		
Equipment: cost	280 000	
Revaluation income		100 000
Revaluation surplus		180 000
<i>Reversal of revaluation expense up to historical carrying amount (current carrying amount: 220 000 – historical carrying amount: 320 000)</i>		
<i>Revaluation above historical carrying amount (fair value: 500 000 – historical carrying amount: 320 000)</i>		
Revaluation surplus	54 000	
Deferred tax		54 000
<i>Deferred tax on revaluation surplus (180 000 x 30%)</i>		
Tax expense	77 000	
Deferred tax		77 000
<i>Deferred tax on depreciation and impairment reversed versus tax allowances: [266 667 – (100 000 – 110 000)] x 30%</i>		

Solution 10.13 continued ...

Workings

W1: Carrying amount of equipment		HCA	ACA
01/07/X0	Cost	800 000	800 000
30/06/X1	Depreciation	(160 000)	(160 000)
	Impairment loss		(200 000)
	Historical carrying amount / Recoverable amount (A and B) or fair value (C)	640 000	440 000
30/06/X2	Depreciation	(160 000)	(110 000)
30/06/X3	Depreciation	(160 000)	(110 000)
	Historical carrying amount / Fair value (part B and C)	320 000	220 000
	Reversal of impairment loss		100 000
(For part A)	Limited to		320 000
(For part B and C)	Revaluation surplus		180 000
	Fair value		500 000

W2: Deferred tax (Part A)		Carrying amount	Tax base	Temporary difference	Deferred tax	
01/07/X0	Cost	800 000	800 000			
30/06/X1	Depreciation / tax allowance	(160 000)	(266 667)			
		640 000				
	Impairment loss (A) or Revaluation expense(B)	(200 000)	-	93 333	28 000	Dr DT Cr TE
	Balance	440 000	533 333	93 333	28 000	DTA
30/06/X2	Depreciation / tax allowance	(110 000)	(266 667)	(156 667)	(47 000)	Dr TE Cr DT
	Balance	330 000	266 666	(63 334)	(19 000)	DTL
30/06/X3	Depreciation / tax allowance	(110 000)	(266 666)			
	Reversal of impairment loss	100 000	-	(256 666)	(77 000)	Dr TE Cr DT
	Balance	320 000	-	(320 000)	(96 000)	DTL

W3: Deferred tax (Part B and C)		Carrying amount	Tax base	Temporary difference	Deferred tax	
01/07/X0	Cost	800 000	800 000			
30/06/X1	Depreciation / tax allowance	(160 000)	(266 667)			
	Impairment loss	(200 000)	-	93 333	28 000	Dr DT Cr TE
	Balance	440 000	533 333	93 333	28 000	DTA
30/06/X2	Depreciation / tax allowance	(110 000)	(266 667)	(156 667)	(47 000)	Dr TE Cr DT
	Balance	330 000	266 666	(63 334)	(19 000)	DTL
30/06/X3	Depreciation / tax allowance	(110 000)	(266 666)			
	Reversal of impairment loss (B) or Revaluation income (C)	100 000	-	(256 666)	(77 000)	Dr TE Cr DT
	Revaluation surplus	180 000	-	(180 000)	(54 000)	Dr RS Cr DT
	Balance	500 000	-	(500 000)	(150 000)	DTL

Solution 10.13 continued ...

W4: Tax computation (Part A and B)		X 0.30	
Profit before tax	290 000	87 000	Dr Tax expense
Temporary differences	(256 666)	77 000	Cr Deferred tax
+ depreciation	110 000		
- impairment loss reversed	(100 000)		
- wear and tear	(266 666)		
Taxable profit	33 334	10 000	Cr Current tax payable

Ledger accounts (not required in question)

Cost model: Part A

Equipment				Accumulated depreciation			
Description	C	Description	C	Description	C	Description	C
Bank	800 000					Depreciation (X1)	160 000
						Impairment (X1)	200 000
						Depreciation (X2)	110 000
						Depreciation (X3)	110 000
		Balance	800 000	Reversal of impairment (X3)	100 000		
	800 000		800 000	Balance	480 000		
Balance	800 000				580 000		580 000
						Balance	480 000

Revaluation model: Part B

Equipment				Accumulated depreciation & impairment losses			
Description	C	Description	C	Description	C	Description	C
Bank	800 000					Depreciation (X1)	160 000
		Balance	800 000	Balance	360 000	Impairment (X1)	200 000
	800 000		800 000		360 000		360 000
Balance	800 000					Balance	360 000
		Accumulated depreciation (X3)	480 000	Reversal of impairment (X3)	100 000	Depreciation (X2)	110 000
Revaluation surplus (X3)	180 000	Balance	500 000	Equipment (X3)	480 000	Depreciation (X3)	110 000
	980 000		980 000	Balance	0		
Balance	500 000				580 000		580 000
						Balance	0

Solution 10.13 continued ...

Revaluation model: Part C

Equipment				Accumulated depreciation			
Description	C	Description	C	Description	C	Description	C
Bank	800 000	Accumulated depreciation (X1)	160 000	Equipment (X1)	160 000	Depreciation (X1)	160 000
		Revaluation expense (X1)	200 000			Depreciation (X2)	110 000
		Balance	440 000			Depreciation (X3)	110 000
	800 000		800 000				
Balance	440 000			Equipment (X3)	220 000		
Revaluation income (X3)	100 000	Accumulated depreciation (X3)	220 000				
Revaluation surplus (X3)	180 000	Balance	500 000	Balance	0		
	720 000		720 000		220 000		220 000
Balance	500 000					Balance	0

Solution 10.14

a) IAS 16: terms used

Both the cost model and the revaluation model refer to the *measurement* of property, plant and equipment. The cost model requires that the asset be carried at 'cost less accumulated depreciation and accumulated impairment losses' and prevents the value of the asset from ever exceeding the historical carrying amount. The revaluation model requires the asset to be carried at 'fair value less accumulated depreciation and accumulated impairment losses' and does not prevent the carrying amount from exceeding the historical carrying amount. In both cases, however, the asset may be shown at a value below historical carrying amount.

b) Increase excluding deferred tax effects (IAS 16 – revaluation model)

i) Increase in value:

Actual carrying amount [100 000 – (100 000 x 20% x 1 year)]	80 000
Fair value	90 000
Increase in value	10 000

	Debit	Credit
Plant: accumulated depreciation	20 000	
Plant		20 000
<i>Reversal of accumulated depreciation</i>		
Plant	10 000	
Revaluation surplus		10 000
<i>Increase in value of plant</i>		

ii) Depreciation of plant for 20X2

Revised carrying amount (fair value)	90 000
Less residual value	0
Depreciable amount (FV : C90 000 – residual value : C0)	90 000
Divide by remaining useful life (5 – 1 years)	4
Depreciation	22 500

	Debit	Credit
Depreciation	22 500	
Plant		22 500
<i>Depreciation of plant</i>		

iii) Transfer of revaluation surplus for 20X2

Revaluation surplus	10 000
Divide by remaining useful life (5 – 1 years)	4
Transfer (Dr revaluation surplus; Cr retained earnings)	2 500

	Debit	Credit
Revaluation surplus	2 500	
Retained earnings		2 500
<i>Realised portion of revaluation surplus transferred to retained earnings</i>		

Solution 10.14 continued ...

The company makes this transfer to offset the decrease in profits resulting from the additional increase in depreciation (which resulted from the increase in value of the asset by C10 000). This can be proved as follows:

Revised depreciation	22 500
Historic depreciation (80 000 / 4 yrs or 100 000 / 5 yrs)	20 000
Increase in depreciation, thus decrease in profits	<u>2 500</u>

c) Increase including deferred tax (IAS 16 – revaluation model with IAS 12)**i) Increase in value:**

Actual carrying amount [100 000 – (100 000 x 20% x 1 year)]	80 000
Fair value	90 000
Increase in value	10 000
Revaluation surplus (10 000 x 70%)	7 000
Deferred tax (10 000 x 30%)	3 000

		<i>CA</i>	<i>TB</i>	<i>TD</i>	<i>DT</i>	
01/01/X1	Cost	100 000	100 000			
	Depreciation / tax allowance	(20 000)	(20 000)			
31/12/X1	Balance	80 000	80 000	0	0	
01/01/X2	Revaluation surplus	10 000	-	(10 000)	(3 000)	[^] Dr RS Cr DT
		90 000	80 000	(10 000)	(3 000)	
31/12/X2	Depreciation / tax allowance	(22 500)	(20 000)	2 500	750	[^] Dr DT Cr TE
		67 500	60 000	(7 500)	(2 250)	DT liability

	Debit	Credit
Plant: accumulated depreciation	20 000	
Plant		20 000
<i>Reversal of accumulated depreciation on plant</i>		
Plant carrying amount	10 000	
Revaluation surplus		7 000
Deferred taxation		3 000
<i>Increase in value of plant with deferred tax effect</i>		

Explanation:

The tax base is still C80 000 (Cost: C100 000 – Tax allowance: C100 000 x 20%) yet the carrying amount is C90 000. This equates to a taxable temporary difference of C10 000 which must be provided for: C10 000 x 30%. Please note that the transfer to deferred tax does not affect the tax expense in any way. It is statement of financial position deferred tax (i.e. debited to revaluation surplus and not debited to tax expense).

Solution 10.14 continued ...

This may be better understood if the adjusting journal entry is done in two steps instead:

	Debit	Credit
Plant	10 000	
Revaluation surplus		10 000
<i>Increase on revaluation of plant (pre-tax)</i>		
Revaluation surplus	3 000	
Deferred taxation		3 000
<i>Deferred tax effect of revaluation surplus on plant</i>		

ii) Depreciation of plant for 20X2 (unchanged)

Revised carrying amount (fair value)	90 000
Less residual value	0
Depreciable amount	90 000
Divide by remaining useful life (5 - 1 years)	4
	<u>22 500</u>

	Debit	Credit
Depreciation	22 500	
Plant: accumulated depreciation		22 500
<i>Depreciation on plant</i>		
Deferred tax	750	
Tax expense		750
<i>Deferred tax on depreciation vs tax allowance (22 500 – 20 000) x 30%</i>		

iii) Transfer of revaluation surplus for 20X2

Revaluation surplus (C10 000 – C3 000)	7 000
Divide by remaining useful life (5 - 1 years)	4
	<u>1 750</u>

	Debit	Credit
Revaluation surplus	1 750	
Retained earnings		1 750
<i>Realised portion of revaluation surplus transferred to retained earnings</i>		

The company makes this transfer to offset the additional decrease in after tax profits as a result of increasing the value of the asset by C10 000. This can be proved as follows:

Revised depreciation	22 500
Historic depreciation (80 000 / 4 yrs or 100 000 / 5 yrs)	20 000
Increase in depreciation, thus decrease in profits (before tax effects thereof)	2 500
Decrease in tax expense as a result of a decrease in profits (2 500 x 30%)	(750)
After tax effect (decrease) on profits for the year	<u>1 750</u>

Solution 10.14 continued ...

d) Decrease excluding tax effects (IAS 16 – revaluation model)

i) Decrease in value:

Actual carrying amount [100 000 – (100 000 x 20% x 1 year)]	80 000
Fair value	70 000
Decrease in value	10 000

	Debit	Credit
Plant: accumulated depreciation	20 000	
Plant		20 000
<i>Reversal of accumulated depreciation on plant</i>		
Revaluation expense	10 000	
Plant		10 000
<i>Revaluation of plant</i>		

ii) Depreciation of plant for 20X2

Revised carrying amount (fair value)	70 000
Less residual value	0
Depreciable amount	70 000
Divide by remaining useful life (5 – 1 years)	4
Debit depreciation; credit accumulated depreciation	17 500

	Debit	Credit
Depreciation	17 500	
Plant: accumulated depreciation		17 500
<i>Depreciation of plant</i>		

iii) N/A because there is no revaluation surplus

e) Decrease including deferred tax effects (IAS 16 – revaluation model with IAS 12)

	CA	TB	TD	DT	
01/01/X1	Cost	100 000	100 000		
	Depreciation	(20 000)	(20 000)		
	/ tax allowance				
31/12/X1	Balance	80 000	80 000	0	
01/01/X2	Reval decrease	(10 000)	-	10 000	3 000
					^Dr DT
					Cr TE
31/12/X2	Depreciation	(17 500)	(20 000)	(2 500)	(750)
	/ tax allowance				
					^Dr TE
					Cr Cr
					DT DT
					asset
	52 500	60 000	7 500	2 250	

Solution 10.14 continued ...

i. Decrease in value (unchanged)

Actual carrying amount [100 000 – (100 000 x 20% x 1 year)]	80 000
Fair value	70 000
Decrease in value	10 000

	Debit	Credit
Plant: accumulated depreciation	20 000	
Plant		20 000
<i>Reversal of accumulated depreciation</i>		
Revaluation expense	10 000	
Plant		10 000
<i>Revaluation of plant (PS the deferred tax on this adjustment is included in (ii) below)</i>		

ii. Depreciation of plant for 20X2 (unchanged)

Revised carrying amount (fair value)	70 000
Less residual value	0
Depreciable amount	70 000
Divide by remaining useful life (5 – 1 years)	4
	17 500

	Debit	Credit
Depreciation	17 500	
Plant: accumulated depreciation		17 500
<i>Depreciation of plant</i>		
Deferred tax ^ (3 000 – 750)	2 250	
Tax expense		2 250
<i>Deferred tax effects of plant-related expenses and tax allowances</i>		

f) IAS 16: revaluation model – impairment; ignoring tax

i) Decrease in value:

Actual carrying amount [100 000 – (100 000 x 20% x 1 year)]	80 000
Recoverable amount	70 000
Decrease in value	10 000

	Debit	Credit
Impairment loss	10 000	
Plant: accumulated depreciation / accumulated impairment losses		10 000
<i>Impairment of plant</i>		

Solution 10.14 continued ...

ii) Depreciation of plant for 20X2

Revised carrying amount (recoverable amount)	70 000
Less residual value	<u>0</u>
Depreciable amount	70 000
Divide by remaining useful life (5 – 1 years)	<u>4</u>
Debit depreciation; credit plant: accumulated depreciation	<u>17 500</u>

	Debit	Credit
Depreciation	17 500	
Plant: accumulated depreciation		17 500
<i>Depreciation of plant</i>		

iii) N/A because there is no revaluation surplus

g) IAS 16 – cost model – increase in value; ignoring tax

No adjustment is made since the recoverable amount (90 000) exceeds the historical carrying amount (C80 000), which is, in this case, equal to the actual carrying amount. The cost model disallows valuing the asset above its historical carrying amount.

h) IAS 16: cost model – decrease in value

i) Decrease in value

Actual carrying amount [100 000 – (100 000 x 20% x 1 year)]	80 000
Recoverable amount	<u>70 000</u>
Decrease in value	<u>10 000</u>

	Debit	Credit
Impairment loss	10 000	
Plant: accumulated depreciation / accumulated impairment losses		10 000
<i>Impairment of plant</i>		

ii) Depreciation of plant for 20X2

Revised carrying amount (fair value)	70 000
Divide by remaining useful life (5 - 1 years)	<u>4</u>
	<u>17 500</u>

	Debit	Credit
Depreciation	17 500	
Plant carrying amount		17 500
<i>Depreciation of plant</i>		

Solution 10.15

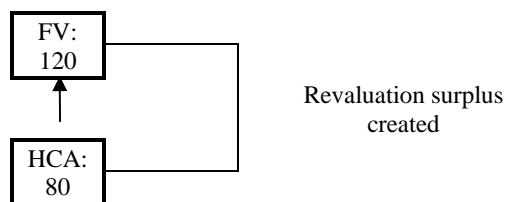
Comprehensive calculation (combining all 4 year's adjustments in one calculation)

		ACA	HCA
01/01/X1	Cost	100 000	100 000
31/12/X1	Depreciation	(20 000)	(20 000)
		80 000	80 000
01/01/X2	Revaluation surplus (above HCA)	40 000	
01/01/X2	Fair value	120 000	
31/12/X2	Depreciation	(30 000)	(20 000)
		90 000	60 000
01/01/X3	Revaluation surplus (down to HCA)	(30 000)	
		60 000	
01/01/X3	Revaluation expense	(10 000)	
01/01/X3	Fair value	50 000	
31/12/X3	Depreciation	(16 667)	(20 000)
		33 333	40 000
01/01/X4	Revaluation income	6 667	
		40 000	
01/01/X4	Revaluation surplus (above HCA)	10 000	
01/01/X4	Fair value	50 000	
31/12/X4	Depreciation	(25 000)	(20 000)
31/12/X4	Carrying amount	(25 000)	(20 000)

Alternative calculations (detailing each year's adjustments on a year-by-year basis)

1 January 20X2

Actual carrying amount (100K - 20K)	80 000
Adjustment through Statement of comprehensive income	0
Historical carrying amount (100K - 20K)	80 000
Adjustment through statement of financial position (Revaluation Surplus - Cr)	40 000
Fair value	120 000



Solution 10.15 continued . . .

Journal

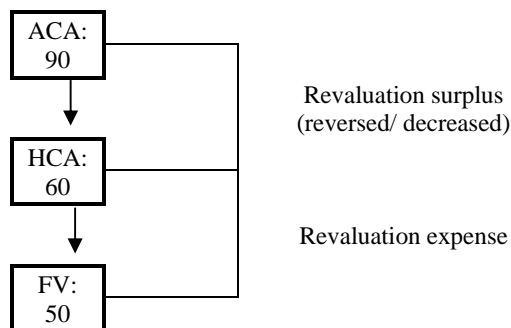
	Debit	Credit
Plant: accumulated depreciation	20 000	
Plant		20 000
<i>Reversal of accumulated depreciation</i>		
Plant	40 000	
Revaluation surplus		40 000
<i>Increase in value</i>		

Journal at end of 20X2:

	Debit	Credit
Depreciation	30 000	
Plant: accumulated depreciation		30 000
<i>Depreciation of asset (120 000 / 4 years)</i>		
Revaluation surplus	10 000	
Retained earnings		10 000
<i>Reversal of excess depreciation (40 000 / 4 years left)</i>		

1 January 20X3

Actual carrying amount (120K - 120K/4 x 1yr) or (80 + 40 - 30)	90 000
Adjustment through statement of financial position (reversal: 90 - 60) or (40 - 10)	30 000
Historical carrying amount (100K - 100K/ 5 x 2 yrs)	60 000
Adjustment through Statement of comprehensive income (revaluation expense: 60 - 50)	10 000
Fair value (given)	50 000



Solution 10.15 continued . . .

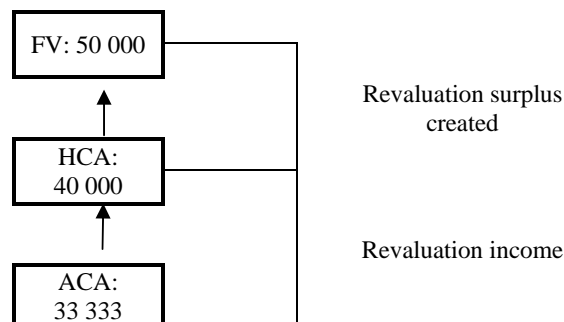
	Debit	Credit
Plant: accumulated depreciation	30 000	
Plant		30 000
<i>Reversal of accumulated depreciation</i>		
Revaluation Surplus	30 000	
Revaluation expense	10 000	
Plant		40 000
<i>Reversal of revaluation surplus on asset (40 - 10) or (90 - 60)</i>		
<i>Further impairment of asset (below HCA) (60 - 50)</i>		

Journal at end of 20X3:

	Debit	Credit
Depreciation	16 667	
Plant: accumulated depreciation		16 667
<i>Depreciation of asset (C50 000 / 3 remaining years)</i>		

1 January 20X4

Actual carrying amount (50K – 16 667)	33 333
Adjustment through statement of comprehensive income (revaluation income)	6 667
Historical carrying amount (100K - 100K/ 5 x 3 yrs)	40 000
Adjustment through statement of financial position (Revaluation Surplus)	10 000
Fair value	50 000



	Debit	Credit
Plant: accumulated depreciation and impairment losses	16 667	
Plant		16 667
<i>Reversal of accumulated depreciation</i>		
Plant	16 667	
Revaluation income		6 667
Revaluation surplus		10 000
<i>Revaluation income (up to HCA) (40 000 – 33 333)</i>		
<i>Revaluation of asset (above HCA) (50 000 – 40 000)</i>		

Solution 10.15 continued ...

Journal at end of 20X4:

	Debit	Credit
Depreciation	25 000	
Plant: accumulated depreciation and impairment losses		25 000
<i>Depreciation of asset (50 000 / 2 remaining years)</i>		
Revaluation surplus	5 000	
Retained earnings		5 000
<i>Reversal of excess depreciation (10 000 / 2 years)</i>		

Ledger accounts: not required but given for your interest

Revaluation decrease at 1/1/20X3

Plant				Accumulated depreciation			
Description	C	Description	C	Description	C	Description	C
Cost	100 000	Accumulated depreciation (X2)	20 000	Balance	20 000	Depreciation (X1)	20 000
Revaluation surplus (X2)	40 000	Balance	120 000		20 000		20 000
	140 000		140 000	Plant (X2)	20 000	Balance	20 000
Balance	120 000	Accumulated depreciation (X3)	30 000	Balance	30 000	Depreciation (X2)	30 000
		Revaluation surplus (X3)	30 000		50 000		50 000
		Revaluation expense (X3)	10 000	Plant (X3)	30 000	Balance	30 000
		Balance	50 000	Balance	16 667	Depreciation (X3)	16 667
	120 000		120 000		46 667		46 667
Balance	50 000	Accumulated depreciation (X4)	16 667	Plant (X4)	16 667	Balance	16 667
Revaluation income (X4)	6 667					Depreciation (X4)	25 000
Revaluation surplus (X4)	10 000	Balance	50 000		25 000		25 000
	66 667		66 667			Balance	25 000
Balance	50 000						

Revaluation surplus			
Description	C	Description	C
C/ earnings (X2)	10 000	Plant (X2)	40 000
Balance c/d	30 000		
	40 000		40 000
Plant (X3)	30 000	Balance b/d	30 000
C/ earnings (X4)	5 000	Plant (X4)	10 000
Balance c/d	5 000		
	10 000		10 000
		Balance b/d	5 000

Solution 10.16**Part A****i) Journals**

	Debit	Credit
Year end 31/12/20X8		
1 January 20X8		
Plant	1 000 000	
Bank		1 000 000
<i>Purchase of plant</i>		
31 December 20X8		
Depreciation	200 000	
Plant: accumulated depreciation		200 000
<i>Depreciation of plant: $(1\,000\,000 - 0) / 5$ years</i>		
Year end 31/12/20X9		
1 January 20X9		
Plant: accumulated depreciation	200 000	
Plant		200 000
<i>Set-off of acc depr against cost before revaluation</i>		
Plant	100 000	
Revaluation surplus		100 000
<i>Increase in carrying amount: $FV\,900\,000 - CA\,(1\,000\,000 - 200\,000)$</i>		
31 December 20X9		
Depreciation	225 000	
Plant: accumulated depreciation		225 000
<i>Depreciation of plant: $900\,000 / 4$ years</i>		
Revaluation surplus	25 000	
Retained earnings		25 000
<i>Realised portion of revaluation surplus: $100\,000 / 4$ yrs</i>		
Year end 31/12/Y0		
1 January 20Y0		
Plant: accumulated depreciation	225 000	
Plant		225 000
<i>Set-off of acc depr against cost before revaluation</i>		
Revaluation surplus	75 000	
Plant		75 000
Revaluation expense	100 000	
Plant		100 000
<i>ACA = $900\,000 - 225\,000 = 675\,000$; HCA = $1\,000\,000 - 200\,000 \times 2\text{yrs} = 600\,000$</i>		
<i>FV = 500 000 (given)</i>		
<i>Total decrease = $675\,000 - 500\,000 = 175\,000$</i>		
<i>Debit to RS = $675\,000 - 600\,000 = 75\,000$</i>		
<i>Debit to revaluation expense = $600\,000 - 500\,000 = 100\,000$</i>		
31 December 20Y0		
Depreciation	166 667	
Plant: accumulated depreciation and impairment losses		166 667
<i>Depreciation of plant: $500\,000 / 3$ years</i>		

Solution 10.16 continued. . .

Part A continued ...

ii) Statement of changes in equity

CARRYON LTD**EXTRACT FROM STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20Y0**

	Revaluation surplus C	Retained earnings C	Total C
Balance - 1 January 20X9	0	xxx	xxx
Total comprehensive income	100 000	x	x + 100 000
Transfer to retained earnings	(25 000)	25 000	0
Balance - 1 January 20Y0	75 000	xxx	xxx
Total comprehensive income	(75 000)	x	X - (75 000)
Balance – 31 December 20Y0	0	xxx	xxx

iii) Note disclosure

CARRYON LTD.**NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20Y0**

	20Y0 C	20X9 C	20X8 C
4. Property, Plant and Equipment			
Net carrying amount - 1 January	675 000	800 000	0
Gross carrying amount	900 000	1 000 000	0
Accumulated depreciation and impairment losses	(225 000)	(200 000)	0
Acquisition	0	0	1 000 000
Increase / (decrease) in asset value			
- through revaluation surplus	(75 000)	100 000	0
- through revaluation expense	(100 000)	0	0
Depreciation	(166 667)	(225 000)	(200 000)
Net carrying amount – 31 December	333 333	675 000	800 000
Gross carrying amount	600 000	900 000	1 000 000
Accumulated depreciation and impairment losses	(266 667)	(225 000)	(200 000)
Carrying amount based on the cost model	400 000	600 000	800 000

Plant was re-valued by an independent appraiser and member of the Institute of Valuers. The effective date of the most recent valuation is 1 January 20Y0. The fair value was determined with reference to an active market.

Please note: the 20X8 and 20X9 amounts (comparatives) were not required and have been given for interest sake only.

Solution 10.16 continued. . .

Part B

i) Journals

	Debit	Credit
Year end 31/12/20X8		
1 January 20X8		
Plant	1 000 000	
Bank		1 000 000
<i>Purchase of plant</i>		
31 December 20X8		
Depreciation	200 000	
Plant: accumulated depreciation and impairment losses		200 000
<i>Depreciation of plant: $(1\,000\,000 - 0) / 5$ years</i>		
Year end 31/12/20X9		
1 January 20X9		
Plant: accumulated depreciation and impairment losses	200 000	
Plant		200 000
<i>Set-off of acc depr against cost before revaluation</i>		
Plant	100 000	
Revaluation surplus		100 000
<i>Increase in carrying amount: $FV\,900\,000 - CA\,(1\,000\,000 - 200\,000)$; all above HCA of 800 000</i>		
Revaluation surplus	30 000	
Deferred taxation		30 000
<i>Statement of financial position based deferred tax:</i>		
<i>DT on creation of revaluation surplus: $100\,000 \times 30\%$ or W1</i>		
31 December 20X9		
Depreciation	225 000	
Plant: accumulated depreciation and impairment losses		225 000
<i>Depreciation of plant: $900\,000 / 4$ years</i>		
Revaluation surplus	17 500	
Retained earnings		17 500
<i>Realised portion of revaluation surplus: $(100\,000 - 30\,000) / 4$ yrs</i>		
Deferred tax	7 500	
Taxation expense		7 500
<i>Statement of comprehensive income based deferred tax:</i>		
<i>[tax allowance on plant $(1\,000\,000 \times 20\%)$ - plant expenses</i>		
<i>(depreciation: 225 000)] $\times 30\%$ or W1</i>		

Solution 10.16 continued. . .

Part B continued ...

	Debit	Credit
Year end 31/12/Y0		
1 January 20Y0		
Plant: accumulated depreciation and impairment losses	225 000	
Plant		225 000
<i>Set-off of acc depr against cost before revaluation</i>		
Revaluation surplus	75 000	
Plant		75 000
Revaluation expense	100 000	
Plant		100 000
<i>ACA = 900 000 – 225 000 = 675 000</i>		
<i>HCA = 1 000 000 – 200 000 x 2yrs = 600 000</i>		
<i>FV = 500 000 (given)</i>		
<i>Total decrease = 675 000 – 500 000 = 175 000</i>		
<i>Debit to RS = 675 000 – 600 000 = 75 000</i>		
<i>Debit to impairment expense = 600 000 – 500 000 = 100 000</i>		
Deferred tax	22 500	
Revaluation surplus		22 500
<i>Statement of financial position based deferred tax:</i>		
<i>reversed revaluation surplus: 75 000 x 30%</i>		
31 December 20Y0		
Depreciation	166 667	
Plant: accumulated depreciation and impairment losses		166 667
<i>Depreciation of plant: 500 000 / 3 years</i>		
Deferred tax	20 000	
Tax expense		20 000
<i>Statement of comprehensive income based deferred tax:</i>		
<i>[tax allowance on plant (1 000 000 x 20%) – plant expenses (depr 166 667 + imp loss 100 000)] x 30% or W1: 30 000 – 10 000</i>		

ii) Statement of changes in equity

CARRYON LTD

EXTRACT FROM STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20Y0 (EXTRACTS)

	Revaluation surplus C	Retained earnings C	Total C
Balance - 1 January 20X9	0	xxx	xxx
Total comprehensive income	*70 000	x	x + 70 000
Transfer to retained earnings	(17 500)	17 500	0
Balance - 1 January 20Y0	52 500	xxx	xxx
Total comprehensive income	^(52 500)	x	x - (52 500)
Balance – 31 December 20Y0	0	xxx	xxx

* (100 000 – 30 000)

^ [(75 000) + 22 500]

Solution 10.16 continued. . .

Part B continued ...

iii) Disclosure

CARRYON LTD.**NOTES TO THE FINANCIAL STATEMENTS****FOR THE YEAR ENDED 31 DECEMBER 20Y0 (EXTRACTS)****3. Taxation**

Normal taxation

Current tax	xxx	xxx	xxx
Deferred tax	(20 000)	(7 500)	0

4. Property, Plant and Equipment

Net carrying amount – 1 January	675 000	800 000	0
Gross carrying amount	900 000	1 000 000	0
Accumulated depreciation and impairment losses	(225 000)	(200 000)	0
Acquisition	-	-	1 000 000
Increase / (decrease) in asset value			
- through revaluation surplus	(75 000)	100 000	-
- through revaluation expense	(100 000)		-
Depreciation	(166 667)	(225 000)	(200 000)
Net carrying amount – 31 December	333 333	675 000	800 000
Gross carrying amount	600 000	900 000	1 000 000
Accumulated depreciation and impairment losses	(266 667)	(225 000)	(200 000)
Carrying amount based on the cost model	400 000	600 000	800 000

Plant was revalued by an independent, sworn appraiser and member of the Institute of Valuers. The effective date of the most recent valuation is 1 January 20Y0. The fair value was determined with reference to an active market.

5. Tax on other comprehensive income

	20Y0 C	20X9 C	20X8 C
Revaluation of plant			
Net	(52 500)	70 000	
Gross	(75 000)	100 000	-
Tax	22 500	(30 000)	-

Solution 10.16 continued. . .

Part B continued ...

	20Y0 C	20X9 C	20X8 C
6. Deferred Taxation Asset/ (Liability)			
Property, plant and equipment	20 000	(22 500)	0
Opening balance	(22 500)	0	0
Statement of comprehensive income based deferred tax	20 000	7 500	0
Statement of financial position based deferred tax			0
- Revaluation surplus	22 500	(30 000)	
Closing balance	20 000	(22 500)	0

Please note: Disclosure of the 20X9 and 20X8 amounts (comparatives) were not required and have been given for interest sake only.

Workings

W1: Deferred tax calculation:

Deferred tax on property, plant and equipment

	Historical CA	Carrying amount	Tax base	Temporary difference	Deferred tax	Reval surplus	Retain earn
Cost	1 000 000	1 000 000	1 000 000	0	0		
Depr/ w&t (CA/5 years)	(200 000)	(200 000)	(200 000)	0	0		
20X8 balances	800 000	800 000	800 000	0	0		
Revaluation surplus		100 000		(100 000)	(30 000) cr DT dr RS	(70 000)	
	800 000	900 000	800 000			(70 000)	
Depr/ w&t (CA/4 years)	(200 000)	(225 000)	(200 000)	25 000	7 500 dr DT cr TE	17 500	(17 500)
20X9 balances	600 000	675 000	600 000	(75 000)	(22 500) DTL	(52 500)	
Reversal of RS		(75 000)		75 000	22 500 dr DT cr RS	52 500	
	600 000	600 000	600 000			0	
Reval exp		(100 000)		100 000	30 000 dr DT cr TE		
Fair value		500 000					
Depr/ w&t (CA/3years)	(200 000)	(166 667)	(200 000)	(33 333)	(10 000) cr DT dr TE	0	
20Y0 balances	400 000	333 333	400 000	66 667	20 000 DTA	0	

Please note that historical carrying amounts, revaluation surplus and retained earnings are not required as part of the deferred tax calculation.

iv) Disclosure of the closing balance assuming the GRVM was used

Net carrying amount – 31 December 20Y0	333 333	balancing figure
Gross carrying amount - 31 December 20Y0	833 333	500 000 / 3 x 5yrs
Accumulated depreciation – 31 December 20Y0	(500 000)	833 333 / 5 x 3yrs

Solution 10.17

Part A

i) Journals	Debit	Credit
20X5		
01-07-20X5		
Vehicles	500 000	
Bank		500 000
<i>Purchase of vehicles</i>		
31-12-20X5		
Depreciation	50 000	
Vehicles: accumulated depreciation		50 000
<i>Depreciation on vehicles: 500 000 / 5 x 6/12</i>		
20X6		
31-12-20X6		
Depreciation (500 000 / 5 x 1 full year)	100 000	
Vehicles: accumulated depreciation		100 000
<i>Depreciation on vehicles: (500 000 / 5 x 1 full year)</i>		
20X7		
01-01-20X7		
Vehicles: accumulated depreciation	150 000	
Vehicles		150 000
<i>Set-off of acc depr against cost before revaluing: 100K + 50K</i>		
Vehicles: cost	70 000	
Revaluation surplus		70 000
<i>Revaluation of carrying amount to fair value: 420 000 – (500 000 – 150 000)</i>		
31-12-20X7		
Depreciation	120 000	
Vehicles: accumulated depreciation		120 000
<i>Depreciation on vehicles: 420 000 / (5 - 1.5 years)</i>		
Revaluation surplus	20 000	
Retained earnings		20 000
<i>Realised portion of revaluation surplus: 70 000 / 3.5 years</i>		
20X8		
31-12-20X8		
Depreciation	120 000	
Vehicles: accumulated depreciation		120 000
<i>Depreciation on vehicles: 420 000 / (5 - 1.5 years)</i>		
Revaluation surplus	20 000	
Retained earnings		20 000
<i>Realised portion of revaluation surplus: 70 000 / 3.5 years</i>		

Solution 10.17 continued ...

Part A continued ...

i) Journals continued ...	Debit	Credit
20X9		
01-01-20X9		
Vehicles: accumulated depreciation	240 000	
Vehicles		240 000
<i>Set-off of acc depreciation against cost before revaluing: 120K + 120K</i>		
Revaluation surplus	15 000	
Vehicles		15 000
<i>Total decrease: CA (420 – 240K) – FV: 165 000 = 15 000</i>		
<i>HCA: 500 000 – 50 000 – 100 000 – 100 000 – 100 000 = 150 000</i>		
<i>Since the FV is still greater than HCA, there is no revaluation expense; the entire drop in value is debited to the RS (there will still be a balance on the RS)</i>		
31-12-20X9		
Depreciation	110 000	
Vehicles: accumulated depreciation		110 000
<i>Depreciation on vehicles: 165 000 / (5 - 3.5 years)</i>		
Revaluation surplus	10 000	
Retained earnings		10 000
<i>Realised portion of revaluation surplus:</i>		
<i>(70 000 – 20 000 – 20 000 – 15 000) / (5 - 3.5 years)</i>		

ii) Disclosure

MIDWAY LTD.

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED AT 31 DECEMBER 20X9 (EXTRACTS)

1. Accounting policies (not required - for explanatory purposes only)

1.1 Non-current assets and depreciation

Vehicles are shown at fair value less subsequent accumulated depreciation and impairment losses

Depreciation is charged so as to write off the cost or valuation of assets, over their estimated useful lives using the straight line method. The estimated useful lives, residual values and depreciation method are reviewed at each year end, with the effect of any changes in estimate accounted for in a prospective basis.

1.2 Deferred taxation

Deferred tax is recognized on differences between carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit, and is accounted for using the balance sheet method.

2. Profit from before taxation	20X9 C	20X8 C
Profit before taxation is stated after taking the following into consideration:		
• Depreciation (<i>see journals or W1</i>)	110 000	120 000

Solution 10.17 continued ...

Part A continued ...

3. Non-current assets -

	20X9	20X8
Vehicles	C	C
Net carrying amount - beginning of year	180 000	300 000
Gross carrying amount	420 000	420 000
Accumulated depreciation	(240 000)	(120 000)
Increase/ (decrease) in value - though revaluation surplus	(15 000)	0
Depreciation	(110 000)	(120 000)
Net carrying amount - end of year	55 000	180 000
Gross carrying amount	165 000	420 000
Accumulated depreciation	(110 000)	(240 000)
Carrying amount of vehicles based on cost model:	50 000	150 000

Vehicles were revalued by an independent sworn appraiser and a member of the Institute of Valuers. The adjustment was recorded using a net replacement value basis. The fair value was estimated based on a future income approach. The effective date of the last revaluation is 1 January 20X9.

MIDWAY LTD

STATEMENT OF CHANGES IN EQUITY

FOR THE YEAR ENDED 31 DECEMBER 20X9 (EXTRACTS)

	Revaluation surplus	Retained earnings	Total
	C	C	C
Opening balance: 1/1/20X8	50 000	X	X
Transfer to retained earnings	(20 000)	20 000	0
Opening balance: 1/1/20X9	30 000	20 000	50 000
Total comprehensive income	(15 000)	x	x - (15 000)
Transfer to retained earnings	(10 000)	10 000	0
Closing balance: 31/12/20X9	5 000	30 000	35 000

Solution 10.17 continued ...

Part B

i) Journals	Debit	Credit
20X8		
01-07-20X5		
Vehicles	500 000	
Bank		500 000
<i>Purchase of vehicles</i>		
31-12-20X5		
Depreciation	50 000	
Vehicles: accumulated depreciation		50 000
<i>Depreciation on vehicles: 500 000 / 5 x 6/12</i>		
20X6		
31-12-20X6		
Depreciation	100 000	
Vehicles: accumulated depreciation		100 000
<i>Depreciation on vehicles: (500 000 / 5 x 1 full year)</i>		
20X7		
01-01-20X7		
Vehicles: accumulated depreciation	150 000	
Vehicles		150 000
<i>Set-off of acc depr against cost before revaluing: 100K + 50K</i>		
Vehicles	70 000	
Revaluation surplus		70 000
<i>Revaluation of carrying amount to fair value: 420 000 – (500 000 – 150 000)</i>		
Revaluation surplus	21 000	
Deferred tax		21 000
<i>Statement of financial position based deferred tax: on revaluation surplus: 70 000 x 30% / W1</i>		
31-12-20X7		
Depreciation	120 000	
Vehicles: accumulated depreciation		120 000
<i>Depreciation on vehicles: 420 000 / (5 - 1.5 years)</i>		
Deferred tax	6 000	
Taxation		6 000
<i>Statement of comprehensive income based deferred tax: [tax allowance on vehicles (500 000 x 20%) – depreciation on vehicles: 120 000] x 30% or W1</i>		
Revaluation surplus	14 000	
Retained earnings		14 000
<i>Revaluation surplus transferred to retained earnings: (70 000 - 21 000) / 3.5 years</i>		
20X8		
31-12-20X8		
Depreciation	120 000	
Vehicles: accumulated depreciation		120 000
<i>Depreciation on vehicles: 420 000 / (5 - 1.5 years)</i>		
Deferred tax	6 000	
Taxation		6 000
<i>SOCI based deferred tax: [tax allowance (500 000 x 20%) – depreciation: 120 000] x 30% or W1</i>		
Revaluation surplus	14 000	
Retained earnings		14 000
<i>Revaluation surplus transferred to retained earnings: (70 000 - 21 000) / 3.5 years</i>		

Solution 10.17 continued ...

Part B continued ...

i) Journals continued ...	Debit	Credit
20X9		
01-01-20X9		
Vehicles: accumulated depreciation	240 000	
Vehicles		240 000
<i>Set-off of acc depr against cost before revaluing: 120K + 120K</i>		
Revaluation surplus	15 000	
Vehicles		15 000
<i>Total decrease: CA (420K – 240K) – FV: 165 000 = 15 000</i>		
<i>HCA: 500 000 – 50 000 – 100 000 – 100 000 – 100 000 = 150 000</i>		
<i>Since the FV is still greater than HCA, there is no revaluation expense; the entire drop in value is debited to the RS (and there will still be a balance on the RS)</i>		
Deferred tax	4 500	
Revaluation surplus		4 500
<i>Statement of financial position based deferred tax: on revaluation surplus 15 000 x 30% / W1</i>		
31-12-20X9		
Depreciation	110 000	
Vehicles: accumulated depreciation		110 000
<i>Depreciation on vehicles: 165 000 / (5 - 3.5 years)</i>		
Deferred tax	3 000	
Taxation		3 000
<i>SOCI based deferred tax: [tax allowance (500 000 x 20%) – depreciation: 110 000] x 30% or W1</i>		
Revaluation surplus	7 000	
Retained earnings		7 000
<i>Realised portion of revaluation surplus transferred to retained earnings: (70 000 – 21 000 – 14 000 – 14 000 – 15 000 + 4 500) / 1.5 years</i>		

Solution 10.17 continued . . .

W1: Calculation of Deferred Taxation (Balance sheet approach)						
	HCA	ACA	TB	TD	DT	RS
1/1/20X5	0	0	0	0	0	
	500 000	500 000	500 000			
Dep/tax allow	(50 000)	(50 000)	(50 000)			
31/12/20X5	450 000	450 000	450 000	0	0	
Dep/tax allow	(100 000)	(100 000)	(100 000)			
31/12/20X6	350 000	350 000	350 000	0	0	
RS created		70 000	0	(70 000)	(21 000)	Cr DT Dr RS 49 000
		420 000				
Dep/tax allow	(100 000)	(120 000)	(100 000)	20 000	6 000	Dr DT Cr TE (14 000)
31/12/20X7	250 000	300 000	250 000	(50 000)	(15 000)	L 35 000
Dep/tax allow	(100 000)	(120 000)	(100 000)	20 000	6 000	Dr DT Cr TE (14 000)
31/12/20X8	150 000	180 000	150 000	(30 000)	(9 000)	L 21 000
RS reversed		(15 000)	0	15 000	4 500	Dr DT Cr RS (10 500)
		165 000				10 500
Dep/tax allow	(100 000)	(110 000)	(100 000)	10 000	3 000	Dr DT Cr TE (7 000)
31/12/20X9	50 000	55 000	50 000	(5 000)	(1 500)	L 3 500
Dep/tax allow	(50 000)	(55 000)	(50 000)	5 000	1 500	Dr DT Cr TE (3 500)
30/6/20Y0	0	0	0	0	0	0

Please note:

The movement in 20Y0 was not required to be shown – this was given purely for your interest.

Solution 10.17 continued ...

Part B continued ...

ii) Disclosure

MIDWAY LTD.

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED AT 31 DECEMBER 20X9 (EXTRACTS)

1. Accounting policies (not required - for explanatory purposes only)

1.1 Non-current assets and depreciation

Vehicles are shown at fair value less subsequent accumulated depreciation and impairment losses

Depreciation is charged so as to write off the cost or valuation of assets, over their estimated useful lives using the straight line method. The estimated useful lives, residual values and depreciation method are reviewed at each year end, with the effect of any changes in estimate accounted for in a prospective basis.

1.2 Deferred taxation

Deferred tax is recognized on differences between carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit, and is accounted for using the balance sheet method.

	20X9 C	20X8 C
2. Profit from before taxation		
Profit before taxation is stated after taking the following into consideration:		
Depreciation (<i>see journals or W1</i>)	110 000	120 000

3. Property, plant and equipment

	20X9 C	20X8 C
Vehicles		
Net carrying amount - beginning of year	180 000	300 000
Gross carrying amount	420 000	420 000
Accumulated depreciation	(240 000)	(120 000)
Increase/ (decrease) in value		
- though revaluation surplus	(15 000)	0
Depreciation	(110 000)	(120 000)
Net carrying amount - end of year	55 000	180 000
Gross carrying amount	165 000	420 000
Accumulated depreciation	(110 000)	(240 000)

Vehicles were revalued by an independent sworn appraiser and a member of the Institute of Valuers on a net replacement value basis. The fair value was estimated based on a future income approach. The effective date of the last revaluation is 1 January 20X9.

Carrying amount of vehicles based on cost model:	50 000	150 000
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Solution 10.17 continued ...

4. Taxation	20X9 C	20X8 C
Normal Taxation		
Current	xxx	Xxx
Deferred	(3 000)	(6 000)
5. Deferred taxation asset/ (liability)		
Deferred tax comprises temporary differences caused by:		
Property, plant and equipment	(1 500)	(9 000)
<i>Reconciliation:</i>		
Opening balance	(9 000)	(15 000)
Statement of comprehensive income deferred tax charge	3 000	6 000
Statement of financial position based deferred tax:		
- on reversal of revaluation surplus	4 500	0
Closing balance	(1 500)	(9 000)

6. Tax on other comprehensive income

	20X9	20X8
Revaluation of plant		
Net	(10 500)	-
Gross	(15 000)	-
Tax	4 500	-

MIDWAY LTD

EXTRACT FROM STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X9 (EXTRACTS)

	Revaluation surplus C	Retained earnings C	Total C
Opening balance: 1/1/20X8	35 000	X	X
Transfer to retained earnings	(14 000)	14 000	0
Opening balance: 1/1/20X9	21 000	14 000	35 000
Total comprehensive income	*(10 500)	x	x - (10 500)
Transfer to retained earnings	(7 000)	7 000	0
Closing balance: 31/12/20X9	3 500	21 000	24 500

* [(15 000) + 4 500]

Solution 10.18**(a) Journal entries for 20X6**

		Debit	Credit
01/07/X5	Plant	900 000	
	Bank		900 000
	<i>Purchase of plant</i>		
30/06/X6	Depreciation	225 000	
	Accumulated depreciation (900 000 / 4)		225 000
	Accumulated depreciation	225 000	
	Plant		225 000
	<i>(Reversal of balance of accumulated depreciation)</i>		
	Plant	150 000	
	Revaluation surplus		106 500
	Deferred tax		43 500
	<i>(Revaluation of plant) (825 000 – 675 000)</i>		

(b) Extracts from statement of comprehensive income, statement of financial position and statement of changes in equity
GREENHOUSE LIMITED
EXTRACT FROM STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 JUNE 20X7

		Note	C
Profit before tax		2	300 000
Income tax expense	(116 000 – 29 000)	3	(87 000)
Profit for the period			213 000
<i>Other comprehensive income</i>			
Revaluation decrease	(100 000 x 0.71)		(71 000)
Total comprehensive income			142 000

GREENHOUSE LIMITED
EXTRACT FROM STATEMENT OF FINANCIAL POSITION
FOR THE YEAR ENDED 30 JUNE 20X7

	Note	C
Non-current assets		
Property, plant and equipment	4	400 000
Non-current liabilities		
Deferred tax	5	14 500

Solution 10.18 continued ...

GREENHOUSE LIMITED
EXTRACT FROM STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 30 JUNE 20X7

		Revaluation reserve C	Retained earnings C
01/07/X7	Balance	106 500	xx
	Total comprehensive income	(71 000)	213 000
	Transfer to retained earnings	(35 500)	35 500
30/06/X7	Balance	-	xx

(c) Extracts from notes to the financial statements

GREENHOUSE LIMITED
EXTRACT FROM NOTES TO THE FINANCIAL STATEMENTS
AT 30 JUNE 20X7
1 Accounting policies**Property, plant and equipment**

Plant is stated at revalued amount, being the fair value at the date of revaluation less subsequent accumulated depreciation and subsequent accumulated impairment losses. The plant is revalued annually.

Depreciation is charged so as to write off the cost or valuation of assets over their estimated useful lives, using the straight line method.

Deferred tax (not required for answer)

Deferred tax is recognised on the differences between the carrying amount of assets and liabilities and their corresponding tax bases used in the computation of taxable profit, and is accounted for using the statement of financial position liability method.

C

2 Profit before tax

Profit before tax is stated after taking into account the following:

Depreciation	275 000
Revaluation expense	50 000

3 Taxation

Normal tax		
- Current tax	W2	116 000
- Deferred tax	W1	(29 000)
Income tax expense		87 000

Solution 10.18 continued . . .

		C
4 Property, plant and equipment		
Plant		
Net carrying amount at 01/ 07/X6:		825 000
Gross carrying amount	(900 000 – 225 000 + 150 000)	825 000
Accumulated depreciation		(0)
Depreciation	(825 000 / 3 years)	(275 000)
Revaluation decrease		(150 000)
Net carrying amount at 30/06/X7		400 000
Gross carrying amount	(825 000 – 275 000 – 150 000)	400 000
Accumulated depreciation		(0)
Carrying amount using the cost model		450 000
The plant has been revalued at 30 June 20X7, by an independent valuer, with reference to discounted cash flows.		
5 Deferred tax asset/ (liability)		
The deferred tax balance comprises temporary differences caused by:		
Property, plant and equipment		(14 500)
6. Tax on other comprehensive income		
Revaluation of plant		
Net		71 000
Gross		100 000
Tax		(29 000)

Solution 10.18 continued ...

Workings

W1. HCA / ACA & Deferred tax			HCA	ACA	TB	TD	DT	RS	
01/07/X5	Cost		900	900	900				
30/06/X6	Depreciation / tax allowance	(900 / 4)	(225)	(225)	(225)				
			675	675	675				
	Revaluation		-	150	-	150	43.5		106,5
	Balance		675	825	675	150	43.5	Cr	106,5
30/06/X7	Depreciation / tax allowance	*(825 / 3)	(225)	*(275)	(225)	(50)	(14.5)	Dr	
	Transfer of RS to RE	[(275 – 225) X 0.71] or (106.5 / 3)							(35,5)
			450	550	450	100	29	Cr	71
	Revaluation decrease			(150)					
	(Reversal of RS)			(100)		(100)	(29)	Dr	(71)
	(Revaluation expense)			(50)		(50)	(14.5)	Dr	
	Balance		450	400	450	(50)	(14.5)	Dr	-
30/06/X8	Depreciation / tax allowance	*(400 / 2)	(225)	*(200)	(225)	25	7.25	Cr	
	Balance		225	200	225	(25)	(7.25)	Dr	-

Not required for answer

W2: Tax computation

X 0.29

Profit before tax	300 000	87 000	Dr TE	Cr DT
Temporary differences	100 000	29 000		
+ depreciation	275 000			
- tax allowance	(225 000)			
+ revaluation expense	50 000			
Taxable profit	400 000	116 000	Dr TE	Cr CTP

Solution 10.19**a) Journals**

	Debit	Credit
Year end 28/02/20X8		
1 January 20X8		
Plant: cost	600 000	
Bank		600 000
<i>Purchase of plant</i>		
Depreciation – plant	20 000	
Plant: accumulated depreciation		20 000
<i>Depreciation of plant: (600 000 / 5 x 2/12)</i>		
Year end 28/02/20X9		
1 March 20X8		
Plant: accumulated depreciation	20 000	
Plant: cost		20 000
<i>Set-off of accumulated depreciation before revaluation (NRVM)</i>		
Plant: cost (725 000 – 580 000)	145 000	
Revaluation surplus		145 000
<i>Increase in carrying amount to fair value of 725 000</i>		
Revaluation surplus	43 500	
Deferred taxation (B/S)		43 500
<i>Deferred tax on revaluation surplus: (145 000 x 30%) or W1</i>		
28 February 20X9		
Depreciation – plant	150 000	
Plant: accumulated depreciation		150 000
<i>Depreciation on plant: 725000/58m x 12m</i>		
Revaluation surplus	21 000	
Retained earnings		21 000
<i>Transfer of realised portion of revaluation surplus to retained earnings (145 000 – 43 500)/(58m x 12m) or (actual depreciation: 150 000 – historic depreciation: 120 000) x 70%</i>		
Deferred tax	9 000	
Taxation expense		9 000
<i>Deferred tax adjustment due to plant-related expenses versus tax allowances: (150K – 120K) x 30% OR W1</i>		

Solution 10.19 continued ...

	Debit	Credit
Year end 28/2/20Y0		
1 March 20X9		
Plant: accumulated depreciation	150 000	
Plant: cost		150 000
<i>Set-off of accumulated depreciation before revaluation (NRVM)</i>		
Revaluation surplus	69 000	
Plant: cost		69 000
<i>Decrease in carrying amount to fair value of 506 000</i>		
<i>HCA = 600 000 - 20 000 - 120 000 = 460 000</i>		
<i>ACA = 725 000 - 150 000 = 575 000</i>		
<i>Revaluation decrease = 575 000 - 506 000 = 69 000</i>		
<i>against revaluation surplus =</i>		
<i>575 000 - 506 000 (not limited by the 460 000) = 69 000</i>		
Deferred tax	20 700	
Revaluation surplus		20 700
<i>Deferred tax on revaluation decrease of 69 000 x 30%</i>		
Depreciation – plant	132 000	
Plant: accumulated depreciation		132 000
<i>Depreciation of plant: 506 000 / 46 months x 12 months</i>		
Deferred tax	3 600	
Tax expense		3 600
<i>Deferred tax adjustment due to differences between plant-related expenses and the related tax allowances: (132K – 120K) x 30%</i>		
Revaluation surplus	8 400	
Retained earnings		8 400
<i>Transfer of realised portion of revaluation surplus to retained earnings: (145 – 43.5 - 21 – 69 + 20.7) / 46 x 12 x 70% OR</i>		
<i>(actual depreciation: 132 – historic depreciation: 120) x 70% OR</i>		
<i>(506 000 – 460 000) / 46 m x 12m x 70%</i>		

Solution 10.19 continued ...

b) Statement of changes in equity

WIMBLES LIMITED
(EXTRACTS FROM) STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 28 FEBRUARY 20Y0

		Revaluation surplus	Retained earnings	Total
Balance - 1 March 20X8		0	xxx	
Total comprehensive income	(1)	101 500	xxx	Xxx
Transfer to retained earnings	(3)	(21 000)	21 000	0
Balance - 1 March 20X9		80 500	xxx	Xxx
Total comprehensive income	(2)	(48 300)	xxx	xxx
Transfer to retained earnings	(4)	(8 400)	8 400	0
Balance - 28 February 20Y0		23 800	xxx	Xxx

- (1) $(725\,000 - 580\,000) \times 70\% = 101\,500$
 (2) $(506\,000 - 575\,000) \times 70\% = 48\,300$
 (3) $101\,500 / 58\text{m} \times 12\text{m} = 21\,000$
 (4) $(80\,500 - 48\,300) / 46\text{m} \times 12\text{m} = 8\,400$

c) Note disclosure

WIMBLES LIMITED.
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 28 FEBRUARY 20Y0 (EXTRACTS)

	20Y0	20X9	20X8
2. Profit before tax			
Is stated after taking the following into account:			
Depreciation	132 000	150 000	20 000
3. Taxation			
Normal taxation			
Current tax	xxx	xxx	xxx
Deferred tax	(3 600)	(9 000)	0
4. Property, plant and equipment			
Net carrying amount – 1st March	575 000	580 000	0
Gross carrying amount	725 000	600 000	0
Accumulated depreciation	(150 000)	(20 000)	0
Acquisition	-	-	600 000
Revaluation increase / (decrease)	(69 000)	145 000	-
Depreciation	(132 000)	(150 000)	(20 000)
Net carrying amount - 28 th February	374 000	575 000	580 000
Gross carrying amount	506 000	725 000	600 000
Accumulated depreciation	(132 000)	(150 000)	(20 000)
Plant was revalued on 1 st March 20X9 by Mr. Wimble, an independent, sworn appraiser and member of the Institute of Valuers on the net replacement value basis.			
Cost model carrying amount (600-20-120-120)	340 000	460 000	580 000

Solution 10.19 continued ...

WIMBLES LIMITED.

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 28 FEBRUARY 20Y0 (EXTRACTS)

	20Y0	20X9	20X8
5. Deferred taxation asset/ (liability)			
The deferred tax balance is caused by temporary differences relating to:			
Property plant and equipment	(10 200)	(34 500)	0
Opening balance	(34 500)	0	0
Deferred tax adjustment recognised in:			
- profit or loss	3 600	9 000	0
- other comprehensive income	20 700	(43 500)	0
Closing balance	(10 200)	(34 500)	0

Note: disclosure of the 20X8 figures were not required and have been given for interest sake only.

6. Tax on other comprehensive income

	20Y0	20X9	20X8
Revaluation of plant			
Net	(48 300)	101 500	0
- Gross	(69 000)	145 000	0
- Less tax	20 700	(43 500)	0

Workings

W1: Deferred tax calculation:

Capital allowances

	HCA	ACA	Tax base	Temporary difference	Deferred tax	Revaluation surplus	Retained earnings
01/01/20X8							
Cost	600 000	600 000	600 000	0	0		
Depr/ tax all (/60 X2)	(20 000)	(20 000)	(20 000)	0	0		
28/02/20X8	580 000	580 000	580 000	0	0		
Revaluation surplus		145 000		(145 000)	(43 500) Cr DT Dr RS	(145 000) 43 500	
	580 000	725 000	580 000			(101 500)	
Depr/ tax all (/58 X12)	(120 000)	(150 000)	(120 000)	30 000	9 000 Dr DT Cr TE	21 000	(21 000)
28/02/20X9	460 000	575 000	460 000	(115 000)	(34 500) DTL	(80 500)	
Reversal of RS		(69 000)		69 000	20 700 Dr DT Cr RS	69 000 (20 700)	
	460 000	506 000	460 000			(32 200)	
Depr/ tax all (/46 X12)	(120 000)	(132 000)	(120 000)	12 000	3 600 Dr DT Cr TE	8 400	(8 400)
28/02/20Y0	340 000	374 000	340 000	(34 000)	(10 200) DTL	(23 800)	

Please note:

The historical carrying amount column (HCA), revaluation surplus and retained earnings columns are not required as part of the deferred tax calculation.

Solution 10.19 continued ...

Supporting ledger accounts (not required – given for your interest only)

Plant: cost				Plant: accumulated depreciation			
Description	C	Description	C	Description	C	Description	C
Bank	600 000	Balance c/f	600 000	Balance c/f	20 000	Depreciation (X8)	20 000
	600 000		600 000		20 000		20 000
Balance b/f	600 000	Plant: accum. depreciation	20 000	Plant: cost	20 000	Balance b/f	20 000
Revaluation surplus	145 000	Balance c/f	725 000	Balance c/f	150 000	Depreciation (X9)	150 000
	745 000		745 000		150 000		150 000
Balance b/f	725 000	Plant: accum. depreciation	150 000	Plant: cost	150 000	Balance b/f	150 000
		Revaluation surplus	69 000	Balance c/f	132 000	Depreciation (Y0)	132 000
		Balance c/f	506 000		282 000		282 000
	725 000		725 000			Balance b/f	132 000
Balance b/f	506 000						

Solution 10.20**a) Journal entries**

	Debit	Credit
31/12/20X1		
Machinery:	500 000	
Bank/ Accounts payable		500 000
<i>Purchase of machinery</i>		
31/12/20X2		
Depreciation	100 000	
Accumulated depreciation & impairment loss: machinery		100 000
<i>Depreciation: $(500\,000 - 0) / 5\text{ years}$</i>		
Note: recoverable amount (RA: 420 000) exceeds actual carrying amount (ACA: 400 000): no adjustment using the cost model since the ACA equals the HCA		
31/12/20X2		
Depreciation	100 000	
Accumulated depreciation & impairment loss: machinery		100 000
<i>Depreciation: $(500\,000 - 0) / 5\text{ years}$</i>		
Impairment loss (expense)	20 000	
Accumulated depreciation & impairment loss: machinery		20 000
<i>Write- down ACA of 300 000 to RA of 280 000</i>		
Deferred tax (asset)	6 000	
Taxation (expense)		6 000
<i>See deferred tax table W1</i>		
31/12/20X3		
Depreciation	93 333	
Accumulated depreciation & impairment loss: machinery		93 333
<i>Depreciation: $(280\,000 - 0) / 3\text{ years remaining}$</i>		
Accumulated depreciation & impairment loss: machinery	13 333	
Reversal of impairment loss		13 333
<i>Write-back of ACA to RA, limited to HCA</i>		
<i>ACA: $280\,000 - 93\,333 = 186\,667$; HCA: $500\,000 - 500\,000/5 \times 3 = 200\,000$</i>		
<i>RA: 250 000; therefore write-back: limited to 200 000 (not 250 000) - 186 667 = 13 333</i>		

Solution 10.20 continued**a) Journal entries continued ...****31/12/20X3 continued ...**

	Debit	Credit
Taxation (expense)	6 000	
Deferred taxation (asset)		6 000
<i>See deferred tax table W1: 2 000 + 4 000</i>		

31/12/20X4

Depreciation	100 000	
Accumulated depreciation & impairment loss: machinery		100 000
<i>Depreciation: (200 000 – 0) / 2 years</i>		

Impairment loss	15 000	
Accumulated depreciation & impairment loss: machinery		15 000
<i>Write-down ACA of 100 000 to RA of 85 000</i>		
<i>HCA: 500 000 – 500 000 / 5 x 4 = 100 000</i>		
<i>ACA: 200 000 – 100 000 = 100 000</i>		
<i>RA: 85 000; therefore write-down = 100 000 – 85 000 = 15 000</i>		

Deferred tax (asset)	4 500	
Taxation (expense)		4 500
<i>See deferred tax table W1</i>		

31/12/20X5

Depreciation	85 000	
Accumulated depreciation & impairment loss: machinery		85 000
<i>Depreciation: (85 000 – 0) / 1 year</i>		

Taxation (expense)	4 500	
Deferred taxation (asset)		4 500
<i>See deferred tax table W1</i>		

Note:

It is submitted that, in the event that the recoverable amount at the end of 31/12/20X5 (the end of its useful life) was greater than the residual value at the end of its useful life, (in this case, zero) then this should be treated as a change in estimate:

- either the estimated useful life was too short
- or the residual value was underestimated

In which case, the depreciation will be held to have been too much over the years, and the depreciation adjusted. In either case, it is not possible to *write-back* anything since a write-back is limited to all previous depreciated write-downs/ impairments.

Solution 10.20 continued**b) Disclosure**

**MACHINES LTD.
EXTRACTS FROM STATEMENT OF FINANCIAL POSITION
AT 31 DECEMBER 20X5**

	Note	20X5 C	20X4 C	20X3 C	20X2 C	20X1 C
ASSETS						
Property, plant and equipment	5	0	85 000	200 000	280 000	400 000
Deferred tax	6	0	4 500	0	6 000	0

**MACHINES LTD.
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X5**

1. Basis of preparation

These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 198, provisions of and directives issued by under the Companies Ordinance, 1984. In case the requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

2. Accounting policies**2.1 Non-current assets**

Machinery is stated at cost less subsequent accumulated depreciation and subsequent accumulated impairment losses. .

Depreciation is charged so as to write off the cost of assets over their estimated useful lives, using the straight line method.

2.2 Deferred taxation

Deferred tax is provided using the balance sheet liability method, on all the temporary differences at the balance sheet date between the tax base of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred tax asset are recognized for all deductible temporary differences, carry forward of unused tax losses, to the extent that is probable that future taxable profit will be available against which the deductible temporary difference, unused tax losses and tax credits can be utilized.

Carrying amount of deferred tax asset is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that the related tax benefit will be realized. Deferred tax is calculated at the rates that are expected to apply to the period when differences reverse based on the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.

3. Profit before tax

Profit before tax is stated after

	20X5	20X4	20X3	20X2	20X1
	C	C	C	C	C
Depreciation	85 000	100 000	93 333	100 000	100 000
Impairment of machinery	0	15 000	0	20 000	0
Reversal of impairment of machinery	0	0	(13 333)	0	0

Solution 10.20 continued

b) Disclosure continued ...

**MACHINES LTD.
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X5 CONTINUED ...**

4. Taxation

	20X5 C	20X4 C	20X3 C	20X2 C	20X1 C
Normal tax					
- current tax	xxx	xxx	xxx	xxx	xxx
- deferred tax	4 500	(4 500)	6 000	(6 000)	0

5. Property, plant and equipment

	20X5 C	20X4 C	20X3 C	20X2 C	20X1 C
Net carrying amount: 1 January	85 000	200 000	280 000	400 000	0
Gross carrying amount	500 000	500 000	500 000	500 000	0
Accumulated depreciation and impairment losses	(415 000)	(300 000)	(220 000)	(100 000)	0
Purchases	0	0	0	0	500 000
Depreciation	(85 000)	(100 000)	(93 333)	(100 000)	(100 000)
Impairment loss	0	(15 000)	0	(20 000)	0
Reversal of impairment	0	0	13 333	0	0
Net carrying amount: 31 December	0	85 000	200 000	280 000	400 000
Gross carrying amount	500 000	500 000	500 000	500 000	500 000
Accumulated depreciation and impairment losses	(500 000)	(415 000)	(300 000)	(220 000)	(100 000)

6. Deferred taxation asset/ (liability)

	20X5 C	20X4 C	20X3 C	20X2 C	20X1 C
The deferred tax balance is caused by temporary differences resulting from:					
Property, plant and equipment	0	4 500	0	6 000	0

Solution 10.20 continued

Workings

W1 Deferred tax calculation - balance sheet approach

		HCA	ACA	Tax base	Temporary difference	Deferred tax	
Cost	20X1	500 000	500 000	500 000	0	0	
Depreciation	20X1	(100 000)	(100 000)	(100 000)	0	0	
31/12/20X1	20X1	400 000	400 000	400 000	0	0	
Depreciation	20X2	(100 000)	(100 000)	(100 000)	0	0	
	20X2	300 000	300 000	300 000			
Impairment loss	20X2	0	(20 000)	0	20 000	6 000	Dr DT Cr TE
31/12/20X2	20X2	300 000	280 000	300 000	20 000	6 000	DTA
Depreciation	20X3	(100 000)	(93 333)	(100 000)	(6 667)	(2 000)	Cr DT Dr TE
	20X3	200 000	186 667	200 000			
Reversal of IL (up to HCA)	20X3	0	13 333	0	(13 333)	(4 000)	Cr DT Dr TE
31/12/20X3	20X3	200 000	200 000	200 000	0	0	
Depreciation	20X4	(100 000)	(100 000)	(100 000)	0	0	
	20X4	100 000	100 000	100 000			
Impairment loss	20X4	0	(15 000)	0	15 000	4 500	Dr DT Cr TE
31/12/20X4	20X4	100 000	85 000	100 000	15 000	4 500	DTA
Depreciation	20X5	(100 000)	(85 000)	(100 000)	(15 000)	(4 500)	Cr DT Dr TE
31/12/20X5	20X5	0	0	0	0	0	

The 'Historical CA' column is used as a check to ensure that the carrying amount of the machine does not exceed the historical carrying amount. It is, however, generally unnecessary to show this column as part of your deferred tax calculation.

Solution 10.21**Part A****a) Journals**

	Debit	Credit
Year end 31/12/20X1		
<i>1 January 20X1</i>		
Plant	100 000	
Bank		100 000
<i>Purchase of plant</i>		
31 December 20X1		
Depreciation	20 000	
Plant: accumulated depreciation and impairment loss		20 000
<i>Depreciation of plant: (100 000 – 0) / 5 years</i>		
Impairment loss	10 000	
Plant: accumulated depreciation and impairment loss		10 000
<i>Depreciation of plant: CA: (100 000 – 20 000) – RA: 70 000</i>		
Year end 31/12/20X2		
31 December 20X2		
Depreciation	17 500	
Plant: accumulated depreciation and impairment loss		17 500
<i>Depreciation of plant: 70 000 / 4 years</i>		
Plant: accumulated depreciation and impairment loss	7 500	
Impairment loss reversed		7 500
<i>Previous impairment loss reversed: CA: (70 000 – 17 500) – RA: 65 000, limited to HCA: (100 000 – 100 000 x 20% x 2 years)</i>		
Year end 31/12/20X3		
31 December 20X3		
Depreciation	20 000	
Plant: accumulated depreciation and impairment loss		20 000
<i>Depreciation of plant: 60 000 / 3 years</i>		
Impairment loss	10 000	
Plant: accumulated depreciation and impairment loss		10 000
<i>Impairment loss: CA: (60 000 – 20 000) – RA: 30 000</i>		

Solution 10.21 continued ...

Part A continued ...

b) Note disclosure

RAINGO LTD.

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 20X3 (EXTRACTS)

	20X3 C	20X2 C	20X1 C
2. Profit before tax			
Is stated after taking the following into account:			
Depreciation	20 000	17 500	20 000
Impairment loss / (impairment loss reversed)	10 000	(7 500)	10 000
4. Property, plant and equipment			
Net carrying amount - 1 January	60 000	70 000	0
Gross carrying amount	100 000	100 000	0
Accumulated depreciation	(40 000)	(30 000)	0
Acquisition	0	0	100 000
Depreciation	(20 000)	(17 500)	(20 000)
Impairment loss	(10 000)	0	(10 000)
Impairment loss reversed	0	7 500	0
Net carrying amount – 31 December	30 000	60 000	70 000
Gross carrying amount	100 000	100 000	100 000
Accumulated depreciation	(70 000)	(40 000)	(30 000)

The plant has been pledged as security for a loan (see note 6).

The impairment in 20X3 is as a result of damage incurred during a riot on the factory premises in October 20X3. The reversal of the impairment in 20X2 is as a result of repairs to the plant carried out during 20X2.

24. Capital commitments

The directors have contracted for the construction of a plant (to be complete in April 20X4) to the value of C500 000.

Please note that the figures for the year ended 31 December 20X1 were not required. These have been given for your interest only.

Solution 10.21**Part B****a) Journals**

	Debit	Credit
Year end 31/12/20X1		
1 January 20X1		
Plant	100 000	
Bank		100 000
<i>Purchase of plant</i>		
31 December 20X1		
Depreciation	20 000	
Plant: accumulated depreciation and impairment loss		20 000
<i>Depreciation of plant: $(100\,000 - 0) / 5$ years</i>		
Impairment loss	10 000	
Plant: accumulated depreciation and impairment loss		10 000
<i>Depreciation of plant: CA: $(100\,000 - 20\,000) - RA: 70\,000$</i>		
Deferred tax	3 000	
Taxation		3 000
<i>Deferred tax adjustment:</i> <i>[Tax allowance: $(100\,000 \times 20\%) - \text{plant expenses:}$</i> <i>(depreciation 20 000 + impairment loss 10 000)] x 30%</i>		
Year end 31/12/20X2		
31 December 20X2		
Depreciation	17 500	
Plant: accumulated depreciation and impairment loss		17 500
<i>Depreciation of plant: $70\,000 / 4$ years</i>		
Plant: accumulated depreciation and impairment loss	7 500	
Impairment loss reversed		7 500
<i>Previous impairment loss reversed: CA: $(70\,000 - 17\,500) - RA: 65\,000$, limited to HCA: $(100\,000 - 100\,000 \times 20\% \times 2 \text{ years})$</i>		
Taxation	3 000	
Deferred tax		3 000
<i>Deferred tax adjustment:</i> <i>Tax allowance on plant: $(100\,000 \times 20\%) - \text{plant expenses (depreciation 17 500 - impairment loss reversed 7 500) x 30\%}$</i>		
Year end 31/12/20X3		
31 December 20X3		
Depreciation	20 000	
Plant: accumulated depreciation and impairment loss		20 000
<i>Depreciation of plant: $60\,000 / 3$ years</i>		
Impairment loss	10 000	
Plant: accumulated depreciation and impairment loss		10 000
<i>Impairment loss: CA: $(60\,000 - 20\,000) - RA: 30\,000$</i>		
Deferred tax	3 000	
Taxation		3 000
<i>Deferred tax adjustment:</i> <i>[Tax allowance: $(100\,000 \times 20\%) - \text{plant expenses:}$</i> <i>(depreciation 20 000 + impairment loss 10 000)] x 30%</i>		

Solution 10.21 continued ...

Part B continued ...

b) Note disclosure

RAINGO LTD.

NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X3 (EXTRACTS)

	20X3 C	20X2 C	20X1 C
2. Profit before tax			
Is stated after taking the following into account:			
Depreciation	20 000	17 500	20 000
Impairment loss / (impairment loss reversed)	10 000	(7 500)	10 000
4. Taxation			
Normal taxation			
• Current	xxx	xxx	Xxx
• deferred	(3 000)	3 000	(3 000)
5. Deferred taxation asset/ (liability)			
Deferred tax comprises temporary differences on:			
• property, plant and equipment	3 000	0	3 000

Please note that the reconciliation between the deferred tax opening and closing balances is not required because the user is able to determine the amount of deferred tax charged to the statement of comprehensive income per class of deferred tax (i.e. property, plant and equipment) by subtracting the opening and closing balances of deferred tax.

10. Property, plant and equipment

Net carrying amount - 1 January	60 000	70 000	0
Gross carrying amount	100 000	100 000	0
Accumulated depreciation	(40 000)	(30 000)	0
Acquisition	0	0	100 000
Depreciation	(20 000)	(17 500)	(20 000)
Impairment loss	(10 000)	0	(10 000)
Impairment loss reversed	0	7 500	0
Net carrying amount – 31 December	30 000	60 000	70 000
Gross carrying amount	100 000	100 000	100 000
Accumulated depreciation	(70 000)	(40 000)	(30 000)

The plant has been pledged as security for a loan (see note 6).

The impairment in 20X3 is as a result of damage incurred during a riot on the factory premises in October 20X3. The reversal of the impairment in 20X2 is as a result of repairs to the plant carried out during 20X2.

24. Capital commitments

The directors have contracted for the construction of a plant (to be complete in April 20X4) to the value of C500 000.

Please note that the figures for the year ended 31 December 20X1 were not required. These have been given for your interest only.

Solution 10.21 continued ...

Part B continued ...

Workings

W1: Calculation of deferred tax using the balance sheet approach

	Date	HCA	ACA	TB	TD	DT
Balance	1 Jan 20X1	0	0	0	0	0
Purchase	1 Jan 20X1	100 000	100 000	100 000		
Depreciation (/ 5yrs)	31 Dec 20X1	(20 000)	(20 000)	(20 000)		
		80 000	80 000	80 000		
Impairment loss	31 Dec 20X1		(10 000)	0		
Balance	31 Dec 20X1	80 000	70 000	80 000	10 000	3 000
Depreciation (/ 4yrs)	31 Dec 20X2	(20 000)	(17 500)	(20 000)		
		60 000	52 500	60 000		
Impairment loss reversed	31 Dec 20X2		7 500	0		
Balance	31 Dec 20X2	60 000	60 000	60 000	0	0
Depreciation (/ 3yrs)	31 Dec 20X3	(20 000)	(20 000)	(20 000)		
		40 000	40 000	40 000		
Impairment loss	31 Dec 20X3		(10 000)	0		
Balance	31 Dec 20X3	40 000	30 000	40 000	10 000	3 000

Solution 10.22

a) Journals		
	Debit	Credit
20X5		
01-05-20X5		
Plant	450 000	
Bank		450 000
<i>Purchase of plant</i>		
31-12-20X5		
Depreciation	60 000	
Plant: accumulated depreciation & impairment losses		60 000
<i>Depreciation for the year (450 000 / 5 x 8/12)</i>		
20X6		
31-12-20X6		
Depreciation	90 000	
Plant: accumulated depreciation & impairment losses		90 000
<i>Depreciation for the year (450 000 / 5 x 12/12)</i>		
Impairment loss	80 000	
Plant: accumulated depreciation and impairment losses		80 000
<i>Impairment of plant (300-220)</i>		
Deferred tax	24 000	
Tax expense		24 000
<i>Deferred tax adjustment W2</i>		
20X7		
31-12-20X7		
Depreciation	66 000	
Plant: accumulated depreciation & impairment losses		66 000
<i>[220 000 / (60-8-12) x 12months]</i>		
Tax expense	7 200	
Deferred tax		7 200
<i>Deferred tax adjustment W2</i>		
20X8		
31-12-20X8		
Depreciation	66 000	
Plant: accumulated depreciation & impairment losses		66 000
<i>Depreciation for the year [220 000 / (60-8-12) x 12months]</i>		
Plant: accumulated depreciation and impairment losses	32 000	
Impairment loss reversed		32 000
<i>Reversal of impairment loss up to HCA W2</i>		
Plant: accumulated depreciation & impairment losses	330 000	
Plant		330 000
<i>Reversal of accumulated depreciation</i>		
Tax expense	16 800	
Deferred tax		16 800
<i>Deferred tax adjustment for 20X8 W2</i>		
Plant	70 000	
Deferred tax		21 000
Revaluation surplus		49 000
<i>Revaluation of plant to fair value (70 000 x 70%) / (70 000 x 30%)</i>		

Solution 10.22 continued ...**20X9****31-12-20X9**

Depreciation	142 500	
Plant: accumulated depreciation & impairment losses		142 500
<i>Depreciation for the year $[190\,000 / (60-8-12-12-12) \times 12]$</i>		
Revaluation surplus	36 750	
Retained earnings		36 750
<i>Realised portion of revaluation surplus $[49\,000 / (60-8-12-12-12) \times 12]$ or $(142\,500 - 90\,000) \times 70\%$</i>		
Deferred tax	15 750	
Taxation		15 750
<i>Deferred tax adjustment W2</i>		

Workings**W1: Calculation of revaluation**

Actual carrying amount (450 – 150 – 212)	88 000
Fair value	190 000
Increase in value	102 000
Reversal of impairment loss (ACA - HCA: 88 - 120)	32 000
Revaluation surplus (HCA - NRV: 120 – 190)	70 000

Where Historical CA = 450 - 60 - 90 - 90 - 90 = 120K

Solution 10.22 continued ...

W2: Calculation of deferred taxation (balance sheet approach)

	HCA	ACA	TB	TD	DT	RS	RE
Cost	450 000	450 000	450 000	0	0		
Depreciation (450 000/60x8)	(60 000)	(60 000)	(60 000)	0	0		
31/12/20X5	390 000	390 000	390 000	0	0		
Depreciation (450 000/60x12)	(90 000)	(90 000)	(90 000)	0	0		
Impairment loss		(80 000)		80 000	24 000	Dr DT Cr TE	
31/12/20X6	300 000	220 000	300 000	80 000	24 000	DTA	
Depreciation (300 000/40x12)	(90 000)	(66 000)	(90 000)	(24 000)	(7 200)	Dr TE Cr DT	
Depreciation (220 000/40x12)						DTA	
31/12/20X7	210 000	154 000	210 000	56 000	16 800	DTA	
Depreciation	(90 000)	(66 000)	(90 000)	(24 000)	(7 200)	Dr TE Cr DT	
	120 000	88 000	120 000	32 000	9 600	DTA	
IL reversal up to HCA		32 000		(32 000)	(9 600)	Dr TE Cr DT	
	120 000	120 000	120 000	0	0		
Revaluation surplus		70 000		(70 000)	(21 000)	Dr RS Cr DT	(49 000)
31/12/20X8	120 000	190 000	120 000	(70 000)	(21 000)	DTL	
Depreciation (120 000/16x12)	(90 000)	(142 500)	(90 000)	52 500	15 750	Dr DT Cr TE	36 750 (36 750)
Depreciation (190 000/16x12)							
31/12/20X9	30 000	47 500	30 000	(17 500)	(5 250)	DTL	12 250
Depreciation (30 000/12 x 12)	(30 000)	(47 500)	(30 000)	17 500	5 250	Dr DT Cr TE	12 250 (12 250)
Depreciation (47 500/12 x 12)							
31/12/20X10	0	0	0	0	0		0

Solution 10.22 continued ...

Supporting ledger accounts

Plant				Accumulated depreciation			
Description	C	Description	C	Description	C	Description	C
Bank	450 000	Balance	450 000			Depreciation (X5)	60 000
	450 000		450 000			Depreciation (X6)	90 000
Balance	450 000			Balance	230 000	Impairment Loss	80 000
					230 000		230 000
				Balance	296 000	Balance	230 000
	450 000		450 000		296 000	Depreciation (X7)	66 000
Balance	450 000	Accumulated depreciation	330 000				296 000
				Plant	330 000	Balance	296 000
Revaluation surplus	70 000			Impairment loss income	32 000	Depreciation (X8)	66 000
				Balance	0		
		Balance	190 000		362 000		362 000
	520 000		520 000			Balance	0
Balance	190 000			Balance	142 500	Depreciation (X9)	142 500
					274 500		274 500
						Balance	142 500

b) Disclosure in statement of comprehensive income

VALUES LTD
EXTRACT FROM STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 28 FEBRUARY 20X9

	Note	20X9 C	20X8 C
Profit before tax	2	800 000	600 000
Income tax expense			
	(20X9: 255 750 – 15 750)		
	(20X8: 163 200 + 16 800)	(240 000)	(180 000)
Profit for the period		560 000	420 000
<i>Other comprehensive income</i>			
Revaluation of plant		-	49 000
Total comprehensive income		560 000	469 000

Solution 10.22 continued ...

Working

Tax computation	20X9	20X8
Profit before tax	800 000	600 000
Add depreciation	142 500	66 000
Less tax depreciation	(90 000)	(90 000)
Less impairment loss reversal	-	(32 000)
Taxable income	852 500	544 000
Current taxation at 30%	(255 750)	(163 200)

c) Disclosure in the statement of changes in equity

VALUES LTD

EXTRACT FROM STATEMENT OF CHANGES IN EQUITY

FOR THE YEAR ENDED 28 FEBRUARY 20X9

	Revaluation surplus C	Retained earnings C	Total C
Opening balance: 1/1/20X8	0	x	x
Total comprehensive income	49 000	420 000	469 000
Closing balance: 31/12/20X8	49 000	x	x
Transfer from revaluation surplus to retained income	(36 750)	36 750	-
Total comprehensive income	-	560 000	560 000
Closing balance 31/12/20X9	12 250	x	x

d) Disclosure in the notes to the financial statements

VALUES LTD.

EXTRACTS FROM NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED AT 31 DECEMBER 20X9

	20X9 C	20X8 C
2. Profit from before taxation		
Profit before taxation is stated after taking the following into consideration		
Depreciation	142 500	66 000
Impairment loss reversed	-	(32 000)
3. Taxation		
Normal taxation		
- current tax	(255 750)	(163 200)
- deferred tax	15 750	(16 800)
<i>Tax rate reconciliation</i>		
Applicable tax rate	30%	30%
Tax effects of profit before tax	240 000	180 000
Income tax expense	240 000	180 000

Solution 10.22 continued ...

	20X9 C	20X8 C
4. Deferred taxation asset/ (liability)		
Property, plant & equipment	(5 250)	(21 000)
Opening balance	(21 000)	16 800
Deferred tax in the statement of comprehensive income	15 750	(16 800)
Deferred tax on revaluation surplus	-	(21 000)
	(5 250)	(21 000)

5. Tax on other comprehensive income

Revaluation of plant		
Net	-	49 000
Gross	-	70 000
Tax	-	(21 000)

6. Property, plant and equipment

Plant

Net carrying amount - beginning of year	190 000	154 000
Gross carrying amount	190 000	450 000
Accumulated depreciation	0	(296 000)
Impairment loss	-	-
Revaluation	-	102 000
- Impairment loss reversal	-	32 000
- Revaluation surplus	-	70 000
Depreciation	(142 500)	(66 000)
Net carrying amount - end of year	47 500	190 000
Gross carrying amount	190 000	190 000
Accumulated depreciation	(142 500)	0

Plant was revalued by Mr. X an independent sworn appraiser and a member of the Institute of Valuers on a net replacement value basis.

The carrying amount of plant based on historical cost less accumulated depreciation would have been:

30 000	120 000
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Solution 10.23

a) Gross replacement value method

ABLE LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X9

15 Property, plant and equipment		20X9 C	20X8 C
Net carrying amount – 1 January		6 000 000	6 500 000
Gross carrying amount – 1 January	20X8: 8 000 000/80% x 100% <i>Note 1</i>	10 000 000	10 000 000
Less accumulated depreciation and impairment losses – 1 January	20X8: 10 000 000 / 20 x 7 <i>Note 2</i>	(4 000 000)	(3 500 000)
Revaluation surplus	20X9: 9 000 000 – 6 000 000	3 000 000	0
Depreciation	20X8: 10 000 000/ 20 years in total 20X9: 9 000 000/ 12 years remaining Or: 15 000 000 / 20 years in total	(750 000)	(500 000)
Net carrying amount – 31 December		8 250 000	6 000 000
Gross carrying amount – 31 December	20X9: 9 000 000 / 60% x 100% <i>Note 3</i>	15 000 000	10 000 000
Less accumulated depreciation and impairment losses – 31 December	20X8: 10 000 000 / 20 x 8 20X9: 15 000 000 / 20 x 9	(6 750 000)	(4 000 000)
Carrying amount had the cost model been used		X	X

Plant was revalued by Trust Valuers, an independent valuer, to its fair value in use on 1 January 20X9.

Plant is revalued every 4 years and is recorded on the gross replacement value basis.

Note 1:

1 January 20X1 – 1 January

20X5 = 4 years

4 years / 20 years = 20% useful life expired

100% - 20% = 80% remaining useful life on date of first revaluation (or 16 years left)

Note 2:

1 January 20X1 – 1 January

20X8 = 7 years

Note 3:

1 January 20X1 – 1 January

20X9 = 8 years

8 years / 20 years = 40% useful life expired

100% - 40% = 60% remaining useful life on date of second revaluation

Solution 10.23 continued ...

b) Net replacement value method

ABLE LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X9

15 Property, plant and equipment		20X9 C	20X8 C
Net carrying amount – 1 January		6 000 000	6 500 000
Gross carrying amount – 1 January	Given	8 000 000	8 000 000
Less accumulated depreciation and impairment losses – 1 January	20X8: 8 000 000 / 16 x 3 Note 1 & 2 20X9: 8 000 000 / 16 x 4 Note 1 & 3	(2 000 000)	(1 500 000)
Revaluation surplus	20X9: 9 000 000 – 6 000 000	3 000 000	
Depreciation	20X8: 8 000 000 / 16 years Note 1 20X9: 9 000 000 / 12 years Note 4	(750 000)	(500 000)
Net carrying amount – 31 December		8 250 000	6 000 000
Gross carrying amount – 31 December	Given	9 000 000	8 000 000
Less accumulated depreciation and impairment losses – 31 December	20X8: 8 000 000 / 16 x 4 Note 3 20X9: 9 000 000 / 12 x 1 year Note 4	(750 000)	(2 000 000)
Carrying amount had the cost model been used		X	X

Plant was revalued by Trust Valuers, an independent valuer, to its fair value in use on 1 January 20X9. Plant is revalued every 4 years and is recorded on the net replacement value basis.

Note 1:

1 January 20X1 – 1 January 20X5 = 4 years
 20 – 4 years = 16 remaining years on date of first revaluation

Note 2:

1 January 20X5 – 1 January 20X8 = 3 years

Note 3:

1 January 20X5 – 31 December 20X8 = 4 years

Note 4:

1 January 20X1 – 1 January 20X9 = 8 years
 20 years – 8 years = 12 remaining years on date of second revaluation

Solution 10.24

ABC LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X4 (EXTRACTS)

	20X4	20X3	20X2	20X1
	C	C	C	C

2. Accounting policies**2.1 Property, plant and equipment**

Plant is revalued annually to fair values and is thus carried at fair value less accumulated depreciation and impairment losses.

Depreciation is provided on all property, plant and equipment over the expected economic useful life to expected residual values using the following rates and methods:

Plant: 20% per annum, straight-line method.

3. Profit before tax

Profit before tax is stated after taking the following (income)/ expenses into account:

Depreciation on plant	44 000	36 000	45 000	40 000
Revaluation expense	0	12 000	0	0
Revaluation income	(8 000)	0	0	0

4. Property, plant and equipment (extracts)**Plant**

Net carrying amount: 1 January	72 000	135 000	160 000	0
Gross carrying amount:	108 000	180 000	200 000	0
Accumulated depreciation and impairment losses:	(36 000)	(45 000)	(40 000)	0

Additions	0	0	0	200 000
Depreciation	(44 000)	(36 000)	(45 000)	(40 000)
Revaluation surplus increase/ (decrease)	8 000	(15 000)	20 000	0
Revaluation income/ (expense)	8 000	(12 000)	0	0

Net carrying amount: 31 December	44 000	72 000	135 000	160 000
Gross carrying amount:	88 000	108 000	180 000	200 000
Accumulated depreciation and impairment losses:	(44 000)	(36 000)	(45 000)	(40 000)

The last revaluation was performed on 1/1/20X4 by an independent sworn appraiser to the fair value in use and the fair value adjustment was recorded on a *net* replacement value basis. Revaluations are performed annually.

Carrying amount had the cost model been used instead:	40 000	80 000	120 000	160 000
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Solution 10.24 continued ...

ABC LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X4 (EXTRACTS)

	20X4 C	20X3 C	20X2 C	20X1 C
5. Deferred taxation asset/ (liability)				
<i>The deferred taxation balance comprises:</i>				
Property, plant and equipment	(1 200)	2 400	(4 500)	0
	(1 200)	2 400	(4 500)	0
<i>Reconciliation:</i>				
Opening balance	2 400	(4 500)	0	0
Deferred tax adjustments:				
- recognised in profit or loss	(1 200)	2 400	1 500	0
- recognised in other comprehensive income	(2 400)	4 500	(6 000)	0
Closing balance	(1 200)	2 400	(4 500)	0
6. Taxation expense/ (income)				
Normal income tax				
- current	X	X	X	X
- deferred	1 200	(2 400)	(1 500)	0

7. Tax effects of components of other comprehensive income

Revaluation surplus / (devaluation)				
Gross	8 000	(15 000)	20 000	0
Tax	(2 400)	4 500	(6 000)	0
Net	5 600	(10 500)	14 000	0

ABC LTD
STATEMENT OF COMPREHENSIVE INCOME (EXTRACTS)
FOR THE YEAR ENDED 31 DECEMBER 20X4

	Notes	20X4 C	20X3 C	20X2 C	20X1 C
Profit before tax	3	X	X	X	X
Taxation	4	X	X	X	X
Profit for the period		200 000	200 000	200 000	200 000
<i>Other comprehensive income (net of tax)</i>	7				0
Revaluation surplus / (devaluation)		5 600	(10 500)	14 000	0
20X2: (160 – 180) x 70%					
20X3: (135 – 120) x 70%					
20X4: (80 – 88) x 70%					
Total comprehensive income		205 600	189 500	214 000	200 000

Solution 10.24 continued ...

ABC LTD

STATEMENT OF CHANGES IN EQUITY

FOR THE YEAR ENDED 31 DECEMBER 20X4 (EXTRACTS)

	Revaluation surplus C	Retained earnings C	Total C
Balance at 1 January 20X1	0	X	X
Total comprehensive income	0	200 000	0
Balance at 31 December 20X1	0	X	X
Total comprehensive income	14 000	200 000	214 000
Realised portion transferred to retained earnings (/ 4 RUL)*	(3 500)	3 500	0
Balance at 31 December 20X2	10 500	X	X
Total comprehensive income	(10 500)	200 000	189 500
Balance at 31 December 20X3	0	X	X
Total comprehensive income	5 600	200 000	205 600
Realised portion transferred to retained earnings (/ 2 RUL)	(2 800)	2 800	0
Balance at 31 December 20X4	2 800	X	X

*RUL = remaining useful life (in years)

ABC LTD

STATEMENT OF FINANCIAL POSITION

AS AT 31 DECEMBER 20X4 (EXTRACTS)

	Note	20X4 C	20X3 C	20X2 C	20X1 C
ASSETS					
Non-current assets					
Property, plant and equipment	4	44 000	72 000	135 000	160 000
Deferred taxation	5	0	2 400	0	0
EQUITY AND LIABILITIES					
Equity					
Revaluation surplus (from SOCIE)		2 800	0	10 500	0
Non-current liabilities					
Deferred taxation	5	1 200	0	4 500	0

Solution 10.24 continued ...

WORKINGS

W1: Deferred tax calculation:

Plant	Carrying amount	Tax base	Temp diff	Deferred taxation	Details	Revaluation surplus
Balance: 1/1/20X1	0	0	0	0		
Purchase	200 000	200 000	0	0		
Depreciation (200 000/ 5 years)	(40 000)	(40 000)	0	0		
Balance: 31/12/20X1	160 000	160 000	0	0		
Revaluation surplus (equity increase)	20 000	0	(20 000)	(6 000)	Cr DT Dr RS	(20 000) 6 000
Fair value	180 000	160 000				(14 000)
Depreciation (180 000/ 4 years)	(45 000)	(40 000)	5 000	1 500	Dr DT Cr TE	3 500
Balance: 31/12/20X2	135 000	120 000	(15 000)	(4 500)	Liability	(10 500)
Revaluation surplus (equity decrease)	(15 000)	0	15 000	4 500	Dr DT Cr RS	15 000 (4 500)
Historical carrying amount	120 000	120 000	0			0
Revaluation expense	(12 000)	0	12 000		Dr DT	
Fair value	108 000	120 000			Cr TE	
Depreciation (108 000/ 3 years)	(36 000)	(40 000)	(4 000)			
Balance: 31/12/20X3	72 000	80 000	8 000	2 400	Asset	0
Revaluation income	8 000	0	(8 000)	(2 400)	Cr DT Dr TE	
Historical carrying amount	80 000	80 000				
Revaluation surplus (equity increase)	8 000	0	(8 000)	(2 400)	Cr DT Dr RS	(8 000) 2 400
Fair value	88 000	80 000				5 600
Depreciation (88 000/ 2 years)	(44 000)	(40 000)	4 000	1 200	Dr DT Cr TE	(2 800)
Balance: 31/12/20X4	44 000	40 000	(4 000)	(1 200)	Liability	2 800

Please note: the revaluation surplus is not necessary to include in this deferred tax table. All calculations relating to the revaluation surplus have been included directly on the face of the SOCI and SOCIE.

Solution 10.25**W1. Carrying amount of plant****W1.1 Basic plant (excluding platform and inspection costs and replacement engine)**

Raw materials	$400\,000 + 200\,000 / 125\% \times 100\%$	560 000
Labour	$500\,000 + 300\,000 + 200\,000 + 300\,000$ (co. contrib.)	1 300 000
Provision for dismantling	W2	445 931
		<hr/> 2 141 592
Less Depreciation of basic plant	$(27\,400\,691 - 0) / 20 \text{ years} \times 7 / 12$	(67 256)
Less Impairment of engine	Cost: $100\,000 - AD: (100\,000 - 0) / 20 \text{ years} \times 7 / 12 - RV: 0$ (scrapped)	(97 083)
Carrying amount		<hr/> 26 504 421

W1.2 Engine replacement

	<i>A separate part since the useful life now differs</i>	
Cost	Given	110 000
Less Depreciation of new engine	No depreciation yet	(0)
Carrying amount		<hr/> 110 000

W1.3 Specialised platform

Cost	Given	750 000
Less Depreciation of platform	$(750\,000 - 50\,000) / 10 \text{ years} \times 7 / 12$	(40 833)
Carrying amount		<hr/> 709 167

W1.4 Major inspection

Cost	Given	600 000
Less Depreciation of inspection	$(600\,000 - 0) / 3 \text{ years} \times 7 / 12$	(116 667)
Carrying amount		<hr/> 483 333

Carrying amount of plant: 31/12/20X1	$2\,141\,592 + 110\,000 + 709\,167 + 483\,333$	<hr/> 3 444 092
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W2: Present value of future dismantling cost Use a financial calculator or the PV table below:

Year	Future Amount	Present value factor for 10%	Present values
1	3 000 000	0.909	2 727 273
2	3 000 000	0.826	2 479 339
3	3 000 000	0.751	2 253 944
4	3 000 000	0.683	2 049 040
5	3 000 000	0.621	1 862 764
6	3 000 000	0.564	1 693 422
7	3 000 000	0.513	1 539 474
8	3 000 000	0.467	1 399 522
9	3 000 000	0.424	1 272 293
10	3 000 000	0.386	1 156 630
11	3 000 000	0.350	1 051 482
12	3 000 000	0.319	955 892
13	3 000 000	0.290	868 993
14	3 000 000	0.263	789 994
15	3 000 000	0.239	718 176
16	3 000 000	0.218	652 887
17	3 000 000	0.198	593 534
18	3 000 000	0.180	539 576
19	3 000 000	0.164	490 524

20

3 000 000

0.149

445 931

Solution 11.1

Part A

An intangible asset is an identifiable non-monetary asset without physical substance.

An asset is:

- a resource,
- controlled by the entity,
- as a result of a past event,
- from which future economic benefits are expected to flow.

The market share does not have physical substance and is non-monetary and thus the issue is whether the market share is identifiable.

An asset meets the identifiability criterion in the definition of an intangible asset when it

- Is separable, or
- Arises from contractual or other legal rights
(IAS 38, p12)

The market share is not separable from the business as a whole and it does not arise from legal rights.

The market is a resource in that it generates sales for the company.

The event was the creation of the customer loyalty that constitutes the market share (perhaps through entertainment, advertising etc). This event is a past event if the creation occurred before year-end.

Future economic benefits can be expected from the market through sales made to customers that form part of the market.

There is, however, little or no control over a market since a company's market can be easily usurped by another company offering better products, service, advertising etc.

Therefore, the market share should not be recognised as an intangible asset (not identifiable and not controllable).

Part B

An intangible asset is an identifiable non-monetary asset without physical substance.

An asset is:

- a resource,
- controlled by the entity,
- as a result of a past event,
- from which future economic benefits are expected to flow.

The patent and the staff skills are identifiable (sold, leased or rented out separately and/ or are identifiable through legal rights: registered patent). (IAS 38, p15)

Both the patent and staff skills are non-monetary and do not have physical substance.

Thus the issue is whether or not they meet the definition of an asset.

The patent and staff skills are a resource in that they can be used to generate sales of software and services provided by their staff.

Solution 11.1 continued ...

Part B continued ...

The past event would be the hiring of staff and creating the patented software prior to the year-end.

The future economic benefits would be expected through the sale of the software and services offered by its staff.

An entity controls an asset (and therefore, an intangible asset) if it:

- Has the power to obtain future economic benefits from the item and
 - Is able to restrict the access of others to those benefits
- (IAS 38, p13)

The company controls the future benefits from the software and the knowledge is protected by the legal rights of the patent.

Although the company will obtain future benefits from the work performed by the staff, the company does not have control over their skills as the staff can resign at any time by giving one month's notice.

Therefore, the patent must be recognised as an intangible asset but the staff skills cannot be recognised as an intangible asset.

Part C

The licence to operate the toll road is an intangible asset with a finite useful life. Therefore, the cost of C 10 000 000 is amortised on a systematic basis over its estimated useful life (originally being twenty years), in line with the pattern in which the asset's future economic benefits are expected to be consumed by the entity.
(IAS 38, p97)

The residual value is zero as there is no active market for toll road licences.
(IAS 38, p100)

The straight-line method is used only if it reflects the pattern of future economic benefits or if the expected pattern of future economic benefits cannot be estimated reliably. During the eighteenth year, it was estimated that the useful life in cars would be 1 800 000 cars (Yr 18: 800 000 + Yr 19: 600 000 + Yr 20: 400 000). Since the pattern has changed from an even usage of 1 000 000 cars per year over the remaining 3 years, a more appropriate method of amortisation would be to use the number of cars using the road instead. This change is accounted for as a change in accounting estimate in terms of IAS 8.

CA at the 18th year is 1 500 000 ($10\,000\,000 / 20 * 3$)

This is then amortized over 1 800 000 cars as follows:

- Year 18: C666 667 ($C1\,500\,000 / 1\,800\,000 \times 800\,000$ cars)
- Year 19: C500 000 ($C1\,500\,000 / 1\,800\,000 \times 600\,000$ cars)
- Year 20: C333 333 ($C1\,500\,000 / 1\,800\,000 \times 400\,000$ cars)

Solution 11.2

Recognition:

The issue here is whether the cost of the fishing licence should have been expensed or recognised as an intangible asset.

To be recognised as an intangible asset, the item must meet the definition of an intangible asset and the recognition criteria.

An intangible asset is defined as an *identifiable* non-monetary *asset* without *physical substance*.

- The fishing licence is *identifiable* as it arises from a legal right to fish in the demarcated area
- As an *asset*, the intangible asset must be a resource controlled by the entity, from a past event and must result in an expected inflow of future economic benefits
 - Hurtigruten Limited does have control over the fishing licence as no other company may fish for tuna in the demarcated area during the term of the licence.
 - The past event is the acquisition of the license before year-end.
 - Future economic benefits should flow through increased revenue from the sale of fish.
- The fishing licence (although the related documentation has physical form), does not have *physical substance* as the most significant aspect is the licensed ability to perform fishing.

Applying the recognition criteria,

- As the fishing license is a separately acquired intangible asset, the probability of future economic benefits is satisfied (IAS 38 allows this criteria to be assumed in such an instance).
- The cost is reliably measured as an amount of C 600 000 was paid for the fishing license.

Conclusion:

The licence should be capitalized as an intangible asset since it meets the relevant definition and recognition criteria.

Measurement:

- The fishing licence has a finite life and must be amortised.
- The life is determined as the shorter of the actual life and legal life.
- The actual life is not relevant but the licence provides the company with a legal life of four years.
- The residual value is zero.
- The pattern of future economic benefits is not apparent and therefore the straight-line may be used as the default method of amortisation.
- Amortisation of C150 000 must be expensed during 20X6 $[(C600\,000 - 0) / 4 \text{ years} \times 1 \text{ year}]$
- An impairment test would have to be performed. Assuming there is no indication of impairment, the recoverable amount would not need to be calculated. It is assumed that the asset is not impaired, since there is no information provided regarding any evidence thereof.
- The carrying amount of the licence will therefore be measured at C450 000 (Cost: 600 000 – Accumulated amortisation: 150 000 - Accumulated impairments: 0).

Solution 11.2 continued ...

Disclosure:

- The carrying amount of the licence would be included in the line item 'intangible assets' on the face of the statement of financial position.
- The amortisation expense would be included in the calculation of the profit before tax line item in the statement of comprehensive income.
- Accounting policies relating to intangible asset would need to be disclosed.
- The roll forward of the opening and closing carrying amount for the licence is included in the intangible asset note.
- The amortization is disclosed in the profit before tax note.

Solution 11.3

Part a) N-Gee brand

i) Acquisition of N-Gee brand

In terms of IAS 38, an item must meet all the components of the definition of an intangible asset in order to be capitalised – if not, it must be expensed.

An intangible asset is thus:

- *Definition of an asset*
 - Resource controlled by enterprise
 - from past events
 - from which future economic benefits are expected to flow
- *Definition of an intangible asset*
 - Identifiable
 - non-monetary asset
 - without physical substance

The brand, N-Gee has been purchased and is therefore a *resource which is controlled by the enterprise* due to the fact that Quencher has the power to obtain the future economic benefits flowing from this brand, and to restrict the access of others to these benefits. This would be legally enforceable in a court of law.

The *past event* is the purchase transaction of the brand, which occurred on 1 April 20X5.

Future economic benefits expected to flow from the purchase of the brand, will result from the sale of the N-Gee soft drinks.

Indentifiability is met, as the brand name is capable of being *separated* and arises from a *legal right* as it has been sold individually and for a specific value in the sale transaction that occurred in April 20X5.

Although there may be legal documentation on paper, the brand purchased has *no physical substance* and is considered intangible.

However an intangible asset can only be recognised if:

- it is probable that the future benefits that are attributable to the asset will flow to the entity
- and the cost can be reliably measured.

It is *probable* that the brand should give rise to *future economic benefits*, which will arise from future sales of the N-Gee drink. Since the brand name has been purchased by Quencher, all future benefits will flow directly to the entity. In addition, the price an entity pays to acquire separately an intangible asset reflects expectations about the probability that the expected future economic benefits embodied in the asset will flow to the entity. In other words, the effect of probability is reflected in the cost of the asset. The *cost can be reliably measured* as this is known: the purchase price paid for the brand was C 2.5million.

The brand, N-Gee should therefore be recognised as an asset in terms of IAS 38: Intangible Assets.

Solution 11.3 continued ...

ii) Accounting treatment of all N-Gee costs

As discussed above, the brand, N-Gee should be recognised as an asset in terms of IAS 38: Intangible Assets. The amount capitalised should be the purchase price plus any directly attributable expenditure. Therefore an amount of C2 675 000 (the purchase price of C2 500 000, as well as the legal fees incurred of C175 000) should be capitalised.

The brand should be amortised over its estimated useful life of fifteen years.

The staff training costs of C 200 000 which were incurred in order to train staff to produce this new product should be expensed during the year ended 31 May 20X5. The definition of an asset is not met in terms of The Framework since the trained staff members may not necessarily be under sufficient control of the entity to be considered to be an asset.

Part b) Internal generation of patent for Flip top can

Research involves the search for new scientific or technical knowledge. Development involves the application of these research findings with the aim of using it in commercial production or in the business.

For an item to be recognised as an asset, it must meet the asset definition and also meet the recognition criteria: (the cost or value must be reliably measurable; and the inflow of expected future economic benefits must be probable.)

By the very nature of research, the inflow of future economic benefits cannot be said to be probable (although they may be considered to be possible) since it is merely investigations that are being performed. For this reason, research costs must be expensed.

Development costs, on the other hand, may result in a resource where the expected inflow of future economic benefits is probable. Development costs must be capitalised if the criteria per IAS 38 are met: the cost or value is reliably measurable; and the inflow of expected future economic benefits are probable. The inflow of future economic benefits are considered to be probable when all of the 6 criteria per IAS 38 (par 57) can be demonstrated.

If just one of these criteria is not demonstrable then the development costs *must* be expensed. Once all these criteria are met, it can be said that future economic benefits are probable and that there is a cost that can be reliably measured.

Expenditure on the **research** phase of the project should be *expensed*. For the year end 31 May 20X5, this will be C 240 000 and will include:

- C 40 000 for market surveys
- C 200 000 for evaluations of the prototypes and designs

The research phase of the project should end on **30/09/20X4**, once the design is chosen and engineers produce a plan which indicates that it is technically possible to produce the Fliptop can.

Solution 11.3 continued ...**Part b) continued ...**

Expenditures from 01/10/20X4 relating to the **development** phase may be *capitalised* as an intangible asset if Quenchers can demonstrate that the 6 conditions have been met:

The technical feasibility of completing the intangible asset so that it will be available for use or sale.	After the evaluation of a number of prototypes and designs, Quenchers began development of a pilot plant, and engineers produced a plan which indicated that it was technically possible to produce the flip-top can.
Its intention to complete the intangible asset and use or sell it.	Quencher has applied to register the Flip-top can as a patent.
Its ability to use or sell the intangible asset.	Market surveys
How the intangible asset will generate probable future economic benefits.	Detailed market research was carried out by Quenchers, prior to 01/10/20X4, which indicates that the cans will be able to be used and will generate future economic benefits for the company as there is a market for the product.
The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.	Adequate funding was obtained prior to the project beginning, which indicates that the company has the necessary resources to complete development.
Its ability to measure reliably the expenditure attributable to the intangible asset during its development.	The expenditure attributable to the development of the asset have been able to have been reliably measured.

Development costs amounting to C 1 700 000 should be **capitalised** at 31/05/20X5.

This includes the following:

- C 1 100 000 – Design and construction of a pilot plant
- C 600 000 – Testing of a pilot plant

Since the development is not yet completed and therefore has not yet been put into production, amortization of this intangible asset should not yet begin. As a result, this is classified as an 'intangible asset not yet available for use'. This means that impairment testing must be done every year (this can be done at any time during the year, but should be done at the same time every year). In the case of 'intangible assets not yet available for use', the impairment testing requires that a recoverable amount be calculated even if the indicator review does not suggest that an impairment may have occurred.

Solution 11.4

a) Definitions and recognition criteria relevant to the acquisition of a trademark

The trademark acquired via a business combination, may only be recognised when both the definition of an intangible asset and the recognition criteria are met.

A trademark is an intangible asset, the definition of which is as follows:

- a resource
- controlled by the entity
- from a past event
- from which future economic benefits are expected to flow
- separately identifiable
- non-monetary
- non-physical.

The recognition criteria include:

- the flow of future economic benefits is probable; and
- the cost or value thereof is reliably measurable.

The trademark is a non-monetary resource that has no physical substance. Food Limited controls the trademark (i.e. has the ability to restrict access to the trademark and has the power to obtain the related economic benefits) through the purchase agreement. The past event is the signing of the purchase agreement. Future economic benefits are expected through the use of the trademark and are probable since the trademark has been profitable for many years already.

The most difficult aspects of the definition and recognition criteria to meet when purchasing an intangible asset as part of a business combination are:

- it must be separately identifiable (from goodwill and the other assets acquired): (part of the definition); and
- has a cost or value that can be reliably measured: (part of the recognition criteria).

In the event that the trademark

- cannot be separately identified and /or
- cannot be reliably measured,

then the entire excess paid should be classified as purchased goodwill (and not as a trademark).

In order to separately identify an intangible asset, it must

- be 'separable', i.e. be capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; OR
- arise from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Since the trademark is mentioned in the purchase agreement as being acquired by Food Limited, it is considered to be separately identifiable through contractual rights.

Solution 11.4 continued ...

As already mentioned, it is generally difficult to reliably measure the cost or value of the trademark in this instance since, by definition, there can be no active market for trademarks. Where an active market does not exist, the fair value will either be:

- the amount that would have been paid for the asset at date of acquisition, in an arm's length transaction between knowledgeable and willing parties; or
- another method of calculating the estimated fair value (e.g. discounted cash flow projections) so long as a *reliable* estimate results.

Although the trademark is separately identifiable from goodwill it would still form part of goodwill if the fair value is not reliably measurable.

b) Initial recognition

The trademark must initially be measured at its cost (measured at its fair value with reference to an active market or in another manner).

The trademark may therefore only be recognised at C20 500 if the definition and recognition criteria are met and more specifically if it can be proved that the

- C20 500 is a reliable measure of its cost; and that
- the trademark can be separately identified from the other assets and goodwill.

If recognition of the trademark is not allowed (because the definition, recognition criteria or both are not met in full), then the excess paid (C20 500) is recognised as goodwill instead.

c) Amortisation

If an intangible asset is believed to have an indefinite useful life, no amortisation will be processed. An intangible asset may be assessed as having an indefinite useful life, when 'there is no foreseeable limit over which the asset is expected to generate net cash inflows for the entity'. Although the trademark indicates unlimited profitability, Food Limited has purchased the trademark for a period of 22 years only. This means that the trademark can only generate net cash inflows *to the entity* for a period of 22 years. It should be noted that the legal life will not be a limiting factor if:

- the legal rights are renewable; and
- there is evidence to suggest that the rights will be renewed at no significant cost.

There is no evidence apparent from the question that the legal rights to the trademark are renewable and renewable at *insignificant* cost. The trademark should therefore be amortised over 22 years.

It should also be noted that the residual value (for the purpose of calculating the depreciable amount) should be taken as zero, unless

- a third party has committed to purchasing the asset at the end of its useful life; OR
- there is an active market and it is possible to determine the residual value using that market and it is probable that the active market will still be in existence at the end of the asset's useful life

Intangible assets are usually amortised on the straight-line method unless a more suitable method can be established (in relation to the expected pattern of expected flow of future economic benefits) although IAS 38 states that there is rarely a justifiable situation in which the method used results in a lower 'accumulated amortisation' balance than had the straight-line method been used instead.

Solution 11.4 continued ...

d) Impairment testing and revaluing to fair value

An annual indicator review is mandatory for all intangible assets to assess whether or not there is a possible impairment, in which case the recoverable amount must be calculated and compared with the asset's carrying amount.

Intangible assets may be revalued to fair values under the revaluation model, but these fair values must be obtained with reference to an active market.

For an active market to exist, the following criteria should be met:

- The items traded within the market are homogenous
- Willing buyers and sellers can be found at any time
- Prices are available to the public.

By definition, there can be no active market for trademarks since an active market requires that the items traded are homogenous and the trademark, by nature, is unique.

The trademark may therefore not be revalued to its fair value since the fair value is not reliably measurable. The trademark must, however, be checked for impairments at the end of every year.

Solution 11.5

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Development involves the application of these research findings or other knowledge to a plan or design for production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

For an item to be recognised as an asset, it must meet the definition of an asset and also meet the recognition criteria:

- the cost or value must be reliably measurable; and
- the inflow of expected future economic benefits must be probable.

By the very nature of research, the inflow of future economic benefits (although perhaps possible) cannot be said to be probable since the investigation is in its infancy. For this reason, research costs must be expensed.

Development costs, on the other hand, may result in a resource where the expected inflow of future economic benefits is probable. Development costs must be capitalised if (criteria stipulated in IAS 38):

- the cost or value is reliably measurable; and
- the inflow of expected future economic benefits are probable. The inflow of future economic benefits is considered to be probable when all of the following can be demonstrated:
 - the technical feasibility of completing the asset;
 - the intention to complete the asset and to either use or sell it;
 - the ability to use or sell the asset;
 - how the asset will generate future economic benefits, through, for instance, demonstrating that there is a market to sell to, or if the asset is to be used internally, then the usefulness thereof; and
 - the adequate availability of necessary resources (technical, financial or otherwise) to complete the development and to sell or use the asset.

It is interesting to note that if these criteria are met, then the development costs *must* be capitalised, but if any one of the criteria are not met, then the development costs *must* be expensed.

Once the development costs are capitalised, amortisation must begin. It is also interesting to note, that if costs incurred do not meet the criteria initially and are expensed as a result, these costs *may not* be capitalised at a later date assuming the criteria are subsequently met.

Solution 11.6

The capitalisation of the cost of the original brand name is correct.

Since the brand was considered to have an indefinite useful life, it was correct not to amortise the cost.

The classification as an intangible asset with an 'indefinite useful life' should, however, have been reviewed annually: as soon as there was an indication that the brand had a finite useful life, amortisation should have been recognised as a change in accounting estimate.

Similarly, the recoverable amount of the brand should have been recalculated at the end of every year, irrespective of the results of an indicator review, since it has been classified as having 'an indefinite useful life'. The drop in sales of Yog-Nog in recent years indicates that the recoverable amount would have been less than the carrying amount, in which case an impairment loss should have been processed.

On abandonment of the Yog-Nog brand name, it is correct to write-off the balance of its carrying amount (since there are no further economic benefits expected from its use or disposal).

Depending on the materiality of the failure to:

- amortise the brand once it became apparent that it had a finite life; and
- impair the brand in each of the years during which the recoverable amount was less than the carrying amount

this should be treated as a correction of an error.

IAS 38 specifically disallows the capitalisation of the internally generated brand name 'Yogi-Yippi' on the grounds that it is too difficult to prove that the recognition criteria have been met (i.e. reliable estimates of the costs of creation are almost impossible since the costs incurred will be difficult to separate from the general costs of running the business). The launch costs of Yogi-Yippi should therefore be expensed as marketing costs.

Solution 11.7

Capitalisation

- It is correct to capitalise the brand at its original cost (assuming the definition of an asset and the recognition criteria were met).

Amortisation

- It is correct that an intangible asset that has been classified as having an indefinite useful life should not be amortised.
- The useful life of the 'pie' brand, although purchased for a period of only 30 years, may be renewed and this renewal is at an insignificant cost. It is therefore acceptable to classify this brand as having an indefinite useful life and therefore it is correct that no amortisation be processed.
- The status of the useful life of the brand as being 'indefinite' must be reassessed every year.

Impairment testing

- It is not acceptable, however, to fail to estimate the recoverable amount annually.
- Since the 'pie' brand is classified as having an indefinite useful life, the recoverable amount must be calculated irrespective of whether or not the indicator review suggests a possible impairment.
- The only instance where the recoverable amount of an indefinite useful life asset need not be calculated is when:
 - the intangible asset is part of a cash generating unit and
 - there is a previous detailed calculation done in the immediately preceding year
 - where the recoverable amount was 'substantially greater' than the carrying amount and
 - where 'events and circumstances subsequent to this calculation suggest that there is only a remote chance that the current recoverable amount would now be less than the carrying amount'.

Since this previous detailed calculation indicated an immaterial difference between the recoverable amount and carrying amount of the 'pie' brand and not that the recoverable amount was significantly greater than the carrying amount, a new detailed calculation of the recoverable amount of the 'pie' brand will have to be performed.

Solution 11.8

Initial measurement:

Gobblers is currently shown in the balance sheet at C500 000 – which is the original cost of acquisition. It is correct to measure the initial acquisition of an intangible asset at its cost, but the information provided seems to indicate that neither amortisation has been provided nor impairment testing has been done.

Amortisation:

- It is correct that an intangible asset with an indefinite useful life should not be amortised. This brand, however, has a legal life of only 25 years and therefore should not have been classified as having an indefinite useful life.
- Amortisation of this brand should be provided over the shorter of
 - its expected useful life – originally considered to be ‘almost indefinite’
 - limited to its legal life: 25 years unless
 - the legal rights are renewable and
 - there is evidence to support renewal without significant cost.
- Since the legal life may be extended for a sum of C1 000 000, it is submitted that the legal life is not renewable ‘without significant cost’. The legal life of 25 years should therefore have been a limiting factor when considering the useful life of the asset and although, the useful life of the brand is otherwise considered to be indefinite, amortisation should have been provided over 25 years.
- The residual value of this brand should be assumed to be zero on the grounds that:
 - there was no third party who had committed to purchasing the brand at the end of the useful life; and
 - there is no active market for brands making it impossible to estimate the fair value at the end of the useful life.
- The amortisation would normally be provided on the straight-line method (unless another method is considered more appropriate).
- The amortisation would therefore have been C20 000 pa $(C500\,000 - C0) / 25\text{ years}$
- This adjustment should be treated as a correction of an error.

Impairment:

- Since unexpected diminishing profits are being earned from the gobbler products, it would appear that the future benefits from this asset are impaired.
- This should have been discovered during the required annual indicator review.
- After assessing whether the apparent drop in value is material or not, extra amortisation should first be considered.
- Assuming this was not the cause for the apparent drop in value, the recoverable amount of the brand should then have been estimated and compared with the carrying amount calculated above.

Solution 11.8 continued ...

- The recoverable amount is the higher of the:
 - fair value less costs to sell; or
 - value in use.
- Since an offer has been received, the estimated fair value less costs to sell may be calculated as:

	C
Expected selling price	220 000
Less expected selling costs	2 000
	218 000

- The value in use is the C70 000 expected net cash inflows, which must first be present valued (discounted).
- The Gobblers brand should therefore be impaired to its fair value less costs to sell of C218 000 (higher than the value in use of C70 000, even before calculating the present value thereof).
- The carrying amount at 31 December 20X3 (before impairment) should be C440 000 (C500 000 – C20 000 x 3 years). The impairment loss will then be C222 000 (C440 000 – C218 000). The final carrying amount of intangible assets in the balance sheet must be C218 000.

Solution 11.9

General journal	Debit	Credit
20X1		
Research expense <i>40% x 200 000</i>	80 000	
Development expense <i>60% x 200 000</i>	120 000	
Bank		200 000
<i>100% research costs and development costs expensed (recognition criteria not met: not technically feasible)</i>		
20X2		
Development asset: cost	900 000	
Bank		900 000
<i>100% development costs capitalised (relevant definitions and recognition criteria met)</i>		
Impairment loss expense - development <i>Cost 900 000 - RA 800 000</i>	100 000	
Development asset: accumulated impairment losses		100 000
<i>Impairment of development asset: competition from Blue Sky Limited would have affected profitability projections</i>		
20X3		
Research expense	40 000	
Administration expense	60 000	
Development asset: cost	300 000	
Bank		400 000
<i>Research and admin costs expensed and development costs capitalised (relevant definitions and recognition criteria met)</i>		
Development asset: accumulated impairment losses	100 000	
Impairment loss reversed - development		100 000
<i>CA: (900 000 + 300 000 – 100 000): 1 100 000 - RA: 1 300 000 limited to original cost: 900 000 + 300 000: 1 200 000</i>		
<i>Development impairment in 20X2 reversed in 20X3 due to reasons for previous impairment having disappeared</i>		
20X4		
Amortisation - development	240 000	
Development asset: accumulated amortisation		240 000
<i>Amortisation on development asset: amortisation starts from date asset was available for use:</i>		
<i>CA: (900 000 + 300 000 – 100 000 + 100 000) / 5 years x 1 full year</i>		

Solution 11.10

a) Recognition and measurement: brands

- i) Recognition: Orange blossom Brand versus Infused ginger Brand
 - The Orange blossom brand is a brand that was purchased.
 - There is therefore a reliable measure of its value (being the purchase price of C2 000 000) with the result that it may be capitalised (assuming the rest of the definition and recognition criteria are met).
 - The Infused ginger brand, on the other hand, is internally generated.
 - Internally generated brands may not be capitalised on the basis that it is not possible to reliably estimate their cost.
- ii) Measurement: residual value for purposes of amortization: Orange blossom versus Infused ginger
 - The Infused ginger brand is expensed, thus there will be no amortization thereof – the discussion of residual value is therefore not applicable to the Infused ginger Brand.
 - The Orange blossom brand is capitalised and has a finite life, and thus it must be amortised.
 - The discussion of the residual value is therefore relevant:
 - There is no evidence of a third party offering to purchase the brand at the end of its useful life; and
 - There is no active market by way in which a residual value could be determined,
 - The residual value should be taken to be zero.
- iii) Measurement models: Orange blossom versus Infused ginger
 - The Infused ginger brand is expensed, the application of a measurement model is not applicable.
 - The Orange blossom brand has been acquired and thus capitalised. Therefore Beehive Limited is able to choose between two models.
 - Either the cost model or the revaluation model may be used.
 - The IFRS on intangible assets requires, however, that the fair value used in the revaluation model be determined in accordance with an active market.
 - Therefore, there is no active market for the Orange blossom brand, the revaluation model may not be used and therefore the cost model is the appropriate model to use for the Orange blossom brand.

Solution 11.10 continued ...**iv) Journal entries required:**

	Debit	Credit
<i>1 April 20X6</i>		
Orange blossom Brand asset	2 000 000	
Bank/ accounts payable		2 000 000
<i>Purchase of Orange blossom Brand</i>		
<i>May 20X6</i>		
Infused ginger Brand expenses	300 000	
Bank/ accounts payable		300 000
<i>Development of internal brand: Infused ginger</i>		
<i>31 December 20X6</i>		
Amortisation	150 000	
Orange blossom Brand: accumulated amortisation		150 000
<i>Amortisation of Orange blossom Brand:</i> <i>(2 000 000 – 0) / 10 x 9 /12</i>		

b) Recognition and measurement: research versus development of lollipop flashlight**i) Recognition: research versus development**

- Since research is conducted in the very early stages of the research and development process, and is the search for new information and knowledge rather than the practical application thereof,
- there can be no future economic benefits expected (or the expected future economic benefits cannot be said to be probable).
- This therefore means that the cost of research cannot be capitalised and must always be expensed.
- Development is the application of the research findings and
- Therefore there is a chance that there are expected future economic benefits that are probable.
- There are six recognition criteria that must all be met in which case the development costs must be capitalised.
- If one of these six recognition criteria are not met, the development costs must be expensed.
- Since all criteria were met in 20X4, the development costs incurred in 20X4 must be capitalised.
- Since cash flow problems were being experienced in 20X5, one of the criteria for recognition, being 'are there sufficient resources to complete the development and use/ sell the item', was not met,
- with the result that the development costs incurred in 20X5 must be expensed.
- Once the cash flow problems were removed:
 - development costs incurred in 20X6 must be capitalised, but
 - the development costs incurred and expensed in 20X5 may not be subsequently capitalised.

Solution 11.10 continued ...

- ii) Measurement: amortization and impairment testing of development costs
- Since research costs are expensed, neither amortization nor impairments are relevant.
 - Where development costs are capitalised, they will, until completion (and therefore available for use), be considered to be an 'intangible asset not yet available for use'
 - and as a result, these costs will:
 - not be amortised, but
 - will be tested for impairment annually:
 - since there were cash flow problems during 20X5, (which resulted in the expensing of the development costs), the development asset at 31 December 20X4 may need to be impaired at the end of 20X5;
 - this impairment (that may need to be processed in 20X5) may then be reversed in 20X6 when the cash flow problems are resolved;
 - the development costs expensed during 20X5 may not be subsequently capitalised in 20X6 (recognition issue discussed in part (a) above);
 - the impairment test requires the calculation of the recoverable amount.
 - Only once the development is complete, will amortization of the development asset begin.
 - The amortization will be:
 - capitalised to the product/ asset being developed or
 - expensed if no inventory or other property, plant and equipment is created through the use of the development asset.

c) Measurement: useful life of the patent

- Since the patent is purchased and was capitalised, one must determine whether it has a finite or indefinite useful life.
- Since there is a finite life (both actual and legal), the patent must be amortised.
- Since the patent is to be amortised, the useful life for purposes of amortization must be estimated.
- The useful life will be:
 - the shorter of its actual life (20 years) and its legal life (5 years).
 - however, the legal life of 5 years is renewable and is renewable at an insignificant cost (C30 000 for a period of 3 years relative to the cost of C5 000 000 for a period of 5 years), this legal life may be taken to be 8 years instead (5 years + 3 years).

Solution 11.11

Part A

An expense for advertising and promotional activities is recognised when the entity has a right to access those goods (IAS 38, p69).

The company had access to the catalogues when they were received from the printers on 15 September. Therefore, an amount of C24 000 is recognised as an expense on the statement of comprehensive income for the year ended 30 September 20X8.

Even though the catalogues are distributed evenly from 15 September to 15 December, the expense is not apportioned between the 20X8 and 20X9 financial years and no asset is recognised at 30 September 20X8.

Part B

An entity is not precluded from recognising a prepayment as an asset when payment for the goods has been made in advance of the entity obtaining a right to access those goods (IAS 38, p70).

The company had paid for the catalogues on 15 August 20X8 but will only have access to them on 15 September, which is after the year end of 31 August. Therefore, an amount of C24 000 is recognised as an asset in the statement of financial position at 31 August 20X8.

Solution 12.1

- a) An investment property is held for rental income or capital appreciation whereas an owner-occupied property is used by the entity in the production of goods or services or for administration purposes.
- b) A comparison of the models allowed in terms of IAS 40 for investment properties with the models allowed in terms of IAS 16 for property, plant and equipment is as follows:
- Property, plant and equipment may be measured under the cost model or revaluation model.
 - Investment properties may be measured under the cost model or fair value model.
 - The cost model is the same in both cases.
 - The revaluation model requires that increases/ decreases above HCA be recognised as other comprehensive income (revaluation surplus: equity) whereas increases and decreases below HCA are to be recognised in profit or loss
 - The fair value model requires that all increases/ decreases, irrespective of the HCA be recognised directly in profit or loss.

HCA: historical carrying amount (depreciated historic cost).

- c) The four scenarios under which a transfer may be made into investment property or from investment property from/ to another asset are as follows:
- From investment property to:
 - i) Inventories: when development for future sale begins
 - ii) Property, plant and equipment: when owner-occupation begins
 - From property, plant and equipment to:
 - iii) Investment property: when owners move out
 - From inventories to:
 - iv) Investment property: when operating lease begins.

Solution 12.2***Introduction***

The farm is used:

- by Splurge Limited for milking and grazing (stand-alone shed and 40 hectares of land); and
- to earn rentals (from the 160 hectares and four sheds).

According to IAS 40 if a building is owner occupied building and can be sold separately (which it can because it has separate title deeds) it must be disclosed as property, plant and equipment in accordance with IAS 16.

Owner-occupied

This means that the owner-occupied stand-alone shed together with the related 40 hectares must be measured using either:

- the cost model; or
- revaluation model.

Whichever model is used, the property will be initially measured at cost. Assuming that all the sheds are similar, the owner-occupied shed and 40 hectares should be recorded at C400 000 ($C2\,000\,000 \times 40 / 200$ hectares).

Cost model:

The cost model entails measuring the asset at cost less accumulated depreciation and impairment losses.

Revaluation model:

The revaluation model entails measuring the asset at fair value less subsequent accumulated depreciation and impairment losses. If the revaluation model is adopted and a revaluation to fair value results in an increase in carrying amount above its historical carrying amount, this increase must be recognised in other comprehensive income and accumulated in equity (not profit and loss).

Depreciation under both models:

Depreciation must be provided over the useful life of the property to its estimated residual value. The most appropriate methods of depreciation would be either the straight-line or reducing balance method. If at any stage the residual value is greater than the property's carrying amount, depreciation must cease. Depreciation should begin when the property is available for use and should not cease when temporarily idle. Land would not be depreciated as it has an indefinite useful life.

Not owner-occupied

Since the 160 hectares and remaining four sheds are leased out to earn rentals, this property is recognised and measured as investment property in terms of IAS 40. Investment properties may be measured using either the:

- cost model (IAS 16) or
- fair value model (IAS 40 prefers this method).

Solution 12.2 continued ...

Whichever model is used, the investment property will be initially measured at cost. Assuming that all the sheds are similar, the four remaining sheds and 160 hectares should be recorded at C1 600 000 ($C2\,000\,000 \times 160 / 200$ hectares).

Cost model:

If Splurge Limited uses the cost model the farm sheds and 160 hectares are carried at cost less subsequent accumulated depreciation and impairment losses (i.e. in terms of IAS 16). It may not be re-valued.

Fair value model:

If Splurge Limited uses the fair value model, the entity must report the farm (the four sheds and the 160 hectares) at fair value. Any increase or decrease in fair value from the end of one reporting period to the next must be recognised as an income or expense in the year of the change.

If Splurge Limited cannot ascertain the fair value (where fair value is the market price between knowledgeable, willing parties in an arms length transaction) of the investment property it must apply the following rules:

- If the fair value could not be ascertained on the date of purchase, the investment property must be carried at depreciated historic cost (cost model).
- If the fair value could not be ascertained at the end of a subsequent reporting period, the investment property must be carried at the last available fair value.

Solution 12.3**a) Journals**

	Debit	Credit
1 January 20X5		
Quetta building: cost (PPE)	1 200 000	
Bank/ liability		1 200 000
<i>Purchase of Quetta building (owner-occupied)</i>		
Karachi building: cost (Investment prop)	500 000	
Bank/ liability		500 000
<i>Purchase of Karachi building (leased to a tenant)</i>		
30 June 20X5		
Depreciation (1 200 000 / 10 x 6 / 12 months)	60 000	
Quetta building: accum. depr. and impairment losses (PPE)		60 000
<i>Depreciation of building (PPE) to date of destruction</i>		
Impairment (1 200 000 - 60 000)	1 140 000	
Quetta building: accum. depr. and impairment losses (PPE)		1 140 000
<i>Write-off after earthquake</i>		
Quetta building: accum. depr. and impairment losses (PPE)	1 200 000	
Quetta building: cost (PPE)		1 200 000
<i>Derecognition of Quetta building after the earthquake destroyed it</i>		
Karachi building: cost (Investment prop) (950 000 – 500 000)	450 000	
Fair value adjustment to investment property (income)		450 000
<i>Revaluation of investment property prior to change in use</i>		
Karachi building: cost (PPE)	950 000	
Karachi building (Investment property)		950 000
<i>Transfer from investment property to property, plant and equipment</i>		
31 December 20X5		
Depreciation (950 000 / 9.5 x 6 / 12 months)	50 000	
Karachi building: accumulated depreciation and impairment losses		50 000
<i>Depreciation to year-end Karachi building (PPE)</i>		

b)

Investment property is defined as land or buildings (or both) that are held to earn rentals or for capital appreciation. Investment properties do not include land or buildings that are:

- held for use in production or supply of goods or services;
- held for resale as trading stock;
- in the process of being constructed by the entity itself; or
- held for administrative purposes.

Owner-occupied property is defined as land or buildings held for use in the supply of goods and services or for administration use, which could include:

- property being developed;
- administration buildings;
- employees housing; and
- factory buildings.

Solution 12.3 continued ...

c)

Fair value is the value that the property could be sold for in an arms length transaction between knowledgeable, willing parties, without deducting transaction costs, but taking into account the:

- actual and potential uses;
- the market conditions at the end of the reporting period;
- rental incomes; and
- future market conditions.

IAS 40 recommends, but does not require, that this fair value be determined by an independent and suitably qualified valuator.

Solution 12.4**a) Office block**

		Debit	Credit
30 June 20X5			
Depreciation	$(1\,000\,000 - 0) / 10 \text{ years} \times 6/12$	50 000	
Office block: accumulated depreciation (PPE)			50 000
<i>Depreciation on owner-occupied office block to date of change in use</i>			
<hr/>			
Office block: accum. depr (PPE)	$O/bal (1\,000\,000 - 0) / 10 \text{ years} + 20X5 \text{ depr: } 50\,000 \text{ (above)}$	150 000	
Office block: cost (PPE)	<i>Given</i>		1 000 000
Office block (investment property)		850 000	
<i>Transfer from property, plant and equipment to investment property on date of change in use</i>			
<hr/>			
31 December 20X5			
Office block (investment property)	$(1\,500\,000 - 850\,000)$	650 000	
Fair value adjustment to investment property (income)			650 000
<i>Investment property re-measured to fair value at year-end</i>			
<hr/>			

b) Leasing to a subsidiary within a group

Since Chattels Chief Limited does not occupy the property but holds it to earn rental income, it should be accounted for as investment property in the books of Chattels Chief Limited.

Since, however, the group of companies owns a property that is occupied by a subsidiary within the group, it is classified as owner-occupied from the group perspective and should therefore be measured according to the principles laid out in IAS 16: *Property, Plant and Equipment* when preparing the books for the group.

Solution 12.5

SNAKE LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X5 (EXTRACTS)

			20X5 C
3 Profit before tax			
Profit before tax is stated after:			
Income:			
Income from investment properties:			
- Fair value adjustments: investment properties (W1)	Note	2 000 000	
27		2 000 000	
- Rental income earned from investment properties			
Expenses:			
Investment property expenses		1 000 000	
- Properties earning rentals (rates)		400 000	
- Depreciation on investment property (<i>Balochistan</i>): see calculation (a)		475 000	
- Depreciation on property, plant and equipment (<i>Karachi and Lahore</i>)			
(a) <i>Balochistan building</i>	$(5\,000\,000 - 1\,000\,000) / 10 \text{ years} \times 1 \text{ year}$	400 000	
(b) <i>New Karachi head office</i>	$(4\,000\,000 - 500\,000) / 5 \times 3 / 12$	175 000	
<i>Old Lahore head office</i>	$(4\,000\,000 - 0) / 10 \times 9 / 12$	300 000	
		475 000	

27 Investment property

There is an active market for the investment property.

		20X5 C	
		Carried at cost	Carried at fair value
Carrying amount: 1 January 20X5		3 800 000	3 000 000
• Cost	<i>Given</i>	5 000 000	
• Accumulated depreciation	$(5\,000 - 1\,000) / 10 \times 3$	1 200 000	
Transferred from inventory			1 000 000
Transferred from property, plant and equipment as no longer owner occupied			3 200 000
[CA: $4\,000K - (4\,000K - 0) / 10 \times 2 \text{ years}$] [CA = FV]			
Transferred to property, plant and equipment when it became owner occupied	<i>(the Karachi property: transferred out at its CA, which is its FV)</i>		(4 000 000)
Depreciation	<i>(the Balochistan property: because the FV could not be ascertained, the Balochistan property is measured under cost model)</i>	(400 000)	

Fair value adjustment (W1)			2 000 000	
Carrying amount: 31 December 20X5	(W2)	3 400 000	5 200 000	8 600 000
• Cost		5 000 000		
• Accumulated depreciation		1 600 000		

Solution 12.5 continued ...**Workings****W1: Fair value adjustment****C**

Islamabad building	1 500 000 – 1 000 000	500 000
Karachi building	4 000 000 – 3 000 000	1 000 000
Lahore building	3 700 000 – 3 200 000	500 000
		<u>2 000 000</u>

W2: Carrying amount of investment properties measured at fair value**C**

Islamabad building	Given	1 500 000
Lahore building	Given	3 700 000
		<u>5 200 000</u>

Summary of the situation for explanation purposes only:*Islamabad building:*

- this was inventory
- this is now investment property
- measured under the fair value model.

Balochistan building:

- this is investment property
- that has to be measured under the cost model (despite the accounting policy for all other investment property being the fair value model) because the fair value is not ascertainable.

Karachi building:

- this started out as investment property (leased out) but then
- became property, plant and equipment (owner-occupied): change in use.

Lahore building:

- this started out as property, plant and equipment (owner-occupied) but then
- became investment property (leased out): change in use

Solution 12.6**a)**

	Debit	Credit
1 January 20X4		
Investment property: cost (300 000 + 20 000)	320 000	
Bank		320 000
<i>Purchase price plus conveyancer's fees (which are necessarily incurred in order to bring the building into use)</i>		
31 July 20X4		
Maintenance expense	50 000	
Bank		50 000
<i>Painting expensed (does not increase the future economic benefits embodied in the asset)</i>		
1 October 20X4		
Investment property: cost (200 000 + 30 000 + 50 000)	280 000	
Bank		280 000
<i>Capitalisation of the air-conditioning system</i>		
31 December 20X4 (320 000 / 10) + (280 000 / 111m x 3m)		
Depreciation	39 568	
Investment property: accumulated depreciation		39 568
<i>Depreciation of investment property – see note 1</i>		
31 December 20X4		
Investment property 1 250 000 – 1 000 000	250 000	
Fair value adjustment to investment property		250 000
<i>Fair value adjustment on other investment property – see note 2</i>		

Note 1: although the air-conditioning system has a useful life of 10 years, it is integral to the building. This means that it must be depreciated over the remaining useful life of the building. At the time of installation, there were 9 years and 3 months left (9 x 12 months + 3m months = 111 months).

Note 2: This fair value adjustment relates to *other* investment property (*not* Tromp Towers). Please note that the question did not give you the fair value of Tromp Towers on 31 December 20X4. If the question had given you the fair value of Tromp Towers, however, you would have had to ignore it because IAS 40.53 states that if a fair value was not reliably determinable on a continuing basis on initial acquisition and was therefore forced to use the cost model initially, then that property must always be held under the cost model (i.e. even if it subsequently becomes possible to determine the fair values, the fair value model may never be used for this property).

Solution 12.6 continued ...

b)

TROMP LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X4 (EXTRACTS)

25. Investment property

	Carried at Cost C	20X4 Carried at fair value C	Total
Balance: 1 January 20X4	0	1 000 000	1 000 000
Cost/ fair value	0		
Accumulated depreciation	(0)		
Additions	320 000	0	
Improvements	280 000	0	
Fair value adjustments	0	250 000	
Depreciation	(39 568)	0	
Balance: 31 December 20X4	560 432	1 250 000	1 810 432
Cost/ fair value	600 000		
Accumulated depreciation	(39 568)		

Please note:

When originally purchased, the fair value of Tromp Towers could not be reliably determined. As a result, this investment property could only be accounted for using the cost model.

Tromp Limited is, however, allowed to adopt the fair value model for all its other investment properties (IAS 40.53).

At the end of the current year, the fair value of Tromp Towers became reliably determinable for the first time. Tromp Towers must, however, still be measured under the cost model until disposal despite its fair value being reliably determinable (IAS 40.53).

Solution 12.7**a)**

	Debit	Credit
31 July 20X4		
Investment property: the Poplar	500 000	
Bank		500 000
<i>Recording the acquisition of investment: the Poplar</i>		
31 December 20X4		
Investment property: the Poplar 600 000 – 500 000	100 000	
Fair value adjustment to investment property (Income)		100 000
<i>Fair value adjustment to investment property: the Poplar</i>		
Tax expense W1	7 500	
Deferred tax		7 500
<i>Deferred tax adjustment relating to FV adj. on the Poplar</i>		
31 December 20X5		
Investment property: the Poplar 700 000 – 600 000	100 000	
Fair value adjustment to investment property		100 000
<i>Fair value adjustment to investment property: the Poplar</i>		
Tax expense W1	7 500	
Deferred tax		7 500
<i>Deferred tax adjustment relating to FV adj. on the Poplar</i>		
31 December 20X6		
Investment property: the Poplar 750 000 – 700 000	50 000	
Fair value adjustment to investment property		50 000
<i>Fair value adjustment to investment property</i>		
Tax expense W1	7 500	
Deferred tax		7 500
<i>Deferred tax adjustment relating to FV adj. on the Poplar</i>		

Workings 1: Deferred tax calculation

	CA	TB	Difference	Permanent Difference	DT	
Balance: 1/1/20X4	0	0	0	0	0	
Purchase: 31/7/20X4	500 000	500 000	0	0	0	
FVA/ W&T	100 000	(25 000)	125 000	100 000	(7 500)	Cr DT; Dr TE
Balance: 31/12/20X4	600 000	475 000	125 000	100 000	(7 500)	Liability
FVA/ W&T	100 000	(25 000)	125 000	100 000	(7 500)	Cr DT; Dr TE
Balance: 31/12/20X5	700 000	450 000	250 000	200 000	(15 000)	Liability
FVA/ W&T	50 000	(25 000)	75 000	50 000	(7 500)	Cr DT; Dr TE
Balance: 31/12/20X6	750 000	425 000	325 000	250 000	(22 500)	Liability

Solution 12.7 continued ...

b)

		Debit	Credit
2 January 20X5			
Investment property: Palms		200 000	
Bank			200 000
<i>Purchase of investment property: The Palms</i>			
31 December 20X5			
Investment property: Palms	(250 000 – 200 000)	50 000	
Fair value adjustment to investment property			50 000
<i>Fair value adjustment to investment property: The Palms</i>			
31 December 20X6			
Investment property: Palms	(400 000 – 250 000)	150 000	
Fair value adjustment to investment property			150 000
<i>Fair value adjustment to investment property</i>			
Tax expense			
Deferred tax	W1	3 000	
<i>Deferred tax adjustment relating to FV adjustment The Palms</i>			3 000
31 December 20X6			
Investment property: Palms	(400 000 – 250 000)	150 000	
Fair value adjustment to investment property			150 000
<i>Fair value adjustment to investment property</i>			
Tax expense			
Deferred tax	W1	3 000	
<i>Deferred tax adjustment relating to FV adjustment The Palms</i>			3 000

W1: Deferred tax calculation

Investment property: intention to sell	Carrying amount	Tax base	Difference	Permanent difference	Deferred taxation	
Balance: 1 Jan 20X4	0	0	0		0	Liability
Purchase 2 Jan 20X5	200 000	200 000				
Movement	⁽³⁾ 50 000	(10 000)	(60 000)	(50 000)	(3 000)	Cr DT Dr TE
Balance: 31 Dec 20X5	⁽¹⁾ 250 000	190 000	(60 000)	(50 000)	(3 000)	Liability
Movement	⁽³⁾ 150 000	(10 000)	(160 000)	(150 000)	(3 000)	Cr DT Dr TE
Balance: 31 Dec 20X6	⁽¹⁾ 400 000	180 000	(220 000)	(200 000)	(6 000)	Liability

Solution 12.8

Letterhead

*My contact details
Date of letter*

*Cool Limited's address
Attention: Financial Director's name*

Dear Sir

Re: your request for clarification regarding the accounting for the office building

Your head office building was previously 100% owner-occupied. This meant that it was previously classified as property, plant and equipment (IAS 16).

Since 60% of this building is now leased out whilst 40% is owner-occupied, this property is now a joint-use property.

Had the two portions been separable (i.e. were it possible to sell the 60% separately from the remaining 40% or were it possible to lease this 60% separately from the 40% under a finance lease), it would have meant that each portion would have had to be classified separately (i.e. 60% classified as an investment property and 40% as property, plant and equipment).

However, since you have indicated that this property is not separable, IAS 40 requires that you establish whether the portion used as an investment property is the most significant portion or not.

Professional judgment is required in determining what constitutes a significant portion and your company will need to establish its own criteria such that this judgment can be applied consistently (these criteria would then need to be disclosed).

My opinion is that 60% should be considered a significant portion of the property, in which case the entire property would need to be classified as an investment property since the 60% was used as investment property. In the event that you believe that, for example, a minimum of 70% would need to be reached before classifying a portion as a *significant* portion, then the entire property would *remain* classified as property, plant and equipment since it must *only* be classified as investment property *if the significant portion is used as investment property*. The property is therefore classified as property, plant and equipment if the significant portion is used as property, plant and equipment or if there is no significant portion.

Assuming you agree with my suggestion that 60% is a significant portion, (i.e. that the property must now be reclassified as an investment property), then we are agreed that there has effectively been a change in use: from owner-occupied (*IAS 16: Property, plant and equipment*) to a property held to earn rental income (*IAS 40: Investment property*). The property must therefore be transferred from property, plant and equipment to investment property.

Before the transfer is journalised, the property must first be depreciated, revalued to fair value (given that your property was previously measured using the revaluation model) and then checked for impairment. All these measurement adjustments must be accounted for in terms of IAS 16 (IAS 40.61). Thereafter, the property is transferred to investment property and measured under the fair value model.

P.T.O.

Solution 12.8 continued ...*Letter continued*

I have taken the liberty of including the journals that you would need to process:

1 January 20X5	Debit	Credit
Office building: carrying amount (PPE)	600 000	
Bank/ liability		600 000
<i>Purchase of head-office building(owner-occupied)</i>		
30 June 20X5		
Depreciation expense <i>(600 000 – 0) / 10 x 6 / 12 months)</i>	30 000	
Office building: carrying amount (PPE)		30 000
<i>Depreciation to date of change in use</i>		
Office building: carrying amount (PPE)	230 000	
Revaluation surplus		230 000
<i>Revaluation of head office to fair value on date of change in use</i> <i>[800 000 – (600 000 – 30 000)]</i>		
Office building: fair value (Investment property)	800 000	
Office building: carrying amount (PPE)		800 000
<i>Transfer head office building from PPE to IP on date of change in use</i>		
Office building: fair value (Investment property)	20 000	
Fair value adjustment on investment property (income)		20 000
<i>Measurement of investment property to fair value at year-end</i>		

Please do not hesitate to contact me if you have any further queries.

Sincerely

S Mart
Your IFRS consultant

Solution 12.9

It is apparent that the office park is being held for two separate purposes:

- To house the head office for administration purposes
- To earn operating lease rentals

As the head office building is used for administration purposes it would be classified as property, plant and equipment. It can be measured using the cost model or the revaluation model. If the cost model is used the building will be measured at cost and depreciated each year. If measured using the revaluation model the building must be revalued with sufficient regularity so that the carrying amount will not differ significantly from fair value. Any adjustment needed due to a revaluation will be recognised in other comprehensive income. The building will also be depreciated each year.

The other two stand-alone buildings will be classified as investment property. IAS 40 allows the cost model or the fair value model to be used. Under the fair value model, the fair value of the investment property is determined at reporting date and the property's carrying amount in the statement of financial position must reflect this fair value. The fair value adjustment is recorded in profit or loss.

IAS 40 prefers the fair value model on the basis that it gives more relevant information. The problem with using the fair value model is that IAS 40.31 explains that a voluntary change, back to cost model, would be highly unlikely given that the fair value model provides more relevant information. IAS 40.55 actually takes this further and actually disallows the change in model for an investment property that was measured under the fair value model.

The fact that a number of properties are held under operating leases might suggest that the fair value model should be used since this would then enable Uncertain Limited to bring these properties into the statement of financial position as investment properties in terms of IAS 40.6 (assuming that these properties would otherwise meet the definition of an investment property).

The CEO's assumption that the cost model will be cheaper to implement as the fair value will not be needed is incorrect. IAS 40.32 requires that the fair value be determined, whether it is for measurement purposes or just for disclosure purposes.

The CEO's assumption that the cost model might have the least impact on the financial statements is debatable because the impact depends on the economic situation in the property market. The fair value model may indeed have a greater effect on the financial statements than the cost model during periods in which the property market is experiencing dramatic fluctuations in fair values, which would now be brought into your profits. If on the other hand, the property market is stable, the cost model would have more impact via the standard depreciation charge versus a potentially negligible fair value adjustment.

Solution 12.10

- a. The block of flats is a dual use (joint use) property. If the first three storeys can be sold or leased (in terms of a finance lease) separately from the top three storeys, then the first 3 storeys must be classified as property, plant and equipment and the top three storeys must be classified as investment property. If they cannot be separated in this way, then only if a significant portion is used as an investment property should the whole building be classified as investment property (i.e. if an insignificant portion is used as an investment property, then the whole building would be classified as property, plant and equipment). In order to classify the building one way or the other, Gary Limited must develop criteria as to what they consider a significant portion of the property (these criteria will then need to be disclosed). If the three storeys that are leased out under operating lease agreements is not considered to be a significant portion (IAS 40.10) of the building, the entire building must be classified as property, plant and equipment. The building will be measured using the cost or revaluation model and will be depreciated each year. If the property is classified as investment property, then there is a choice between the cost model and the revaluation model.
- b. This is also a dual use (joint use) property. If the first three office rooms can be sold or leased (in terms of a finance lease) separately from the remaining seven rooms, then the first 3 rooms must be classified as property, plant and equipment and the other seven rooms must be classified as investment property. If this is not the case, since a significant portion is held to earn rentals (i.e. used as investment property), the entire property must be classified as investment property. The ancillary services provided are insignificant. Had these services been significant or had the rooms been occupied by employees of Gary Limited, the motel would have been classified as property, plant and equipment. If the three rooms could not be separated from the seven rooms as described above, the motel would be classified as an investment property. The motel would therefore be measured at fair value. Any fair value adjustments will be recorded in profit or loss.
- c. Fairvalue Limited is a property dealer. The buildings that it owns would therefore have been classified as inventory. The block of flats is being refurbished with the intention of leasing it under operating leases. The change in intention will cause the flats to be reclassified to investment property. The carrying amount of the flats (lower of cost and NRV) will be transferred to investment property and then any fair value adjustments to the flats will be recorded in profit or loss. This transfer may only be made when the operating lease agreements are entered into, see IAS 40.57(d).

The town house is also classified as inventory. A decision has now been made to hold the town house for capital appreciation (i.e. will no longer be sold as part of ordinary business activities). The town house will not be reclassified however and will remain recorded as inventories and measured at the lower of cost and net realizable value.

Solution 13.1**a) Notes to the financial statements****1. Significant Accounting Policies:****1.1 Statement of compliance**

These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 1984, provisions of and directives issued under the Companies Ordinance, 1984. In case the requirements differ, the provisions or the directives of the Companies Ordinance, 1984 shall prevail.

1.2 Accounting Convention

These financial statements have been prepared on the basis of historical cost convention

1.3 Inventory

Inventory is valued at the lower of cost and net realisable value. Cost is determined on first in, first-out basis. Cost of work-in-progress and finished goods include all direct costs and an appropriate portion of manufacturing overhead expenses.

1.4 Revenue

Revenue represents net invoiced sales to customers. Other income includes commission and rental income.

b) Further information**2. Inventory**

- Finished goods
- Work-in-progress
- Raw materials
- Consumable stores

Solution 13.2

		Debit	Credit
1 July 20X9			
Inventory	$28\,000 \times 80\%$	22\,400	
Settlement discount allowance (asset)	$28\,000 \times 20\%$	5\,600	
Creditors	$30\,000 - 2\,000$		28\,000
<i>Purchase of inventory on credit</i>			
2 September 20X9			
Creditors		28\,000	
Bank	$30\,000 - 2\,000$		28\,000
<i>Payment for inventory purchased (only net of trade discount)</i>			
Discount forfeited (expense)		5\,600	
Settlement discount allowance (asset)			5\,600
<i>Reversal of allowance (missed early settlement date)</i>			

Solution 13.3

Scenario a)

<i>Class of inventory</i>	<i>Cost</i>	<i>NRV if sold in present condition</i>	<i>NRV if sold as completed product</i>	<i>NRV applicable</i>
Raw materials	140 000			
Used in moisturising lotion	65 000	60 000	55 000	60 000
Used in sunblock	75 000	60 000	80 000	80 000
Work in progress	95 000			
Moisturising lotion	40 000	30 000	35 000	35 000
Sunblock	55 000	45 000	50 000	50 000
Finished goods	190 000			
Moisturising lotion	90 000	N/A	140 000	140 000
Sunblock	100 000	N/A	80 000	80 000

<i>Class of inventory</i>	<i>Adjusted Value</i>
Raw materials	135 000
Used in moisturising lotion	60 000
Used in sunblock	75 000
Work in progress	85 000
Moisturising lotion	35 000
Sunblock	50 000
Finished goods	170 000
Moisturising lotion	90 000
Sunblock	80 000
Total net realisable value	$135\,000 + 85\,000 + 170\,000$
Total cost before	$140\,000 + 95\,000 + 190\,000$
Total write down required	390 000 (425 000) <u>35 000</u>

Solution 13.3 continued ...

Scenario b)

<i>Class of inventory</i>	<i>Cost</i>	<i>NRV if sold in present condition</i>	<i>NRV if sold as completed product</i>	<i>NRV applicable</i>
Raw materials	140 000			
Used in moisturising lotion	65 000	60 000	55 000	55 000
Used in sun-block	75 000	60 000	80 000	75 000
Work in progress	95 000			
Moisturising lotion	40 000	30 000	35 000	35 000
Sun-block	55 000	45 000	50 000	50 000
Finished goods	190 000			
Moisturising lotion	90 000	N/A	140 000	90 000
Sun-block	100 000	N/A	80 000	80 000

<i>Class of inventory</i>	<i>Adjusted Value</i>
Raw materials	130 000
Used in moisturising lotion	55 000
Used in sunblock	75 000
Work in progress	85 000
Moisturising lotion	35 000
Sunblock	50 000
Finished goods	170 000
Moisturising lotion	90 000
Sunblock	80 000
Total net realisable value	$130\,000 + 85\,000 + 170\,000$
Total cost before	$140\,000 + 95\,000 + 190\,000$
Total write down required	40 000

Solution 13.4

a)

1. Fixed overhead application rate

$$\frac{\text{Fixed overheads}}{\text{Greater of budgeted production and actual production}}$$

$$= \frac{\text{C}20\,000}{40\,000}$$

$$= \text{C}0.50 / \text{unit}$$

2. Value of finished goods on hand at year-end**Cost:**

- labour and other conversion costs	(given: C3 x 500u)	C1 500
- material	(given: C2 x 500u)	C1 000
- fixed overheads	(W1: C0.50 x 500u)	C 250
		<u>C2 750</u>

Net realisable value: (given) C3 000

Inventory balance at year end: Lower of cost or net realisable value* C2 750

*There was no need for a write down of the inventories since the cost of C2 750 is less than the NRV of C3 000.

b)

Cost of inventories	C
Finished goods (see above)	2 750
Work-in-progress	235 000

Net realisable value of inventories	C
Finished goods (sales value after year-end)	3 000
Work-in-progress:	230 050
Sales value (235 000 + 12 000) x 1.15	284 050
Less costs to complete	(12 000)
Less selling costs	<u>(42 000)</u>

Write-down of work in progress:	C
Cost	235 000
Net realisable value	<u>(230 050)</u>
	<u>4 950</u>

Inventory balances at year end:	C
Finished Goods (at cost*)	2 750
Work-in-progress (at net realisable value **)	<u>230 050</u>
	<u>232 800</u>

*The finished goods are not written down because the cost of C2 750 is less than the NRV of C3 000.

**The work in progress is written down because its cost of C235 000 is greater than its NRV of C230 050.

Solution 13.4 continued . . .

c)

STOCKY LTD.**STATEMENT OF FINANCIAL POSITION AT**

	Note	C
ASSETS		
Current assets		
Inventories	3	252 800

STOCKY LTD.**NOTES TO THE FINANCIAL STATEMENTS****FOR THE YEAR ENDED**

3. Inventories	<i>Workings:</i>	C
Finished goods	See part (b)	2 750
Work-in-progress	See part (b)	230 050
Raw materials	Given	20 000
		<u>252 800</u>

All of the raw materials have been offered as security for a loan (see note).

Solution 13.5

Part a)

i)

Variable manufacturing costs:	
- direct labour (C3 x 500 units)	1 500
- direct materials (C4 x 500 units)	2 000
- variable overheads (C2 x 500 units)	1 000
Fixed manufacturing overheads:	300
- actual fixed manufacturing overhead absorbed per unit:	
<u>Fixed manufacturing overheads</u>	
Greater of BP or AP (BP)	
= C30 000/ 50 000 = C0.60/u	
- fixed overheads still in inventory: C0.60 x 500 u = C300	

Value of inventory at year end	<u>4 800</u>
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ii)

Fixed overheads absorbed (capitalised):	<i>C0.60 x 30 000</i>	18 000
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iii)

Fixed overheads still in inventory at year-end	<i>C0.60 x 500</i>	300
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iv)

Fixed manufacturing overheads expensed to cost of inventories expense:		
• Through goods sold	$C0.60 \times (0u + 30\,000u - 500u)$	17 700
• Underproduction (under-absorption of fixed manufacturing overheads)	$C30\,000 - 18\,000$ or $C0.60 \times (50\,000u - 30\,000u)$	12 000
		<hr/> 29 700

v)

		Debit	Credit
<i>20X1</i>			
Raw materials (asset)	<i>4 x 30 000</i>	120 000	
Bank			120 000
<u>Raw materials purchased</u>			
<i>20X1</i>			
Work-in-progress (asset)	<i>3 x 30 000</i>	90 000	
Bank			90 000
<u>Labour costs</u>			
<i>20X1</i>			
Work-in-progress (asset)	<i>2 x 30 000</i>	60 000	
Bank			60 000
<u>Variable manufacturing overheads</u>			
<i>20X1</i>			
Fixed manufacturing overhead (suspense)	<i>given</i>	30 000	
Bank			30 000
<u>Fixed manufacturing overheads</u>			
<i>20X1</i>			
Work-in-progress (asset)	<i>0.60 x 30 000 units</i>	18 000	
Fixed manufacturing overhead (suspense)			18 000
<u>Fixed man. overheads allocated based on normal production</u>			
<i>20X1</i>			
Fixed manufacturing overheads (expense)	<i>30 000 - 18 000</i>	12 000	
Fixed manufacturing overhead (suspense)			12 000
<u>Unallocated fixed manufacturing overheads expensed (under-recovery)</u>			
<i>20X1</i>			
Work-in-progress (asset)		120 000	
Raw materials			120 000
<u>Raw materials used: 100% used (no opening or closing balances)</u>			

Solution 13.5 continued ...

Part a) continued ...

		Debit	Credit
20X1			
Finished goods (asset)	$90K + 60K + 18K + 120K$	288 000	
Work-in-progress (asset)			288 000
<i>Work-in-progress completed: 100% (no opening or closing balances)</i>			
20X1			
Cost of sales (expense)	$(0 + 288K) / 30\,000 \times (30\,000 - 500)$	283 200	
Finished goods (asset)			283 200
<i>Finished goods sold</i>			

vi)

Cost of inventories expense:

Goods sold	$(4 + 3 + 2 + 0.60) \times (0u + 30\,000u - 500u)$	283 200
Underproduction (under-absorption of fixed manufacturing overheads)	$C30\,000 - 18\,000$ or $C0.60 \times (50\,000u - 30\,000u)$	12 000
		<u>295 200</u>

Part b)

i)

Variable manufacturing costs:

- direct labour (C3 x 500 units)	1 500
- direct materials (C4 x 500 units)	2 000
- variable overheads (C2 x 500 units)	1 000
Fixed manufacturing overheads:	250

- actual fixed manufacturing overheads absorbed per unit:

Fixed manufacturing overheads

Greater of BP or AP (AP)

 $= C30\,000 / 60\,000 = C0.50/u$

- fixed overheads still in inventory:

 $C0.50 \times 500 u = C250$

Value of inventory at year end	<u>4 750</u>
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ii)

Fixed overheads absorbed (capitalised):	$C0.50 \times 60\,000u$	30 000
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iii)

Fixed overheads still in inventory at year-end:	$C0.50 \times 500u$	250
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iv)

Fixed manufacturing overheads expensed to cost of inventories expense:

• Through goods sold	$C0.50 \times (0u + 60\,000u - 500u)$	29 750
• Underproduction (under-absorption of fixed manufacturing overheads)	<i>N/A because the company manufactured more than normal (not less than normal)</i>	0
		<u>29 750</u>

v)

		Debit	Credit
20X1			
Raw materials (asset)	$4 \times 60\,000$	240 000	
Bank			240 000
<i>Raw materials purchased</i>			
20X1			
Work-in-progress (asset)	$3 \times 60\,000$	180 000	
Bank			180 000
<i>Labour costs</i>			
20X1			
Work-in-progress (asset)	$2 \times 60\,000$	120 000	
Bank			120 000
<i>Variable manufacturing overheads</i>			

Solution 13.5 continued ...

Part b) continued ...

	Debit	Credit
<i>20X1</i>		
Fixed manufacturing overhead (suspense) <i>Same as part A</i>	30 000	
Bank		30 000
<i>Fixed manufacturing overheads</i>		
<i>20X1</i>		
Work-in-progress (asset) <i>0.60 x 60 000 units</i>	36 000	
Fixed manufacturing overhead (suspense)		36 000
<i>Fixed man. overheads allocated based on normal production: see comment 1 below (and comment 3)</i>		
<i>20X1</i>		
Fixed manufacturing overhead (suspense) <i>30 000 – 36 000</i>	6 000	
Work-in-progress (asset)		6 000
<i>Over-allocated fixed manufacturing overheads reversed: see comment 2 below (and comment 3)</i>		
<i>20X1</i>		
Work-in-progress (asset) <i>Same as part A</i>	240 000	
Raw materials		240 000
<i>Raw materials used: 100% used (no opening or closing balances)</i>		
<i>20X1</i>		
Finished goods (asset) <i>180K + 120K + 36K – 6K + 240K</i>	570 000	
Work-in-progress (asset)		570 000
<i>Work-in-progress completed: 100% (no opening or closing balances)</i>		
<i>20X1</i>		
Cost of sales (expense) <i>(0 + 570K) / 60K x (60K – 500)</i>	565 250	
Finished goods (asset)		565 250
<i>Finished goods sold</i>		

Comment 1: Fixed manufacturing overheads are first allocated to the inventory account (work-in-progress) using *normal budgeted* production.

Comment 2: If by year-end, the actual production exceeds the normal production, the amount allocated to inventory will be too great and must be decreased (reversed out).

Comment 3: If during the year it becomes apparent that the actual production will be abnormally high (higher than normal production) then the fixed manufacturing overhead application rate (FMOAR) may be revised earlier in the year to be:

Fixed manufacturing overheads

Greater of BP or AP (AP)

= C30 000 / 60 000 = C0.50/u

In this case the journals during the year would have been as follows:

	Debit	Credit
<i>20X1</i>		
Work-in-progress (asset) <i>0.50 x 60 000 units</i>	30 000	
Fixed manufacturing overhead (suspense)		30 000
<i>Fixed man. overheads allocated based on actual production:</i>		

No further journal entry relating to reversing over-applied overheads would then have been necessary.

vi)

Cost of inventories expense:

Goods sold	$(4 + 3 + 2 + 0.50) \times (0u + 60\,000u - 500u)$	565 250
Overproduction (over-absorption) of fixed manufacturing overheads)	<i>Debit suspense account; credit inventory account: no effect on expense</i>	0
		<u>565 250</u>

Solution 13.6**a) Journals**

		Debit	Credit
20X1			
Raw materials (asset)	1 020 000 – 20 000 (trade discount) – 30 000 (cash discount)	970 000	
Bank / creditors	1 000 000 – 30 000		970 000
<i>Raw materials purchased</i>			
20X1			
Work-in-progress (asset)	3 000 000 x 60%	1 800 000	
Wages (admin expense)	3 000 000 x 40%	1 200 000	
Bank	Given		3 000 000
<i>Wages paid: 60% manufacturing and 40% non-manufacturing</i>			
20X1			
Work-in-progress (asset)	1 000 000 x 60%	600 000	
Variable overheads	1 000 000 x 40%	400 000	
Bank	Given		1 000 000
<i>Variable overheads paid: 60% manufacturing and 40% non-manufacturing</i>			
20X1			
Fixed manufacturing overhead (suspense)	1 000 000 x 80%	800 000	
Depreciation (admin expense)	1 000 000 x 20%	200 000	
Plant: accumulated depreciation	1 000 000 x 80%		800 000
Buildings: accumulated depreciation	1 000 000 x 20%		200 000
<i>Depreciation: 80% manufacturing and 20% non-manufacturing</i>			
20X1			
Fixed manufacturing overhead (suspense)	1 000 000 x 70%	700 000	
Bank *			700 000
<i>Factory rent paid: manufacturing</i>			
20X1			
Salaries (expense)	1 000 000 x 30%	300 000	
Bank *			300 000
<i>Managerial salaries paid: non-manufacturing</i>			
20X1			
Raw materials (asset)		100 000	
Bank			100 000
<i>Transport inwards of raw materials</i>			
20X1			
Transport outwards (distribution expense)		50 000	
Bank			50 000
<i>Transport outwards of finished goods</i>			
20X1			
Storage warehouse rent and insurance (expense)		100 000	
Bank			100 000
<i>Storage costs relating to finished goods</i>			
20X1			
Salaries (distribution expense)		400 000	
Bank			400 000
<i>Sales representative salaries</i>			
20X1			
Work-in-progress (asset)		300 000	
Bank			300 000
<i>Wooden boxes used to package biltong product</i>			

*: notice that 2 separate journals were processed for the C1 000 000 fixed overheads. This is because 2 separate payments would have been made: one to the landlord and one to the employees).

Solution 13.6 continued . . .**a) continued ...**

		<u>Debit</u>	<u>Credit</u>
20X1			
Delivery costs (expense)		500 000	
Bank			500 000
<i>Cardboard boxes used in deliveries of biltong boxes to customers</i>			
20X1			
Work-in-progress (asset)	W1	1 200 000	
Fixed manufacturing overhead (suspense)			1 200 000
<i>Allocation of fixed manufacturing overheads to WIP at C6 per box</i>			
20X1			
Fixed manufacturing overheads (expense)	W1	300 000	
Fixed manufacturing overhead (suspense)			300 000
<i>Unallocated fixed manufacturing overheads expensed</i>			
20X1			
Work-in-progress (asset)	W2	819 000	
Raw materials (asset)			819 000
<i>Raw materials used:</i>			
20X1			
Finished goods (asset)	W3	3 975 200	
Work-in-progress (asset)			3 975 200
<i>Work-in-progress completed:</i>			
20X1			
Cost of sales (expense)	W4	3 712 680	
Finished goods (asset)			3 712 680
<i>Finished goods sold:</i>			

W1: allocation of fixed manufacturing overheads

Fixed manufacturing overheads are allocated to the products at year end using the normal production (unless actual production is higher than normal):

Fixed manufacturing overheads
Budgeted production
800 000 depreciation + 700 000 rent
250 000
1 500 000
250 000

= C6 per box

Notice that when you process the 'allocation of FOs journal', you use the budgeted production as the denominator. If the actual production was greater than this, a subsequent reversal of an over-allocation of overheads would be processed and what results is that the actual overheads finally allocated to inventories is = FO / greater of the BP or AP.

Fixed overheads allocated to work-in-progress:

= 6 x 200 000

= 1 200 000

Fixed overheads expensed (unallocated):

= 800 000 + 700 000 – 1 200 000

= 300 000

Solution 13.6 continued . . .**a) continued ...****W2: Costs**

Opening balance
Purchases of raw materials
Transport inwards of raw materials

Raw materials used $1\,170\,000 \times (100\% - 30\%)$
Balance on hand $1\,170\,000 \times 30\%$

Raw materials

100 000
970 000
100 000
1 170 000
819 000
351 000

W3: Costs

Opening balance
Raw materials used
Wages
Variable overheads
Wooden boxes
Fixed manufacturing overheads

From W2
From journals above
From journals above
From journals above
From journals above/ W1

Work-in-progress completed $4\,969\,000 \times (100\% - 20\%)$
Balance on hand $4\,969\,000 \times 20\%$

Work-in-progress

250 000
819 000
1 800 000
600 000
300 000
1 200 000
4 969 000
3 975 200
993 800

W4: Costs

Opening balance
Work-in-progress completed

From W3

Cost of goods sold $4\,125\,200 \times (100\% - 10\%)$
Balance on hand $4\,125\,200 \times 10\%$

Finished goods

150 000
3 975 200
4 125 200
3 712 680
412 520

b) Year-end measurement

Normally it is considered to be inappropriate to calculate the net realisable value per classification of inventory, but since the raw materials is to be sold as is, it becomes its own product line and must be evaluated separately.

			Finished goods & Work-in-progress	Raw materials
W5. Net realisable value:	FG	WIP		
Expected selling price	1 300 000	700 000	2 000 000	300 000
Less:				
expected costs to complete	(0)	(100 000)	(100 000)	0
expected costs to sell	(80 000)	(20 000)	(100 000)	(50 000)
Net realisable value	1 220 000	580 000	1 800 000	250 000

Cost:

Balance at 31/12/20X1	412 520 (W4)	993 800 (W3)	1 406 320	351 000 (W2)
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W6. Lower of cost or net realisable value:

1 406 320 250 000

W7. Write-down required: *RM: 351 000 – 250 000*

0 101 000

Journal required:

31 December 20X1

Write-down (expense)

 Raw materials (asset)

Write-down of inventories

Debit	Credit
101 000	
	101 000

Solution 13.6 continued . . .**b) continued ...**

Notice that the net realisable value of the finished goods 1 220 000 (W5) exceeds its cost of 412 520 (W4) by a significant amount. The work-in-progress, on the other hand, has a net realisable value of 580 000, which is far less than its cost of 993 800. Since the work-in-progress is to be sold as a finished product, the net realisable value of the combined work-in-progress and finished goods is compared with the combined cost thereof, with the result that no write-down was required (the combined net realisable value exceeded the combined cost). Had this not been the case, the work-in-progress would have been written-down to 580 000.

c) Disclosure

BUCK LTD
EXTRACTS FROM STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X1

	Note	20X1 C	20X0 C
ASSETS			
Current assets			
Inventories	3	1 656 320	500 000

BUCK LTD
EXTRACTS FROM STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X1

	Note	20X1 C	20X0 C
Revenue		xxx	Xxx
Cost of inventories expense		4 113 680	Xxx
Cost of administration		xxx	Xxx
Cost of distribution		xxx	Xxx
Other costs		xxx	Xxx
Finance charges		xxx	Xxx
Profit before tax	5	xxx	Xxx

BUCK LTD
EXTRACTS FROM NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X1

		20X1 C	20X0 C
3. Inventory			
Finished goods	W4	412 520	150 000
Work-in-progress	W3	993 800	250 000
Raw materials	W2 and Part B	250 000	100 000
		<u>1 656 320</u>	<u>500 000</u>

The company pledged C150 000 of finished goods as security for a non-current loan (see note...)

5. Profit before tax

Profit before taxation is stated after taking into account the following separately disclosable items:

		20X1 C	20X0 C
Cost of inventories expense		4 113 680	xxx
- cost of goods sold	3 712 680 (W4) + 300 000 (W1)	4 012 680	xxx
- write-down of inventories	(Part B)	101 000	xxx
Depreciation		200 000	xxx
- total depreciation	800 000 + 200 000	1 000 000	xxx
- less capitalised to inventory		(800 000)	xxx

Notice that cost of inventories expense includes all costs of inventories that were expensed through sales, underabsorption of fixed manufacturing overheads (300 000) and write-downs (101 000).

Solution 13.7**a) Fixed overhead application rate (actual):**

Total fixed overheads for the 10 month period: C80 000/12x10 + C40 000/12x10 = C100 000

$$\frac{\text{C100 000}}{20\,000 \text{ (budget greater than actual)}}$$

$$= \text{C5/ unit}$$

b) Fixed overhead held (absorbed) in closing stock:

$$\text{C5/unit} \times (12\,000 - 10\,000)$$

$$= \text{C10 000}$$

c) Fixed overhead expensed:

Through under-productivity: C100 000 – C5 x 12 000u = C40 000

Through Cost of sales: C5 x 10 000u = C50 000

Total expensed during the year: C40 000 + C50 000 = C90 000

Ledger accounts (not required – given for interest sake only)

Inventory				Bank			
Description	C	Description	C	Description	C	Description	C
FMOS	(2) 60 000	Cost of sales	(4) 50 000			FMOS (given)	(1) 100 000
		C/ balance	(5) 10 000				
	60 000		60 000				
O/ balance	(5) 10 000						

Fixed manufacturing overheads suspense				Cost of sales			
Description	C	Description	C	Description	C	Description	C
Bank (FMO)	(1) 100 000	Inventory (C5 x 12 000)	(2) 60 000	FMO suspense	(3) 40 000	P&L	90 000
		FMO expense/ Cost of sales	(3) 40 000	Inventory	(4) 50 000		
	100 000		100 000		90 000		90 000

Note:

- (1) Assumed that fixed overheads were paid for in cash.
- (2) The company under-produced with the result that not all fixed manufacturing overheads are allocated to the inventory account.
- (3) The balance of the fixed manufacturing overheads are expensed immediately (generally to cost of sales)
- (4) 10 000 units sold during the year at a fixed manufacturing cost per unit of C5
- (5) 2 000 units left at year-end (12 000 – 10 000) at total cost per unit of C5

Solution 13.8

Journals		Debit	Credit
Inventory: raw materials (asset)	Given	1 600 000	
Bank			1 600 000
<i>Raw materials purchased</i>			
Inventory: work-in-progress (asset)	$100\,000 \times 4$	400 000	
Inventory: raw materials (asset)			400 000
<i>Raw materials used during the year</i>			
Inventory: work-in-progress (asset)	Given	500 000	
Bank			500 000
<i>Labour costs paid</i>			
Telephone expense	Given	20 000	
Bank			20 000
<i>Telephone expense paid (office phone bill = administration)</i>			
Inventory: work-in-progress (asset)	$100\,000 \text{ u} \times 1 \text{ kw} \times \text{C0.1}$	10 000	
Electricity expense	$15\,000 - 10\,000$	5 000	
Bank			15 000
<i>Electricity costs paid</i>			
Entertainment expense	Given	8 000	
Bank			8 000
<i>Braai for factory staff is entertainment (may not be capitalised)</i>			
Rent expense	$25\% \times 400\,000$	100 000	
Fixed manufacturing overheads suspense	$75\% \times 400\,000$	300 000	
Bank	Given		400 000
<i>Rent of factory and administration space paid for</i>			
Inventory: work-in-progress (asset)	$(300\text{k} \div 300\text{k units}) \times 100\text{k units}$	100 000	
Fixed manufacturing overheads suspense			100 000
<i>Fixed manufacturing overheads allocated based on BFMOAR</i>			
Fixed manufacturing overheads expense: under provision		200 000	
Fixed manufacturing overheads suspense	$300\,000 - 100\,000$		200 000
<i>Unallocated fixed manufacturing overheads expensed (under-productivity = inefficiency, which may not be capitalised)</i>			
Inventory: finished goods (asset)	$100\,000 \text{ u} \times 90\% \times 10.10 \text{ (W3)}$	909 000	
Inventory: work-in-progress (asset)			909 000
<i>Finished work in progress transferred to finished goods</i>			
Cost of sales expense	W4	333 300	
Inventory: finished goods (asset)			333 300
<i>Cost of sales for the year</i>			

Solution 13.8 continued ...**Workings:****W1. Budgeted fixed manufacturing overhead application rate (BFMOAR):**

$$300\,000 \text{ overheads} \div 300\,000 \text{ units} = \text{C } 1/\text{unit}$$

W2. Fixed manufacturing overhead allocated to work-in-progress

$$\text{C1 BFMOAR} \times 100\,000 \text{ units actual production} = \text{C}100\,000 \text{ capitalised}$$

Fixed manufacturing overheads suspense			
Description	C	Description	C
Bank (FMO)	300 000	WIP	100 000
		FMO expense/ under provision	200 000
	300 000		300 000

W3. Total manufacturing cost per unit

		Cost per unit
		C
Raw materials	<i>Given</i>	4.00
Electricity	<i>1 KW x C0.1</i>	0.10
Labour	<i>C500 000 / 100 000</i>	5.00
FMOAR	<i>Budgeted rate</i>	1.00
		<u>10.10</u>

W4. Finished goods manufactured and cost of sales thereof

		Balance/ contra-entry:	C
Stock on hand at the beginning of the year	<i>Opening balance</i>	<i>20 000 x 10.10 (W3) *</i>	202 000
Completed during the year	<i>Work-in-progress</i>	<i>100 000 x 90% x 10.10 (W3)</i>	909 000
Finished goods available during the year			<u>1 111 000</u>
Finished goods sold	<i>Cost of sales</i>	<i>1 111 000 x 30%</i>	<u>(333 300)</u>
Stock on hand at the end of the year	<i>Closing balance</i>		<u>777 700</u>

- The costs per unit in the prior year were the same as in the current year.

Solution 13.9

a)

Carrying amounts on each inventory account at 31 January 20X8**20X8****C****W1. Consumables (packing materials): 31 January 20X8**

Opening balance	<i>First month of operations</i>	0
Purchased	$(685\,000/7 \times 9)$	880 714
Used in production	$(880\,714 \times 75\%)$	<u>(660 536)</u>
Closing balance		<u>220 178</u>

W2. Raw materials: 31 January 20X8

Opening balance	<i>First month of operations</i>	0
Cost of purchases		
• Marked price including VAT	<i>Given</i>	605 000
• Less VAT	$605\,000 / 114\% \times 100\%$	<u>(74 298)</u>
		530 702
• Less trade discount (8%)	$530\,702 \times 8\%$	(42 456)
• Less settlement discounts	<i>Cost of inventory to be net of all settlement discounts, even if not successfully earned</i>	<u>(4 200)</u>
		484 046
Used in production (80% balancing)	$484\,046 \times (100\% - 20\%)$	<u>(387 237)</u>
Closing balance	$484\,046 \times 20\%$	<u>96 809</u>

W3. Work in progress: 31 January 20X8

Opening balance	<i>First month of operations</i>	0
Raw materials used (above)	W2	387 237
Salaries and wages	$500\,000 \times 55\%$	275 000
Variable overheads	$100\,000 \times 70\%$	70 000
Fixed manufacturing overheads allocated (W1)	$W5: 151.278 \times 1\,100$	166 406
Packing materials (above)	W1 *	<u>660 536</u>
		1 559 179
Less transferred to finished goods		<u>(1 559 179)</u>
Closing balance	<i>Given</i>	<u>0</u>

W4. Finished goods: 31 January 20X8

Opening balance	<i>First month of operations</i>	0
Transferred from WIP (above)		1 559 179
Less cost of goods sold	$1\,559\,179 \times 80\%$	<u>(1 247 343)</u>
Closing balance	<i>Given</i>	<u>311 836</u>

* these packing materials could also have been included in a raw materials account if preferred since it constitutes part of the final product, unlike a pure consumable (e.g. cleaning materials).

Solution 13.9 continued ...**a) continued ...****W5: Fixed manufacturing overheads (FMO)**

		C
Rent and insurance - factory	<i>140 000 for the year / 12</i>	11 667
Rent - warehouse	<i>Included: a necessary part of the production process</i>	30 000
Other fixed manufacturing overheads	<i>285 000 for January x 65%</i>	<u>185 250</u>
Total actual FMO for January		226 917
Normal units per month	<i>18 000 / 12</i>	1 500
Fixed manufacturing overheads per unit	<i>226 917 / 1 500 units</i>	151.278
Fixed manufacturing overheads allocated	<i>1 100 actual x 151.278</i>	166 406

b)**W4. Finished goods: 31 January 20X8 – after flood damage**

		C
Finished goods at cost	<i>W4</i>	311 836
Net realisable value		(295 000)
• Expected selling price	<i>Given</i>	400 000
• Costs to complete	<i>Given</i>	(90 000)
• Selling costs	<i>Given</i>	(15 000)
Inventory write down required to NRV		<u>16 436</u>
Finished goods balance as at 31 January 20X8		<u>295 000</u>

c)**PRENA LTD****NOTES TO THE FINANCIAL STATEMENTS FOR
THE MONTH ENDED 31 JANUARY 20X8****3. Inventory**

		20X8
		C
Finished goods	<i>W6</i>	295 000
Work-in-progress	<i>W3</i>	0
Raw materials	<i>W2</i>	96 809
Consumable stores	<i>W1</i>	<u>220 178</u>
		<u>611 988</u>

Solution 13.10**a)**

In terms of IAS 2.18, any costs (regardless of the amount), that are directly attributable in bringing the inventory to the location and in a condition to be used as intended by management may be capitalised to the asset. Thus the C50 000 can be included in the cost of the fabric. Note however that additional consideration must be given to calculating the net realisable value and ensuring that it is not less than this new higher cost of the fabric (or else a write down would be required).

b)

Yes, the consultant's fees may be capitalised to the cost of the baggies inventory under IAS 2.18: any costs (regardless of the amount), that are directly attributable in bringing the inventory to the location and in a condition to be used as intended by management may be capitalised to the asset.

c)

		Debit	Credit
Fixed overheads suspense account	$85\,000 \times 30$	700 000	
Bank/ creditors etc			700 000
<i>Fixed manufacturing overhead costs paid</i>			
Inventory	$(700\,000 / 100\,000 \times 85\,000)$	595 000	
Fixed overheads suspense account			595 000
<i>Allocation of fixed overheads using the BFMOAR</i>			
Fixed manufacturing overhead expense	$(700\,000 - 595\,000)$	105 000	
Fixed overheads suspense account			105 000
<i>Unallocated fixed overheads expensed</i>			
Inventory	$85\,000 \times 30$	2 550 000	
Bank/ creditors etc			2 550 000
<i>Variable costs paid and capitalised</i>			
Cost of sales	$(595\,000 + 2\,550\,000) / 85\,000 \times 75\,000$	2 775 000	
Inventory			2 775 000
<i>Cost of inventory sold:</i>			

Note: In this case, actual production was lower than normal production and thus the under-absorbed portion of fixed overheads is expensed to cost of sales. However, if actual production exceeds normal production then actual production is used as the allocation base and the total fixed overhead is absorbed into inventory.

d)

Fabric X should be valued at cost because no write down below cost to NRV is permitted if the finished goods in which the fabric is used (the T-shirts) are expected to be sold at or above cost (IAS 2.32).

Solution 14.1
MISTY RIDGE LIMITED
STATEMENT OF FINANCIAL POSITION
AT 30 APRIL 20X5

ASSETS	Notes	C
Non-current assets		
Property, plant and equipment	5	813 000
Patents and trademarks	6	45 000
		<u>1 175 700</u>
Current assets		
Inventory	7	575 700
Accounts receivable (472 700 -9 200)	8	463 500
		<u>721 500</u>
Current liabilities		
Accounts payable		259 080
Shareholders for dividends		8 000
Provision for taxation		27 520
Bank overdraft	9	18 400
		<u>313 000</u>

MISTY RIDGE LIMITED
NOTES TO THE FINANCIAL STATEMENTS
1. Accounting policies

The principal accounting policies adopted in the preparation of the financial statement are as follows:

- **Statement of compliance**

These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 1984, provisions of and directives issued under the Companies Ordinance, 1984. In case the requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

- **Accounting convention**

The financial statements have been prepared on the historical cost basis. These policies are consistent in all material respects with these applied in the previous years.

- **Property, plant and equipment**

These are stated at cost less accumulated depreciation and impairment losses except for land and building which are stated at cost. Depreciation is charged @ 10% of the cost on straight line basis over its useful life.

- **Intangible**

Intangible assets include patents and trademarks which are non monetary assets with out physical substance. These are recognized at cost, which comprises its purchase price and directly attributable expenditures.

After initial recognition an intangible asset is carried at its cost less accumulate depreciation and any impairment losses. Amortization is charged against income over the finite useful life of 10 years.

- **Inventory**

These are valued at lower of cost and NRV. Cost is determined using the following basis

Raw material	- FIFO
WIP and FG	- Actual cost including appropriate overheads

- **Accounts Receivable**

These are carried at cost less any provision for impairment.

- **Accounts Payable**

These are carried at cost which is there fair value of the consideration to be paid

Solution 14.1 continued . . .

5. Property, plant and equipment

	Land and buildings	Plant and machinery	Total
Cost			
Balance 1/5/X4	638 000	250 000	988 000
Additions			
Disposals			
Revaluation			
Balance 30/4/X5	638 000	250 000	988 000
Accumulated depreciation			
Balance 1/5/X4		50 000	95 000
Depreciation / Amortisation		25 000	35 000
Balance 30/4/X5		75 000	130 000
Carrying value			
Beginning of year	638 000	200 000	893 000
End of year	638 000	175 000	858 000

Land and buildings comprise factory and administration buildings situated at Sub 11 of Lot 888, Wadeville, Germiston.

Land and buildings

Acquired 1 April W8	580 000
Improvements: 20X0	13 000
Improvements: 20X4	45 000
	<u>638 000</u>

6. Intangible Assets

Patents and Trademarks

	C	
	30/X/X5	30/X/X4
Cost		
Opening balance	100 000	-
Additions	-	-
Disposals	-	-
Revaluation	-	-
Closing balance	<u>100 000</u>	-
Amortisation		
Opening	45 000	-
Amortization for the period	10 000	-
Closing balance	<u>55 000</u>	-
Carrying Value		
Beginning of year	<u>55 000</u>	-
End of year	<u>45 000</u>	-

The patents and trademarks have the finite useful life of 10 years. These are recognized at cost. These are amortized at 10% p.a. on a straight line basis.

7. Inventory

Inventory consists of:

Finished goods	202 000
Work-in-progress	177 300
Raw materials	196 400
	<u>575 700</u>

8. Accounts receivable

Included in accounts receivable is an amount of C5 000 owing by the managing director:

Balance at beginning of year	15 000
Advanced during year	-
	<u>15 000</u>
Repaid during the year	(10 000)
Balance at end of year	<u>5 000</u>

9. Bank overdraft

Bank overdraft facilities of the company are secured by a notarial bond over the movable assets of the company.

Solution 14.1 continued . . .**Workings**

	Plant and machinery
Carrying amount at 30/4/X5	175 000
Accumulated depreciation at 30/4/X4	50 000
Depreciation - current year	25 000
Accumulated depreciation at 30/4/X5	75 000
Cost (25 000 / 0,10)	250 000

Solution 14.2

AUBERGINE LIMITED
STATEMENT OF FINANCIAL POSITION
AS AT 30 JUNE 20X9

	Note	C
ASSETS		
Non-current assets		1 278 000
Property, plant and equipment	4	1 278 000
Current assets		208 200
Inventory	5	65 000
Accounts receivable		79 000
Bank		64 200
		<u>1 486 200</u>
EQUITY AND LIABILITIES		
Capital and reserves		1 304 800
Ordinary share capital	2	856 800
6% redeemable preference shares	2	100 000
Distributable reserves (290 000 + 78 000 – 20 000)		348 000
Non-current liabilities		70 000
10% Debentures	3	70 000
Current liabilities		117 200
Short-term loans	3	10 000
Accounts payable (101 400 – 48 840 - 18 700)		33 860
Shareholders for dividends (42 840 + 6 000)		48 840
Current tax payable		18 700
		<u>1 486 200</u>

SURF ENTERPRISES LIMITED
NOTES TO THE FINANCIAL STATEMENTS
1. Accounting policies

- Statement of compliance**

These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 1984, provisions of and directives issued under the Companies Ordinance, 1984. In case the requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

- Accounting convention**

The financial statements have been prepared on the historical cost basis. These policies are consistent in all material respects with these applied in the previous years.

- Property, plant and equipment**

Land and buildings held for the use in the production or supply of goods or services, or for administration purposes, are stated at fair value less any subsequent accumulated depreciation and subsequent impairment losses.

Depreciation is charged so as to write off the cost of assets, over their estimated useful lives using the straight line method. The estimated useful lives, residual values and depreciation method are reviewed at each year end, with the effect of any changes in estimate accounted for in a prospective basis.

- **Inventory**

Inventories are stated at the lower of cost and net realizable value. Costs are assigned to inventories on a first-in-first-out basis. Net realizable values represent the estimated selling price for inventories less all estimated costs of completion and costs necessary to make the sale.

2. Share capital

Authorised

1 000 000 ordinary shares of C1 each

100 000 6% redeemable preference shares of C1 each

Issued number of shares

856 800 ordinary shares of C1 each

100 000 6% redeemable preference shares of C1 each

The preference shares are redeemable at a premium of C0.30 per share at the option of the company at any date after 30 June 20X8.

3. Non-current liabilities

800 10% debentures of C100 each	80 000
Current amount disclosed under current liabilities	10 000
	<u>70 000</u>

The debentures are secured by a mortgage bond over land and buildings, with a book value of C1 118 000, and are repayable in annual instalments of C10 000, the last instalment being due on 31 December 19Y6.

4. Property, plant and equipment

	Land and buildings	Plant and machinery	Furniture and fittings	Total
Cost / Valuation				
Balance 1/7/X8	1 350 000	[^] 150 000	10 000	1 510 000
Additions			4 000	4 000
Disposals				-
Revaluation decrease	(170 000)			(17 000)
Balance 30/6/X9	<u>1 180 000</u>	<u>150 000</u>	<u>14 000</u>	<u>1 344 000</u>
Accumulated depreciation				
Balance 1/7/X8		30 000	5 500	35 500
Depreciation		30 000	500	30 500
Disposal				
Impairment				
Balance 30/6/X9		<u>60 000</u>	<u>6 000</u>	<u>66 000</u>
Carrying value				
Beginning of year	1 350 000	120 000	4 500	1 474 500
End of year	<u>1 180 000</u>	[^] 90 000	<u>8 000</u>	<u>1 278 000</u>

[^] Cost* – 0,40Cost = C90 000

*Cost = C150 000

Solution 14.2 continued . .

Land and buildings are situated on 82-E, Port Qasim.

Land and buildings

Acquired 1 June 20X4	1 200 000
Revaluation: 20X6	150 000
Revaluation decrease: 20X9	(170 000)
	<u>1 180 000</u>

Land and buildings are revalued every three years. The valuation was carried out by Consulting Engineers CC, who are independent appraisers.

5. Inventory

Merchandise	65 000
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Solution 14.3

a) Journal entries for equipment

		Debit	Credit
01/01/X3	Equipment	2 400 000	
	VAT input	336 000	
	Bank		2 736 000
	<i>(2 736 000 X 100/114)</i>		
31/12/X3	Depreciation expense	480 000	
	Accumulated depreciation		480 000
	<i>(2 400 000 / 5)</i>		
	Taxation expense	96 000	
	Deferred taxation		96 000
	<i>(800 000 – 480 000) X 0.30</i>		
<i>20X3 entries given for information – not required for answer</i>			
01/01/X4	Deferred taxation	3 200	
	Taxation expense		3 200
	<i>Change in tax rate (320 000 X 0.01)</i>		
	Accumulated depreciation	480 000	
	Cost		480 000
	<i>(Reversal of accumulated depreciation)</i>		
	Machine A	3 080 000	
	Revaluation surplus		2 186 800
	Deferred taxation		893 200
	<i>(3 080 000 X 0.71) (3 080 000 X 0.29)</i>		
31/12/X4	Depreciation expense	1 250 000	
	Accumulated depreciation		1 250 000
	<i>(5 000 000 / 4)</i>		
	Deferred taxation	130 500	
	Taxation expense		130 500
	<i>(450 000 X 0.29)</i>		
	Revaluation surplus	546 700	
	Retained earnings		546 700
	<i>(2 186 800 / 4)</i>		
	<i>or (1 250 000 – 480 000) X 0.71</i>		

Solution 14.3 continued ...

b) Notes to taxation and deferred taxation for 20X4

Note		C	%
Taxation			
Normal tax			
Current	See current tax working	1 010 300	
Deferred			
- Rate change	(1 600 + 3 200)	(4 800)	
- Temporary differences	[(855.5 – 893.2 – 92.8) – 46.4] * 1 000	(176 900)	
Income tax expense		828 600	
Tax rate reconciliation			
Profit before tax / Applicable rate	(2 900 000 X 0,29)	841 000	29.00
Dividends received	(40 000 X 0,19)	(7 600)	(0.26)
Rate change		(4 800)	(0.17)
Income tax expense / Effective rate		828 600	28.57
Deferred taxation			
Capital allowances on property, plant & equipment		855 500	

c) Notes to Property, plant and equipment for 20X4

	Total C	Vehicles C	Equipment C
Net carrying amount: 01/01/X3	3 600 000	1 200 000	2 400 000
Gross carrying amount	3 600 000	1 200 000	2 400 000
Accumulated depreciation	0	0	0
Depreciation	(720 000)	(240 000)	(480 000)
Net carrying amount: 01/01/X4	2 880 000	960 000	1 920 000
Gross carrying amount	3 600 000	1 200 000	2 400 000
Accumulated depreciation	(720 000)	(240 000)	(480 000)
Revaluation	3 080 000	-	3 080 000
Depreciation	(1 490 000)	(240 000)	(1 250 000)
Disposals	(720 000)	(720 000)	-
Net carrying amount: 31/12/X4	3 750 000	-	3 750 000
Gross carrying amount	5 000 000	-	5 000 000
Accumulated depreciation	(1 250 000)	-	(1 250 000)
Net carrying amount on historic cost	1 440 000	-	1 440 000

The last revaluation was performed on 1 January 20X4 by an independent sworn appraiser to the fair value in use on a net replacement value basis. Revaluations are performed annually.

Solution 14.3 continued ...

Workings

Equipment

		HCA	ACA	TB	TD	DT		RS	RE
01/01/X3	Cost	2 400	2 400	2 400					
31/12/X3	Depreciation / Tax allowance	(480)	(480)	(800)	320	96	Dr TE Cr DT		
		1 920	1 920	1 600	320	96			
01/01/X4	Decrease in tax rate					(3,2)	Cr Dr DT Cr TE		
						92,8	Cr		
	Revaluation	-	3 080	-	3 080	893,2	Cr	2 186,8	
		1 920	5 000	1 600	3 400				
31/12/X4	Depreciation / Tax allowance	(480)	(1 250)	(800)	(450)	(130,5)	Dr DT Cr TE	(546,7)	546,7
		1 440	3 750	800	2 950	855,5	Cr		

Vehicle

		ACA	TB	TD	DT	
01/01/X3	Cost	1 200	1 200			
31/12/X3	Depreciation / tax allowance	(240)	(400)	160	48	Dr TE Cr DT
		960	800	160	48	Cr (30%)
01/01/X4	Change in tax rate				(1,6)	Dr DT Cr TE
					46,4	Cr (29%)
31/12/X4	Depreciation / tax allowance	(240)	(400)	160	46,4	Dr TE Cr DT
		720	400	320	92,8	Cr
	Sale	(720)	(400)	(320)	(92,8)	
		0	0	0	0	

Tax computation (Current tax)

Profit before tax	2 900 000
Less:	
Capital gain	(780 000)
(150 000 – 720 000)	
Add: Tax gain on disposal	1 100 000
(150 000 – (1 200 000 – 40 000 – 40 000))	
Add: Accounting depreciation	1 490 000
(1 250 000 + 240 000)	
Less: Tax depreciation	(1 200 000)
(800 000 + 400 000)	
	3 510 000
Less: Dividend income	(40 000)
Taxable income	3 470 000
Tax @ 29%	1 006 300
Add: Tax on dividend @ 10%	4 000
(40 000 * 10%)	

1 010 300

Solution 14.4

a)

READ LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 MAY 20X6

	C
Profit before tax	1 720 000
Taxation expense	(490 150)
Profit for the period	1 229 850
<i>Other comprehensive income</i>	-
Total comprehensive income	1 229 850

b)

	Dr	Cr
Taxation expense	2 750	
Current tax payable		2 750
<i>Underprovision from previous year</i>		
Current tax payable	11 550	
Bank		11 550
<i>Settlement of amount owing</i>		
Taxation expense	603 400	
Current tax payable		603 400
<i>20X6 current tax</i>		
Deferred tax	116 000	
Taxation expense		116 000
<i>20X6 deferred tax movement</i>		
<i>Or, by type of temporary difference</i>		
Taxation expense	30 450	
Deferred taxation		30 450
<i>Originating temporary difference on equipment</i>		
Deferred tax	149 350	
Taxation expense		149 350
<i>Reversing temporary difference on sale of equipment</i>		
Taxation expense	5 800	
Deferred taxation		5 800
<i>Reversing temporary difference on income in advance</i>		
Deferred tax	2 900	
Taxation expense		2 900
<i>Reversing temporary difference on expenses prepaid</i>		
Current tax payable	450 000	
Bank		450 000
<i>20X6 provisional payment</i>		

Solution 14.4 continued ...

c)

READ LIMITED

NOTES TO THE FINANCIAL STATEMENTS

		20X6 C
Taxation		
Normal tax		490 150
Current tax		603 400
Deferred tax	(30 450 – 149 350 + 5 800 – 2 900)	(116 000)
Underprovision of current tax in prior year		2 750
Income tax expense		490 150
	%	
Tax rate reconciliation		
Tax expense on profit / applicable rate	29.00	498 800
Dividend taxed at lower rate (60 000 * 19%)	(0.66)	(11 400)
Under provision in prior year	0.16	2 750
Tax expense / effective rate	28.50	490 150

READ LIMITED

NOTES TO THE FINANCIAL STATEMENTS

		20X6 C	20X5 C
Deferred tax liability			
Property, plant & equipment		-	118 900
Expenses prepaid		8 700	11 600
Income in advance		(2 900)	(8 700)
		5 800	121 800
Plant			
Carrying amount at beginning of year		760 000	820 000
Cost		1 000 000	1 000 000
Accumulated depreciation		(240 000)	(180 000)
	X5 [(820 000 – 355 000) / 93 X 12]		
Depreciation expense	X6 [(820 000 – 355 000) / 93 X 9] or [(760 000 – 355 000) / 81 X 9]	(45 000)	(60 000)
Sale of plant		(715 000)	-
Purchase of plant		2 000 000	-
Carrying amount at end of year		2 000 000	760 000
Cost		2 000 000	1 000 000
Accumulated depreciation		-	(240 000)

Solution 14.4 continued ...

Workings

1. Deferred tax computation

			CA	TB	TD	DT	
Old equipment							
01/03/X2	Cost		1 000 000	1 000 000	0	0	
01/03/X2 – 30/05/X4	Accumulated depreciation / tax allowance	(*800 000 X 0.10 X 2.25) *(1 000 000 – 200 000) / (1 000 000 X 0.20 X 2.25)	(180 000)	(450 000)	270 000	78 300	Cr
			820 000	550 000	270 000	78 300	Cr DTL
01/06/X4 – 30/05/X5	Depreciation / tax allowance	(*465 000 / ^93 X 12) *(820 000 – 355 000) ^ (7yrs 9mths) / (1 000 000 X 0.20)	(60 000)	(200 000)	140 000	40 600	Cr
			760 000	350 000	410 000	118 900	Cr DTL
01/06/X5 – 28/02/X6	Depreciation / tax allowance	(465 000 / 93 X 9) (1 000 000 X 0.20 X 9/12)	(45 000)	(150 000)	105 000	30 450	Cr
			715 000	200 000	515 000	149 350	Cr
28/02/X6	Sale		(715 000)	(200 000)	(515 000)	(149 350)	Dr
			-	-	-	-	
New equipment							
31/05/X6	Cost		2 000 000	2 000 000	0	0	
30/05/X5	Income in advance		30 000	0	30 000	8 700	Dr DTA
						(5 800)	Cr DT Dr TE
30/05/X6	Income in advance		10 000	0	10 000	2 900	Dr DTA
30/05/X5	Expenses prepaid		40 000	0	40 000	11 600	Cr DTL
						(2 900)	Dr DT Cr TE
30/05/X6	Expenses prepaid		30 000	0	30 000	8 700	Cr DTL

Solution 14.4 continued ...

2. Plant

	CA	TB
Balance at 28/02/X6	715 000	200 000
Selling price	1 500 000	1 500 000
	785 000	1 300 000

3. Current tax computation

Profit before tax	1 720 000	
<i>Less:</i>		
Accounting gain (1 500 000 – 715 000)	(785 000)	
Dividend income	(60 000)	
Tax depreciation	(150 000)	
Unearned income	(20 000)	
<i>Ad:</i>		
Taxable capital gain (1 500 000 – 200 000)	1 300 000	
Accounting depreciation	45 000	
Prepaid expenses	10 000	
	2 060 000	
Tax @ 29%	597 400	
Tax on dividend income @ 10%	6 000	
	603 400	

4. Tax provision / payment

20X5 assessment	240 000	240 000
Provided / Provisional payments	(237 250)	(228 450)
Under-provision / Top-up	2 750	11 550
	Dr TE Cr CTP	Dr CTP Cr Bank

Solution 14.5

(a) Extracts from the statement of comprehensive income, statement of financial position and statement of changes in equity

ENVIRONMENTAL LIMITED (EXTRACT FROM) STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 JUNE 20X7		
	Note	C
Profit before tax	2	880 000
Income tax expense (282 750 – 27 550 + 5 140)	3	(260 340)
Profit for the period		619 660
<i>Other comprehensive income</i>		
Revaluation decrease		(71 000)
Total comprehensive income		548 660

ENVIRONMENTAL LIMITED (EXTRACT FROM) STATEMENT OF FINANCIAL POSITION FOR THE YEAR ENDED 30 JUNE 20X7		
	Note	C
Non-current assets		
Property, plant and equipment	4	400 000
Deferred tax	5	15 660
Current liabilities		
Current tax payable		50 250

ENVIRONMENTAL LIMITED (EXTRACT FROM) STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 30 JUNE 20X7		
	Revaluation reserve C	Retained earnings C
01/07/X6 Balance	106 500	3 081 000
Total comprehensive income	(71 000)	619 660
Transfer to retained earnings	(35 500)	35 500
30/06/X7 Balance	-	3 736 160

Solution 14.5 continued ...**(b) Extracts from notes to the financial statements**

ENVIRONMENTAL LIMITED
(EXTRACT FROM) NOTES TO THE FINANCIAL STATEMENTS
AT 30 JUNE 20X7

1 Accounting policies***Property, plant and equipment***

Plant is stated at revalued amount, being the fair value at the date of revaluation less subsequent accumulated depreciation and subsequent accumulated impairment losses. The plant is revalued annually.

Depreciation is charged so as to write off the cost or valuation of assets over their estimated useful lives, using the straight line method.

Deferred tax

Deferred tax is provided using the balance sheet liability method, on all the temporary differences at the balance sheet date between the tax base of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred tax asset are recognized for all deductible temporary differences, carry forward of unused tax losses, to the extent that is probable that future taxable profit will be available against which the deductible temporary difference, unused tax losses and tax credits can be utilized.

Carrying amount of deferred tax asset is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that the related tax benefit will be realized. Deferred tax is calculated at the rates that are expected to apply to the period when differences reverse based on the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.

C**2 Profit before tax**

Profit before tax is stated after taking into account the following:

Depreciation	275 000
Revaluation expense	50 000

3 Taxation

Normal tax		
- Current tax	W3	282 750
- Prior year under-provision	(326 750 – 321 610)	5 140
- Deferred tax	W1 / W2	(27 550)
Income tax expense		<u>260 340</u>

4 Tax on other comprehensive income

Revaluation decrease on plant	
Net	(71 000)
Gross	(100 000)
Tax	<u>29 000</u>

Solution 14.5 continued ...

C

5 Property, plant and equipment*Plant*

Net carrying amount at 01/07/X6:	825 000
Gross carrying amount (900 000 – 225 000 + 150 000)	825 000
Accumulated depreciation	(0)
Depreciation	(275 000)
Revaluation decrease	(150 000)
Net carrying amount at 30/06/X7	400 000
Gross carrying amount (825 000 – 275 000 – 150 000)	400 000
Accumulated depreciation	(0)
Carrying amount using the cost model	450 000

The plant has been revalued at 30 June 20X7, by an independent valuer, with reference to discounted cash flows.

6 Deferred tax asset/ (liability) (W2)

The deferred tax balance comprises temporary differences caused by:

Property, plant and equipment	14 500
Prepaid expenses	(2 320)
Income in advance	3 480
	15 660

Solution 14.5 continued ...

Workings

W1. HCA / ACA & Deferred tax			HCA	ACA	TB	TD	DT	C	
01/07/X5	Cost		900	900	900				
30/06/X6	Depreciation / tax allowance	(900 / 4)	(225)	(225)	(225)				
			675	675	675				
	Revaluation		-	150	-	150	43.5		106.5
	Balance		675	825	675	150	43.5	Cr	106.5
30/06/X7	Depreciation / tax allowance	*(825 / 3)	(225)	*(275)	(225)	(50)	(14.5)	Dr	
	Transfer of RS to RE	[(275 - 225) X 0.71] or (106.5 / 3)							(35,5)
			450	550	450	100	29	Cr	71
	Revaluation decrease			(150)					
	(Reversal of RS)			(100)		(100)	(29)	Dr	(71)
	(Revaluation expense)			(50)		(50)	(14,5)	Dr	
	Balance		450	400	450	(50)	(14.5)	Dr	-
30/06/X8	Depreciation / tax allowance	*(400 / 2)	(225)	*(200)	(225)	25	7.25	Cr	
	Balance		225	200	225	(25)	(7.25)	Dr	-

Not required for answer

W2:Deferred tax summary		CA	TB	TD	DT	
30/06/X6	Plant	825 000	675 000	15 000	43 500	L
	Interest in advance	(15 000)	0	(15 000)	(4 350)	A
	Rent prepaid	6 000	0	6 000	1 740	L
					40 890	L
30/06/X7	Plant	400 000	450 000	(50 000)	(14 500)	A
	Interest in advance	(12 000)	0	(12 000)	(3 480)	A
	Rent prepaid	8 000	0	8 000	2 320	L
					(15 660)	A
	Movement X6 – X7				56 550	Dr
	Reversal of RS				(29 000)	Dr
	Net I/S movement				27 550	Dr

Solution 14.5 continued ...

W3: Current tax computation	C	X 0.29	
Profit before tax	880 000	255 200	
Temporary differences	95 000	27 550	Dr Deferred tax Cr Tax expense
+ depreciation	275 000		
- tax allowance	(225 000)		
+ revaluation expense	50 000		
+ Rent prepaid X6	6 000		
- Rent prepaid X7	(8 000)		
- Interest in advance X6	(15 000)		
+ Interest in advance X7	12 000		Dr Tax expense
Taxable profit	975 000	282 750	Cr Current tax payable

W4: Current tax payable			
<i>Description</i>	<i>C</i>	<i>Description</i>	<i>C</i>
Bank	10 015	Balance	4 875
(4 875 + 5 140)			
Bank (1 st p/p)	150 750	Tax expense (Under-provision)	5 140
Bank (2 nd p/p)	182 250	Tax expense (current)	282 750
Balance	50 250		
	291 525		291 525
		Balance	50 250

Solution 15.1

Journals	Debit	Credit
<i>30 May 20X4</i>		
Bank (10 000 x 6)	60 000	
Ordinary shares (10 000 x 1)		10 000
Share premium (balancing)		50 000
<i>Rights issue at C6 (market price of C9)</i>		
Share premium	15 000	
Bank		15 000
<i>Share issue expenses written off</i>		
Share premium (30 000 + 50 000 – 15 000)	65 000	
Retained earnings (balancing)	47 000	
Ordinary share capital (112 000 x C1)		112 000
<i>Capitalisation issue of ordinary shares</i>		
<i>112 000 (W1) x C1 PV = 112 000</i>		

W1: Number of shares issued in terms of the capitalization issue	Actual
Opening balance	270 000
Rights issue	10 000
	<u>280 000</u>
Capitalisation issue $280\,000 / 5 \times 2$	112 000
Closing balance	<u>392 000</u>

Solution 15.2

a)

**WOLVERINE LIMITED
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 MARCH 20X3**

	Share capital	Share premium	Preference share capital	Non distributable reserve	Retained earnings	Total
	C	C	C	C	C	C
Balance at 31 March 20X1	1 800 000	150 000	500 000	100 000	9 500 000	12 050 000
Share issue on 1 July 20X1	200 000	40 000	-	-	-	240 000
Share issue expenses	-	(10 000)	-	-	-	(10 000)
Total comprehensive income	-	-	-	-	930 000	930 000
Preference dividend declared	-	-	-	-	(60 000)	(60 000)
Balance at 31 March 20X2	2 000 000	180 000	500 000	100 000	10 370 000	13 150 000
Capitalisation issue	500 000	(180 000)	-	-	(320 000)	-
Total comprehensive income	-	-	-	50 000	1 100 000	1 150 000
Ordinary dividend declared	-	-	-	-	(125 000)	(125 000)
Preference dividend declared	-	-	-	-	(60 000)	(60 000)
Balance at 31 March 20X3	2 500 000	-	500 000	150 000	10 965 000	14 115 000

b)

**WOLVERINE LIMITED
EXTRACT OF NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 MARCH 20X3**

3. Earnings per share

Earnings per share is based on earnings of C 1 040 000 (20X2: 870 000) and on a weighted average of 2 500 000 shares (20X2: 2 437 500). There was a capitalisation issue during the year of 1 share for every 4 shares held. Comparative number of shares have been restated.

	20X3	20X2
Profit for the period	1 100 000	930 000
Preference dividend declared	(60 000)	(60 000)
Earnings	1 040 000	870 000

Solution 15.2 continued . . .

4. Share capital

Authorised

5 000 000 ordinary shares of C1 each.

100 000 12% non-cumulative preference shares of C5 each.

Issued	20X3 C	20X2 C
2 500 000 ordinary shares of C1 each	2 500 000	
2 000 000 ordinary shares of C1 each		2 000 000
100 000 12% non-cumulative preference shares of C5 each	500 000	500 000

50 000 shares were taken up by the directors wives in 20X2.

In terms of members resolution 101, the un-issued shares are under the unrestricted control of the directors until the next annual general meeting.

Reconciliation of number of shares

	Ordinary	Preference
Balance at 01 April 20X1	1 800 000	100 000
Share issue on 1 July 20X1	200 000	-
Balance at 31 March 20X2	2 000 000	100 000
Capitalisation issue on 31 December 20X2	500 000	-
Balance at 31 March 20X3	2 500 000	100 000

Workings: Weighted average number of shares

	Total	20X3	20X2
01/04/X1 Balance	1 800 000	1 800 000	1 800 000
01/07/X1 Share issue (X2 : X 9/12)	200 000	200 000	150 000
31/03/X2 Balance	2 000 000	2 000 000	1 950 000
31/12/X2 Capitalisation issue	500 000	500 000	487 500
31/03/X3 Balance	2 500 000	2 500 000	2 437 500

Solution 15.3

KLAUS LIMITED
EXTRACT FROM STATEMENT OF FINANCIAL POSITION
AS AT 30 JUNE 20X5

		Note	20X5 C	20X4 C
EQUITY & LIABILITIES				
Capital and reserves				
Share capital	215 000 + 73 600	2	258 880	215 000
Preference shares			0	100 000
Distributable reserves – retained earnings	140 000 – 3 000		140 000	X
Share premium account			26 720	15 000
Non-current liabilities				
Cl debentures		3	29 400	0

KLAUS LIMITED
(EXTRACT FROM) STATEMENT OF CHANGES IN EQUITY
AT 30 JUNE 20X5

	Ordinary stated capital C	Preference share capital C	Retained earnings C	Share premium account	Total C
(Preliminary) Balance 30/6/X5	200 000	100 000	140 000	15 000	455 000
Shares issued during the year	58 880			14 720	73 600
Preference shares redeemed		(100 000)			(100 000)
Premium on redemption written off				(3 000)	(3 000)
Balance 30/6/X5	258 880	0	140 000	26 720	425 600

Solution 15.3 continued

EXTRACT FROM THE NOTES TO THE FINANCIAL STATEMENTS

2. Share capital

Authorised

300 000 ordinary shares of no par value
100 000 16% preference shares of C1 each

Issued

	Ordinary Number	Preference Number
Number of shares in issue at beginning of year	200 000	100 000
Issued during the year (<i>W1</i>)	58 880	
Redeemed during the year		(100 000)
Number of shares in issue at end of year	<u>258 880</u>	<u>-</u>

3. Non-current liabilities

30 000 debentures of C1 each	30 000
Debenture discount unamortised	<u>(600)</u>
	<u>29 400</u>

Workings

W1 Financing

Cash needed (100 000 + 3 000)	<u>103 000</u>
Cash resources	
- Debentures (30 000 x 0.98)	29 400
- Fresh issue required (103 000 – 29 400)	<u>73 600</u>
	<u>103 000</u>

Issue price	
Number of shares issues (73 600 / 1.25)	58 880

W2 Premium written off

- Retained earnings	3 000
- Share premium	<u>3 000</u>
	<u>-</u>

Solution 15.4

a) Calculation of number of shares to be issued

Cash required		
Preference shares	120 000 x C0.50	60 000
Premium	120 000 x C0.05	6 000
Dividend	(15% x 120 000 x C0.50 x 4/12)	3 000
		<u>69 000</u>
Cash		
Balance 29/4/X9	given	8 000
Share issue expenses		<u>(1 200)</u>
		6 800
Balance to remain		<u>(3 000)</u>
Cash available before loan		3 800
Loan raised		<u>40 000</u>
Cash available after loan		43 800
Cash required		<u>(69 000)</u>
Shortage of cash to be resolved through share issue		<u>25 200</u>
Share price		2.50
Number of shares	(25 200 / C2.50)	10 080

b) Proof that scheme will fulfill directors' requirements

Retained earnings		
Balance 30/4/X9		120 000
		(5 160)
Dividend	120 000 x 0.50 x 15% x 4/12	(3 000)
Premium on redemption	W1	(960)
Share issue expenses	Given	(1 200)
		<u>114 840</u>
Balance		114 840
Less balance to remain		<u>(70 000)</u>
Excess profits available	(therefore the plan works)	<u>44 840</u>

If 10 080 shares are issued then a balance of C3 000 will remain on the cash account and a balance in excess of C70 000 will remain on the retained earnings account. Therefore, the directors' requirements are met.

Workings

W1: Premium

- Share premium	(10 080 x C0.50)	5 040
- Retained earnings	(Balancing because directors want to use share premium to maximum extent possible)	960

Solution 15.5

a) Effective interest rate table: 14.808368%

	Interest	Payments/ Dividends	Premium accrued	Balance
01/01/20X1				3 000 000
31/12/20X1	444 251	(300 000)	144 251	3 144 251
31/12/20X2	465 612	(300 000)	165 612	3 309 863
31/12/20X3	490 137	(300 000)	190 137	3 500 000
		(3 000 000)	(500 000)	0
	1 400 004	(3 900 000)	0	0

b) Statement of financial position disclosure

YUSUF LIMITED
STATEMENT OF FINANCIAL POSITION
AT 31 DECEMBER 20X2

	20X2 C	20X1 C
<i>EQUITY AND LIABILITIES</i>		
Non-current liabilities		
Preference shares	0	3 144 251
Current liabilities		
Preference shares	3 309 863	0

c) Calculation of number of shares to be issued:

Cash required:		
Redemption of preference shares	Excludes the preference dividends of 300 000 because these are to be paid out of currently available cash resources	3 500 000
Cash raised:		
Loan		1 800 000
Cash still needed		1 700 000
Issue price per share		2.50
Number of shares to be issued		680 000

Solution 15.5 continued ...

d) Journals

	Debit	Credit
Interest (expense) (<i>per (a) above</i>)	490 137	
Preference shares (liability)		190 137
Bank		300 000
<i>Effective interest and dividend payment</i>		
<hr/>		
Preference shares (liability)	3 500 000	
Preference shareholders (current liability)		3 500 000
<i>Preference share capital and dividends to be redeemed</i>		
<hr/>		
Preference shareholders (current liability)	3 500 000	
Bank (<i>per (c) above</i>)		3 500 000
<i>Redemption of preference shares</i>		
<hr/>		
Bank (<i>per (c) above</i>)	1 800 000	
Loan (liability)		1 800 000
<i>Raising of loan</i>		
<hr/>		
Bank (<i>per (c) above</i>)	1 700 000	
Share capital (equity)		1 360 000
Share premium (equity)		340 000
<i>Issue of ordinary shares</i>		
<hr/>		
Share premium (equity)	20 000	
Bank		20 000
<i>Share issue costs written off against share premium</i>		
<hr/>		

Working

Share premium	500 000
Share premium	0
Retained earnings	500 000

Note: The question stated that the premium on redemption is to be set off against profits. As the preference shares were classified as a liability, finance charges using the effective interest rate method already allocated the premium to profit and loss, and thus no additional journal is necessary for the transfer to retained earnings.

Solution 15.6

JOURNAL			
Date	Description	Debit	Credit
20Y0			
	Interest expense (Preference share dividend)	12 140	
	Preference shares (NCL) (W5)		2 140
	Preference shareholders (CL)		10 000
	<i>Dividend for the year& premium accrued</i>		
	Preference share	110 000	
	Preference shareholders	10 000	
	Bank		120 000
	Bank (W6)	24 000	
	Share capital		24 000
	<i>10 000 ordinary shares issued at C2.40 per share</i>		
	Bank (W6)	96 000	
	10% debentures (NCL)		96 000
	<i>10% Debentures issued: 9 600 x C10 each</i>		

Solution 15.6 continued ...

Workings

W1 Fresh issue of shares required

Authorised shares	310 000
Issued shares	(300 000)
Fresh issue of shares	<u>10 000</u>

W2 Financing

Cash needed	(capital: 50 000 x C2.20 + dividend: 50 000 x C2 x 10%)	<u>120 000</u>
Cash resources from:		
- Fresh issue of ordinary shares	10 000 (W1) X C2.40	24 000
- Fresh issue of debentures required	(balancing)	<u>96 000</u>
		<u>120 000</u>

W3 Premium to be set off against:

50 000 x C0.2	
- Retained earnings	(already done via interest charge)
	<u>10 000</u>

W4 Cash flow

	Inflow/ (outflow)	Calculations
1/1/X5	100 000	
31/12/X5	(10 000)	50 000 x C2 x 10%
31/12/X6	(10 000)	50 000 x C2 x 10%
31/12/X7	(10 000)	50 000 x C2 x 10%
31/12/X8	(10 000)	50 000 x C2 x 10%
31/12/X9	(10 000)	50 000 x C2 x 10%
31/12/Y0	(120 000)	50 000 x C2 x 10% + 50 000 x C2.20

The effective interest rate is 11.25563551% (using a financial calculator).

W5 Preference shares

	Interest	Dividend	Premium	Premium balance	PV
1/1/X5					100 000
31/12/X5	11 256	(10 000)	1 256	1 256	101 256
31/12/X6	11 397	(10 000)	1 397	2 653	102 653
31/12/X7	11 554	(10 000)	1 554	4 207	104 207
31/12/X8	11 729	(10 000)	1 729	5 936	105 936
31/12/X9	11 924	(10 000)	1 924	7 860	107 860
30/12/Y0	12 140	(10 000)	2 140	10 000	110 000
	<u>70 000</u>	<u>60 000</u>			

Solution 15.7

RFK LIMITED
STATEMENT OF FINANCIAL POSITION
AT 28 FEBRUARY 20X5

			20X5	20X4
<i>EQUITY AND LIABILITIES</i>			C	C
Capital and reserves		Note	1 168 200	995 000
		2		
Non-current liabilities				
Debentures	W1		25 000	0
Current liabilities				
12% Redeemable preference share capital	W5		-	155 620
Bank overdraft	(30K + 9K + 18K)		57 000	xxx
Current tax payable			30 670	

RFK LIMITED
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 28 FEBRUARY 20X5

	Ordinary share capital	Share premium	Retained earnings	Total
	C	C	C	C
Balance 1/3/X4	400 000	480 000	115 000	995 000
Ordinary shares issued during year	106 000	26 500		132 500
Share issue expenses written off		(9 000)		(9 000)
Total comprehensive income			49 700	49 700
Transfer of premium on redemption from share premium		(7 500)	7 500	0
	506 000	490 000	172 200	1 168 200

Solution 15.7 continued ...

**EXTRACT FROM NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 28 FEBRUARY 20X5**

1. Accounting policies

Preference shares

Preference shares, which are redeemable at the option of the shareholder, are presented as long-term liabilities, as they are in substance borrowings. The dividends on such preference shares are recognised in the statement of comprehensive income as interest expense on the effective interest rate basis.

2. Ordinary shares

Authorised

1 000 000 ordinary shares of C1 each	1 000 000
--------------------------------------	-----------

Issued

	R
506 000 shares of C1 each	506 000

	Quantity
Number of shares in issue at the beginning of the year	400 000
Number of shares issued during the year	106 000
Number of shares in issue at the end of the year	<u>506 000</u>

The directors have been granted permission to issue the unissued ordinary shares at their sole discretion. Such authority is exercisable until the next annual general meeting.

2. Redeemable preference shares

Authorised	C
100 000 12% redeemable preference shares of C2 each	200 000

Issued	Quantity
Number of shares in issue at the beginning of the year	75 000
Shares redeemed during the year	<u>(75 000)</u>
Number of shares in issue at the end of the year	<u>-</u>

The preference shares were redeemed, at the option of the shareholders, on 28 February 20X5 at a premium of C0.10 per share. The 12% preference dividends are cumulative. The effective interest rate is 12.7750262%.

Solution 15.7 continued . .

Workings

W1 Cash required from issue of ordinary shares

		C
Redemption of 75 000 12% preference shares at C2.00 each		150 000
Premium of C0.10 per share		7 500
		<u>157 500</u>
Cash received from debenture issue	100 x C250	(25 000)
Cash required from issues of shares		<u>132 500</u>

$$\therefore \text{Number of shares to be issued} = \frac{\text{C132 500}}{\text{C1.25}} = 106\,000$$

Note: the issue expenses and preference dividends will be financed by utilising the bank overdraft.

W2 Share premium

Premium

- Share premium*	7 500
- Retained earnings	-
	<u>7 500</u>

* Debit Share premium 7 500
Credit Retained earnings 7500

Reversing the effect of the premium portion of the interest charge to share premium (because the directors want maximum distributable reserves).

W3 T-accounts

ORDINARY SHARE CAPITAL				SHARE PREMIUM			
Description	C	Description	C	Description	C	Description	C
		Balance	400 000	Share issue expenses	9 000	Balance	480 000
		Bank	106 000	Retained earnings	7 500	Bank	26 500
Balance	506 000			Balance	490 000		
	506 000		506 000		506 500		506 500
		Balance	506 000			Balance	490 000

RETAINED EARNINGS			
Description	C	Description	C
		Balance	115 000
		Profit and loss (W4)	49 700
Balance	172 200	Share premium	7 500
	172 200		172 200
		Balance	172 000

Solution 15.7 continued ...

W4 Profit for the period

Profit before finance charges and tax		98 000
Finance charges	W5	<u>(19 880)</u>
Profit before tax		78 120
Tax expense	W6	<u>(28 420)</u>
Total comprehensive income		<u>49 700</u>

W5 Preference shares

Cash flow

1/3/X0	150 000	
28/2/X1	(18 000)	
28/2/X2	(18 000)	
28/2/X3	(18 000)	
28/2/X4	(18 000)	
28/2/X5	(175 500)	(157 500 + 18 000)

	Interest 12,775%	Dividend	Premium	Premium balance	PV
28/2/X0					150 000
28/2/X1	19 163	(18 000)	1 163	1 163	151 163
28/2/X2	19 311	(18 000)	1 311	2 474	152 474
28/2/X3	19 479	(18 000)	1 479	3 953	153 953
28/2/X4	19 667	(18 000)	1 667	5 620	155 620
28/2/X5	19 880	(18 000)	1 880	7 500	157 500
	<u>97 500</u>	<u>(90 000)</u>			

W6 Tax calculation

Profit before tax		78 120
<i>Permanent differences:</i>		
Finance charge		<u>19 880</u>
Taxable profit		<u>98 000</u>
Tax at 29%	(98 000 x 29%)	<u>28 420</u>

Solution 15.8

	Debit	Credit
Interest expense (53 770 x 11.5870684%)	6 230	
Bank		5 000
Preference share liability		1 230
<i>Recording of preference dividend paid</i>		
Preference dividends	5 000	
Bank		5 000
<i>Preference dividend paid</i>		
Preference share liability	50 000	
Preference shareholders		50 000
<i>Redemption of preference shares</i>		
Bank	22 500	
Share capital		15 000
Share premium		7 500
<i>Issue of ordinary shares (55 000 – 32 500 cash)</i>		
Share issue expenses	2 750	
Bank		2 750
<i>Share issue expenses</i>		
Share premium	2 750	
Share issue expenses		2 750
<i>Write-off of share issue expenses against share premium</i>		
Share premium	5 000	
Retained earnings		5 000
<i>Premium offset against share premium</i>		
Preference shareholders	55 000	
Bank		55 000
<i>Payment of preference shareholders</i>		

(b)

Tax expense		C
Current	[(120 000 + 6 230 interest) X 0.29]	36 607
Deferred		-
		<u>36 607</u>
Tax rate reconciliation	%	
Tax expense on profit	29.0	34 800
On amortization of preference shares	1.5	<u>1 807</u>
	31.5	<u>36 607</u>

Workings

Financing requirements		
Nominal value	(50 000 X C1)	50 000
Premium on redemption	(50 000 X C0.10)	5 000
		<hr/> 55 000
Cash reserves		<hr/> (32 000)
Issue of ordinary shares		<hr/> 22 500

Solution 15.9

a) Definitions:

i) Liability:

- Present obligation of the entity
- As a result of a past event
- The settlement of which will result in an outflow of future economic benefits.

ii) Equity:

- The net increase in assets after deducting liabilities

iii) Expense:

- A decrease in economic benefits
- During the accounting period
- Through an increase in liabilities or decrease in assets
- Resulting in a decrease in equity, other than a distribution to equity participants.

b) Discussion: Recognition

i) Recognition of the initial issue of preference shares:

Liability:

- Since Keeptrying Ltd's preference shares are compulsorily redeemable, they represent a present obligation of the entity.
- The past event is the issue of these shares on 1 January 20X3.
- The settlement of this obligation will result in an outflow of cash of C420 000 (in respect of the par value of the shares: C300 000, the premium: C30 000 and the annual dividends: $C30\,000 \times 3\text{ years} = C90\,000$).

The preference shares therefore meet the definition of a liability.

Equity:

- Since bank (an asset) and preference shares (a liability) were both increased, there is no impact on equity.

ii) Recognition of the redemption of preference shares:

Expense:

- A decrease in economic benefits: cash outflow
- During the accounting periods: 20X5
- Through an increase in liabilities or decrease in assets: decrease in bank (i.e. an asset decreased).

Solution 15.9 continued . . .

- Resulting in a decrease in equity, other than a distribution to equity participants:
 - Since the issue of the preference shares represents a liability, none of the payments to the preference shareholders represent distributions to equity participants.
 - Since the par value of the shares and premium on redemption are both committed to on the date that the preference shares are issued and are thus recognised as liabilities, the repayment of each represents a decrease in assets (decrease in the bank account) and a decrease in this preference share liability balance, with the result that there is no impact on the equity. These repayments are therefore not expenses
 - The C300 000 paid is a settlement of the original liability
 - The C30 000 paid is a settlement of the premium that accrued over the 3 years.
 - Both the above payments thus decrease liabilities and, at the same time, decrease the assets (bank) with the result that the payments do not represent expenses.

c) Calculation: Measurement

Effective interest rate table	Interest	Bank	Premium accrued	Preference share liability
	12.937%			
				300 000
31/12/20X3	38 811	(30 000)	8 811	308 811
			8 811	
31/12/20X4	39 951	(30 000)	9 951	318 762
			18 762	
31/12/20X5	41 238	(30 000)	11 238	330 000
			30 000	
31/12/20X5		(330 000)	(30 000)	0
	120 000	(420 000)		

- Liabilities should be recognised at the present value of the future obligation (future obligation is C420 000):
 - C318 762 at 31 December 20X4.

d) Correcting journals:

		Debit	Credit
1 January 20X4	Preference share (equity)	300 000	
	Preference share (liability)		300 000
	<i>Correction: recognition of preference shares as a liability</i>		
1 January 20X4	Retained earnings	8 811	
***	Preference share (liability)		8 811
	<i>Correction: preference dividend & premium recognised as interest expense</i>		

Solution 15.9 continued . . .

The correct journal entries would have been processed in prior years as follows:

		Debit	Credit
1 January 20X3	Preference share (equity)	300 000	
	Preference share (liability)		300 000
	<i>Correction: recognition of preference shares as a liability</i>		
31 December 20X3 ***	Finance charges (<i>per (c) above</i>)	38 811	
	Preference dividend		30 000
	Preference share (liability)		8 811
	<i>Correction: preference dividend & premium recognised as interest expense (see alternative journal below)</i>		
31 December 20X4	Finance charges (<i>per (c) above</i>)	39 951	
	Preference dividend		30 000
	Preference share (liability)		9 951
	<i>Correction: preference dividend & premium recognised as interest expense</i>		
31 December 20X4	Preference share (liability)	318 762	
	Preference shareholders (current liability)		318 762
	<i>Correction: recognition of preference shares as a current liability</i>		

Solution 16.1

**AARHUS LIMITED
EXTRACT FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 JUNE**

	20Y2	20X5	20X4
	C	C	C
Profit from operating activities	xxxx	xxxx	xxxx
Finance cost	18 531	18 887	18 920

**AARHUS LIMITED
EXTRACT FROM THE STATEMENT OF FINANCIAL POSITION
AS AT 30 JUNE**

	Notes	20Y2	20X5	20X4
		C	C	C
Non-current liabilities	8		164 207	164 520
Current liabilities	8	160 746		

**AARHUS LIMITED
EXTRACT FROM THE NOTES TO THE FINANCIAL STATEMENTS**

8. Debentures	Non-current liabilities		Current liabilities
	20Y2	20X5	20X4
Unsecured			
80 000 C2 debentures	160 746	164 207	164 520
	160 746	164 207	164 520

The debentures bear interest at 12% and are redeemable at par on 30 June 20Y3. The effective interest rate is 11,48%.

Workings

Date	Nominal interest	Effective interest	Liability Balance
	(160 000 x 0.12)	(11.48029%)	
1/7/X3			164 800
30/6/X4	19 200	18 920	164 520
30/6/X5	19 200	18 887	164 207
30/6/X6	19 200	18 851	163 858
30/6/X7	19 200	18 811	163 470
30/6/X8	19 200	18 767	163 036
30/6/X9	19 200	18 717	162 554
30/6/Y0	19 200	18 662	162 015
30/6/Y1	19 200	18 600	161 415
30/6/Y2	19 200	18 531	160 746
30/6/Y3	19 200	18 454	160 000

Solution 16.2

a)

BERGEN LIMITED JOURNAL			
Date	Description	Debit	Credit
20X1			
October 1	Bank Debenture liability	95 000	95 000
December 31	Interest expense (W1) Debenture liability	3 095	3 095
	Debenture liability Interest accrued	2 500	2 500
	Profit and loss Interest expense	3 095	3 095
20X2			
March 31	Interest expense (W1) Interest accrued Bank Debenture liability	3 095 2 500	5 000 595
September 30	Interest expense (W1) Bank Debenture liability	6 268	5 000 1 268
December 31	Interest expense (W1) Debenture liability	3 175	3 175
	Debenture liability Interest accrued	2 500	2 500
	Profit and loss Interest expense	12 538	12 538

Workings

W1: Amortisation table

Date	Interest (10%)	Effective Interest(13,032%)	Liability
1/10/X1			95 000
31/12/X1	(2 500)	3 095	95 595
31/3/X2	(2 500)	3 095	96 190
30/9/X2	(5 000)	6 268	97 458
31/12/X2	(2 500)	3 175	98 133

Solution 16.2 continued ...

b)

BERGEN LIMITED EXTRACT FROM STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X2		
		C
Finance costs		
Interest expense		^12 538

^ (3 095 + 6 268 + 3 175)

BERGEN LIMITED EXTRACT FROM STATEMENT OF FINANCIAL POSITION AT 31 DECEMBER 20X2		
	Note	C
Non-current liabilities		
C1 Debentures	9	98 133

EXTRACTS FROM THE NOTES TO THE FINANCIAL STATEMENTS		C
9. Non-current liabilities		
Unsecured		
100 000 C1 debentures		98 133
		<u>98 133</u>

The debentures bear interest of 10% per annum payable on 31 March and 30 September each year and are redeemable at a premium of 7% on 30 September 20X5. The effective interest rate is 13.03% per annum.

Solution 16.3

(a) Amortisation table

Year	Effective interest cost (15%)	Interest paid (12%)	Liability balance
			100 000
20X1	15 000	12 000	103 000
20X2	15 450	12 000	106 450
20X3	15 968	12 000	110 418
20X4	16 563	12 000	114 981
20X5	17 247	12 000	120 228
20X6	18 034	12 000	126 262

(b) Journal entries

ELK LIMITED JOURNAL			
Date	Description	Debit	Credit
20X1 Jan 1	Bank Debenture liability	100 000	100 000
Dec 31	Interest expense Bank	12 000	12 000
	Interest expense Debenture liability	3 000	3 000
	Profit and loss Interest expense	15 000	15 000
20X2 Dec 31	Interest expense Bank	12 000	12 000
	Interest expense Debenture liability	3 450	3 450
	Profit and loss Interest expense	15 450	15 450
20X3 Dec 31	Interest expense Bank	12 000	12 000
	Interest expense Debenture liability	3 968	3 968
	Profit and loss Interest expense	15 968	15 968

Solution 16.3 continued . .

(c) Extract from the financial statements

ELK LIMITED	
STATEMENT OF FINANCIAL POSITION	
AS AT 31 DECEMBER 20X3	
	C
Non-current liabilities	
Debentures	110 418

ELK LIMITED	
STATEMENT OF COMPREHENSIVE INCOME	
FOR THE YEAR ENDED 31 DECEMBER 20X3	
	C
Finance costs	15 968

NOTES TO THE FINANCIAL STATEMENTS	
	C
11. Non-current liabilities	
100 000 12% p.a. debentures	110 418
	<u>110 418</u>

The debentures are repayable on 31 December 20X6 at a premium of 26.262%. They are secured over the land and buildings. The effective interest rate is 15% per annum.

Solution 16.4

a)

IFRS 7 lists the risks associated with financial instruments as follows:

- Market risk, which is made up of three distinct risks:
 - Currency risk
 - Interest rate risk; and
 - Other price risk
- Credit risk
- Liquidity risk

b)

Blues Ltd is exposed to almost all of the abovementioned financial risks. Each of the risks to which it is exposed is discussed below.

Market Risk:

- *Currency risk:*

Currency risk is defined as: the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

Since Blues Limited buys its machinery and raw materials from Country Limited, a company based in the USA, it has a debt that is dollar denominated. Since Blues Limited is based in South Africa, this means that Blues Limited is exposed to the risk that the debt payable increases due to changes in the currency exchange rates. The exchange rate on the date that goods are purchased (transaction date) will differ from the rate available on the date that the creditor is paid (settlement date).

Although Blues Limited sells to both local and foreign customers, the trial balance indicates that a significant portion of the sales are constituted by sales to customers based in London (Great Britain). If the sales are denominated in Pounds (i.e. the foreign currency as opposed to the local currency of Rands), the amounts receivable from the sales will be variable based on the exchange rate ruling on the date of settlement. The measurement of the sales income will be dependant on the exchange rate ruling when the sale is made (transaction date) and the amount of cash that will be received will depend on the exchange rate ruling on the date the debtor settles the debt (settlement date).

- *Interest rate risk:*

Interest rate risk is defined as: the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

Blues Limited has fixed rate debentures and is thus exposed to interest rate risk (e.g. if the market rates decrease, Blues Limited will unfortunately continue to pay at the high fixed rate and the fair value thereof will increase). Since the loan is at a variable interest rate, it is not exposed to interest rate risk (the fair value will move with the market rate changes).

Solution 16.4 continued ...

b) continued ...

- *Other price risk:*

Other price risk is defined as the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate and currency risk). E.g. an increase in the share price of shares to be purchased: This risk is not applicable to Blues Limited.

Credit risk:

Credit risk is defined as the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

Blues Limited is exposed to credit risk as it offers 60 days credit to all customers worldwide. These debtors may be unable to pay Blues within the 60 days, or indefinitely, and Blues is therefore exposed to credit risk.

Liquidity risk:

Liquidity risk is defined as the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities.

Blues Limited is exposed to this risk as they have:

- A substantial loan with variable interest rates, where an increase in the interest rate may make it difficult to repay interest and capital
- A substantial trade payable, which is compounded by the fact that it is denominated in a foreign currency, which means that the amount owing could increase with a change in the exchange rate.

Blues Limited offers credit to all of its customers and will therefore have an irregular cash flow, with cash from a sale being delayed for up to 60 days. This will obviously compound its liquidity risk.

Solution 16.4 continued ...

c)

Blues Limited should be able to mitigate these risks as follows:

How Blues Limited may limit its currency risk

The exposure to fluctuating exchange rates may be reduced through:

- forward exchange contracts,
- currency swaps,
- futures for either buying or selling in different currencies, or
- internal matching, whereby the value of Blues Limited's exports substantially equal the value of its imports thus offsetting its risks.

How Blues Limited may limit its interest rate risk

The exposure to fluctuating interest rates may be reduced through:

- internal matching of interest rates (e.g. lending at variable rates as well as borrowing at variable rates),
- interest rate swaps,
- *options* to swap interest rates, and
- forward rate agreements.

How Blues Limited may limit its credit risk

The exposure to credit risk can be reduced by:

- limiting the value of credit given to customers;
- implementing stricter collection policies (e.g. sending frequent statements and reminders to customers),
- ensuring the quality of debtors by performing a credit review before granting credit to customers, (thus reducing potential bad debts levels).

How Blues Limited may limit its liquidity risk

Its exposure to liquidity risk can be reduced by:

- reducing current assets and converting them to cash, for example:
 - encouraging payment on transaction date (increase cash sales);
 - implementing credit terms that will result in the debtors settling as soon as possible (high interest on late payments), or
 - reducing inventory levels (by increasing sales) or purchasing and manufacturing inventory on a 'demand basis'.

This will increase available cash resources that can be used to remove debts and release money for other investments that may currently be tied up in working capital.

Comment: This question offers an in-depth discussion of the financial risks outlined in IFRS 7 and the real world responses to mitigate these risks.

Solution 16.5

Effective interest rate table - debentures

	Interest 19.99274% Debit/ (Credit)	Bank Debit/ (Credit)	Debenture liability Debit/ (Credit)
2 Jan 20X5		4 000 000	(4 000 000)
31 Dec 20X5	799 709	(500 000)	(4 299 709)
31 Dec 20X6	859 630	(500 000)	(4 659 339)
31 Dec 20X7	931 529	(500 000)	(5 090 868)
31 Dec 20X8	1 017 804	(500 000)	(5 608 672)
31 Dec 20X9	1 121 327	(500 000)	(6 230 000)
		(6 230 000)	0
	<u>4 730 000</u>	<u>4 730 000</u>	

TINKERBELL LIMITED

**EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X9**

	20X9 C	20X8 C	20X7 C	20X6 C	20X5 C
Profit before finance costs	xxx	xxx	xxx	xxx	xxx
Finance costs	<u>1 121 327</u>	<u>1 017 804</u>	<u>931 529</u>	<u>859 630</u>	<u>799 709</u>
Profit before tax	xxx	xxx	xxx	xxx	xxx

Comment:

This is a basic question illustrating the issue of a financial liability and the use of the effective interest rate method to discount the future cash flow (premium) to the present value of the debentures.

Notice how the debenture liability is increased by the interest (effective rate) and reduced by actual payments based on the coupon rate (10%), until at maturity, it is the same value as the repayment period.

Solution 16.6

In accordance with IAS 39, the directors correctly classified the debentures as a non-current interest-bearing liability. Unfortunately, however, they incorrectly measured both the liability balance and the finance costs. IAS 39 requires that the finance costs (interest, discounts and premium) and the financial liability be measured using the effective interest rate method.

Backstab Limited calculated the finance costs using the nominal rate of 12% on the face value of the debentures instead of the effective interest rate method and has therefore inappropriately accounted for the compulsorily redeemable debentures in the following respects:

- The cost of the discount on the issue as well as the cost of the premium on the future redemption has been ignored in the measurement of the finance costs. The finance costs have therefore been understated for the year ended 31 December 20X6 by C362 748 (842 748 – 480 000)
- Consequently, the measurement of the liability has been understated by C362 748 [(3 200 000 + 842 748) – (3 200 000 + 480 000)].

The journal entries processed would have to be corrected as follows (the third journal entry below assumes that the deferred tax journal entry will have also already been processed by Backstab Limited):

	Debit	Credit
<i>31 December 20X6</i>		
Interest payable	480 000	
Finance costs – debenture interest		480 000
<i>Reversal of the accrual of interest on debentures</i>		
Finance costs – debenture interest	842 748	
Debenture liability <i>W1</i>		842 748
<i>Accrual of interest on debentures</i>		

A further journal would also be processed for the payment of the actual interest:

	Debit	Credit
<i>31 December 20X6</i>		
Debenture liability	480 000	
Bank		480 000
<i>Actual payment of interest on debentures</i>		

W1: Effective interest rate table - debentures

	Interest	Bank	Debenture liability
	26.33586%		
1 Jan 20X6		3 200 000	(3 200 000)
31 Dec 20X6	842 748	(480 000)	(3 562 748)
31 Dec 20X7	938 280	(480 000)	(4 021 028)
31 Dec 20X8	1 058 972	(480 000)	(4 600 000)
1 Jan 20X9			(4 600 000)
		(4 600 000)	0
	2 840 000	(2 840 000)	

Solution 16.7

		Debit	Credit
1 January 20X6			
Bank		1 100 000	
Debentures: financial liability	W2		388 310
Debentures: equity	W3		711 690
<i>Issue of debentures</i>			
31 December 20X6			
Finance costs (expense)	W4	77 662	
Debentures: financial liability	150 000 – 77 662	72 338	
Bank	W1		150 000
<i>Finance cost and repayment for the period</i>			
31 December 20X7			
Finance costs (expense)	W4	63 194	
Debentures: financial liability	150 000 – 63 194	86 806	
Bank	W1		150 000
<i>Finance cost and repayment for the period</i>			
31 December 20X8			
Finance costs (expense)	W4	45 833	
Debentures: financial liability	150 000 – 63 194	104 167	
Bank	W1		150 000
<i>Finance cost and repayment for the period</i>			
31 December 20X9			
Finance costs (expense)	W4	25 000	
Debentures: financial liability	150 000 – 25 000	125 000	
Bank	W1		150 000
<i>Finance cost and repayment for the period (debentures are now ordinary shares – represented by the 711 690, which was journalised on issue of the debentures)</i>			

Solution 16.7 continued ...

W1: Debenture interest paid

$$= 100\,000 \times C10 \times 15\%$$

$$= 150\,000$$

W2: Present value of liability (using a 20% discount rate)

Discount factor		Cash payment	Present value of cash payment
0.8333	(1)	150 000	125 000
0.6944	(2)	150 000	104 167
0.5787	(3)	150 000	86 806
0.4823	(4)	150 000	72 338
		<u>600 000</u>	<u>388 310</u>

(1) $1 / 1.2$ (2) $0.8333 / 1.2$ (3) $0.6944 / 1.2$ (4) $0.5787 / 1.2$

The PV of the liability can also be calculated as follows:

$$= (150\,000 / 1.2) + (150\,000 / 1.2^2) + (150\,000 / 1.2^3) + (150\,000 / 1.2^4)$$

$$= 388\,310$$

W3: Equity portion

Cash received	$100\,000 \times (C10 + C1)$	1 100 000
Present value of liability	W2	<u>(388 310)</u>
Equity (balancing)		<u>711 690</u>

W4: Interest rate table

	Instalment	Interest	Balance
1 Jan X6			388 310
31 Dec X6	(150 000)	77 662	315 972
31 Dec X7	(150 000)	63 195	229 167
31 Dec X8	(150 000)	45 833	125 000
31 Dec X9	(150 000)	25 000	(0)
	<u>600 000</u>	<u>211 690</u>	

Comment:

This question shows the 'residual value' approach in IAS 32, also known as 'splitting the compound'. As the debentures are compulsorily convertible, the interest is the liability portion and the balance is equity relating to conversion.

Note how the liability is reduced by the effective interest rate method until it has a nil balance on conversion date.

Solution 16.8

	Debit	Credit
1 January 20X5		
Bank	5 000 000	
Equity		303 735
Liability		4 696 265
<i>Issue of 1 000 000 C5 preference shares that are redeemable (W1)</i>		
31 December 20X5		
Liability	500 000	
Bank		500 000
<i>Payment of the preference dividend</i>		
Interest expense	563 552	
Liability		563 552
<i>Interest expense for the year on preference dividends (W2)</i>		
31 December 20X6		
Liability	500 000	
Bank		500 000
<i>Payment of the preference dividend</i>		
Interest expense	571 178	
Liability		571 178
<i>Interest expense for the year on preference dividends (W2)</i>		
31 December 20X7		
Liability	500 000	
Bank		500 000
<i>Payment of the preference dividend</i>		
Interest expense	579 719	
Liability		579 719
<i>Interest expense for the year on preference dividends (W2)</i>		
31 December 20X8		
Liability	500 000	
Bank		500 000
<i>Payment of the preference dividend</i>		
Interest expense	589 286	
Liability		589 286
<i>Interest expense for the year on preference dividends (W2)</i>		
Liability	5 000 000	
Equity (80% x 5 000 000)		4 000 000
Bank (20% x 5 000 000)		1 000 000
<i>Conversion and repayment of the preference shares</i>		

Solution 16.8 continued ...

Workings:

W1: Present value of future payments

The liability consists of the:

- Annuity of C500 000 each year (dividend: 1 000 000 x C5 x 10%)
- Capital redemption of C5 000 000 at the end of 20X8

W1.1 Present value calculation

Due date	Payments due	PV factor	Present value
1 January 20X5	500 000	0.892857	446 429
31 December 20X5	500 000	0.797194	398 597
31 December 20X6	500 000	0.71178	355 890
31 December 20X7	500 000	0.635518	317 759
31 December 20X8	5 000 000	0.635518	3 177 590
	<u>7 000 000</u>		<u>4 696 265</u>

PV factors:

After 1 year: $1/1.12 = 0.892857$

After 2 years: $0.892857/1.12 = 0.797194$

After 3 years: $0.797194/1.12 = 0.71178$

After 4 years: $0.71178/1.12 = 0.635518$

W1.3 Present value calculation – alternative calculation

Annuity:

500 000 for 4 years

$= 500\,000 / 1.12^1 + 500\,000 / 1.12^2 + 500\,000 / 1.12^3 + 500\,000 / 1.12^4$

$= 1\,518\,675$

Capital:

5 000 000 in four years time

$= 5\,000\,000 / 1.12^4$

$= 3\,177\,590$

Total liability (present value of future cash outflows):

$1\,518\,675 + 3\,177\,590 = 4\,696\,265$

Total equity:

$5\,000\,000 - 4\,696\,265 = 303\,735$

W2: Effective interest

	Interest @ 12%	Payment @ 10%	Balance
1 January 20X5			4 696 265
31 December 20X5	563 552	(500 000)	4 759 817
31 December 20X6	571 178	(500 000)	4 830 995
31 December 20X7	579 719	(500 000)	4 910 714
31 December 20X8	589 286	(500 000)	5 000 000

Comment:

In terms of IAS 32, if the preference shares are convertible/ redeemable at the option of the HOLDER, they must be treated as a pure liability (i.e. assume redemption will occur).

Note how the preference share liability grows over the 4 years under the effective interest rate method until it reaches full redemption value on redemption date (C5 million).

Solution 16.9

Introduction

A liability is defined as a present obligation of the entity as a result of past events the settlement of which is expected to result in an outflow of future economic benefits.

Equity is defined as the net interest in assets after deducting liabilities.

The measurement of equity is therefore a balancing exercise.

Compulsorily redeemable preference shares

The accountant has processed the share issue as being totally equity, which is a mistake.

The issuer of the financial instrument shall classify the instrument as a liability or equity in accordance with the substance of the agreement. The critical feature to differentiate between a financial liability and equity is whether the entity has an unconditional right to avoid delivery of cash or other financial assets. If the entity does have an unconditional right to avoid payment, then the instrument is classified as equity (because there is technically no obligation, the financial instrument cannot be classified as a liability).

Through issuing the compulsory redeemable preference shares, the entity has committed itself to the following outflows of economic benefits (cash):

- a capital redemption of C2 000 000 (compulsorily redeemable); and
 - an annuity payment consisting of preference dividends of C200 000
- and thus the entity does not have an unconditional right to avoid payment.

Such a commitment constitutes a present obligation, the past event being the issue of the shares. The shares, therefore, effectively constitute a 'loan', bearing interest at 10%, and not equity at all.

The correcting journal entry would be:

	Debit	Credit
Preference shares: equity	2 000 000	
Preference shares: liability		2 000 000
<i>Correction of error.</i>		

Solution 16.9 continued ...

Compulsorily convertible preference shares

This is a compound financial instrument and must be disclosed as such. The instrument has the following components:

- deferred shares (equity)
- debt instrument (liability)

The accountant is therefore incorrect.

Since the conversion into ordinary shares is compulsory, a portion of the preference shares is equity (deferred equity). The fact that preference dividends must be paid each year, however, constitutes a present obligation where the past event is the issue of the preference shares. The annuity (annual payment of dividends) is a liability (debt instrument).

Payment of dividends (annuity for 5 years):

Annual dividend: $400\,000 \times 2 \times 12\% = 96\,000$

Present value

$$= 96\,000 / 1.15^1 + 96\,000 / 1.15^2 + 96\,000 / 1.15^3 + 96\,000 / 1.15^4 + 96\,000 / 1.15^5$$

$$= 346\,059$$

Repayment of capital:

= 0

Total liability = $346\,059 + 0 = 346\,059$

Total equity = $800\,000 - 346\,059 = 453\,941$

Correcting journal entry:

	Debit	Credit
Preference shares: Equity	346 059	
Preference shares: Liability		346 059
<i>Correction of error.</i>		

Note:

Only CORRECTING journal entries were required, thus journals relating to interest are ignored.

This question shows the importance of the terms of financial instruments (compulsory redemption or conversion) and the effect thereof on the accounting treatment of the liability.

Solution 16.10

Options: Since these were designated as fair value through profit or loss, they are carried at fair value, with the change in fair value recognised in profit or loss. The carrying amount will be the fair value:
 $= 100 \times 300 = \mathbf{30\,000}$

Ordinary shares: Since these were designated as available for sale, they are carried at fair value, with the change in fair value recognised in other comprehensive income (equity). The carrying amount will be the fair value:
 $= 200 \times 200 = \mathbf{40\,000}$

Redeemable preference shares: Since these were *not* designated as fair value through profit or loss, they are carried at amortised cost, therefore carrying amount at 31 December 20X5:
 $= \text{effective interest rate table below} = \mathbf{3\,231}$

Effective interest rate table	Interest (16.7%)	Cash received (10%)	Balance
1 January 20X5			3000
31 December 20X5	531	(300)	3 231
31 December 20X6	572	(300)	3 503
31 December 20X7	620	(300)	3 823
31 December 20X8	677	(300)	4 200
31 December 20X8		(4 200)	0

Journals:

Options

1 January 20X5

Dr: Options in Smiley Limited (Asset)

20 000

Cr: Bank

20 000

Purchase of Smiley Limited options: 100 x 200

31 December 20X5

Dr: Options in Smiley Limited (Asset)

10 000

Cr: Fair value adjustment on financial asset (P/L)

10 000

Fair value adjustment for Smiley Limited options: 100 x 300 – 20 000

Ordinary shares

1 January 20X5

Dr: Shares in Grin Limited (Asset)

30 000

Cr: Bank

30 000

Purchase of Grin Limited shares: 200 x 150

31 December 20X5

Dr: Shares in Grin Limited (Asset)

10 000

Cr: Fair value adjustment on available for sale shares (OCI)

10 000

Revaluation of Grin Limited shares to fair value: 200 x 200 – 30 000

Redeemable preference shares

1 January 20X5

Dr: Preference shares in Giggle Limited (Asset)

3 000

Cr: Bank

3 000

Purchase of Giggle Limited preference shares: 300 x 10

31 December 20X5

Dr: Preference shares in Giggle Limited (Asset)

531

Cr: Interest income (P/L)

531

Effective interest on financial asset (effective interest table above)

Dr: Bank

300

Cr: Preference shares in Giggle Limited (Asset)

300

Dividend received from Giggle Limited: 300 x 10 x 10%

Comment:

This basic question shows the different accounting treatments of financial assets under IAS 39.

Solution 16.11

Introduction

The accountant has *incorrectly* classified the entire instrument as equity. The dividends declared and share issue expenses have also been *incorrectly* dealt with.

Recognition

The financial instruments should be recognised in accordance with the economic substance of the agreement rather than in accordance with their legal form. The substance of the agreement is that the company has issued:

- compulsory redeemable preference shares; (liability) and
- options to acquire ordinary shares (equity).

The convertible preference shares are thus compound instruments and the compound instrument must be split so that the equity and liability portions are recognised separately.

This split is performed at the date of issue and is achieved by calculating the liability portion and then calculating the equity portion as the balancing figure.

The liability portion

Initial measurement:

The liability portion is measured by discounting the future payments to be made (i.e. dividends and redemption payments) to their present value. The redemption payment is included in the calculation as the shares are convertible at the option of the shareholder. Thus the company does not have an unconditional right to avoid payment the redemption amount.

The discount rate used to discount the future payments is the market rate for purely redeemable fixed rate preference shares with the same issue and redemption date.

Subsequent measurement:

How the liability portion is subsequently measured depends on how it is designated.

The redeemable preference shares can either be

- designated as fair value through profit and loss; or
- carried at amortised cost.

If they are designated at fair value through profit and loss then the instrument is valued at fair value each period and the changes made are recognised in profit or loss.

If amortised cost is used, the liability is measured using the effective interest rate method. An amortisation table is constructed to compute finance costs and to build the liability up from the amount initially recorded (present value) to redemption value. This is the most likely treatment.

The equity portion

Measurement:

The conversion options are measured as the difference between the total proceeds received and the liability amount (i.e. the discounted future dividend and redemption payments).

Solution 16.11 continued ...

The options are carried at cost established at initial recognition. No subsequent changes to equity are recorded until conversion date.

Share issue expenses

The share issue expenses should not be expensed. The only exception is if the instrument is designated at fair value through profit or loss, in which case the share issue costs would be expensed. They should be set-off against the carrying amount of the liability and equity portions in proportion to their carrying amounts. This is because financial instruments must be raised at the fair value of the consideration received net of transaction costs. The set-off will result in a change in the present value of the liability and a recalculation of the effective interest rate.

Dividends

No dividends are presented in the statement of changes in equity because, in terms of the:

- equity component: options do not bear dividends;
- liability component: redeemable preference shares bear finance costs, which are reflected in the statement of comprehensive income.

Comment:

This is a very good question dealing with financial liabilities (IAS 39) and 'splitting the compound' as well as the treatment of the transaction costs and dividends.

Solution 16.12

a) Discussion of financial assets

Investments in Mich Ltd's preference shares satisfy the definition of a financial asset as the preference dividends and the redemption amount are receivable in cash in accordance with the formalised terms of the preference share issue documentation (i.e. they represent a contractual right to receive cash).

Financial assets are classified into four categories:

1. Fair value through profit and loss
2. Held to maturity
3. Loans and receivables
4. Available for sale

The category chosen by the investor depends on the investor's intention in relation to the investment

Fair value through Profit and Loss:

If the investor intends to trade with the shares then 'fair value through profit and loss' must be used. Furthermore, even if the shares are not held for sale in the ordinary course of business, the investors can designate the shares as fair value through profit and loss.

If the shares are initially categorised as fair value through profit and loss, the investor may not subsequently reclassify the investment into another category.

If fair value through profit and loss is used the shares are initially recorded at the fair value of the consideration given (excluding transaction costs, which must be expensed). The asset is then adjusted to fair value at the end of each reporting period and any adjustments are recognised in profit and loss.

Dividends received would be recognised in profit or loss.

Held to Maturity:

Financial assets can only be classified as held to maturity if:

- They have fixed or determinable payments (this is satisfied as the shares yield a fixed preference dividend of 10% each period); and
- They have a fixed maturity date (this is satisfied as the shares are compulsory redeemable on the 31 December 20X10)

Furthermore the investor must have:

- The intention to hold to maturity; and
- The ability to hold to maturity

If all the above criteria are met the shares may be classified as held to maturity. In this case the financial assets are accounted for at amortised cost using the effective interest rate method. The assets are initially recorded at the fair value of the consideration given (including transaction costs).

The dividend received is not recognised as dividend income. Instead, the effective interest rate method is used to calculate finance income. The difference between the actual dividend received and the finance income recognised is used to build the initial amount recorded to redemption value.

Solution 16.12 continued ...

a) Discussion of financial assets continued ...

Loans and receivables

Loans and receivables are not quoted on an active market. If this category is used the financial asset is accounted for using amortised cost in the same manner as described for held to maturity financial assets. This method is not possible as the preference shares are quoted at fair value in an active market.

Available for sale

Those preference shareholders that do not fall into any of the previous three categories should classify their investment in Mich Ltd's preference shares as an available for sale financial asset.

These financial assets are initially recorded at the fair value of the consideration given (including transaction costs). They are subsequently recorded at fair value. Any changes in fair value will then be recognised in other comprehensive income (equity).

Any dividends received will be recognised in profit and loss.

Solution 16.12 continued ...

b) Journals for financial assets

<i>i) Fair value through profit and loss</i>		Debit	Credit
1 January 20X6			
Financial asset : Investment in Mich Ltd	$1\,000\,000 \times C10$	10 000 000	
Bank			10 000 000
<i>Purchase of Mich Ltd's preference shares</i>			
31 December 20X6			
Bank	$1\,000\,000 \times C10 \times 10\%$	1 000 000	
Dividend income			1 000 000
<i>Preference dividend received from Mich Ltd</i>			
Financial asset : Investment in Mich Ltd	$(11 - 10) \times 1\,000\,000$	1 000 000	
Gain on financial asset (P/L)			1 000 000
<i>Fair value adjustment to financial assets</i>			
31 December 20X7			
Bank	$1\,000\,000 \times C10 \times 10\%$	1 000 000	
Dividend income			1 000 000
<i>Preference dividend received from Mich Ltd</i>			
Financial asset : Investment in Mich Ltd	$(12 - 11) \times 1\,000\,000$	1 000 000	
Gain on financial asset (P/L)			1 000 000
<i>Fair value adjustment to financial assets</i>			
31 December 20X8			
Bank	$1\,000\,000 \times C10 \times 10\%$	1 000 000	
Dividend income			1 000 000
<i>Preference dividend received from Mich Ltd</i>			
Loss on financial asset (P/L)	$(9 - 12) \times 1\,000\,000$	3 000 000	
Financial asset : Investment in Mich Ltd			3 000 000
<i>Fair value adjustment to financial assets</i>			
31 December 20X9			
Bank	$1\,000\,000 \times C10 \times 10\%$	1 000 000	
Dividend income			1 000 000
<i>Preference dividend received from Mich Ltd</i>			
Financial asset : Investment in Mich Ltd	$(14 - 9) \times 1\,000\,000$	5 000 000	
Gain on financial asset (P/L)			5 000 000
<i>Fair value adjustment to financial assets</i>			
31 December 20X10			
Bank	$1\,000\,000 \times C10 \times 10\%$	1 000 000	
Dividend income			1 000 000
<i>Preference dividend received from Mich Ltd</i>			
Financial asset : Investment in Mich Ltd	$(15 - 14) \times 1\,000\,000$	1 000 000	
Gain on financial asset (P/L)			1 000 000
<i>Fair value adjustment to financial assets</i>			
Bank	$1\,000\,000 \times C15$	15 000 000	
Financial asset : Investment in Mich Ltd			15 000 000
<i>Cash received on redemption (compulsory)</i>			

Solution 16.12 continued ...

b) Journals for financial assets continued ...

<i>ii) Held to maturity (W1)</i>		Debit	Credit
1 January 20X6			
Financial asset : Investment in Mich Ltd	<i>1 000 000 x C10</i>	10 000 000	
Bank			10 000 000
<i>Purchase of Mich Ltd's preference shares</i>			
31 December 20X6			
Bank	<i>1 000 000 x C10 x 10%</i>	1 000 000	
Financial asset : Investment in Mich Ltd	<i>W1</i>	711 239	
Interest revenue	<i>W1</i>		1 711 239
<i>Preference dividend received and interest accrual</i>			
31 December 20X7			
Bank	<i>1 000 000 x C10 x 10%</i>	1 000 000	
Financial asset : Investment in Mich Ltd	<i>W1</i>	832 949	
Interest revenue	<i>W1</i>		1 832 949
<i>Preference dividend received and interest accrual</i>			
31 December 20X8			
Bank	<i>1 000 000 x C10 x 10%</i>	1 000 000	
Financial asset : Investment in Mich Ltd	<i>W1</i>	975 486	
Interest revenue	<i>W1</i>		1 975 486
<i>Preference dividend received and interest accrual</i>			
Impairment expense	<i>W2</i>	3 519 674	
Financial asset: accumulated impairment			3 519 674
<i>Impairment of financial asset recoverable amount</i>			

For your information: If the expected future cash flows have not changed then no impairment would be recorded. This would be the case where changes in the market interest rates are the sole cause of the decline in the preference shares value. However, if the fair value changes are solely attributable to Mich Ltd being in a poor financial position and thus future cash flows are expected to reduce, then an impairment of C3 519 674 (W2) would be recorded. In this case the fair value of C9 would represent the less than originally anticipated cash flows discounted at the original effective interest rate.

31 December 20X9			
Bank	<i>1 000 000 x C10 x 10%</i>	1 000 000	
Financial asset : Investment in Mich Ltd	<i>W1</i>	1 142 416	
Interest revenue	<i>W1</i>		2 142 416
<i>Preference dividend received and interest accrual</i>			
Financial asset: accumulated impairment	<i>W3</i>	3 519 674	
Impairment reversal income			3 519 674
<i>Reversal of impairment of financial asset</i>			

For your information: If no impairment was recorded in the previous reporting period then no reversal can be recorded. However, if an impairment was recorded in the prior period then an impairment reversal would be recorded at an amount of C3 519 674.

31 December 20X10

Solution to Gripping IFRS : Graded Questions

Financial instruments

Bank	$1\,000\,000 \times C10 \times 10\%$	1 000 000	
Financial asset : Investment in Mich Ltd	W1	1 337 910	
Interest revenue	W1		2 337 910
<i>Preference dividend received and interest accrual</i>			
Bank	$1\,000\,000 \times C15$	15 000 000	
Financial asset : Investment in Mich Ltd			15 000 000
<i>Cash received on redemption</i>			

Solution 16.12 continued ...

b) Journals for financial assets continued ...

<i>iii) Available for sale</i>		Debit	Credit
1 January 20X6			
Financial asset : Investment in Mich Ltd	<i>1 000 000 x C10</i>	10 000 000	
Bank			10 000 000
<i>Purchase of Mich Ltd's preference shares</i>			
31 December 20X6			
Bank	<i>1 000 000 x C10 x 10%</i>	1 000 000	
Dividend income			1 000 000
<i>Preference dividend received from Mich Ltd</i>			
Financial asset : Investment in Mich Ltd	<i>(11 – 10) x 1 000 000</i>	1 000 000	
Equity : Fair value adjustment reserve			1 000 000
<i>Fair value adjustment to financial assets</i>			
31 December 20X7			
Bank	<i>1 000 000 x C10 x 10%</i>	1 000 000	
Dividend income			1 000 000
<i>Preference dividend received from Mich Ltd</i>			
Financial asset : Investment in Mich Ltd	<i>(12 – 11) x 1 000 000</i>	1 000 000	
Equity : Fair value adjustment reserve			1 000 000
<i>Fair value adjustment to financial assets</i>			
31 December 20X8			
Bank	<i>1 000 000 x C10 x 10%</i>	1 000 000	
Dividend income			1 000 000
<i>Preference dividend received from Mich Ltd</i>			
Impairment of investment (P/L)	<i>3 000 000 – 2 000 000</i>	1 000 000	
Equity : Fair value adjustment reserve	<i>Balance in equity</i>	2 000 000	
Financial asset : Investment in Mich Ltd	<i>(9 – 12) x 1 000 000</i>		3 000 000
<i>Fair value adjustment to financial assets</i>			
<i>For your information: It has been assumed that there is sufficient objective evidence of impairment. If this was not the case then the entire impairment would have been debited to the fair value adjustment reserve.</i>			
31 December 20X9			
Bank	<i>1 000 000 x C10 x 10%</i>	1 000 000	
Dividend income			1 000 000
<i>Preference dividend received from Mich Ltd</i>			
Financial asset : Investment in Mich Ltd	<i>(14 – 9) x 1 000 000</i>	5 000 000	
Impairment reversed on investment (P/L)	<i>20X8 impairment</i>		1 000 000
Equity : Fair value adjustment reserve	<i>5 000 000 – 1 000 000</i>		4 000 000
<i>Fair value adjustment to financial assets</i>			

Solution 16.12 continued ...

b) Journals for financial assets continued ...

<i>iii) Available for sale continued ...</i>		Debit	Credit
31 December 20X10			
Bank	$1\,000\,000 \times C10 \times 10\%$	1 000 000	
Dividend income			1 000 000
<i>Preference dividend received from Mich Ltd</i>			
<hr/>			
Financial asset : Investment in Mich Ltd	$(15 - 14) \times 1\,000\,000$	1 000 000	
Equity : Fair value adjustment reserve			1 000 000
<i>Fair value adjustment to financial assets</i>			
<hr/>			
Bank	$1\,000\,000 \times C15$	15 000 000	
Financial asset : Investment in Mich Ltd			15 000 000
<i>Cash received on redemption</i>			
<hr/>			
Equity : Fair value adjustment reserve	$(1K + 1K - 2K + 4K + 1K)$	5 000 000	
Gain on financial investment (P/L)			5 000 000
<i>Reclassification adjustment: OCI recognised in profit or loss (a reclassification adjustment)</i>			
<hr/>			

Working 1: Effective interest rate table (used for held to maturity financial assets)

	O/ balance	Interest @ 16.11239%	Cash received @ 10% (dividends and capital)	C/ balance
20X6	10 000 000	1 711 239	(1 000 000)	10 711 239
20X7	10 711 239	1 832 949	(1 000 000)	11 544 188
20X8	11 544 188	1 975 486	(1 000 000)	12 519 674
20X9	12 519 674	2 142 416	(1 000 000)	13 662 090
20X10	13 662 090	2 337 910	(1 000 000)	15 000 000
			(15 000 000)	0
	58 437 191	10 000 000	(20 000 000)	

Working 2: Impairment calculation (assuming objective evidence of an impairment exists)

Carrying amount	31/12/20X8	W1	12 519 674
Fair value (recoverable amount)	31/12/20X8	1 000 000 x 9	9 000 000
Impairment loss			3 519 674

Working 3: Impairment loss reversed calculation

Carrying amount	1/1/20X9	W2	9 000 000
Interest income	20X9	W1	2 142 416
Dividend received	20X9		(1 000 000)
Carrying amount	31/12/20X9		10 142 416
Lower of:			13 662 090
Value per EIRT (W1)	31/12/20X9	W1	13 662 090
Fair value (recoverable amount)	31/12/20X9	1 000 000 x 14	14 000 000
Impairment loss reversed			(3 519 674)

Reversal is limited to the carrying amount under amortised cost (W1).

Solution 16.12 continued ...

c) Disclosure: assuming that financial asset is classified as available for sale: no tax

KIM LIMITED

**EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X10**

	20X10	20X9	20X8	20X7	20X6
	C	C	C	C	C
Gain on redemption	5 000	0	0	0	0
Other income	1 000	1 000	1 000	1 000	1 000
Impairment reversal/ (loss)	0	1 000	(1 000)	0	0
Profit for the period	6 000	2 000	0	1 000	1 000

Other comprehensive income

Available for sale financial assets:					
- Gain on available for sale financial asset	1 000	4 000	(2 000)	1 000	1 000
- Less reclassification adjustment to P/L	(5 000)				

Total comprehensive income	2 000	6 000	(2 000)	2 000	2 000
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KIM LIMITED

**EXTRACTS FROM THE STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X10**

	Retained earnings	Fair value adjustment reserve	Total
	C	C	C
Balance: 1/1/20X6	0	0	0
Total comprehensive income	1 000	1 000	2 000
Balance: 31/12/20X6	1 000	1 000	2 000
Total comprehensive income	1 000	1 000	2 000
Balance: 31/12/20X7	2 000	2 000	4 000
Total comprehensive income	0	(2 000)	(2 000)
Balance: 31/12/20X8	2 000	0	2 000
Total comprehensive income	2 000	4 000	6 000
Balance: 31/12/20X9	4 000	4 000	8 000
Total comprehensive income	6 000	(4 000)	2 000
Balance: 31/12/20X10	10 000	0	10 000

Solution 16.12 continued ...

d) Disclosure: assuming that financial asset is classified as available for sale: with tax

KIM LIMITED

**EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X10**

	20X10	20X9	20X8	20X7	20X6
	C	C	C	C	C
Gain on redemption	5 000	0	0	0	0
Other income	1 000	1 000	1 000	1 000	1 000
Impairment reversal/ (loss)	0	1 000	(1 000)	0	0
Profit before tax	6 000	2 000	0	1 000	1 000
Tax	(1 800)	(600)	0	(300)	(300)
Profit for the period	4 200	1 400	0	700	700

Other comprehensive income

Available for sale financial assets:

- Gain on available for sale financial asset	700	2 800	(1 400)	700	700
- Less reclassification adjustment to P/L	(3 500)				

Total comprehensive income	1 400	4 200	(1 400)	1 400	1 400
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KIM LIMITED

**STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X5**

	Retained earnings	Fair value adjustment reserve	Total
	C	C	C
Balance: 1/1/20X6	0	0	0
Total comprehensive income	700	700	1 400
Balance: 31/12/20X6	700	700	1 400
Total comprehensive income	700	700	1 400
Balance: 31/12/20X7	1 400	1 400	2 800
Total comprehensive income	0	(1 400)	(1 400)
Balance: 31/12/20X8	1 400	0	1 400
Total comprehensive income	1 400	2 800	4 200
Balance: 31/12/20X9	2 800	2 800	5 600
Total comprehensive income	4 200	(2 800)	1 400
Balance: 31/12/20X10	7 000	0	7 000

KIM LIMITED

**NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X5**

44. Tax on other comprehensive income	20X10	20X9	20X8	20X7	20X6
	C	C	C	C	C
Fair value adjustment reserve	(2 800)	2 800	(1 400)	700	700
• Gross	(4 000)	4 000	2 000	1 000	1 000
• Tax	1 200	(1 200)	(600)	(300)	(300)

Solution 16.13

a)

Interest income should be calculated using the effective interest rate method. The average exchange rate for the period should be used to translate the interest income.

Any exchange differences on the monetary item (the debenture), should be recognized directly in profit and loss. Fair value adjustments to the debenture are recognized in other comprehensive income (equity).

b)

1 January 20X9

		Debit	Credit
Debenture asset	<i>At spot rate</i>	114 950	
Bank (W1)			114 950
<i>Purchase of debenture</i>			

31 December 20X9

Bank	<i>At spot rate</i>	8 190	
Debenture asset	<i>Balancing</i>	557	
Interest income (W1)	<i>At average rate</i>		8 747
<i>Recognition of interest for 20X9</i>			

31 December 20X9

Forex loss		3 947	
Debenture asset (W1)			3 947
<i>Recognition of exchange difference in P/L: re-measure balance at spot rate at year-end</i>			

31 December 20X9

Debenture asset		11 290	
Equity Reserve (OCI)			11 290
<i>Fair value adjustment taken to equity: re-measure balance at fair value at spot rate at year-end</i>			

Working 1:

		€	Rate	R
Cost	$10\,000 \times 95\%$	9 500	12.10	114 950
Interest income (effective)	$9\,500 \times 7.736\%$	735	11.90	8 747
Coupon interest	$10\,000 \times 7\%$	(700)	11.70	(8 190)
Exchange difference (bal)	$111\,560 - 114\,950 - 8\,747 - 8\,190$			(3 947)
Closing balance		9 535	11.70	111 560
Fair value adjustment (OCI)				11 290
Fair value at 31/12/X9	<i>Given</i>	10 500	11.70	122 850

Solution 16.14

i)

Held to maturity

		Debit	Credit
1 March 20X9			
Debenture asset	$100\,000 \times 98\%$	98 000	
Bank			98 000
<i>Purchase of debenture</i>			
30 August 20X9			
Bank	$100\,000 \times 11\% \times 6/12$	5 500	
Debenture asset (bal)	Balancing	527	
Interest income	$98\,000 \times 12.3\% \times 6/12$		6 027
<i>Interest income for the 6 month period.</i>			
31 December 20X9			
Debenture asset	$(9\,800 + 527) \times 12.3\% \times 4/12$	4 040	
Interest income			4 040
<i>Interest at year end</i>			

ii)

Available for sale

		Debit	Credit
30 June 20X9			
Investment in shares		23 800	
Bank			23 800
<i>Purchase: (23 x 1000 shares) + 800</i>			
31 December 20X9			
Investment in shares		1 200	
Fair value adjustment reserve (OCI)			1 200
<i>Fair Value Adj: (25x1000) - 23800</i>			

iii)

		Debit	Credit
30 June 20X9			
Bank		500 000	
Preference share liability			500 000
<i>The entity does not have the unconditional right to avoid paying cash (share price is not controlled). Therefore it is a liability (IAS32).</i>			
31 December 20X9			
Interest expense (dividend)		25 000	
Shareholders for dividends			25 000
<i>Dividend declared at year end.</i>			

Solution 16.14 continued ...

(iv)

Fair value through profit or loss	Debit	Credit
1 November 20X9		
Margin deposit (asset)	40 000	
Bank		40 000
<i>Margin deposit made on futures</i>		
31 December 20X9		
Bank <i>10 x 10 x (2700 - 2500)</i>	20 000	
Gain on futures (income)		20 000
<i>Futures re-measured at fair value at year-end</i>		

(v)

	Debit	Credit
1 December 20X9		
Margin deposit	15 000	
Bank		15 000
<i>Margin deposit on call options</i>		
31 December 20X9		
Bank <i>10 x 10 x (9100 - 9000)</i>	10 000	
Gain on call options (P/L)		10 000
<i>Gain made on exercise of options</i>		
Bank	15 000	
Margin deposit		15 000
<i>Return of deposit on exercise of options.</i>		

Solution 16.15

a) Shares available for sale

		Debit	Credit
1 April 20X8			
Investment: shares	$6\,000 + 600$	6 600	
Bank			6 600
<i>Purchase of shares</i>			
<hr/>			
31 December 20X8			
FV adjustment reserve (OCI)	$5\,900 - 6\,600$	700	
Investment: shares			700
<i>FV Adjustment:</i>			
<hr/>			
31 December 20X9			
Equity (OCI)	$300 \times 18 - 5\,900$	500	
Investment: shares			500
<i>FV Adjustment at year-end</i>			
<hr/>			
Bank		2 700	
Investment: shares			2 700
<i>(150 shares \times C 18)</i>			
<hr/>			
Loss on sale of shares (P/L)	$(700 + 500) \times 150 / 300$	600	
Equity (OCI)			600
<i>Reclassification adj out of equity</i>			
<hr/>			

Solution 16.15 continued ...

b)

		Debit	Credit
1 January 20X9			
Investment in government gilts	<i>Given</i>	270 000	
Bank			270 000
<i>Purchase of gilts</i>			
30 June 20X9			
Bank	$300\,000 \times 8\% \times 6/12$	12 000	
Investment in government gilts	<i>Balancing</i>	4 292	
Interest income	$270\,000 \times 6.034\%$		16 292
<i>Interest up to date of sale</i>			
Bank	<i>Given</i>	170 000	
Investment in government gilts	$(270\,000 + 4\,292) \times 60\%$		164 575
Profit on sale (bal)			5 425
<i>Sale of gilts</i>			
Investment in government gilts (available for sale)		109 717	
Investment in government gilts (held to maturity)			109 717
<i>IAS 39.51 and .52: Must reclassify as AFS once a significant portion is sold $(270\,000 + 4\,292) \times 40\%$</i>			
Investment in government gilts (available for sale)		3 616	
FV adjustment reserve (OCI)	$(170\,000 / 60 \times 40) - 109\,717$		3 616
<i>FV Adjustment:</i>			

31 December 20X9

A further fair value would need to be obtained at this point and a further fair value adjustment would need to be journalized. No such fair value was made available and therefore this journal has not been processed.

Solution 17.1

Introduction:

In order for the directors to be able to recognise the rehabilitation costs, it is necessary to consider whether these costs represent a provision or a contingent liability.

Definitions

- A provision is a liability of uncertain timing or amount
- A liability is
 - A present obligation (legal or constructive)
 - as a result of a past event
 - the settlement of which is expected to result in an outflow of future economic benefits

Recognition criteria

- It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- A reliable estimate can be made of the amount of the obligation.

Discussion:

Present obligation of the entity

It is more likely than not that a present obligation exists at reporting date. In determining whether or not a present obligation exists, IAS 37 provides further guidance in stating that a present obligation may be either a legal or a constructive obligation.

A constructive obligation is an obligation that derives from an entity's actions where:

- by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities, and
- as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

The company is not legally obliged to rehabilitate the soil but a constructive obligation does exist: Toxins Waste Disposal Limited's directors made a statement in the press – before year-end – accepting responsibility for the contamination and committing the company to the rehabilitation of the area by 15 February 20X9. This statement would create a valid expectation on the part of the residents, environmentalists and public that the company will rehabilitate the area.

Past event

The past event must exist independent of the entity's future actions. The press statement is a past event as it was made before 31 December 20X8 and has resulted in the entity having no realistic alternative but to replace the soil.

Outflow of future economic benefits

The rehabilitation in early 20X9 will involve costs, which will result in an outflow of resources when these costs are paid.

Solution 17.1 continued . .

Thus the definition of a liability has been met. The amount of this liability is uncertain and thus the definition of a provision is also met

The next step is to ascertain whether or not the recognition criteria are met.

Probable outflow of future economic benefits

Since there has been a public statement that the company will rehabilitate the area, it is unlikely that the company would go back on their word. The resultant outflow of economic benefits is therefore probable.

Reliable estimate possible

Since this is the first time that this chemical has ever been spilt, the directors requested a team of experts and are still awaiting a detailed evaluation of the extent of the damage and related costs. They have admitted that they are as yet 'unable to estimate' what it will cost. It is submitted that the complete lack of suitable information means that there is such a high degree of 'uncertainty' that a 'reliable' estimate would not be possible.

Therefore the costs meet the definition of a liability and a provision but not the recognition criteria, with the result that a provision may not be recognised.

Conclusion

The rehabilitation costs are thus a contingent liability because they represent:

- a present obligation from past events
- that may not be recognised because the recognition criteria are not completely met: the amount of the obligation cannot be measured with sufficient reliability.

This contingent liability must be disclosed in the notes (and possibly the directors' report due to the possible materiality of the costs involved) showing the following:

- a brief description of the nature of the contingent liability;
- an estimate of its financial effect;
- an indication of the uncertainties relating to the amount or timing of any outflow; and
- the possibility of any reimbursement.

Solution 17.2

In order to account for the guarantee of the director's loan in the statement of financial position of Beta Limited, it would be necessary for the guarantee to meet the definition of a liability. A liability is defined in The Framework as follows:

- A present obligation of the entity
- That has arisen as a result of a past event,
- The settlement of which is expected to result in an outflow of future economic benefits.

A past event that leads to a present obligation is called an obligating event. The obligating event is the giving of the guarantee and thus there is a present legal obligation.

A liability should be recognised when it is probable that there will be an outflow of resources embodying economic benefits and that a reliable estimate of this outflow can be made. There is no probable outflow of resources until the director defaults and thus the guarantee should not be recognised as a liability, but as a contingent liability.

IAS 37 defines a contingent liability as.

- a possible obligation from past events
- whose existence will be confirmed only by the
- occurrence or non-occurrence of one or more
- uncertain future events
- not wholly within the control of the entity (i.e. the possible default by the director).

Beta Limited should therefore disclose a contingent liability in the notes to the financial statements as required by IAS 37. The relevant disclosure would be as follows:

BETA LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED ...

11. Contingent liability

The company has guaranteed Mr X's loan of C250 000 and will be liable for repayment of the loan should Mr X default on one or more of his loan repayments.

Solution 17.3

A liability exists when the definition of a liability is met, that is when:

- an entity has a present obligation (legal or constructive);
- as a result of a past event;
- the settlement of which is expected to result in an outflow of future economic benefits.

A provision is a liability of uncertain timing or amount. Provisions are disclosed separately from the other liabilities that are not uncertain in timing or amount.

Liabilities should be recognised when the above definition is met and when the following recognition criteria is met:

- It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- A reliable estimate can be made of the amount of the obligation.

The accountant should not provide for the future maintenance costs unless there is a past obligating event, being either a:

- legal obligation (e.g. a contract or law that requires maintenance to be carried out); or
- constructive obligation (would not be applicable to this situation).

Only obligations arising from past events that exist independent of the entity's future actions may be raised as provisions. Since the future maintenance is prescribed only by the policy imposed on the company by the directors, no provision should be made since this does not represent a legal or constructive obligation (the directors are still able to change their intention or policy).

Solution 17.4

An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

At 31 December 20X8, it is the costs of the contract are as follows:

	C
Costs already incurred	12 000 000
Costs to complete	8 000 000
Total costs	20 000 000

Total revenue to be received under the contract: C15 000 000

Received already: 7 months = C10 500 000

Still to be received: 3 months = C4 500 000

This contract meets the definition of an onerous contract as the costs of the contract exceed the revenue to be derived from it.

A provision must be raised immediately for the lower of the costs of completing the contract or of cancelling it.

Costs to complete: C8 000 000

Costs to cancel: C2 000 000

Thus a provision should be raised for C2 000 000.

Solution 17.5

Rich Kid Ltd

Rich Kid Ltd offers a guarantee to customers, thus a provision must be raised for the expected costs of fulfilling guarantees. Goods were sold with a six-month guarantee and sales for the 20X8 year amount to C500 000. The guarantee relating to goods sold from 1 January to 30 June 20X8 has expired, and it is only the goods sold from 1 July to 31 December 20X8 that are still under guarantee. Thus a provision must be raised for:
 $C500\,000 \times 50\% \times 15\%$ (most likely returns) = C37 500.

Super-Duper Ltd offers a guarantee on goods sold to Rich Kid Ltd, thus returns to Rich Kid Ltd may be passed on to Super-Duper Ltd for fulfillment. Thus the portion of C37 500 expected returns to Rich Kid Ltd that relates to goods originally bought from Super-duper Ltd may be raised as an asset (if reimbursement from Super-Duper Ltd is virtually certain) or as a contingent asset (if reimbursement from Super-duper Ltd is probable).

Super-Duper Ltd

Super-duper Ltd also offers a guarantee to customers, thus a provision must be raised for the expected costs of fulfilling guarantees. Goods were sold with a six-month guarantee and sales for the 20X8 year amount to C7 000 000. Thus a provision must be raised for:
 $C7\,000\,000 \times 50\%$ (6-month guarantee) $\times 10\%$ (most likely returns) = C350 000.

Money-cruncher Ltd

No guarantee is offered, yet returns are still refunded. A provision must be raised for the expected costs of refunds, to the extent that Money-Cruncher is prepared to accept returned goods. The period for which goods will be refunded is not known. Sales for the 20X8 year were C5 000 000 and it is estimated that 5% of goods will be returned.

Solution 17.6

a) Repairs at sea

It is necessary to determine whether or not the cost of the repairs meet the requirements for recognising a liability in terms of The Framework.

The Framework defines a liability as:

- a present obligation of the entity
- arising from a past event
- the settlement of which is expected to result in an outflow of future economic benefits.

A liability is then recognised if

- it is probable that an outflow of resources will result from the settlement of the liability, and
- the amount of the settlement can be measured reliably.

The cost of repairing the tanker at sea results in a 'pure' liability. Applying the definition and recognition criteria above:

- the work was carried out by the special crew on 29 September 20X9, which is classified as a past event since this date occurs before year end;
- since there is a past event, being the repair carried out on 29 September 20X9, there is a present legal obligation to pay for these repairs;
- the future payment of C365 000 is an outflow of economic resources;
- the amount will probably be paid since there is no evidence to the contrary; and
- the repair has already been invoiced at C365 000 and is therefore a reliably measure.

A liability of C365 000 should therefore be recognised in the statement of financial position at 30 September 20X9 and an expense of C365 000 included in the statement of comprehensive income for the year.

b) Repairs at the dry-dock

BatterSea Shipping need to assess whether the cost of repairs to the tanker in the dry dock meet the definition of a liability at 30 September 20X9.

The Framework defines a liability as:

- a present obligation of the entity
- arising from a past event
- the settlement of which is expected to result in an outflow of economic benefits.

As at 30 September 20X9 no work has been performed and therefore there is no past event and consequently no present obligation has yet arisen. The amount of C2 750 000 would, however, be disclosed in the commitments note in the annual financial statements, as 'capital expenditure not yet contracted for'. Since the definition has not been met, the estimated cost of C2 750 000 to repair the tanker once docked may not be recognized as a liability.

When the repairs are performed after reporting date it will not constitute an adjusting post reporting period event. This is because the repairs do not provide additional information about a condition that existed at reporting date. The contract was signed and the repairs were performed after reporting date.

Solution 17.6 continued ...

It would also be necessary to perform an impairment test on the tanker at year end.

c) Clean up of the environment

Introduction:

It is necessary to determine whether or not the costs of cleaning up the environment meet the definition of a provision.

IAS 37 defines a provision as

- a liability
- of uncertain timing or amount.

The Framework defines a liability as:

- a present obligation of the entity
- arising from a past event
- the settlement of which is expected to result in an outflow of future benefits.

Discussion of definitions:

Present obligation of the entity

A present obligation is the result of an obligating event. An obligating event is defined by IAS 37 as an event

- that creates a legal or constructive obligation
- that results in an entity having no realistic alternative to settling that obligation.

Per IAS 37 a constructive obligation is an obligation that derives from an entity's actions where:

- by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities, and
- as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

The entity is not legally obliged to rehabilitate the area but the managing director's announcement in the press on 30 September 20X9 of the company's intention to clean up the entire area of the spill, indicates the company's acceptance of its responsibility to rehabilitate the area. This action has created a valid expectation on the part of the public and environmentalists that the company will actually bear these costs. After making a public announcement, it is unlikely that the company will *not* clean up the environment; as such an action would have an adverse effect on their business reputation. Therefore the announcement before year-end is the past obligating event that has created a constructive obligation on behalf of the company to clean up the area.

Past event:

There is a past event since the press statement that obligated the entity was made before year-end.

Expected outflow of future economic benefits:

There will be costs incurred from the specialists hired to advise on the extent/ most effective method of cleaning up to the actual costs of cleaning up.

Solution 17.6 continued ...

Since the actual amount is uncertain, the liability would be recognised as a provision.

Discussion of recognition criteria:

IAS 37 requires a provision to be recognised when:

- it is probable that an outflow of resources will be required to settle the obligation,
- and a reliable estimate can be made of the obligation.

It is probable that there will be an outflow of resources as a constructive obligation exists and a team of experts was engaged to assess the extent of the damage and the most effective method of cleaning up the spill.

A reliable estimate of the cost of the clean up can be made based on the past experience of the team of environmentalists. Since this estimate will be available before the financial statements are authorised for issue, a provision should be recognised in the financial statements of the company at 30 September 20X9. In effect, the results of the environmental assessment on 31 October 20X9 will be an adjusting post reporting period event.

IAS 37 requires disclosure of the following in respect of a provision

- the amount of the provision made during the period;
- a brief description of the nature of the obligation;
- the expected timing of any resulting outflows of economic benefits; and
- an indication of the uncertainties about the amount or timing of those outflows.
- Where necessary to provide adequate information, an entity should disclose the major assumptions made concerning future events.

Solution 17.7

Introduction

A liability should be recognised when

- An entity has a present obligation (legal or constructive) as a result of a past event, the settlement of which is expected to result in an outflow of future economic benefits;
- It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- A reliable estimate can be made of the obligation.

There are two trains of thought with regard to recognising audit fees. One is that the audit fees should be recognised as a liability in the financial year in which the audit services are rendered (the past event), as that is when the obligation (legal) to pay the audit firm arises, and the other is that audit fees may be recognised in the year to which the audit pertains, even if that audit is only performed after reporting date, as there is a legal obligation to have the financial statements audited as a result of having traded during the year (the past event).

Discussion

The C900 000:

- the delivery of the audit services before 30 September 20X1 is the past event;
- the past event results in a obligation being present at year-end, since it had not yet been paid as at year-end;
- this obligation is reliably measured at the C900 000 payable in respect of these services, since this figure has either been provided by way of an invoice from the auditors or would have been checked by the auditors; and
- since there is no evidence to the contrary, the payment of these fees appears probable.

A provision is a liability, the amount or timing of which is uncertain. Since there appears to be no uncertainty regarding the amount or timing (it is assumed that the C900 000 was determined per an invoice received from the auditors or will have been checked by the auditor for reasonableness), it would appear to be a 'pure' liability and not a provision.

The C300 000:

Recognition of the C300 000 depends on the train of thought followed regarding what represents the past event:

- the physical audit (which leads to the legal obligation to pay the audit firm); or
- the trading of the business (which leads to the legal obligation to have a statutory audit).

If having the physical audit services performed is regarded as the past event:

- Although the C300 000 may be a reliable estimate (based probably on the audit budget and/ or past experience or an invoice received from the auditors after year-end),
- the related services have not been rendered as at 30 September 20X1, and therefore there is no past event at year end, and
- thus there is no obligation present at year end.

If having traded during the financial year is considered the past event:

- There is a present legal obligation to have the financial statements audited,
- Although the audit has not yet occurred, there is a reliable estimate of the amount of the outflow (C300 000),

Solution 17.7 continued ...

- There is some uncertainty as to the amount and timing of the outflow because the work still has to be performed, and the amount will only be paid based on the work done once it has been done, thus the obligation at reporting date may be recognised as a provision.

Conclusion

A liability for audit fees of C900 000 should therefore be recognised as at 30 September 20X1. The C300 000 may be recognised as a provision at 30 September 20X1 (if trading is considered to be the past event) or it may not be recognised at all (if the physical audit is considered to be the past event).

In Pakistan, it is a normal industry practice to book the liability by the whole amount, i.e. to book the liability of the audit fees in the year to which the audit pertains as there is a legal audit obligation for the companies.

Solution 17.8

a) The Framework definition and recognition criteria

Liability definition (The Framework):

- A present obligation of the entity
- As a result of a past event
- The settlement of which is expected to lead to an outflow of future economic benefits.

Recognition criteria (The Framework):

- Probable outflow of future economic benefits
- Cost/ value can be reliably measured.

b) IAS 37 recognition criteria for restructuring provisions

The recognition criteria stipulated in IAS 37 to be met before recognising a provision for restructuring include the following:

- There must be a detailed formal plan that identifies at least the following:
 - The business or part of the business affected
 - The principal locations affected
 - The location, function and approximate number of employees who will be compensated for terminating their services
 - The expenditure that will be undertaken
 - When the plan will be implemented; AND
- A valid expectation must have been raised in those parties that would be affected by the restructuring (thus creating a 'constructive obligation') through:
 - starting to implement the plan; or
 - announcing the main features to those affected by it.

Restructuring is defined in IAS 37 as:

- A programme planned and controlled by management that materially changes either:
 - the scope of the business; or
 - the manner in which the business is conducted.

c) Discussion

Restructuring:

The plan meets the definition of a restructuring since:

- It is a programme planned and controlled by management since management was responsible for the development of a formal plan to which all directors have agreed;
- The plan will result in the cessation of tyre manufacturing (a material change in the scope of the business) and will involve the importation of goods in the future (thus materially changing the manner in which the business is conducted).

Solution 17.8 continued . . .

Liability definition:

For there to be a liability, it must meet the definition of a liability:

- Present obligation
- As a result of a past event
- From which future economic benefits are expected to flow in settlement thereof.

The entity has no obligation as at 30 June 20X3:

- There is no legal obligation to close the tyre manufacturing business; and
- There is no constructive obligation as at 30 June 20X3.

For the restructuring to cause a constructive obligation:

- There must be a detailed formal plan stipulating at least the following:
 - The business or part of the business affected
 - The principal locations affected
 - The location, function and approximate number of employees who will be compensated for terminating their service
 - The expenditure that will be undertaken
 - When the plan will be implemented.
- The entity must have created valid expectations in those affected by the future restructuring before reporting date.

There is a detailed formal plan that stipulates:

- The business or part of the business affected: tyre manufacturing
- The principal locations affected: Eshowe
- The location, function and approximate number of employees who will be compensated for terminating their services: Eshowe; 50 factory and admin staff
- The expenditure that will be undertaken: retrenchment packages
- When the plan will be implemented: December 20X4.

Valid expectations had not been created at reporting date since the plan had:

- not been announced to those affected: it is only to be announced on 30 September 20X4; and
- not begun.

There is therefore no valid expectation and therefore no obligation as at 30 June 20X3.

- There is an *event* in that a decision was made to discontinue the tyre branch and the development of a formal plan, both of which are *past events* since they occurred before year-end.
- These events on their own do not lead to an *obligation*: the extra event that would have been required in order to lead to an obligation is either the announcement of the plan or starting the implementation thereof.
- The discontinuation would result in retrenchment packages thus an *outflow*, of future economic benefits, is expected.

Recognition criteria:

- The outflow of future economic benefits is probable since the plan has been agreed upon.
- A thorough analysis of the expected cost of the discontinuance has been performed by the company's financial team making the estimate a reliable one (C1 500 000).

Since no legal or constructive obligation exists, no provision for restructuring costs should be recognise in the financial statements as at 30 June 20X3.

Solution 17.8 continued . . .

d) Measurement

- The provision would be C1 500 000.
- The cost of retraining the staff that would remain in Yolande Ltd's employ is considered to be a cost related to the ongoing activities of Yolande Ltd and must therefore be excluded from the provision for costs related to the discontinuance.
- All gains related to the restructuring are to be excluded from the provision.

Solution 17.9

Definitions:

The Framework defines a liability as:

- a present obligation of the entity
- arising from a past event
- the settlement of which is expected to result in an outflow of future economic benefits.

IAS 37 defines a provision as:

- a liability
- of uncertain timing or amount.

A provision is recognised when:

- An entity has a present obligation (legal or constructive) as a result of a past event, the settlement of which is expected to result in an outflow of future economic benefits;
- It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- A reliable estimate can be made of the amount of the obligation.

An asset is:

- a resource controlled by the entity
- as a result of a past event
- from which future economic benefits are expected to flow into the entity.

Discussion:

Previous major inspection as an asset:

The previous major inspection (carried out by the seller) represents an asset to Flybynight Limited:

- it is a resource in that the last required inspection has already been performed with the result that Flybynight Limited is legally able to fly the airplane;
- it is controlled by the entity through the receipt of the legal documents proving that the aeroplane passed this inspection;
- the past event was the purchase of the aeroplane that had already undergone the major inspection; and
- the ability to then use the aeroplane obviously leads to the expected inflow of future economic benefits.

The future major inspection as an asset:

The future major inspection does not, however, meet the definition of an asset:

- the company does not control a resource since the major inspection has not yet been performed or paid for;
- there is no past event since the major inspection is to be performed in the future;
- if there is no resource there can be no expectation of an inflow of future economic benefits.

Solution 17.9 continued ...

The future major inspection as a liability:

Similarly, a provision for the future major inspection should not be raised because there is no liability:

- since the major inspection has not yet occurred, there is no past event;
- therefore there is no present obligation at year end (the major inspection could, in fact, be completely avoided by selling or otherwise disposing off/ abandoning the airplane before the inspection becomes necessary); and
- since there is neither a past event or present obligation, the outflow of future economic benefits is not yet expected.

Assets – cost of acquisition and significant parts:

The acquisition of an asset should be measured at the necessary cost incurred in bringing the asset to a location and condition suitable for its intended use. Since the future major inspection is not a prerequisite for the current usage of the aeroplane (there were another $10\,000 - 4\,000 = 6\,000$ flying hours available on the date of acquisition) and has not yet been incurred, it may not be recognised as an asset or liability.

Note that the previous major inspection performed should be recognised as a separate component to the aeroplane asset (i.e. a significant part of) since it is significant in cost and has a different useful life to the rest of the aeroplane parts.

Assets – subsequent measurement:

The major inspection, which is recognised as a separate significant part, is depreciated as the 10 000 allowed flying hours are used up. Thus a ‘major inspection’ asset of C252 000 ($C420\,000$ [cost of previous inspection] \times 6000 hrs / $10\,000$ hrs) should be recognised on acquisition date. This will result in the cost of the ‘physical aeroplane’ asset being C4 248 000 ($C4\,500\,000 - C252\,000$). The ‘major inspection’ asset will have been depreciated by C11 466 since purchase date ($C252\,000 \times 273$ hours / $6\,000$ hours). Once the 6 000 flying hours that were available on purchase date are used up, and a new inspection is actually performed, the previous major inspection cost asset will be derecognised and the new inspection costs will be capitalised (when the next inspection is performed) and depreciated as the renewed flying hours are used up.

Conclusion:

The journal must be reversed as follows:

	Debit	Credit
Provision for major inspection (Liability)	500 000	
Major inspection (Asset)		500 000

*

Solution 17.10

a)

The issue is to determine whether to recognise a provision in respect of the future decommissioning costs.

IAS 37 defines a provision as a liability of uncertain timing or amount. Thus it is necessary to firstly determine whether or not there is a liability. The Framework defines a liability as:

- A present obligation of the entity
- As a result of a past event
- The settlement of which will result in an outflow of future economic benefits.

In determining whether or not a present obligation exists, IAS 37 provides further guidance in stating that a present obligation may be a legal or a constructive obligation. A legal obligation is an obligation that derives from:

- a contract (through its explicit or implicit terms),
- legislation, or
- other operation of law.

The licence granted allows the operation of the plant and machinery but includes a clause that requires the entity to dismantle the plant and restore the area in the future. There is therefore a legal obligation for the costs associated with the future dismantling and restoration.

A past event that leads to a present obligation is called an obligating event. The obligating event is the installation of the plant and machinery in terms of this licence and thus there is a legal obligation present at year-end.

Since there is:

- a past obligating event: the installation of the plant and machinery;
- that leads to a present obligation: the legal obligation results from the installation in terms of the licence; and
- it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation (the payment of the decommissioning costs in the future);
- a reliable estimate can be made of the obligation (the decommissioning costs are estimated at C120 000).

a provision for future decommissioning costs can be raised. The provision must be capitalised to the cost of the plant and machinery. This is because assets are raised at cost and in terms of IAS 16, one of the components of cost is future decommissioning costs.

Note to student:

Decommissioning and dismantling are two terms that are frequently used in the accounting world to refer essentially to the same thing. Strictly speaking, 'decommissioning' refers to taking an asset (e.g. machine or plant) out of operation whereas 'dismantling' refers to the 'taking apart' of an asset.

Solution 17.10 continued ...

b)

		Debit	Credit
01/10/X2	Plant & machinery: cost (Asset)	1 000 000	
	Bank		1 000 000
	(Purchase price)		
10-12/ X2	Plant & machinery: cost (Asset)	175 480	
	Bank		175 480
	(Installation costs)		
01/01/X3	Plant & machinery: decommissioning: cost (Asset)	74 520	
	Provision for decommissioning liability		74 520
	(PV of future decommissioning costs)		
31/12/X3	Finance costs	7 440	
	Provision for decommissioning liability		7 440
	(Unwinding of PV of decommissioning liability)		
	(81 960 – 74 520)		
	Depreciation	250 000	
	Plant & machinery: accumulated depreciation		235 096
	Plant & machinery: decommissioning: accumulated depreciation		14 904
	(1 175 480 / 5) (74 520 / 5)		

Please note: the accumulated depreciation of each of these two parts – the physical plant & machinery versus the expected costs of decommissioning can be combined into a single accumulated depreciation account if preferred (since the rate of depreciation is the same in both cases).

c)

LEO LIMITED
EXTRACT FROM STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X4

	20X4	20X3
	C	C
Finance costs	8 160	7 440

LEO LIMITED
EXTRACT FROM STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X4

	Note	20X4	20X3
		C	C
Non-current assets			
Plant & machinery		750 000	1 000 000
Cost	(1 000 000 + 175 480 + 74 520)	1 250 000	1 250 000
Accumulated depreciation	(1 250 000 / 5 X 2) (1 250 000 / 5 x 1)	(500 000)	(250 000)
Non-current liabilities			
Provision for decommissioning liability	2	90 120	81 960

Solution 17.10 continued ...

LEO LIMITED
EXTRACT FROM NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X4

1. Accounting policies

Provisions

Provisions are recognised when the company has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate of the amount can be made.

2 Provision for decommissioning liability

	20X4
	C
Carrying amount at beginning of period	81 960
Unwinding of discounted present value	8 160
Carrying amount at end of period	<u>90 120</u>

The provision for decommissioning liability arises from the dismantling and restoration costs relating to the plant and machinery. These costs are expected to be incurred at 31 December 20X7.

The dismantling and restoration costs are estimated to be C120 000 and are not expected to change.

Workings

Date	Years to decommissioning date	10% discount factor	PV	Finance costs
01/01/X3	5	0.621	74 520	
31/12/X3	4	0.683	81 960	7 440
31/12/X4	3	0.751	90 120	8 160
31/12/X5	2	0.826	99 120	9 000
31/12/X6	1	0.909	109 080	9 960
31/12/X7	0	1.000	120 000	10 920

Solution 17.11**a) No change in estimate****i) Journals**

	Debit	Credit
1 January 20X1		
Nuclear plant: cost (Asset)	2 000 000	
Bank		2 000 000
<i>Purchase of nuclear plant for cash</i>		
Nuclear plant (decommissioning): cost (Asset)	1 156 630	
Decommissioning liability		1 156 630
<i>Initial recognition of the decommissioning obligation (present value of future cost of C3 000 000 discounted at 10%)</i>		
31 December 20X1		
Finance charges (Expense)	115 663	
Decommissioning liability		115 663
<i>Increase in liability as a result of unwinding of the discount</i>		
Depreciation (Expense)	315 663	
Nuclear plant: accumulated depreciation		315 663
<i>Depreciation of nuclear plant (2 000 000 + 1 156 630) / 10 years</i>		
31 December 20X2		
Finance charges (Expense)	127 229	
Decommissioning liability		127 229
<i>Increase in liability as a result of unwinding of the discount</i>		
Depreciation (Expense)	315 663	
Nuclear plant: accumulated depreciation		315 663
<i>Depreciation of nuclear plant (2 000 000 + 1 156 630) / 10 years</i>		
31 December 20X3		
Finance charges (Expense)	139 952	
Decommissioning liability		139 952
<i>Increase in liability as a result of unwinding of the discount</i>		
Depreciation (Expense)	315 663	
Nuclear plant: accumulated depreciation		315 663
<i>Depreciation of nuclear plant (2 000 000 + 1 156 630) / 10 years</i>		
31 December 20X4		
Finance charges (Expense)	153 947	
Decommissioning liability		153 947
<i>Increase in liability as a result of unwinding of the discount</i>		
Depreciation (Expense)	315 663	
Nuclear plant: accumulated depreciation		315 663
<i>Depreciation of nuclear plant (2 000 000 + 1 156 630) / 10 years</i>		
31 December 20X5		
Finance charges (E)	169 342	
Decommissioning liability		169 342
<i>Increase in liability as a result of unwinding of the discount</i>		
Depreciation (Expense)	315 663	
Nuclear plant: accumulated depreciation		315 663
<i>Depreciation of nuclear plant (2 000 000 + 1 156 630) / 10 years</i>		

Solution 17.11 continued ...

a) continued ...

	Debit	Credit
31 December 20X6		
Finance charges (Expense)	186 276	
Decommissioning liability		186 276
<i>Increase in liability as a result of unwinding of the discount</i>		
Depreciation (Expense)	315 663	
Nuclear plant: accumulated depreciation		315 663
<i>Depreciation of nuclear plant (2 000 000 + 1 156 630) / 10 years</i>		
31 December 20X7		
Finance charges (Expense)	204 904	
Decommissioning liability		204 904
<i>Increase in liability as a result of unwinding of the discount</i>		
Depreciation (Expense)	315 663	
Nuclear plant: accumulated depreciation		315 663
<i>Depreciation of nuclear plant (2 000 000 + 1 156 630) / 10 years</i>		
31 December 20X8		
Finance charges (Expense)	225 394	
Decommissioning liability		225 394
<i>Increase in liability as a result of unwinding of the discount</i>		
Depreciation (Expense)	315 663	
Nuclear plant: accumulated depreciation		315 663
<i>Depreciation of nuclear plant (2 000 000 + 1 156 630) / 10 years</i>		
31 December 20X9		
Finance charges (Expense)	247 934	
Decommissioning liability		247 934
<i>Increase in liability as a result of unwinding of the discount</i>		
Depreciation (Expense)	315 663	
Nuclear plant: accumulated depreciation		315 663
<i>Depreciation of nuclear plant (2 000 000 + 1 156 630) / 10 years</i>		
31 December 20X10		
Finance charges (Expense)	272 727	
Decommissioning liability		272 727
<i>Increase in liability as a result of unwinding of the discount</i>		
Depreciation (Expense)	315 663	
Nuclear plant: accumulated depreciation		315 663
<i>Depreciation of nuclear plant (2 000 000 + 1 156 630) / 10 years</i>		
Decommissioning liability	3 000 000	
Bank		3 000 000
<i>Payment in respect of decommissioning</i>		

Notice that C5 000 000 is expensed through total depreciation of C3 156 630 over the 10 years and total finance charges of C1 843 370 (being the C2 000 000 (the cost of asset excluding decommissioning costs) plus C3 000 000 (the decommissioning costs)).

Solution 17.11 continued ...

a) continued ...

ii) Disclosure

MENACE LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X10

6. Provision for future decommissioning of nuclear plant

	20X10 C'000	20X9 C'000	20X8 C'000	20X7 C'000	20X6 C'000	20X5 C'000	20X4 C'000	20X3 C'000	20X1 C'000	20X0 C'000
Opening balance	2 727	2 479	2 254	2 049	1 863	1 694	1 540	1 400	1 272	0
Present value of future costs	-	-	-	-	-	-	-	-	-	1 157
Finance charges	273	248	225	205	186	169	154	140	127	116
Payment	(3 000)	-	-	-	-	-	-	-	-	-
Closing balance	0	2 727	2 479	2 254	2 049	1 863	1 694	1 540	1 400	1 272

The following information would be provided in all years to 20X9:

Decommissioning of the plant is expected to occur on 31 December 20X10 and is expected to result in cash outflows of C3 000 000. The amount of the outflows is uncertain due to changing prices. The timing of the outflow is uncertain due to the changing asset usage, which may result in a longer or shorter useful life. Major assumptions include that the interest rates will remain at 10% and that the asset has a useful life of 10 years.

Workings:**Present value table:**

Date	Discount factor (rounded):10%	Calculation of discount factor	Liability balance 3 000 000 x Discount factor	Finance charges
1/1/X1	0.38554	$0.424/(1+10\%)$	1 156 630	
31/12/X1	0.42410	$0.467/(1+10\%)$	1 272 293	115 663
31/12/X2	0.46651	$0.513/(1+10\%)$	1 399 522	127 229
31/12/X3	0.51316	$0.565/(1+10\%)$	1 539 474	139 952
31/12/X4	0.56447	$0.621/(1+10\%)$	1 693 422	153 947
31/12/X5	0.62092	$0.683/(1+10\%)$	1 862 764	169 342
31/12/X6	0.68301	$0.751/(1+10\%)$	2 049 040	186 276
31/12/X7	0.75131	$0.826/(1+10\%)$	2 253 944	204 904
31/12/X8	0.82645	$0.909/(1+10\%)$	2 479 339	225 394
31/12/X9	0.90909	$1/(1+10\%)$	2 727 273	247 934
31/12/X10	1.00000	Actual = 1	3 000 000	272 727
				<u>1 843 370</u>

Solution 17.11 continued ...

b) Change in estimate during the 10-year period

i) Journals:

1 January 20X1

	Debit	Credit
Nuclear plant: cost [Asset (A)]	2 000 000	
Bank		2 000 000

Purchase of nuclear plant for cash

Nuclear plant (decommissioning): cost (A)	1 156 630	
Decommissioning liability		1 156 630

Initial recognition of the decommissioning obligation (present value of future cost of C3 000 000 discounted at 10%)

31 December 20X1

Finance charges [Expense (E)]	115 663	
Decommissioning liability		115 663

Increase in liability as a result of unwinding of the discount

Depreciation (E)	315 663	
Nuclear plant: accumulated depreciation		315 663

Depreciation of nuclear plant (2 000 000 + 1 156 630) / 10 years

31 December 20X2

Finance charges (E)	127 229	
Decommissioning liability		127 229

Increase in liability as a result of unwinding of the discount

Depreciation (E)	315 663	
Nuclear plant: accumulated depreciation		315 663

Depreciation of nuclear plant (2 000 000 + 1 156 630) / 10 years

31 December 20X3

Finance charges (E)	139 952	
Decommissioning liability		139 952

Increase in liability as a result of unwinding of the discount

Depreciation (E)	315 663	
Nuclear plant: accumulated depreciation		315 663

Depreciation of nuclear plant (2 000 000 + 1 156 630) / 10 years

31 December 20X4

Nuclear plant (decommissioning): cost (A)	410 527	
Decommissioning liability		410 527

Change in estimated future costs: increase in decommissioning obligation: W3

Finance charges (E)	195 000	
Decommissioning liability		195 000

Increase in liability as a result of unwinding of the discount

Depreciation (E)	374 310	
Nuclear plant: accumulated depreciation		374 310

Depreciation of nuclear plant: W5

Solution 17.11 continued ...

b) continued ...

Journals continued ...

	Debit	Credit
31 December 20X5		
Finance charges (E)	214 500	
Decommissioning liability		214 500
<i>Increase in liability as a result of unwinding of the discount</i>		
Depreciation (E)	374 310	
Nuclear plant: accumulated depreciation		374 310
<i>Depreciation of nuclear plant (2 000 000 + 1 465 064) / 10 years</i>		
31 December 20X6		
Finance charges (E)	235 950	
Decommissioning liability		235 950
<i>Increase in liability as a result of unwinding of the discount</i>		
Depreciation (E)	374 310	
Nuclear plant: accumulated depreciation		374 310
<i>Depreciation of nuclear plant (2 000 000 + 1 465 064) / 10 years</i>		
31 December 20X7		
Finance charges (E)	259 545	
Decommissioning liability		259 545
<i>Increase in liability as a result of unwinding of the discount</i>		
Depreciation (E)	374 310	
Nuclear plant: accumulated depreciation		374 310
<i>Depreciation of nuclear plant (2 000 000 + 1 465 064) / 10 years</i>		
31 December 20X8		
Finance charges (E)	285 500	
Decommissioning liability		285 500
<i>Increase in liability as a result of unwinding of the discount</i>		
Depreciation (E)	374 310	
Nuclear plant: accumulated depreciation		374 310
<i>Depreciation of nuclear plant (2 000 000 + 1 465 064) / 10 years</i>		
31 December 20X9		
Finance charges (E)	314 050	
Decommissioning liability		314 050
<i>Increase in liability as a result of unwinding of the discount</i>		
Depreciation (E)	374 310	
Nuclear plant: accumulated depreciation		374 310
<i>Depreciation of nuclear plant (2 000 000 + 1 465 064) / 10 years</i>		
31 December 20X10		
Finance charges (E)	345 455	
Decommissioning liability		345 455
<i>Increase in liability as a result of unwinding of the discount</i>		
Depreciation (E)	374 310	
Nuclear plant: accumulated depreciation		374 310
<i>Depreciation of nuclear plant (2 000 000 + 1 465 064) / 10 years</i>		
Decommissioning liability	3 800 000	
Bank		3 800 000
<i>Payment in respect of decommissioning</i>		

Notice that C5 800 000 is expensed over the 10 years: depreciation of C3 465 061 and finance charges of C2 334 936 (C2 000 000: cost of asset excluding decommissioning cost and C3 800 000 (decommissioning). Please note that there is a difference of C3, which is due to rounding.

Solution 17.11 continued ...

b) continued ...

Please also note that all journal entries up to 31 December 20X3 remain unchanged, since a change in estimate is processed prospectively, which means that it only affects the year of the change and future years.

ii) Statement of financial position note disclosure

MENACE LIMITED

NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X10

7. Provision for future decommissioning of nuclear plant

	20X10 C'000	20X9 C'000	20X8 C'000	20X7 C'000	20X6 C'000	20X5 C'000	20X4 C'000	20X3 C'000	20X1 C'000	20X0 C'000
Opening balance	3 454.5	3 140.5	2 855.0	2 595.5	2 359.5	2 145	1 540	1 400	1 272	0
Present value of future costs	-	-	-	-	-	-	-	-	-	1 157
Increase in estimated future costs:										
- original PV							410			
Finance charges	345.5	314.0	285.5	259.5	236	214.5	195	140	127	116
Payment	(3 800)	-	-	-	-	-	-	-	-	-
Closing balance	0	3 454.5	3 140.5	2 855.0	2 595.5	2 359.5	2 145	1 540	1 400	1 272

The following information would be provided in all years to 20X9:

Decommissioning of the plant is expected to occur on 31 December 20X10 and is expected to result in cash outflows of C3 800 000 (previous estimate was C3 000 000). The amount of the outflows is uncertain due to changing prices. The timing of the outflow is uncertain due to the changing asset usage, which may result in a longer or shorter useful life. Major assumptions include that the interest rates will remain at 10% and that the asset has a useful life of 10 years.

iii) Statement of comprehensive income note disclosure

8. Profit before tax

			20X4 C	20X3 C	20X2 C	20X1 C
Profit before tax is stated after accounting for the following disclosable (income)/ expense items:						
Finance charges			195 000	139 952	127 229	115 663
- previous estimate			153 947			
- change in estimate	W4	9	41 053			
Depreciation			374 310	315 663	315 663	315 663
- previous estimate			315 663			
- change in estimate	W5	9	58 647			

Solution 17.11 continued ...

b) continued ...

9. Change in estimate

The expected cash outflow on 31 December 20X10 in respect of the decommissioning of plant was changed. The (increase)/ decrease caused by the change is as follows:

			20X4 C
	<i>[Extra int + extra dep]</i>		
• Current year profits (before tax)	<i>[41 053 + 58 647]</i>	W4 & W5	99700
• Future profits (before tax)	<i>[348 420 + 351 880]</i>	W4 & W5	700 300
			<u>800 000</u>

Workings:

W1 Present value table 1: old estimate

Date	Discount factor (rounded):10%	Calculation of discount factor	Liability Balance $3\,000\,000 \times \text{Discount factor}$	Finance charges
1/1/X1	0.38554	$0.424/(1+10\%)$	1 156 630	
31/12/X1	0.42410	$0.467/(1+10\%)$	1 272 293	115 663
31/12/X2	0.46651	$0.513/(1+10\%)$	1 399 522	127 229
31/12/X3	0.51316	$0.565/(1+10\%)$	1 539 474	139 952
31/12/X4	0.56447	$0.621/(1+10\%)$	1 693 422	153 947
31/12/X5	0.62092	$0.683/(1+10\%)$	1 862 764	169 342
31/12/X6	0.68301	$0.751/(1+10\%)$	2 049 040	186 276
31/12/X7	0.75131	$0.826/(1+10\%)$	2 253 944	204 904
31/12/X8	0.82645	$0.909/(1+10\%)$	2 479 339	225 394
31/12/X9	0.90909	$1/(1+10\%)$	2 727 273	247 934
31/12/X10	1.00000	<i>Actual = 1</i>	3 000 000	272 727
				<u>1 843 370</u>

W2 Present value table 2: new estimate

Date	Discount factor (rounded):10%	Calculation of discount factor	Liability balance $3\,800\,000 \times \text{Discount factor}$	Finance charges
	10%			
1/1/X1	0.385543289	$0.424/(1+10\%)$	1 465 064	
31/12/X1	0.424097618	$0.467/(1+10\%)$	1 611 571	146 506
31/12/X2	0.46650738	$0.513/(1+10\%)$	1 772 728	161 157
31/12/X3	0.513158118	$0.565/(1+10\%)$	1 950 001	177 273
31/12/X4	0.56447393	$0.621/(1+10\%)$	2 145 001	195 000
31/12/X5	0.620921323	$0.683/(1+10\%)$	2 359 501	214 500
31/12/X6	0.683013455	$0.751/(1+10\%)$	2 595 451	235 950
31/12/X7	0.751314801	$0.826/(1+10\%)$	2 854 996	259 545
31/12/X8	0.826446281	$0.909/(1+10\%)$	3 140 496	285 500
31/12/X9	0.909090909	$1/(1+10\%)$	3 454 545	314 050
31/12/X10	1	<i>Actual = 1</i>	3 800 000	345 455
				<u>2 334 936</u>

Solution 17.11 continued ...

b) continued ...

W3: change in estimated liability and asset	
Revised present value at 31/12/20X3	1 950 001
Previous present value at 31/12/20X3	1 539 474
Adjustment necessary: debit asset and credit liability	410 527

W4: change in estimated interest/liability				
		Was	Is	Difference
Liability balance	31/12/20X3	1 539 474	1 950 001	410 527
Interest cy		153 947	195 000	41 053
Interest fy (balancing)		1 306 579	1 654 999	348 420
Final balance	31/12/20X10	3 000 000	3 800 000	800 000

W5: change in estimated depreciation/asset				
		Was	Is	Difference
Cost - cash	01/01/20X1	2 000 000		
PV of future decommissioning costs		1 156 630		
		3 156 630		
Depreciation to (3 156 630/ 10 x 3)	31/12/20X3	(946 989)		
Carrying amount	31/12/20X3	2 209 641	2 209 641	
Additional future decommissioning costs			410 527	
Revised carrying amount			2 620 168	
RUL		7	7	
Depreciation – cy		(315 663)	(374 310)	58 647
Carrying amount	31/12/20X4	1 893 978	2 245 858	
Future depreciation		(1 893 978)	(2 245 858)	351 880
Future carrying amount		0	0	410 527

Extra depr cy

Extra depr fy

Solution 17.12**a) Asset is purchased on 31 December 20X1****i) Journals: 20X1**

	Debit	Credit
Plant: paper mill (A)	1 694 800	
Bank		1 000 000
Decommissioning liability		694 800
<i>Acquisition of asset</i>		

ii) Impairment loss calculation: seller to pay decommissioning costs

	C
Expected proceeds on sale of asset (given)	1 200 000
Costs to sell asset (ignore decommissioning costs: these have already been recognised)	0
Net selling price of asset and also the recoverable amount (NSP>VIU: R800 000)	1 200 000
Carrying amount of asset	1 694 800
Impairment loss	494 800

iii) Impairment loss calculation: buyer to pay decommissioning costs

	C
Expected proceeds on sale of asset and liability (1 200 000 – 694 800)	505 200
Costs to sell asset and liability (ignore decommissioning costs: same reason as above)	0
Net selling price of asset and liability and also the recoverable amount (NSP>VIU: 800 000 – 694 800 = 105 200)	505 200
Carrying amount of asset and liability (Asset: 1 694 800 – Liability: 694 800)	1 000 000
Impairment loss	494 800

b) Asset is purchased on 1 January 20X1**i) Journals: 20X1**

	Debit	Credit
1 January 20X1		
Plant: paper mill (A)	1 694 800	
Bank		1 000 000
Decommissioning liability		694 800
<i>Acquisition of asset</i>		
31 December 20X1		
Depreciation	49 480	
Accumulated depreciation: paper mill		49 480
<i>Depreciation of asset: (cost: 1 694 800 – residual value: 1 200 000) / 10 years</i>		
Finance charges	68 400	
Decommissioning liability		68 400
<i>Liability increase due to unwinding of discount: W1 or financial calculator</i>		
Impairment loss	445 320	
Accumulated depreciation and impairment losses		445 320
<i>Impairment loss of asset: part (ii) below</i>		

Solution 17.12 continued ...

ii) Impairment loss calculation: seller to pay decommissioning costs

	C
Expected proceeds on sale of asset (given)	1 200 000
Costs to sell asset (ignore decommissioning costs: these have already been recognised)	0
Net selling price of asset and also the recoverable amount (NSP>VIU: R800 000)	1 200 000
Carrying amount of asset (1 694 800 – 49 480)	1 645 320
Impairment loss	445 320

iii) Impairment loss calculation: buyer to pay decommissioning costs

	C
Expected proceeds on sale of asset and liability (1 200 000 – (694 800 + 64 800))	440 400
Costs to sell asset and liability (ignore decommissioning costs: same reason as above)	0
Net selling price of asset and liability and also the recoverable amount (NSP>VIU: R800 000 – (694 800 + 64 800) = 40 400)	440 400
Carrying amount of asset and liability (A: (1 694 800 – 49 480) – L: (694 800 + 64 800)	885 720
Impairment loss	445 320

Workings

W1 Present value table:

Date	Discount factor (rounded):10%	Calculation of discount factor	Liability balance	Calculation of liability balance (present value)	Finance charges
31 Dec X10	1	<i>Actual = 1</i>	1 800 000	<i>1 800 000 x 1</i>	163 800
31 Dec X9	0.909	<i>1/(1+10%)</i>	1 636 200	<i>1 800 000 x 0.909</i>	149 400
31 Dec X8	0.826	<i>0.909/(1+10%)</i>	1 486 800	<i>1 800 000 x 0.826</i>	135 000
31 Dec X7	0.751	<i>0.826/(1+10%)</i>	1 351 800	<i>1 800 000 x 0.751</i>	122 400
31 Dec X6	0.683	<i>0.751/(1+10%)</i>	1 229 400	<i>1 800 000 x 0.683</i>	111 600
31 Dec X5	0.621	<i>0.683/(1+10%)</i>	1 117 800	<i>1 800 000 x 0.621</i>	100 800
31 Dec X4	0.565	<i>0.621/(1+10%)</i>	1 017 000	<i>1 800 000 x 0.565</i>	93 600
31 Dec X3	0.513	<i>0.565/(1+10%)</i>	923 400	<i>1 800 000 x 0.513</i>	82 800
31 Dec X2	0.467	<i>0.513/(1+10%)</i>	840 600	<i>1 800 000 x 0.467</i>	77 400
31 Dec X1	0.424	<i>0.467/(1+10%)</i>	763 200	<i>1 800 000 x 0.424</i>	68 400
1 Jan X1	0.386	<i>0.424/(1+10%)</i>	694 800	<i>1 800 000 x 0.386</i>	
Total finance charges					1 105 200

Solution 17.13

a) Medical waste:

There are two issues to be discussed here: firstly, whether or not a provision should be raised for the cost of the disposal of the medical waste on hand at 31 December 20X6 and secondly, whether to recognise the penalty levied by the Environmental Agency in the 20X6 financial statements.

Cost of medical waste disposal:

In terms of IAS 37, Provisions, contingent liabilities and contingent assets, a provision is recognized when the following conditions have been met:

- An entity has a present obligation (legal or constructive) as a result of a past event. In terms of environmental legislation Parklands Hospitals Limited have a legal obligation to dispose of medical waste within two weeks of generation. The generation of the waste is the past event that gives rise to the obligation to dispose of it.
- It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation. As the company's incinerator is not working, Parklands Hospitals Limited will have to pay Waste Incinerators to dispose of the waste for them, which will result in an outflow of resources.
- A reliable estimate can be made of the amount of the obligation. A contract has been entered into with Waste Incinerators to dispose of the waste on hand at C10 000 per ton.

As all three conditions have been met a provision of C120 000 should be recognized at 31 December 20X6 for the 12 tons of medical waste on hand that will be disposed of during January 2007.

Penalty in respect of medical waste disposal:

The Environmental Agency levied a penalty on the company on 25 January 2007. This event occurred after the balance sheet date, but before the financial statements were authorized for issue on 15 February 2007. This circumstance meets the definition of an event after reporting date as defined in IAS 10 which defines events after reporting date as those events, favourable and unfavourable, that occur between the balance sheet date and the date when the financial statements are authorized for issue.

The penalty levied on 25 January 2007 provides evidence of conditions that existed at reporting date and qualifies as an adjusting event in terms of IAS 10. The company was in contravention of environmental legislation at 31 December 20X6 and so the condition of a possible penalty existed at balance sheet date. IAS 10 requires adjusting events to be recognized in the financial statements to reflect adjusting events after reporting date. Therefore Parklands Hospitals Limited should adjust the financial statements to recognize a liability of C125 000 at 31 December in respect of the penalty.

Solution 17.13 continued ...

b) Legal claim:

The issue to be discussed is whether or not a provision in respect of the legal claim for damages should be recognized in the financial statements of Parklands Hospitals Limited at 31 December 20X6. In terms of IAS 37 a provision is recognized when:

- An entity has a present obligation (legal or constructive) as a result of a past event - As the company's legal advisors have reported that it is highly probable that Mr Downe's claim for damages will be successful against the company, there is a present obligation as a result of his fall at the hospital.
- It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation - An amount will have to be paid in damages as the attorneys have indicated that Mr Downe's claim will probably be successful, which will result in an outflow of resources.
- A reliable estimate can be made of the amount of the obligation - The directors have applied their minds to the amount of damages likely to be awarded and have decided that there is not enough information at the present to make a reasonable estimate. The attorneys will gain a better understanding of the possible amount of damages after the first court proceedings to be held on 1 March 2007. Thus a reliable estimate cannot be made at 31 December 20X6.

When a reliable estimate cannot be made IAS 37 requires the liability to be disclosed as a contingent liability. A contingent liability is defined as a present obligation that arises from past events but is not recognised because:

- It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation. This requirement does not apply to the claim for damages as some form of damages will be paid.
- Or, the amount of the obligation cannot be measured with sufficient reliability. This requirement is applicable as there is uncertainty as to the amount of damages that will be awarded to Mr Downe at 31 December 20X6.

A contingent liability is not recognized in the financial statements but disclosed in the notes to the financial statements by giving a brief description of its nature, estimate of its financial effect, an indication of the uncertainties relating to the amount or timing of any outflow, and the possibility of reimbursement.

**PARKLANDS HOSPITALS LIMITED
EXTRACT NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X6**

7. Contingent liability:

The company is currently being sued for damages by a visitor who slipped on a wet floor in one of the hospitals. Legal advisors have indicated that it is highly probable that the claimant will be successful, however they are unable to determine the amount of damages likely to be awarded by the court at this point. The case is to be heard in court on 31 March 20X7, when it will be clearer how much can be expected to be paid in damages.

Solution 17.13 continued ...

**PARKLANDS HOSPITALS LIMITED
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X6**

	Ordinary share capital C	Share premium C	Retained earnings C	Total C
Balance at 1 January 20X5	750 000	70 000	7 658 000	8 478 000
Profit for the period			2 858 500	2 858 500
	750 000	70 000	10 516 500	11 336 500
Issue of ordinary share capital	150 000	225 000		375 000
Premium on redemption of preference shares		(20 000)	20 000	-
Capitalisation issue of ordinary shares	300 000	(275 000)	(25 000)	-
Balance at 31 December 20X6	1 200 000	0	10 511 500	11 711 500

Solution 18.1

One of the two types of contingent liabilities is

- a possible obligation
- that arose from past events and
- whose existence will be confirmed only by the occurrence or non-occurrence
- of one or more uncertain future events
- not wholly within the control of the entity.

Initially, Bigmouth Limited would have planned to treat the possible costs of C800 000 as a contingent liability since:

- there are possible legal fees and settlement costs (possible obligation with a possible loss of economic benefits);
- resulting from alleged defamation charges (past event);
- whose existence would only be confirmed by an unfavourable decision in the law suit (uncertain future event);
- which would be decided by the court (therefore not wholly in the control of the entity).

Bigmouth Limited would therefore have been planning to disclose the item in the notes to the annual financial statements as a contingent liability and would not have been planning to recognise it in the balance sheet.

Adjusting post reporting period events are events, both favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue, that provide further evidence of the conditions that existed at the end of the reporting period.

More information came to light during the period after the end of the reporting period, which indicated that a provision should have been recognised at year-end (instead of the disclosure of a contingent liability). This is an adjusting post reporting period event since it provides more information about a court case that was already in existence at the end of the reporting period.

A provision (liability of uncertain timing or amount) for C1 050 000 (C900 000 + C150 000) should be recognised at year-end.

Solution 18.2**a)**

Adjusting post reporting period events are those events, both favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue, that provide further evidence of conditions that existed at the end of the reporting period.

The insolvency of Salmon Fish Shop should be classified as an adjusting post reporting period event because the debtor existed at the end of the reporting period and, assuming that Salmon Fish Shop was already experiencing trading difficulties at 31 December 20X0, the insolvency provides further evidence of the debtor's condition at the reporting period date.

b) Disclosure

PENGUIN FOODS LIMITED
EXTRACT FROM STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X0

Profit for the period	<i>Decrease by: (136 000 X 0.85)</i>	x - 115 600
Taxation	<i>Decrease by: (115 600 X 30%)</i>	x - 34 680

PENGUIN FOODS LIMITED
EXTRACT FROM STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X0

ASSETS**Current assets**

Accounts receivable	<i>Decrease by: (136 000 X 0.85)</i>	x - 115 600
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EQUITY AND LIABILITIES

Retained earnings	<i>Decrease by: (115 600 – 34 680)</i>	x - 80 920
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Current liabilities

Current tax liability	<i>Decrease by: (115 600 X 30%)</i>	x - 34 680
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Solution 18.3

Post reporting period events are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue. The end of the reporting period in this situation is 30 June 20X5 and the financial statements are authorised for issue on 18 September 20X5.

Two types of events can be identified:

- those that provide evidence of conditions that existed at end of the reporting period (adjusting post reporting period events); and
- those that are indicative of conditions that arose after the end of the reporting period (non-adjusting post reporting period events).

An entity shall adjust the amounts recognised in its financial statements to reflect adjusting post reporting period events. An entity shall not adjust the amounts recognised in its financial statements to reflect non-adjusting post reporting period events.

- a) This is an adjusting post reporting period event as it provides evidence of conditions that existed at the end of the reporting period. The reasons for the competitor's price reductions will not have arisen overnight, but will normally have occurred over a period of time, maybe due to superior investment in technology.

An impairment expense of C1 500 000 should be recognised and the amount included as inventory on the Statement of Financial Position reduced to C5 000 000.

	Debit	Credit
Inventory write-down (expense)	1 500 000	
Inventory (asset)		1 500 000
<i>Impairment of inventory following drop in selling price</i>		

- b) This is a non-adjusting post reporting period event as it is indicative of conditions that arose after the end of the reporting period. The tropical storm occurred during late August 20X5, after the end of the reporting period.

Disclosure is required of the nature of the event (the tropical storm) and an estimate of the financial effect (C3 000 000).

- c) This is an adjusting post reporting period event as it provides evidence of conditions that existed at the end of the reporting period. The insolvency of a debtor and the inability to pay usually builds up over a period of time and it has therefore been assumed that he was in financial difficulty at year-end.

A bad debts expense of C400 000 should be recognised and the amount of the accounts receivable on the statement of financial position reduced by C400 000.

	Debit	Credit
Bad/ doubtful debts (expense)	400 000	
Accounts receivable: provision for doubtful debts (asset)		400 000
<i>Doubtful debt written off</i>		

Solution 18.3 continued ...

- d) This is a non-adjusting post reporting period event as it is indicative of conditions that arose after the end of the reporting period. The insolvency of this customer arose solely by the tropical storm, which occurred after the end of the reporting period, 30 June.

Disclosure is required of the nature of the event (the tropical storm which destroyed the customer's premises) and an estimate of the financial effect (C105 000).

- e) This is not a post reporting period event as defined, as it occurred after the financial statements were authorised for issue. No adjustment or disclosure is required in the financial statements for the year to 30 June 20X5.

Solution 18.4**a) Insolvent debtor**

- i Adjusting post-reporting period event.
- ii The event is the vandalism. Since the vandalism that caused the insolvency occurred before year-end (December 20X3), the event is a past event. The announcement therefore provides information regarding a condition that was already in existence at year-end. The measurement of the asset (debtors) at year-end must therefore be adjusted.
- iii The adjustment: the debtor's balance needs to be written down by C80 000
(C100 000 – C100 000 x 0.20).

	Debit	Credit
Bad/ doubtful debt expense	80 000	
Accounts receivable (asset)		80 000
<i>Doubtful debt written off</i>		

b) Drop in value of investment in shares

- i Non-adjusting post-reporting period event.
- ii The event causing the drop in value was the outbreak of war. Since the war broke out after the end of the reporting period, the event is not a past event.
- iii Since the drop in value is material, the drop in the value of the investment should be disclosed since this will affect the users' decision making.

c) Issue of shares

- i No adjustment is required.
- ii The share issue will take place (10 May 20X4) after the financial statements are authorized for issue (5 May 20X4) and therefore after the end of the post reporting period.
- iii The issue would therefore not be recognized or disclosed in the financial statements for the year ended 31 December 20X3.

Solution 18.5

a)

The issue is to determine the correct treatment of the guarantee. The fact that new information came to light after the draft financial statements were prepared (at the end of the reporting period) will result in either an adjusting or non-adjusting post reporting period event.

IAS 37 defines a provision as a liability of uncertain timing or amount. Thus it is necessary to firstly determine whether or not there is a liability. The Framework defines a liability as:

- A present obligation of the entity
- As a result of a past event
- The settlement of which will result in an outflow of resources.

In determining whether or not a present obligation exists, IAS 37 provides further guidance in stating that a present obligation may be a legal or a constructive obligation. A legal obligation is an obligation that derives from:

- a contract (through its explicit or implicit terms),
- legislation, or
- other operation of law.

The signing of the guarantee is a legal obligation because a guarantee is a contract, which states that one person will fulfil the obligations of another in the event of a default.

IAS 37 states that a provision should be recognised when

- there is a present legal obligation as a result of a past event, and, (applying the recognition criteria),
- it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and
- a reliable estimate can be made of the obligation.

A past event that leads to a present obligation is called an obligating event. The obligating event is the giving of the guarantee but at 30 June 20X3 there appears to be no present legal obligation since the directors believed the financial condition to be sound, in which case there is also therefore no probable outflow of resources at that date. The guarantee would thus not have been recognised as a provision in the draft financial statements, but would have been disclosed as a contingent liability (a *possible* obligation).

A contingent liability is not recognised in the financial statements but disclosure would be made of:

- the description of the nature of the contingent liability,
- an estimate of its financial effect,
- an indication of uncertainties relating to the amount or timing of any outflow, and
- the possibility of any reimbursement.

Solution 18.5 continued ...

b)

Adjusting post reporting period events are those events, both favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue, that provide further evidence of conditions that *existed* at the end of the reporting period.

The condition of Smithers Limited's financial difficulty was in existence at the end of the reporting period although Simpson Limited did not know about it. However, management of Simpson Limited are now aware that Smithers Limited was in financial difficulty at the end of the reporting period. Smithers Limited is thus required to adjust its draft financial statements at year end to account for the new information.

The recognition criteria for a provision are now met:

- it is probable that an outflow of economic resources will be required to settle the obligation since Smithers Limited has filed for protection from its creditors; and
- a reliable estimate can be made of the amount, the guarantee being documented as C1 million.

A provision for the full amount of C1 million might be appropriate.

Solution 18.6

Non-adjusting post reporting period events are those events, both favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue, that are indicative of conditions that arose after the end of the reporting period.

The decline in market value of investments is indicative of an event that occurred after the end of the reporting period. No condition of the decline was apparent at the end of the reporting period and the decline in value is clearly indicative of a post reporting period event.

Although no adjustment is required to the market value of investments, disclosure of the decline may be warranted if it is of such importance that it would affect the decision making ability of users. Disclosure would be made of:

- the nature of the event, and
- an estimate of its financial effect.

Solution 18.7

- a) No journal entry required.

Although the debt owing by the customer existed at reporting date, the inability of the customer to pay did not exist at reporting date – this condition only arose in January 20X9 after the fire. Thus reporting the debtor at its full carrying amount of C100 000 is correct at 31 December 20X8, according to circumstances in existence at this date. This is a non-adjusting post reporting period event and no journal entry is required.

- b) The delivery of old flowers to a customer occurred before the reporting date. Thus the cause for the court case and expected outflow of C10 000 was already in existence at reporting date. A provision must be raised for this outflow at 31 December 20X8 as it is an adjusting post reporting event.

		Debit	Credit
31/12/X8	Expense – legal claim	10 000	
	Provision for legal claim		10 000
	Provision for legal claim raised		

- c) An error has been made in the financial statements – inventory has been overstated by C5 000. The error was made before reporting date, and thus existed at reporting date. This is an adjusting post reporting period event, and it must be corrected.

		Debit	Credit
31/12/X8	Cost of sales	5 000	
	Inventory		5 000

- d) No journal entry is required.

The burglary and theft of consumable stores occurred after reporting date, thus the over-valuation of consumable stores on hand was not in existence at reporting date. This is a non-adjusting post-reporting period event.

Solution 18.8

Estimated costs

The estimations by the lawyers as to the settlement costs are an *adjusting event* as they give additional information useful in estimating the obligation that was already in existence at year-end.

A provision for settlement costs must be recognised in the financial statements for the year ended 31 December 20X2 since

- there is a present obligation as the court proceedings have indicated that Lemon Ltd is responsible for the poisoning
- there is a past event, being the court case that began before year-end
- the expected result is an out-of-court settlement of C2 200 000 (the lower of the two estimated costs).

Although an estimate has been made (a settlement of C2 200 000), there is a high degree of estimation and the timing of these payments is uncertain. Therefore, assuming that these estimates are considered to be reliable, these amounts should be recognised in the Statement of Financial Position but disclosed separately under liabilities as a *provision*. (Note that if the estimates were not considered to be reliable, a contingent liability would have to be disclosed in the notes).

Findings by the specialists

The findings of the specialists in January 20X3 are an *adjusting event* since the inventory on hand at year-end was already poisoned.

The 20% of the inventory that is contaminated must be written down to zero:

- $C500\,000 \times 50\% = C250\,000$ on hand;
- $C250\,000 \times 20\% = C50\,000$ being the contaminated portion of the stock on hand; and thus a C50 000 write-down is required;
- $C250\,000 - C50\,000 = C200\,000$ revised value of inventory on hand.

The warning

The warning from Lemon Ltd's lawyers that there may be more similar cases brought against the company is a *contingent liability* in that:

- there is a possible obligation – no further cases have yet been brought against the company and therefore there is no present obligation
- there is a past event – poisoning of the long-life limes, that leads to the guilty plea in the court case.
- the settlement of which would lead to an outflow of future economic benefits similar to that expected from the current case.

This would be disclosed in the notes but would not be recognised as a liability. The nature of the contingent liability and the fact that an estimate is not possible would need to be disclosed.

Possible returns

The possible returns of marmalade seem remote and therefore there is no need to either disclose or recognise a liability of any kind.

Solution 19.1

IAS 17, paragraph 10 provides the following situations where the classification of a lease agreement is in question:

- | | |
|---|----|
| a) Does ownership of the building transfer to North Ltd by the end of the lease? | No |
| • No evidence of this is provided (assume no) | |
| b) Does North Ltd have an option to purchase the building at a price expected to be lower than the fair value at the date the option became exercisable? | No |
| • No evidence of this is provided (assume no) | |
| c) Is the lease term for the major part of the economic life of the building? | No |
| • The lease term is for 8 years whereas the useful life is 20 years. | |
| d) At the inception of the lease, does the present value of the minimum lease payments amount to at least substantially all of the fair value of the leased building? | No |
| • The total of the actual lease payments is only C372 000 (5 years x C5 000 x 12 months + 3 years x C2 000 x 12 months). The present value thereof would be even less. The present value of the actual lease payments would therefore not constitute 'substantially all of the fair value', being C1 000 000. | |
| e) Is the building of such a specialised nature that only North Ltd can use it without major modifications? | No |
| • No evidence of this is provided (assume no) | |

Since none of the criteria have been met, the risks and rewards associated with ownership have not passed from South Ltd to North Ltd.

The lease over the building should therefore be classified as an operating lease.

Solution 19.2

a) The lease in terms of the Framework

Definition of an asset

- A resource controlled by the entity
- As a result of past events
- From which future economic benefits are expected to flow to the entity

Discussion of the asset definition

- Citizen Limited has the exclusive right to use the asset for three years during which they can prevent others from using it. This constitutes control over the resource. The lease agreement provides legal rights over the equipment. This further enhances the control over the resource.
- The agreement was signed on 1 January 20X7 and since the year end is 31 December 20X7, this constitutes a past event.
- Citizen Limited will use the equipment to generate future economic benefits.

Definition of a liability

- A present obligation of the entity
- As a result of past events
- The settlement of which will result in an outflow of future economic benefits from the entity.

Discussion of the liability definition

- The signed agreement may not be cancelled and is legally binding and therefore an obligation is raised on the day it is signed. Since the 3-year agreement is signed on 1 January 20X7, the obligation still exists at 31 December 20X7.
- The agreement was signed on 1 January 20X7 and since the year end is 31 December 20X7, this constitutes a past event.
- The payment of the future instalments constitutes an outflow of economic benefits.

Conclusion:

The definition of an asset and liability are met and hence, had the International Financial Reporting Standard on leases (IAS 17) not existed, Citizen Limited would have had to base the accounting treatment of the lease on the definitions provided in the Framework, in which case an asset and a corresponding liability would have had to be recognised.

Solution 19.2 continued ...**b) The lease in terms of the IAS 17**

IAS 17 requires that the lessee (Citizen Limited) determine the classification of the lease as either a finance or operating lease using the following criteria:

- | | |
|--|----|
| a) Does ownership of the equipment transfer to Citizen Limited by the end of the lease? | No |
| <ul style="list-style-type: none">• The lease agreement stipulates that ownership remains with Bigbrother Limited at the end of the lease. | |
| b) Does Citizen Limited have an option to purchase the equipment at a price expected to be lower than the fair value at the date the option became exercisable? | No |
| <ul style="list-style-type: none">• No evidence to this effect is provided. | |
| c) Is the lease term for the major part of the economic life of the equipment? | No |
| <ul style="list-style-type: none">• The lease term is 3 years and the useful life of the asset is 10 years. | |
| d) At the inception of the lease, does the present value of the minimum lease payments amount to at least substantially all of the fair value of the leased equipment? | No |
| <ul style="list-style-type: none">• The future instalments total C1 500 000, the present value of which would obviously be lower. This does not represent a substantial portion of the fair value (cash cost) of C5 000 000. | |
| e) Is the equipment of such a specialised nature that only Citizen Limited can use it without major modifications? | No |
| <ul style="list-style-type: none">• No evidence to this effect is provided. | |

Conclusion:

None of the criteria are met and the lease should therefore be recognised as an operating lease (i.e. Citizen Limited will recognise neither an asset nor a liability).

Solution 19.3**a) Calculations**

Year	Lease Rentals
20X7	54 720
20X8	67 260
20X9	<u>29 640</u>
	151 620
	<u>/ 3</u>
	50 540

The operating rental income that will therefore be recorded in each of the 3 years concerned will be C50 540 .

b) Journals

31 December 20X7	Debit	Credit
Dr. PPE: Cost	3 000	
Bank		3 000
<i>Initial direct costs of operating lease</i>		
Dr. Depreciation: PPE	1 000	
Cr PPE: Accumulated Depreciation: Initial direct cost		1 000
<i>Depreciate separate component over lease term</i>		

Comment: The initial direct costs of a lessor in an operating lease agreement are capitalized to the leased asset as a separate component and separately depreciated over the lease term.

Solution 19.4**a) Theory**

IAS 17, paragraph 10 provides the following situations where the classification of a lease agreement is in question:

- | | |
|---|-----|
| a) Does ownership of the office furniture transfer to Hello Ltd by the end of the lease? | Yes |
| <ul style="list-style-type: none"> The lease agreement stipulates that ownership transfers to Hello Ltd at the end of the lease. | |
| b) Does Hello Ltd have an option to purchase the office furniture at a price expected to be lower than the fair value at the date the option became exercisable? | No |
| <ul style="list-style-type: none"> No evidence to this effect is provided. | |
| c) Is the lease term for the major part of the economic life of the office furniture? | Yes |
| <ul style="list-style-type: none"> The lease term is 3 years and the useful life of the asset is also 3 years. | |
| d) At the inception of the lease, does the present value of the minimum lease payments amount to at least substantially all of the fair value of the leased office furniture? | Yes |
| <ul style="list-style-type: none"> The future instalments total C600 000 and the present value, calculated using the implicit rate of 10%, is C497 370. The fair value (cash cost) is also C497 370. | |
| e) Is the office furniture of such a specialised nature that only Hello Ltd can use it without major modifications? | No |
| <ul style="list-style-type: none"> No evidence to this effect is provided. | |

Since it is only necessary for one of these criteria to be met for it to be said that the risks and rewards of ownership have passed to the lessee, it is clear that ownership will effectively pass to Hello Ltd. The lease should, therefore, be classified as a finance lease.

b) Journal entries

	Debit	Credit
<i>1/1/20X2</i>		
Furniture: cost	497 370	
Liability: finance lease		497 370
<i>Recognition of the asset leased and the lease liability</i>		
<i>31/12/20X2</i>		
Finance charges	49 737	
Liability: finance lease	150 263	
Bank		200 000
<i>Lease liability interest raised and the instalment paid</i>		
<i>31/12/20X2</i>		
Depreciation	165 790	
Accumulated depreciation		165 790
<i>Depreciation of the leased asset (497 370 – 0)/ 3 years</i>		

Solution 19.5**a) Journal entries**

	Debit	Credit
<i>31/12/20X3</i>		
Operating lease expense	15 000	
Accrual		15 000
<i>Raising the lease expense and accrual (see W1)</i>		
<i>31/12/20X3</i>		
Taxation expense (current)	274 500	
Current tax payable: normal tax		274 500
<i>Raising the years current tax (W2)</i>		
<i>31/12/20X3</i>		
Deferred tax	4 500	
Taxation expense		4 500
<i>Raising a deferred tax asset (W3)</i>		

b) Disclosure**MOON LTD****EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X3**

	Note	20X3 C
Profit before tax (<i>given</i>)		900 000
Taxation	4	(270 000)
Profit for the year		630 000
<i>Other comprehensive income</i>		0
Total comprehensive income		630 000

MOON LTD**EXTRACTS FROM THE STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X3**

	Note	20X3 C
ASSETS		
<i>Non-current assets</i>		
Deferred tax		4 500
EQUITY AND LIABILITIES		
<i>Current liabilities</i>		
Expenses payable		15 000
Current tax payable		274 500

Solution 19.5 continued ...

MOON LTD
EXTRACTS OF THE NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X3

Note **20X3**
C

2. Accounting policies**2.1. Deferred tax**

Deferred tax is provided using the balance sheet liability method, on all the temporary differences at the balance sheet date between the tax base of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred tax asset are recognized for all deductible temporary differences, carry forward of unused tax losses, to the extent that is probable that future taxable profit will be available against which the deductible temporary difference, unused tax losses and tax credits can be utilized.

Carrying amount of deferred tax asset is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that the related tax benefit will be realized. Deferred tax is calculated at the rates that are expected to apply to the period when differences reverse based on the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.

3. Profit before tax

Profit before tax is stated after the following items:

Expenses

- Operating lease expense 15 000

4. Taxation

Normal Tax

270 000

- Current tax
- Deferred tax

274 500

(4 500)

21. Operating lease description

Moon Ltd has entered into an operating lease over a computer system. In accordance with the lease agreement, ownership of the machine remains with the lessor, and there is no option to renew.

Future minimum lease payments under non-cancellable operating leases

		Minimum Lease Payment
Due within 1 year	(20X4: 30 000)	30 000
Due between 1 and 5 years	(20X5:30 000+20X6:30 000+20X7:0+20X8:10 000)	70 000
Due later than 5 years	(20X9: 10 000 + 20X10: 10 000)	20 000
Total		<hr/> 120 000

Solution 19.5 continued . . .**Workings****Working 1: average lease rental**

Year 20X3	0
Years 20X4 to 20X6 (30 000 x 3)	90 000
Year 20X7	0
Years 20X8 to 20X10 (10 000 x 3)	<u>30 000</u>
Total	<u>120 000</u>
Average (120 000 / 8 years)	<u>15 000</u>

Working 2: current normal tax calculation

	20X3
Accounting profit	900 000
Adjust for temporary differences:	
Operating lease rental accrued	15 000
Less lease payment	<u>(0)</u>
Taxable profit	<u>915 000</u>
Current tax (at 30%)	274 500

Working 3: deferred tax

Operating lease payable	Carrying amount	Tax base	Temporary difference	Deferred taxation	
Balances at 1/1/20X3:	0	0	0	0	
Movement				4 500	Dr DT Cr TE
Balances at 31/12/20X3:	(15 000)	0	15 000	<u>4 500</u>	Asset

Solution 19.6

DUX LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 JUNE 20X5

3. Profit before tax**20X5****C**

Profit before tax is stated after the following items:

- Operating lease expense (*see working 1*)

20 000

Analysed as follows:

- Minimum operating lease payment
- Sub-lease income

45 000

(25 000)

Working 1Average annual rental expense: $(50\,000 + 40\,000) / 2 = 45\,000$ Average annual rental income: $(20\,000 + 30\,000) / 2 = 25\,000$ Net average annual rental expense: $45\,000 - 25\,000 = 20\,000$

Solution 19.7**a) Journal entries**

	Debit	Credit
<i>1/1/20X3</i>		
Motor vehicle: cost	700 000	
Liability: finance lease		700 000
<i>Capitalisation of leased asset and raising of corresponding liability</i>		
<i>1/1/20X3</i>		
Liability: finance lease	200 754	
Bank		200 754
<i>First lease instalment (no interest yet accrued)</i>		
<i>31/12/20X3</i>		
Finance charges	49 925	
Liability: finance lease		49 925
<i>Finance charges accrued $(700\,000 - 200\,754) \times 10\%$ or W1</i>		
<i>31/12/20X3</i>		
Depreciation	175 000	
Motor vehicle: accumulated depreciation		175 000
<i>Depreciation charged at 25% $(700\,000 - 0) / 4$ years</i>		
<i>31/12/20X3</i>		
Taxation expense (current)	277 251	
Current tax payable: normal		277 251
<i>Raising the years current tax (W2)</i>		
<i>31/12/20X3</i>		
Deferred tax	7 251	
Taxation expense		7 251
<i>Raising a deferred tax asset (W3)</i>		

Solution 19.7 continued . . .

b) Disclosure

TWEET LTD
EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X3

	Note	20X3 C
Profit before finance charges (<i>work backwards</i>)		949 925
Finance charges	4	(49 925)
Profit before tax (<i>given</i>)	3	900 000
Taxation	5	(270 000)
Profit for the year		630 000
<i>Other comprehensive income</i>		0
Total comprehensive income		630 000

TWEET LTD
EXTRACTS FROM THE STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X3

	Note	20X3 C
ASSETS		
<i>Non-current assets</i>		
Property, plant and equipment	6	525 000
Deferred tax		7 251
EQUITY AND LIABILITIES		
<i>Non-current liabilities</i>		
Non-current portion of finance lease liability	23	348 417
<i>Current liabilities</i>		
Current portion of finance lease liability (see note below)	23	200 754
Current tax payable		277 251

Note: when the lease payments are due in advance, it means that they will be reducing the capital sum owing – in other words, none of the lease payment will be in lieu of interest owing. For this reason, the full amount of the instalment is considered to be the current portion of the liability.

Solution 19.7 continued

b) Disclosure continued ...

TWEET LTD**EXTRACTS OF THE NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X3**

	Note	20X3 C
2 Accounting policies		
2.1 Property, plant and equipment		
Property, plant and equipment is depreciated on the straight line method to their respective residual values at the following rates:		
Motor vehicles	25%	
2.2 Leases		
Assets acquired under a finance lease are capitalised and depreciated over their useful lives. A finance lease liability is raised at the inception of the lease, which is then reduced by the capital portion of each payment. The interest portion of the repayments is calculated using the interest rate implicit in the lease and is expensed in the statement of comprehensive income.		
2.3 Deferred tax		
Deferred tax is provided using the balance sheet liability method, on all the temporary differences at the balance sheet date between the tax base of assets and liabilities and their carrying amounts for financial reporting purposes.		
Deferred tax asset are recognized for all deductible temporary differences, carry forward of unused tax losses, to the extent that is probable that future taxable profit will be available against which the deductible temporary difference, unused tax losses and tax credits can be utilized.		
Carrying amount of deferred tax asset is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that the related tax benefit will be realized. Deferred tax is calculated at the rates that are expected to apply to the period when differences reverse based on the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.		
3 Profit before tax		
Profit before tax is stated after the following items:		
<i>Expenses</i>		
Depreciation		
Motor vehicle		175 000
4 Finance costs		
Finance costs include:		
Finance lease finance costs (W1)		49 925
5 Taxation		
Normal Tax		270 000
Current tax (W2)		277 251
Deferred tax (W3)		(7 251)

Solution 19.7 continued . . .

b) Disclosure continued ...

TWEET LTD
EXTRACTS OF THE NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X3

	Note	20X3 C
6 Property, plant and equipment		
<i>Motor Vehicles</i>		
Net carrying amount: 1 January 20X3		0
Gross carrying amount: 1 January 20X3		0
Accumulated depreciation and impairment losses: 1 January 20X3		(0)
Additions:		
Capitalised lease asset		700 000
Depreciation		(175 000)
Net carrying amount: 31 December 20X3		525 000
Gross carrying amount: 31 December 20X3		700 000
Accumulated depreciation and impairment losses: 31 December 20X3		(175 000)
23 Non-current interest-bearing liabilities		
Capitalised finance lease liability (W1)		549 171
Less: current portion (549 171 – 348 417)		(200 795)
Non-current portion (W1)		348 417

The liabilities bear interest at 10% per annum.

The liability involving a finance lease over a motor vehicle is repayable in 3 remaining equal, annual advance instalments of C200 754.

Reconciliation of future minimum lease payments to their present values (see calculations below)

	Minimum Lease Payment	Finance Charges (a)	Present Value
Due within 1 year	(b) 200 754	0	(c) 200 754
Due between 1 and 5 years	(d) 401 508	(e) 53 092	(f) 348 416
Due later than 5 years	-	-	-
Total	602 262	53 092	549 170

Calculations:

a) Balancing figures

b) Payment due on 1 January 20X4

c) Payment due beginning of the year, therefore no present valuing needed

d) Payment due on 1 January 20X5 and 1 January 20X6: $200\,754 \times 2 \text{ years} = 401\,508$

e) $34\,842 + 18\,250 = 53\,092$

f) $(200\,754 \times 0.909090) + (200\,754 \times 0.826446)$;

where $0.909090 = 1 / 1.1$ and where $0.826446 = 0.90909 / 1.1$

Solution 19.7 continued . . .

Working 1: Effective interest rate table

Date	10% Interest	Instalment	Liability balance
1/1/20X3			700 000
1/1/20X3		(200 754)	499 246
31/12/20X3	49 925		549 171
1/1/20X4		(200 754)	348 417
31/12/20X4	34 842		383 258
1/1/20X5		(200 754)	182 504
31/12/20X5	18 250		200 754
1/1/20X6		(200 754)	0
	103 017	(803 016)	

Working 2: current normal tax calculation

	20X3
Accounting profit	900 000
Adjust for temporary differences:	
• Depreciation	(700 000 – 0) / 4 years
• Finance charges	(W1)
• Lease payment	(W1)
Taxable profit	924 171
Current tax (at 30%)	277 251

Working 3: deferred tax

Finance leased asset	Carrying amount	Tax base	Temporary difference	Deferred taxation
Balances at 1/1/20X3:	0	0	0	0
Leased asset	0	0	0	0
Lease liability	0	0	0	0
Movement				7 251 Dr DT Cr TE Asset
Balances at 31/12/20X3:	(24 171)	0	24 171	7 251
Leased asset (a)	525 000	0		
Lease liability (W1) (b)	(549 171)	0		

Calculations:

- a) Carrying amount of asset at 31 December 20X3: 700 000 (cost) – 175 000 (accum. depreciation)
 b) Carrying amount of liability at 31 December 20X3: W1

Solution 19.8**i) Journals**

		Debit	Credit
2/4/20X2			
Vehicle: cost		124 343	
Liability: finance lease			124 343
<i>Recognition of the asset leased and the lease liability (W1)</i>			
31/3/20X3			
Finance charges	$124\,343 \times 10\%$	12 434	
Liability: finance lease	$50\,000 - 12\,434$	37 566	
Bank			50 000
<i>Lease liability interest raised and the instalment paid (W2)</i>			
31/3/20X3			
Depreciation	$(124\,343 - 0) / 3 \text{ years}$	41 448	
Vehicle: accumulated depreciation			41 448
<i>Depreciation of the leased asset</i>			

ii) Disclosure

QUACK LTD
EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 MARCH 20X3

	Note	20X3 C
Profit before finance charges (<i>work backwards: 300 000 + 12 434</i>)		312 434
Finance charges	2	(12 434)
Profit before tax (<i>given</i>)		300 000
Taxation	3	(90 000)
Profit for the year		210 000
<i>Other comprehensive income</i>		0
Total comprehensive income		210 000

QUACK LTD
EXTRACTS FROM THE STATEMENT OF FINANCIAL POSITION
AS AT 31 MARCH 20X3

	Note	20X3 C
ASSETS		
<i>Non-current assets</i>		
Property, plant and equipment	4	82 895
Deferred tax		1 165
EQUITY AND LIABILITIES		
<i>Non-current liabilities</i>		
Non-current portion: finance lease liability	5	45 455
<i>Current liabilities</i>		
Current portion: finance lease liability	5	41 322
Current tax payable		91 165

Solution 19.8 continued ...

QUACK LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 MARCH 20X3

	Note	20X3 C
2. Finance costs		
Finance costs include:		
• Finance lease costs		12 434
3. Taxation		
Normal Tax		90 000
• Current tax (see working 4)		91 165
• Deferred tax (see working 3)		(1 165)
4. Property, plant and equipment		
Net carrying amount: 1 April		0
Gross carrying amount: 1 April		0
Accumulated depreciation and impairment losses: 1 April		0
Additions:		
• Capitalised lease asset		124 343
Depreciation		(41 448)
Net carrying amount: 31 March		82 895
Gross carrying amount: 31 March		124 343
Accumulated depreciation and impairment losses: 31 March		(41 448)
5. Interest-bearing non-current liabilities		
Capitalised finance lease liability (balance at 31/3/20X3 per working 2)		86 777
Less: current portion (balancing figure or also working 2)		(41 322)
Non-current portion (balance at 31/3/20X4 per working 2)		45 455

The liability bear interest at 10% per annum and is repayable in 2 remaining equal arrear instalments of C50 000, each payable on 31 March.

Reconciliation of future minimum lease payments to their present values: (See calculations below)

	Minimum Lease Payment	Finance Charges (a)	Present Value
Due within 1 year (20X1)	(b) 50 000	4 545	(c) 45 455
Due between 1 and 5 years (20X2)	(d) 50 000	8 678	(e) 41 322
Due later than 5 years	-	-	-
Total	100 000	13 223	86 777

Ownership of the company's finance leased delivery van passes to Quack Ltd upon expiry of the lease.

Calculations

a) Balancing figures

b) Amount to be paid in 20X4

c) $50\,000 \times 0.90909 = 45\,455$ (where $PVF = 1 / 1.1 = 0.90909$)

d) Amount to be paid in 20X5

e) $50\,000 \times 0.826446 = 41\,322$ (where $PVF = 0.90909 / 1.1 = 0.826446$)

Solution 19.8 continued ...

Workings

Working 1: Present value of the minimum lease payments

Present value of the minimum lease payments:

$$(50\,000 \times 0.90909) + (50\,000 \times 0.826446) + (50\,000 \times 0.751315) = 124\,343$$

Where PVFs: $0.909 = 1 / 1.1$ and $0.826446 = 0.90909 / 1.1$ and $0.751315 = 0.826446 / 1.1$

Working 2: Effective interest rate table

Date	Finance charges: 10%	Instalment	Liability	
			Capital repaid	Balance
1/4/20X2				124 343
31/3/20X3	12 434	(50 000)	37 566	86 777
31/3/20X4	8 678	(50 000)	41 322	45 455
31/3/20X5	4 545	(50 000)	45 455	-
	25 657	(150 000)	124 343	

Working 3: deferred normal tax

Finance leased asset	Carrying amount	Tax base	Temporary difference	Deferred taxation	
Balances at 1/4/20X2:	0	0	0	0	
Leased asset	0	0	0	0	
Lease liability	0	0	0	0	
Movement				1 165	Dr DT Cr TE
Balances at 31/3/20X3:	(3 882)	0	3 882	1 165	Asset
Leased asset (a)	82 895	0			
Lease liability (W2)	(86 777)	0			
Movement				37	Dr DT Cr TE
Balances at 31/3/20X4:	(4 008)	0	4 008	1 202	Asset
Leased asset (b)	41 447	0			
Lease liability (W2)	(45 455)	0			
Movement				(1 202)	Cr DT Dr TE
Balances at 31/3/20X5:	0	0	0	0	Asset
Leased asset (c)	0	0			
Lease liability (W2)	0	0			

a) Cost: $124\,343 - \text{Accumulated depreciation: } (124\,343 - 0) / 3 \text{ years} \times 1 \text{ year} = 82\,895$

b) Cost: $124\,343 - \text{Accumulated depreciation: } (124\,343 - 0) / 3 \text{ years} \times 2 \text{ years} = 41\,447$

c) Cost: $124\,343 - \text{Accumulated depreciation: } ((124\,343 - 0) / 3 \text{ years} \times 3 \text{ years}) = 0$

Working 4: current normal tax

	20X3
Profit before tax/Accounting profit	300 000
Depreciation ($124\,343 / 3 \text{ years}$)	41 448
Finance charges (W2)	12 434

Wear and tear (not granted because asset is leased)	-
Lease payment	<u>(50 000)</u>
Taxable profit	<u>303 882</u>
Current tax (at 30%)	91 165

Solution 19.9**a) SP>FV; compensating**

	Debit	Credit
3/1/20X3		
Bank (given)	2 000 000	
Machine: cost (given)		1 200 000
Machine: accumulated depreciation (1 200K – 800K)	400 000	
Deferred profit (2 000K – 1 800K)		200 000
Profit on disposal (1 800K – 800K)		1 000 000
<i>Sale of machine</i>		
31/12/20X3		
Operating lease expense	300 000	
Bank		300 000
<i>Payment of lease expense</i>		
31/12/20X3		
Deferred profit	50 000	
Deferred profit amortised		50 000
<i>Amortisation of deferred profit (200 000/ 4 year lease period)</i>		

b) SP<FV; non-compensating

	Debit	Credit
3/1/20X3		
Bank (given)	1 500 000	
Machine: cost (given)		1 200 000
Machine: accumulated depreciation (1 200K – 800K)	400 000	
Profit on disposal (1 500K – 800K)		700 000
<i>Sale of machine</i>		
31/12/20X3		
Operating lease expense	200 000	
Bank		200 000
<i>Payment of lease expense</i>		

Solution 19.10a) $SP > FV$ with compensation (i.e. lease rentals are greater than market rentals)

SP	}	Deferred profit (always)
FV		
CA		Profit or loss

		Debit	Credit
2 January 20X5			
Bank	<i>Given</i>	1 000 000	
Plant: cost	<i>Given</i>		500 000
Plant: accumulated depreciation	<i>Given</i>	100 000	
Deferred profit	$(1\,000\,000 - 750\,000)$		250 000
Profit on disposal	$(750\,000 - 400\,000)$		350 000
<i>Sale of plant</i>			
31 December 20X5			
Operating lease expense		200 000	
Bank			200 000
<i>Payment of lease expense</i>			
Deferred profit		62 500	
Deferred profit amortised			62 500
<i>Amortisation of deferred profit (250 000/ 4 year lease period)</i>			

Solution 19.10 continued ...

b) $SP > FV$ with no compensation (i.e. lease rentals are not greater than market rentals)

SP	}	Deferred profit (always)
FV		
CA		Profit or loss

		Debit	Credit
2 January 20X5			
Bank	<i>Given</i>	1 000 000	
Plant: cost	<i>Given</i>		500 000
Plant: accumulated depreciation	<i>Given</i>	100 000	
Deferred profit	<i>(1 000 000 – 750 000)</i>		250 000
Profit on disposal	<i>(750 000 – 400 000)</i>		350 000
<i>Sale of plant</i>			
31 December 20X5			
Operating lease expense		150 000	
Bank			150 000
<i>Payment of lease expense</i>			
Deferred profit		62 500	
Deferred profit amortised			62 500
<i>Amortisation of deferred profit (250 000/ 4 year lease period)</i>			

Notice that the journals are identical except for the amount paid by way of lease rentals. This is because where the selling price exceeds the fair value, the excess created is always recognised as a deferred profit and amortised over the period of the lease. This is the treatment whether the unusually high selling price is or is not compensated for by lease rentals that are greater than market value.

Solution 19.10 continued ...**c) $SP < FV$ with compensation (i.e. lease rentals are less than market rentals)**

If lease rentals are reduced to compensate for low selling price:

$$\text{Profit or loss recognised} \left\{ \begin{array}{l} \text{FV} \\ \text{SP} \\ \text{CA} \end{array} \right\} \text{Loss deferred}$$

		Debit	Credit
2 January 20X5			
Bank	<i>Given</i>	500 000	
Plant: cost	<i>Given</i>		500 000
Plant: accumulated depreciation	<i>Given</i>	100 000	
Deferred loss	<i>(750 000 – 500 000)</i>	250 000	
Profit on disposal	<i>(750 000 – 400 000)</i>		350 000
<i>Sale of plant</i>			
31 December 20X5			
Operating lease expense		75 000	
Bank			75 000
<i>Payment of lease expense</i>			
Deferred loss amortised		62 500	
Deferred loss			62 500
<i>Amortisation of deferred loss (250 000/ 4 year lease period)</i>			

Solution 19.10 continued ...**d) $SP < FV$ with no compensation (i.e. lease rentals are not less than market rentals)**

If lease rentals are not reduced to compensate for low selling price:

$$\text{Profit or loss recognised} \left\{ \begin{array}{l} FV \\ SP \\ CA \end{array} \right.$$

		Debit	Credit
2 January 20X5			
Bank	<i>Given</i>	500 000	
Plant: cost	<i>Given</i>		500 000
Plant: accumulated depreciation	<i>Given</i>	100 000	
Profit on disposal	<i>(500 000 – 400 000)</i>		100 000
<i>Sale of plant</i>			
31 December 20X5			
Operating lease expense		150 000	
Bank			150 000
<i>Payment of lease expense</i>			

Notice that where the low selling price is not compensated for by reduced lease rentals, the loss of 250 000 that was incurred by not selling the plant at its fair value (FV: 750 000 – SP: 500 000) is not deferred but is recognised in profit and loss immediately instead.

The profit on sale is therefore measured at 100 000 (SP: 500 000 – CA: 400 000).

Compare this to part (c) above where the profit on sale was measured at 350 000 using the fair value instead of the actual selling price (FV: 750 000 – CA: 400 000) with a deferred loss of 250 000 amortised back to profit and loss over the period of the lease.

Solution 19.11

a) Selling price and lease rentals equal to market prices

W1: Effective interest rate table Date	Interest 10%	Bank	Lease liability
2 January 20X5		500 000	(500 000)
31 December 20X5	50 000	(75 000)	475 000
31 December 20X6	47 500	(75 000)	447 500
31 December 20X7	44 750	(75 000)	417 250
31 December 20X8	41 725	(75 000)	383 975
		(383 975)	0
	183 975	(183 975)	

	Debit	Credit
2 January 20X5		
Bank (given)	500 000	
Plant: cost (given)		200 000
Plant: accumulated depreciation (given)	100 000	
Deferred profit (500 000 – 100 000)		400 000
<i>Sale of plant under a finance lease</i>		
Plant: cost (given)	500 000	
Finance lease liability		500 000
<i>Purchase of plant under a finance lease</i>		
31 December 20X5		
Depreciation	125 000	
Plant: accumulated depreciation		125 000
<i>Depreciation of plant [(500 000 – 0) / 4 years]</i>		
Deferred profit	100 000	
Deferred profit amortised		100 000
<i>Amortisation of deferred profit (400 000 / 4 years)</i>		
Finance costs (W1)	50 000	
Finance lease liability (balancing)	25 000	
Bank (given)		75 000
<i>Payment of lease expense (see W1)</i>		

Solution 19.11

b) Selling price and lease rentals lower than market prices

Date	Interest 10%	Bank	Lease liability
		400 000	400 000
2 January 20X5	40 000	(50 000)	390 000
31 December 20X5	39 000	(50 000)	379 000
31 December 20X6	37 900	(50 000)	366 900
31 December 20X7	36 690	(50 000)	353 590
31 December 20X8		(353 590)	0
	153 590	(153 590)	

		Debit	Credit
<i>2 January 20X5</i>			
Bank	<i>Given</i>	400 000	
Plant: cost	<i>Given</i>		200 000
Plant: accumulated depreciation	<i>Given</i>	100 000	
Deferred profit	<i>(400 000 – 100 000)</i>		300 000
<i>Sale of plant under a finance lease</i>			
Plant: cost	<i>Given</i>	400 000	
Finance lease liability			400 000
<i>Purchase of plant under a finance lease</i>			
<i>31 December 20X5</i>			
Depreciation	<i>(400 000 – 0) / 4 years</i>	100 000	
Plant: accumulated depreciation			100 000
<i>Depreciation of plant</i>			
Deferred profit	<i>(300 000 / 4 years)</i>	75 000	
Deferred profit amortised			75 000
<i>Amortisation of deferred profit</i>			
Finance costs	<i>W1</i>	40 000	
Finance lease liability	<i>Balancing</i>	10 000	
Bank	<i>Given</i>		50 000
<i>Payment of lease expense (see W1)</i>			

Notice that the principle remains the same as in part (a) – that is to say that the profit on ‘sale’ is always deferred and amortised in a sale and finance leaseback irrespective of whether the rentals are reduced or not to compensate for a selling price that is lower than market price.

Solution 19.12**a) Journal entries**

	Debit	Credit
3/1/20X3		
Bank	1 200 000	
Building: accumulated depreciation (1 250 000 – 1 000 000)	250 000	
Building: cost		1 250 000
Deferred profit (SP 1 200 000 – CA 1 000 000)		200 000
<i>Raising the sale and derecognising of building</i>		
Building: cost	1 200 000	
Liability: finance lease		1 200 000
<i>Capitalisation of leased asset and raising of corresponding liability</i>		
31/12/20X3		
Finance charges	120 000	
Liability: finance lease	258 565	
Bank		378 565
<i>Splitting of repayment into finance charges and liability reduction (see working 3)</i>		
Depreciation	300 000	
Accumulated depreciation		300 000
<i>Depreciation charged over 4 years (1 200 000 – 0) / 4 years</i>		
Deferred profit	50 000	
Deferred profit amortised		50 000
<i>Amortisation of deferred profit (SP 1 200 000 – CA 1 000 000) / 4yrs</i>		
Taxation expense (current)	327 431	
Current tax payable: normal		327 431
<i>Raising the years current tax (see working 2)</i>		
Deferred tax	57 431	
Taxation expense		57 431
<i>Raising a deferred tax asset (see workings 3)</i>		

Solution 19.12 continued ...

b) Disclosure

WOOF LTD**EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X3**

	Note	20X3 C
Profit before finance charges (balance back to this figure)		1 020 000
Finance charges	4	(120 000)
Profit before tax (<i>given</i>)	3	900 000
Taxation	5	(270 000)
Profit for the year		630 000
<i>Other comprehensive income</i>		0
Total comprehensive income		630 000

WOOF LTD**EXTRACTS FROM THE STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X3**

	Note	20X3 C
ASSETS		
<i>Non-current assets</i>		
Property, plant and equipment	22	900 000
Deferred tax (<i>W3</i>)		57 431
EQUITY AND LIABILITIES		
<i>Non-current liabilities</i>		
Non current portion of finance lease liability	23	657 014
<i>Current liabilities</i>		
Current portion of finance lease liability	23	284 421
Current tax payable(<i>W2</i>)		327 431

WOOF LTD**EXTRACTS OF THE NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X3****2. Accounting policies****2.1 Property, plant and equipment**

Property, plant and equipment is depreciated on the straight line method to their respective residual values at the following rates:

Buildings 25%

2.2 Leases

Assets acquired under a finance lease are capitalised and depreciated over their useful lives. A finance lease liability is raised at the inception of the lease, which is then reduced by the capital portion of each payment. The interest portion of the repayments is calculated using the interest rate implicit and is expensed in the statement of comprehensive income.

2.3 Deferred tax

Deferred tax is raised on the balance sheet liability method

Solution 19.12 continued ...

WOOF LTD
EXTRACTS OF THE NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X3
3. Profit before tax

Profit before tax is stated after the following items:

Expenses

Depreciation

- Building $(1\,200\,000 - 0) / 4 \text{ years}$ 300 000

Incomes

- Deferred profit amortised $(SP\ 1\,200\,000 - CA\ 1\,000\,000) / 4\text{yrs}$ 50 000

4. Finance costs

Finance costs include:

- Finance lease finance costs (W1) 120 000

5. Taxation

Normal Tax

270 000

- Current tax (W2)
- Deferred tax (W3)

327 431
(57 431)

22. Property, plant and equipment***Building***

Net carrying amount: 1 January 20X3

1 000 000

Gross carrying amount: 1 January 20X3

1 250 000

Accumulated depreciation and impairment losses: 1 January 20X3

(250 000)

Sale

(1 000 000)

Additions:

- Capitalised lease asset

1 200 000

Depreciation

(300 000)

Net carrying amount: 31 December 20X3

900 000

Gross carrying amount: 31 December 20X3

1 200 000

Accumulated depreciation and impairment losses: 31 December 20X3

(300 000)

23. Non-current interest-bearing liabilities

Capitalised finance lease liability (W1)

941 435

Less: current portion $(941\,435 - 657\,014)$

(284 421)

Non-current portion (W1)

657 014

The liabilities bear interest at 10% per annum.

The liability involving a sale and finance leaseback over a building is repayable in 3 remaining equal, annual arrear instalments of 378 565.

Reconciliation of the future minimum lease payments to their present values

	Minimum Lease Payment	Finance Charges (a)	Present Value
Due within 1 year	(b) 378 565	34 415	(c) 344 150
Due between 1 and 5 years	(d) 757 130	159 845	(e) 597 285
Due later than 5 years	-	-	-
Total	1 135 695	194 260	941 435

Calculations:

a) Balancing figures

b) Payment due on 31/12/20X4: 378 565

c) Payment due on 31/12/20X4: $378\,565 / 1.1$

d) Payments due on 31/12/20X5 and 31/12/20X6: $378\,565 \times 2 \text{ years}$

e) Payments due on 31/12/20X5 and 31/12/20X6: $(378\,565 / 1.21) + (378\,565 / 1.331)$

Solution 19.12 continued ...

Workings

Working 1: Effective interest rate table

Date	10% Interest	Instalment	Liability	
			Capital repaid	Balance
3/1/20X3				1 200 000
31/12/20X3	120 000	(378 565)	258 565	941 435
31/12/20X4	94 144	(378 565)	284 421	657 014
31/12/20X5	65 701	(378 565)	312 864	344 150
31/12/20X6	34 415	(378 565)	344 150	0
	314 260	(1 514 260)	1 200 000	

Working 2: Current normal tax calculation

			20X3
Accounting profit			900 000
Adjust for temporary differences:			
Finance charges	W1		120 000
Deferred profit amortised	(SP 1 200 000 – CA 1 000 000) / 4yrs		(50 000)
Depreciation	(1 200 000 - 0) / 4 years		300 000
Wear and tear	Not granted because asset sold		0
Taxable capital gain	(1 200 000 – TB: 1 000 000)		200 000
Lease payment	W1		(378 565)
Taxable profit			1 091 435
Current tax (at 30%)			327 431

Working 3: deferred tax

Building under sale and leaseback	Carrying amount	Tax base	Temporary difference	Deferred taxation
Balances at 1/1/20X3:	1 000 000	1 000 000	0	0
Building	1 000 000	1 000 000	0	0
Lease liability	0	0		
Deferred profit	0	0	0	0
Movement				57 431 Dr DT Cr TE
Balances at 31/12/20X3:	(191 435)	0	191 435	57 431 Asset
Building (a)	900 000	0	0	0
Lease liability (W1)	(941 435)	0		
Deferred profit (b)	(150 000)	0	0	0

Calculations:

a) $1\,200\,000 - (1\,200\,000 - 0) / 4 = 900\,000$ b) $200\,000 - (200\,000 / 4) = 150\,000$

Solution 19.13

	Debit	Credit
1 January 20X5		
Factory building: cost (PPE)	1 500 000	
Bank / Creditor		1 500 000
<i>Purchase of factory building</i>		
Investment property: cost	1 500 000	
Factory building: cost (PPE)		1 500 000
<i>Change in intention: property to be leased therefore transferred to investment property</i>		
31 December 20X5		
Depreciation	150 000	
Investment property: accumulated depreciation		150 000
<i>Depreciation over its useful life (1 500 000 / 10)</i>		
Bank	100 000	
Rent receivable	48 792	
Rent income		148 792
<i>Rent due for the year</i>		
31 December 20X6		
Depreciation	150 000	
Investment property: accumulated depreciation		150 000
<i>Depreciation over its useful life (1 500 000 / 10)</i>		
Bank	120 000	
Rent receivable	28 792	
Rent income		148 792
<i>Rent due for the year</i>		
31 December 20X7		
Depreciation	150 000	
Investment property: accumulated depreciation		150 000
<i>Depreciation over its useful life (1 500 000 / 10)</i>		
Bank	144 000	
Rent receivable	4 792	
Rent income		148 792
<i>Rent due for the year</i>		
31 December 20X8		
Depreciation	150 000	
Investment property: accumulated depreciation		150 000
<i>Depreciation over its useful life (1 500 000 / 10)</i>		
Bank	172 600	
Rent receivable		23 808
Rent income		148 792
<i>Rent due for the year</i>		
31 December 20X9		
Depreciation	150 000	
Investment property: accumulated depreciation		150 000
<i>Depreciation over its useful life (1 500 000 / 10)</i>		
Bank	207 360	
Rent receivable		58 586
Rent income		148 792
<i>Rent due for the year</i>		

Solution 19.13 continued ...

W1 Annual lease charge

	Payment	Annual charge	Movement	Asset / (Liability)
31 December 20X5 <i>given</i>	100 000	148 792	48 792	48 792
31 December 20X6 (<i>100 000 x 1.2</i>)	120 000	148 792	28 792	77 584
31 December 20X7 (<i>120 000 x 1.2</i>)	144 000	148 792	4 792	82 376
31 December 20X8 (<i>144 000 x 1.2</i>)	172 600	148 792	(23 808)	58 568
31 December 20X9 (<i>1726000 x 1.2</i>)	207 360	148 792	(58 568)	0
	743 960	743 960		

The straight-lined annual rental charge:
(*743 960 / 5*)

148 792

Solution 19.14

a)

Journals	Debit	Credit
1/1/20X5		
Inventory	500 000	
Work in progress		500 000
<i>Transfer of inventory after manufacture</i>		
Cost of sale	500 000	
Inventory		500 000
<i>Cost of machine sold under finance lease</i>		
Finance lease debtors – gross investment <i>200 000 x 5 years</i>	1 000 000	
Finance lease debtors – unearned finance income <i>Balancing</i>		360 000
Sale <i>500 000 x 128%</i>		640 000
<i>Finance lease entered into, cash sales price of C320 000 and 5 years of arrear instalments of C100 000 each</i>		
31/12/20X5		
Bank	200 000	
Finance lease debtors – gross investment		200 000
<i>Instalment received under finance lease</i>		
Finance lease debtors – unearned finance income	108 743	
Finance income		108 743
<i>Interest income earned at 16.9911%, (effective interest rate table: W2)</i>		
31/12/20X6		
Bank	200 000	
Finance lease debtors – gross investment		200 000
<i>Instalment received under finance lease</i>		
Finance lease debtors – unearned finance income	93 237	
Finance income		93 237
<i>Interest income earned at 16.9911%, (effective interest rate table: W2)</i>		
31/12/20X7		
Bank	200 000	
Finance lease debtors – gross investment		200 000
<i>Instalment received under finance lease</i>		
Finance lease debtors – unearned finance income	75 097	
Finance income		75 097
<i>Interest income earned at 16.9911%, (effective interest rate table: W2)</i>		
31/12/20X8		
Bank	200 000	
Finance lease debtors – gross investment		200 000
<i>Instalment received under finance lease</i>		
Finance lease debtors – unearned finance income	53 875	
Finance income		53 875
<i>Interest income earned at 16.9911%, (effective interest rate table: W2)</i>		
31/12/20X9		
Bank	200 000	
Finance lease debtors – gross investment		200 000
<i>Instalment received under finance lease</i>		
Finance lease debtors – unearned finance income	29 047	
Finance income		29 047
<i>Interest income earned at 16.9911%, (effective interest rate table: W2)</i>		

Solution 19.14 continued ...

b)

APPLEBEE LIMITED
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X9

	Notes	20X9 C	20X8 C
<i>Non-current assets</i>			
Lease debtors	52	0	0
<i>Current assets</i>			
Lease debtors	52	0	170 953

APPLEBEE LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X9

	20X9 C	20X8 C
52. Finance lease debtor		
<i>Gross investment in finance lease</i>	0	200 000
Within 1 year	0	200 000
After 1 year but before 5 years	0	0
After 5 years	0	0
<i>Unearned finance income</i>	0	(29 047)
<i>Present value of future minimum lease payments (capital):</i>	0	170 953
Within 1 year	0	170 953
After 1 year but before 5 years	0	0
After 5 years	0	0

W1: Analysis of total amount receivable		C
Total future lease payments	200 000 x 5 years	1 000 000
Guaranteed residual value		0
Gross investment		1 000 000
Selling price (net investment)	(500 000 x 1.28)	640 000
Gross profit	640 000 – 500 000	140 000
Cost of asset	Given	500 000
Finance income	1 000 000 – 640 000	360 000

W2: Finance income measured using the effective interest rate method

Date	Instalment	Payment in lieu of:		Capital Balance
		Interest	Capital	
1 Jan X5				640 000
31 Dec X5	200 000	108 743	91 257	548 743
31 Dec X6	200 000	93 237	106 763	441 981
31 Dec X7	200 000	75 097	124 903	317 078
31 Dec X8	200 000	53 875	146 125	170 953
31 Dec X9	200 000	29 047	170 953	0
	1 000 000	360 000	640 000	

Solution 19.15

Journals	Debit	Credit
1/1/20X6		
Machine: cost	400 000	
Bank		400 000
<i>Purchase of machine</i>		
Finance lease debtors – gross investment	470 000	
Finance lease debtors – unearned finance income (470 000 – 400 000)		70 000
Machine: cost		400 000
<i>Finance lease entered into over machine costing C400 000; total receivable: C470 000 (150 000 x 3 years + 20 000 residual value)</i>		
Bank	150 000	
Finance lease debtors – gross investment		150 000
<i>Finance lease instalment received</i>		
31/12/20X6		
Finance lease debtors – unearned finance income	42 705	
Finance income		42 705
<i>Interest income earned, (effective interest table, W2 per 1 Jan X7)</i>		
Tax expense: normal tax	5 000	
Current tax payable: normal tax		5 000
<i>Current tax charge (W6)</i>		
Tax expense: normal tax	7 812	
Deferred tax: normal tax		7 812
<i>Deferred tax adjustment (W5)</i>		
1/1/20X7		
Bank	150 000	
Finance lease debtors – gross investment		150 000
<i>Finance lease instalment received</i>		
31/12/20X7		
Finance lease debtors – unearned finance income	24 377	
Finance income		24 377
<i>Interest income earned, (effective interest table, W2 per 1 Jan X8)</i>		
Tax expense: normal tax	5 000	
Current tax payable: normal tax		5 000
<i>Current tax charge (W6)</i>		
Tax expense: normal tax	2 313	
Deferred tax: normal tax		2 313
<i>Deferred tax adjustment (W5)</i>		
1/1/20X8		
Bank	150 000	
Finance lease debtors – gross investment		150 000
<i>Finance lease instalment received</i>		
31/12/20X8		
Finance lease debtors – unearned finance income	2 918	
Finance income		2 918
<i>Interest income earned, (effective interest table, W2 per 31 Dec X8)</i>		
Bank	20 000	
Finance lease debtors – gross investment		20 000
<i>Finance lease instalment received (final instalment received in arrears)</i>		

Solution 19.15 continued ...

Journals continued ...

31/12/20X8

	Debit	Credit
Tax expense: normal tax	11 000	
Current tax payable: normal tax		11 000
<i>Current tax charge (W6)</i>		
Deferred tax: normal tax	10 125	
Tax expense: normal tax		10 125
<i>Deferred tax adjustment (reversal of asset) (W5)</i>		

W1: Analysis of total amount receivable

C

Total future lease payments	150 000 x 3 years	450 000
Guaranteed residual value	Given	20 000
Gross investment		470 000
Cost of asset	Given	400 000
Finance income	470 000 – 400 000	70 000

W2: Finance income using effective interest rate method

Date	Instalment	Payment in lieu of:		Balance
		Interest	Capital	
1 Jan X6				400 000
1 Jan X6	150 000	0	150 000	250 000
31 Dec X6		42 705		292 705
1 Jan X7	150 000		107 295	142 705
31 Dec X7		24 377		167 082
1 Jan X8	150 000		125 623	17 082
31 Dec X8		2 918		20 000
31 Dec X8	20 000		17 082	0
	470 000	70 000	400 000	

W3: Deferred tax on the lighting equipment

	Carrying amount	Tax base	Temporary difference	Deferred taxation	
Opening balance	20X6	0	0	0	
Purchase		400 000	400 000		
Finance lease disposal		(400 000)	0		
Capital allowance		0	(133 333)		
Closing balance	20X6	0	266 667	80 000	A
Capital allowance		0	(133 333)		
Closing balance	20X7	0	133 334	40 000	A
Capital allowance		0	(133 334)		
Closing balance	20X8	0	0	0	

Solution 19.15 continued ...

W4: Deferred tax on the finance lease debtor		Carrying amount	Tax base	Temporary difference	Deferred taxation	
Opening balance	20X6	0	0	0	0	
New lease		400 000	0			
Movement		(107 295)	0			
Closing balance	20X6	292 705	0	(292 705)	(87 812)	L
Movement		(125 623)	0			
Closing balance	20X7	167 082	0	(167 082)	(50 125)	L
Movement		(167 082)	0			
Closing balance	20X8	0	0	0	0	

W5: Deferred tax summary		Equipment (W3)	Finance lease Debtor (W4)	Total	
Opening balance	20X6	0	0	0	
Adjustment	20X6			(7 812)	Cr DT; Dr TE
Closing balance	20X6	80 000	(87 812)	(7 812)	L
Adjustment	20X7			(2 313)	Cr DT; Dr TE
Closing balance	20X7	40 000	(50 125)	(10 125)	L
Adjustment	20X8			10 125	Dr DT; Cr TE
Closing balance	20X8	0	0	0	

W6: Current tax summary	20X8 C	20X7 C	20X6 C	Total C
Profit before tax:				
- Finance income earned	2 918	24 377	42 705	70 000
Adjust for permanent differences	0	0	0	
	2 918	24 377	42 705	70 000
Adjust for temporary differences				
- less finance income	(2 918)	(24 377)	(42 705)	(70 000)
- add lease instalment received	170 000	150 000	150 000	470 000
- less capital allowance	(133 334)	(133 333)	(133 333)	(400 000)
Taxable income	36 666	16 667	16 667	70 000
Current normal tax at 30%	11 000	5 000	5 000	21 000

Solution 19.16

	Debit	Credit
1/1/20X5		
Selling Expense	2 000	
Bank		2 000
<i>Initial direct costs expensed</i>		
<hr/>		
Finance lease debtors - Gross investment	400 000	
Finance lease debtors - Unearned finance income		153 240
Sales		246 760
<i>Finance lease entered into as lessor (W5)</i>		
<hr/>		
Inventory	189 815	
Bank		189 815
<i>Cost of manufacturing inventory</i>		
<hr/>		
Cost of sales	166 505	
Inventory		166 505
<i>Cost of vehicle sold under finance lease</i>		
<hr/>		
31/12/20X5	70 000	
Bank		70 000
Finance Lease Debtors – Gross Investment		
<i>Receipt of instalment</i>		
<hr/>		
Finance lease debtors - Unearned finance income	41 949	
Finance Income		41 949
<i>Interest Income earned (W5)</i>		
<hr/>		

Solution 19.16 continued ...**W1: Output VAT**

246 760 (FV including VAT) \times 14/114 = 30 304

W2: Cost of sales

246 760 = COS \times 1.3

COS = 189 815

W3: Analysis of total amount receivable

C

Total future payments	350 000
Guaranteed residual value (N/A)	50 000
Gross investment	400 000
Sales	246 760
Finance income (Bal)	153 240

W4: Finance income (effective interest rate method)

Date	Instalment	Interest	Capital	Balance
1 Jan 20X5				246 760
31 Dec 20X5	(70 000)	41 949	28 051	218 709
31 Dec 20X6	(70 000)	37 181	32 819	185 890
31 Dec 20X7	(70 000)	31 601	38 399	147 491
31 Dec 20X8	(70 000)	25 073	44 927	102 564
31 Dec 20X9	(120 000)	17 436	102 564	-
	(400 000)	153 240	246 760	

PS: Had you not been given the fair value on transaction date, you could have worked it out as follows:

Using a financial calculator:

PMT = 70 000

FV = 50 000

n = 5

I = 17%

COMP PV = 246 760

OR

70 000 \times 0.8547	= 59 829	(1 / 1.17 = 0.8547)
70 000 \times 0.7305	= 51 135	(0,8547 / 1.17 = 0.7305)
70 000 \times 0.6244	= 43 708	(0,7305 / 1.17 = 0.6244)
70 000 \times 0.5337	= 37 359	(0,6244 / 1.17 = 0.5337)
70 000 \times 0.4561	= 31 927	(0,5337 / 1.17 = 0.4561)
50 000 \times 0.4561	= 22 805	
246763 (round off to 246 760)		

Solution 19.17**Workings****W1. Factory Building****W1.1 Lease payment received**

The lease payments must be averaged (smoothed) over the lease term:

Total payments (100+200+300+200)	800 000
Lease term	4 years
Lease income recognised annually	200 000

VAT of C140 000 is included in the lease but is not needed to answer the question as the lease payments are given excluding VAT.

Year	Details	Amount	Asset/ (liability)
20X7	Received	(100 000)	
	Recognised	200 000	100 000 <i>(lease receivable)</i>
20X8	Received	(200 000)	
	Recognised	200 000	100 000 <i>(lease receivable)</i>
20X9	Received	(300 000)	
	Recognised	200 000	0
20X10	Received	(200 000)	
	Recognised	200 000	0

W1.2 Contingent rentals.

Operating profit was C5 000 000. Contingent rental of 1% is payable. Thus contingent rentals of C50 000 are required.

W1.3 Depreciation

The lease is an operating lease and thus still reflected in Faith Limited's books. Depreciation must be provided for:

Cost	10 000 000
Residual value	0
Depreciable amount	10 000 000
Rate of depreciation	10%
Annual depreciation	1 000 000
Years depreciated (1/1/X2 – 1/1/X7)	5 years
Accumulated depreciation	5 000 000
Carrying amount on 1/1/X7	5 000 000

W1.4 Wear and tear

Tax authority will still provide Faith Limited with a wear and tear allowance

Cost	10 000 000
Wear and tear rate	5%
Wear and tear per annum	500 000
Years provided for (1/1/X2 – 1/1/X7)	5 years
Accumulated wear and tear	2 500 000
Carrying amount	7 500 000

Solution 19.17 continued...**Workings continued ...****W2 Vehicle****W2.1 Lease schedule**

PV of minimum lease payments – 01/01/20X7	2 000 000
Interest	200 000
Payment	(527 595)
Closing Balance – 31/12/20X7	1 672 405
Interest	167 241
Payment	(527 595)
Closing balance – 31/12/20X8	1 312 051

W2.2 Capitalised leased asset

For your information

Fair value of the vehicle is C2 000 000. The present value of minimum lease payments is C2 000 000.

The asset is raised at the lower of these two amounts excluding VAT

Fair value = PV of MLP	2 000 000
VAT	245 614
Fair value raised at	1 754 386
Initial direct costs (costs expended by the lessee are capitalised to the leased asset)	50 000
Asset raised at	1 804 386

W2.3 VAT movement

For your information;

The VAT component in the agreement is reflected in the deferred tax computation as a tax base of a liability. This liability reduces each year.

Payments made in 20X7	527 595
Total payments to be made	2 637 975
Ratio of payments made to total payments	0.2
VAT movement required (245614×0.2)	49123

W3 Plant**W3.1 Sales revenue**

Sales price	900 000
VAT	110 526
Revenue	789 474

W3.2 Cost of Sales

Cost	1 000 000
Depreciation	20%
Annual depreciation	200 000
Years depreciated (1/1/X5 – 1/1/X7)	2 years
Accumulated Depreciation	400 000
Carrying Amount (1/1/X7)	600 000

Solution 19.17 continued...**Workings continued ...****W3.3 Lease Schedule**

PV of MLP – 01/01/20X7	900 000
Payment	(329 003)
Interest [(900 000 – 329 003) * 10%]	57 100
Closing balance – 31/12/20X7	628 097
Payment	(329 003)
Interest	29 909
Closing Balance – 31/12/20X8	329 003

W3.4 Initial direct cost

Total initial direct costs incurred of C114 000. The VAT component is C14 000. The amount of C100 000 (excluding VAT) must be expensed (because Faith Limited is A manufacturer type lessor)

W3.5 Wear and tear

From tax authority's perspective the asset is still owned by Faith Limited and they will thus still be entitled to a wear and tear allowance

Cost	1 000 000
Wear and tear allowance	25%
Wear and tear per annum	250 000
Years provided for (1/1/X5 – 1/1/X7)	2 years
Accumulated wear and tear	500 000
Tax base on 1/1/20X7	500 000

W3.6 VAT movement

The Vat component in the agreement is reflected in the deferred tax computation as the tax base of an asset.

VAT	110 526
Payments received	329 003
Total payments to be received	987009
Ratio of payments made to total payments	33.333%
VAT movement	36 842

(110 526 x 33.333%)

W4 Land

The payments have to be smoothed over the lease term. Since equal payments are made each year the amount of lease expense recognised is equal to the lease payment made

There is thus no deferred tax effect.

Payment recognised = C1 000 000 annually for 10 years

Solution 19.17 continued...

Workings continued ...

W5 Deferred tax Computation (for 20X7 only)

Factory Building

	Details	Carrying amount	Tax base	Temporary diff.	Deferred tax
(W1.3)/ (W1.4)	Opening balance	5 000 000	7 500 000	2 500 000	750 000 A
	Movement	(1000 000)	(500 000)	500 000	150 000
	Closing balance	4 000 000	7 000 000	3 000 000	900 000 A

Vehicle

	Details	Carrying amount		Tax base		Temp diff.	Deferred tax	
		Asset	Liability	Asset	Liability			
	Opening balance	0	0	0	0	0	0	
(W2.2)/ (W2.1)	Enter into lease	1 804 386	(2 000 000)		(245 614)	(50 000)	(15 000)	
	Depreciation	(451 097)				451 097	135 329	
(W2.1)	Interest		(200 000)			200 000	60 000	
(W2.1)	Finance cost		527 595			(527 595)	(158 279)	
(W2.3)	VAT movement				49 123	49 123	14 737	
	Closing balance	1 353 289	(1 672 405)		(196 49)	122 625	36 788	A

Plant

	Details	Carrying amount		Tax base		Temp diff.	Deferred tax	
		NI: Lease	Asset	NI: Lease	Asset			
(W3.2) / (W3.5)	Opening balance	0	600 000	0	500 000	(100 000)	(30 000)	L
(W3.3) / (W3.6)	Enter into lease	900 000	(600 000)	110 526		(189 474)	(56 842)	
(W3.3)	Payment	(329 003)				329 003	98 701	
(W3.3)	Interest	57 100				(57 100)	(17 130)	
(W3.6)	VAT movement			(36 842)		(36 842)	(11 053)	
(W3.5)	Wear and tear				(250 000)	(250 000)	(75 000)	
	Closing balance	628 097	0	73 684	250 000	(304 413)	(91 324)	L

Factory Building payment received

	Details	Carrying amount	Tax base	TD	DT	
	Opening balance	0	0	0	0	
(W1.1)	Movement	100 000	0	(100 000)	(30 000)	
	Closing balance	100 000	0	(100 000)	(30 000)	L

NIL – net investment in the lease

When Faith Limited enters into the lease, the asset is derecognised from the company's books and a net investment in the lease is raised (asset).

Solution 19.17 continued...**Workings continued ...****W6 Current Tax computation**

Profit before tax		5 000 000
Depreciation on factory building	(W1.3)	1 000 000
Wear and tear on Factory building	(W1.4)	(500 000)
Depreciation on vehicles		451 097
Finance cost on vehicles	(W2.1)	200 000
Lease payment on vehicles	(W2.1) (527 595 – 49 123)	(478 472)
Initial direct costs incurred	(W2.2)	(50 000)
Finance income on plant	(W3.3)	(57 100)
Wear and tear on plant	(W3.5)	(250 000)
Profit on sale of plant	(W3.1)/(W3.2)	(189 474)
Lease payment received	(W3.3) (329 003 – 36 842)	292 161
Factory payment recognised	(W1.1)	(200 000)
Factory payment received	(W1.1)	100 000
Taxable profit		<u>5 318 212</u>
Current tax @ 30%		<u><u>1 595 464</u></u>

Disclosure

FAITH LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE PERIOD ENDING 31 DECEMBER 20X7

	Notes	C 20X7
Revenue	3	XXX
Operating profit		5 200 000
Finance Costs	4	<u>(200 000)</u>
Profit before tax	5	5 000 000
Taxation	6	<u>(1 500 000)</u>
Profit for the period		3 500 000
<i>Other comprehensive income</i>		<u>0</u>
Total comprehensive income		<u><u>3 500 000</u></u>

Solution 19.17 continued...**Disclosure continued ...**
FAITH LIMITED
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X7

	Notes	20X7 C
ASSETS		
Non-current Assets		
Plant property and equipment	7	4 000 000
Capitalised leased vehicle	8	1 353 289
Net investment in the lease	9	299 904
Current Assets		
Current portion of net investment in the lease	9	329 003
EQUITY and LIABILITIES		
Non-Current liabilities		
Leased liability	10	1 312 050
Deferred tax	11	815 464
Current Liabilities		
Current portion of leased liability	10	360 355

FAITH LIMITED
NOTES TO THE FINANCIAL STATEMENTS (EXTRACT)
FOR THE PERIOD ENDING 31 DECEMBER 20X7

		20X7 C
3. Revenue		
Revenue includes the following		
Sale of goods	(W3.1)	789 474
Finance income	(W3.3)	57 100
4. Finance Costs		
Finance costs comprises of		
Finance costs on leased vehicle	(W2.1)	200 000
5. Profit before tax		
Profit before tax includes the following (income) /expense items:		
Depreciation on factory building	(W1.3)	1 000 000
Depreciation on vehicles	(W5.1)	451 097
Operating lease expense recognised	(W4.1)	1 000 000
Initial direct costs incurred	(W3.3)	100 000
Cost of sales	(W3.4)	600 000
Operating lease income recognised:		250 000
Minimum lease payments	(W1.1)	(200 000)

Contingent rentals

(W1.2)

(50 000)

Solution 19.17 continued...

Disclosure continued ...

FAITH LIMITED
NOTES TO THE FINANCIAL STATEMENTS (EXTRACT)
FOR THE PERIOD ENDING 31 DECEMBER 20X7 CONTINUED ...

20X7
C

6. Taxation

Normal current tax		
• Current tax	(W6)	1 595 464
• Deferred tax	(W5)	(95 464)
o Factory building	900 000 – 750 000	(150 000)
o Vehicles	36 788 – 0	(36 788)
o Plant	91 324 – 30 000	61 324
o Factory building lease payments received	30 000 - 0	30 000

Tax expense per the statement of comprehensive income	1 500 000
---	-----------

Rate reconciliation

Applicable tax rate	30%
Tax effect of:	
Profit before tax	5 000 00 x 30%

Tax expense per the statement of comprehensive income	1 500 000
---	-----------

Effective tax rate	30%
--------------------	-----

For your information

The rate recon describes why the applicable tax rate differs from the effective tax rate. This difference is caused by permanent differences. Since the permanent differences will always exist the accountant shows tax expense from tax authority point of view. They then explain why this figure is not 30% of profit before tax by disclosing a tax rate reconciliation. Because no permanent differences arose in this situation the effective tax rate and applicable tax rate are the same.

Deferred tax arises from temporary differences. These differences will disappear over a period of time. For this reason the accountant creates a book entry called deferred tax. The result of the book entry is the tax expense per the statement of comprehensive income equals to the profit before tax multiplied by the applicable tax rate (thus the tax expense is from the accountant's point of view)

As the temporary differences reverse the book entry is used so that the effective tax rate is as close as possible to the applicable tax rate.

7. Factory building

Cost	10 000 000
Accumulated depreciation	(5 000 000)
Carrying amount	5 000 000
Current year movements	
Depreciation	1 000 000
Carrying Amount	4000 000
Cost	10 000 000
Accumulated depreciation	6 000 000

Solution 19.17 continued...**Disclosure continued ...**

FAITH LIMITED
NOTES TO THE FINANCIAL STATEMENTS (EXTRACT)
FOR THE PERIOD ENDING 31 DECEMBER 20X7 CONTINUED ...

20X7
C

8. Capitalised leased vehicles

Cost	0
Accumulated depreciation	0
Carrying amount	0
Current year movements	
Enter into finance lease	1 804 386
Depreciation	(451 097)
Carrying amount	1 353 289
Cost	1 804 386
Accumulated depreciation	(451 097)

9. Net investment in lease

Faith Limited leased an item of plant to Regan Limited. There are two payments of C329 003 remaining that must be paid on the 1 January each year.

The implicit rate to the lease is 10%

Current portion	329 003
Non-Current portion	299 094

Reconciliation of the gross investment in the lease to the present value of minimum lease payments

	Gross investment in lease	Unearned finance income	Net investment in lease
Due within 1 year	329 003	0	329 003
Due between 2-5 years	329 003	29 909	299 094
	658 006	29 909	628 097

10. Capitalised lease liability

Faith Limited leased a vehicle under a finance lease. Four payments of C527 595 are still required on the 31 December each year

Implicit rate to the lease is 10%

Current portion	360 355
Non-current	1 312 051

Reconciliation of the minimum lease payments to the present value

	Minimum lease payments	Finance expense	Present value
Due within one year	527 595	(47 963)	479 632
Due within 2-5 years	1 582 785	(390 012)	1 192 773
	2 110 380	(437 975)	1 672 405

Solution 19.17 continued...

Disclosure continued ...

FAITH LIMITED
NOTES TO THE FINANCIAL STATEMENTS (EXTRACT)
FOR THE PERIOD ENDING 31 DECEMBER 20X7 CONTINUED ...

20X7
C
11. Deferred tax

Deferred tax arises on the following temporary differences [asset/(liability)]

Factory building	(900 000)
Factory building payments received	30 000
Vehicles	(36 788)
Plant	91 324
Total	<u>(815 464)</u>

12. Operating leases

Faith Limited leased a factory building to Olga Limited (as lessor) under a non-cancellable operating lease. In addition to the minimum lease payments contingent rentals of 1% of company's profits is required annually.

Total future minimum lease payments receivable (including VAT)

Within 1 year	228 000
Within 2-5 years	570 000
After 5 years	0

Faith Limited leased a plot of land to Mali Limited (as lessee) under a non-cancellable operating lease. Lease payments of C1000 000 are required annually.

Total future minimum lease payments payable (including VAT)

Within 1 year	1 140 000
Within 2-5 years	4 560 000
After 5 years	5 700 000

Solution 20.1

- In order to issue either the debentures or the redeemable preference shares, the company must be authorized to do so in terms of its articles of association. The articles may be amended to include such authorization provided that the procedures required by the Companies Ordinance, 1984 are complied with.
- Both the preference shares and the debentures may be issued as redeemable at the company's option, which would comply with the directors' wish not to be committed to repayment on a specific date.
- Debentures cannot have any voting rights, whereas preference shares may have voting rights, if specified in its articles and memorandum of association.
- It may be possible to offer a lower rate of return on the debentures than on the preference shares due to the debentures' preference in the event of liquidation, especially if the debentures are secured.
- An important consideration is the deductibility of interest paid on the debentures and the non-deductibility of dividends paid. The fact that the company is profitable indicates that it is probably in a tax paying position. The after tax cost of issuing debentures will be lower than that of issuing preference shares.
- The difficulties experienced with cash flows may be a problem if the debentures are issued as the interest must be paid on the agreed dates, whereas the dividends on preference shares need not be paid unless profits are available. However, provided the directors are correct about the impact of the new system on stock holdings, tight control is maintained over credit policies and the company continues to operate profitably, it should be possible to meet interest payments without much difficulty.
- Unless new shares are issued for the redemption of preference shares, there will have to be a transfer from retained earnings to a non-distributable reserve (capital redemption reserve fund) equaling the nominal value of the preference shares in terms of Sec 85. This decreases the amount available for distribution to ordinary shareholders. No such restriction applies to redeeming debentures.
- Issuing C500 000 debentures will result in Stylish Limited's gearing increasing to 38%. This is still a comfortable gearing ratio and should not restrict potential future borrowings, provided there is no restriction in the articles of the company.
- Any expenses/commission/premium on redemption relating to the issue of preference shares may be written off existing share premium in terms of Sec 83, therefore not impacting distributable reserves. This is also permitted for similar expenditure relating to debentures, Sec 83 (2) (b).

Solution 20.2

WILLIAMSON LIMITED
EXTRACT FROM THE STATEMENT OF FINANCIAL POSITION
AS AT 28 FEBRUARY 20X4

	Note	C
<i>EQUITY & LIABILITIES</i>		
Capital & reserves		
Share capital		
Distributable reserves - Retained earnings		118 009
Non-current liabilities		
C1 debentures	5	19 413
Current liabilities		
Interest accrued		200

NOTES TO THE FINANCIAL STATEMENTS

5. Non current liabilities

Unsecured	C
20 000 C1 debentures	<u>*19 413</u>

These debentures bear interest at 12% p.a. and will be redeemed at a premium of 2% on 31 January 20X9. The effective interest rate is 13.16% p.a.

*Carrying amount at 01/01/X4	19 400
a) Effective interest @ 13.16% (19 400 * 13.16% * 1 / 12)	213
b) Interest @ 12% (accrued) (20 000 * 12% * 1 / 12)	(200)
	19 413

Solution 20.2 continued ...

Workings

Retained earnings

		C
Balance		120 000
Debenture discount written off	(92 x 1/12)	(8)
Debenture premium accrued	(62 x 1/12)	(5)
Debenture interest accrued	(2 400 x 1/12)	(200)
Premium on preference shares		(278)
Preference dividend		(1 500)
		118 009

Debenture amortisation schedule:

Date	Interest	Effective Interest	Premium (x 0.4)	Discount (x 0.6)	Balance Premium	Balance Discount	PV
1/2/X4						600	19 400
31/1/X5	2 400	2 554	62	92	62	508	19 554
31/1/X6	2 400	2 574	70	104	131	403	19 728
31/1/X7	2 400	2 597	79	118	210	285	19 925
31/1/X8	2 400	2 623	89	134	299	151	20 148
31/1/X9	2 400	2 652	101	151	400	0	20 400

Preference shares

Cash flow	
1/3/X1	15 000
28/2/X2	(1 500)
28/2/X3	(1 500)
28/2/X4	*(17 250)

The effective interest rate is 11.4890387% (PV = 15 000 FV = -15 750 PMT = -1 500 n = 3 COMP i)

	Interest	Effective Interest	Premium	Premium balance	PV
1/3/X1					15 000
28/2/X2	1 500	1 723	223	223	15 223
28/2/X3	1 500	1 749	249	472	15 472
28/2/X4	1 500	1 778	278	750	15 750

* Redemption	15 750
Preference dividend	1 500
	17 250

Solution 20.3

NOURISH LIMITED
STATEMENT OF FINANCIAL POSITION
AS AT 28 FEBRUARY 20X7

		C
ASSETS		
Bank	(25 000 + 19 200 – 34 200)	10 000
EQUITY & LIABILITIES		
Capital and reserves		
Ordinary share capital	(100 000 + 16 000)	116 000
Share premium	(25 000 + 3 200 - 600)	27 600
Retained earnings	(78 000 - 3 600 - 1 350 - 34 - 50 – 102 + 600)	73 464
		217 064
Non-current liabilities		
Debentures	(15 000 - 116 + 50)	14 934
Current liabilities		
Interest accrued	(15 000 x 12% x 9/12)	1 350

Workings

Retained earnings

	C
Balance (27/2/X7)	78 000
Transfer to CRRF	(10 800)
Preference dividend	(3 600)
Premium accrued	(102)
Interest on debentures accrued (1 800 x 9/ 12)	(1 350)
Debenture discount written off	(34)
Debenture premium accrued	(50)
Transfer from share premium	600
Balance (28/2/X7)	73 464

Debentures

Date	Interest	Effective Interest	Installment	Premium	Discount	Balance Premium	Balance Discount	PV
01/06/X6							150	14 850
31/05/X7	1 800	1 912		67	45	67	105	14 962
31/05/X8	1 800	1 926	5075	76	50	^68	55	10 013
31/05/X9	1 200	1 289	5075	54	36	47	19	5 028
31/05/Y0	600	647	5075	28	19	0	0	0

Balances at 28/2/X7:

Premium: $9/12 \times 67 = 50$ Discount: $9/12 \times 45 = 34$ thus balance = $150 - 34 = 116$ ^ $[67 + 76 - 75 (5\,000 \times 0.015)]$

Solution 20.3 continued

Cash needed:

Redemption of preference shares (30 000 x 1.02)	30 600
Preference dividends	3 600
Cash required	34 200
Cash from bank	(15 000)
Cash required from share issue	19 200

S76

Premium	- Share premium*	600
	- Retained earnings	-
		600

Dr	Share premium	600	
Cr	Retained earnings		600

Number of shares to be issued:

19 200 / 1.20 = 16 000 shares	
X C1 = C16 000	Share capital
X C0,20 = C3 200	Share premium

Preference shares

	Effective interest	Premium	Premium balance	PV	
28/2/W7				90 000	} Not required
28/2/W8	10 922	122	122	90 122	
28/2/W9	10 937	137	259	90 259	
28/2/X0	10 953	153	412	90 412	
28/2/X1	10 972	172	584	90 584	
28/2/X2	10 993	193	777	90 777	
28/2/X3	11 016	216	993	90 993	
28/2/X4	11 042	242	1 235	91 235	
28/2/X5	11 072	272	1 507	91 507	
			(600)	(30 600)	
			907	60 907	
28/2/X6	7 391	191	1 098	61 098	
			(600)	(30 600)	
			498	30 498	
28/2/X7	3 702	102	600	30 600	
			(600)	(30 600)	
			0	0	

Cash flow

0	28/02/W7	90 000	
1	28/02/W8	(10 800)	
2	28/02/W9	(10 800)	
3	28/02/X0	(10 800)	
4	28/02/X1	(10 800)	
5	28/02/X2	(10 800)	
6	28/02/X3	(10 800)	
7	28/02/X4	(10 800)	
8	28/02/X5	(41 400)	(10 800 + 30 000 + 600)
9	28/02/X6	(37 800)	(7 200 + 30 000 + 600)
10	28/02/X7	(34 200)	(3 600 + 30 000 + 600)

The effective interest rate is 12.1355013%

Solution 20.4

SCOTT LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 JUNE 20Y0

		C
Profit before interest and taxation		265 750
Interest expense	Debentures (15 524 + 15 646) Loan (13 000 + 5 200)	(49 370)
Profit before tax		216 380
Income tax expense		(70 227)
Profit for the period		146 153
<i>Other comprehensive income</i>		0
Total comprehensive income		146 153

SCOTT LIMITED
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 30 JUNE 20Y0

	Ordinary Share capital	Share Premium	Preference Share capital	Retained earnings	Total
	C	C	C	C	C
Balance at 30 June 20X9	450 000	50 000	200 000	335 500	1 035 500
Capitalisation issue	50 000	(50 000)			-
Ordinary shares issued during the year	150 000	18 750			168 750
Preference shares redeemed			(200 000)		(200 000)
Premium on redemption of preference shares		(18 750)		(1 250)	(20 000)
Share issue expenses				(1 688)	(1 688)
Total comprehensive income				146 153	146 15
Dividends paid – ordinary				(12 500)	(12 500)
– preference				(30 000)	(30 000)
Balance at 30 June 20Y0	650 000	-	-	436 215	1 086 215

Solution 20.4 continued ...**NOTES TO THE FINANCIAL STATEMENTS****1. Share capital****Authorised**

500 000 ordinary shares of C2 each

500 000 preference shares of C0.50 each

Issued

	Ordinary share capital	Preference share capital
Number of shares in issue 1 July 20X9	225 000	400 000
Number of ordinary capitalisation shares issued	25 000	
Number of ordinary shares issued for cash during the year	75 000	
Number of preference shares redeemed during the year		(400 000)
Number of shares in issue 30 June 20Y0	325 000	-

The directors have been granted permission to issue the unissued ordinary shares at their sole discretion, at any time before the next annual general meeting.

2. Non-current liabilities**Secured**

200 C1 000 Debentures

198 223

The debentures bear interest at 14% p.a. payable on 1 January and 1 July each year. They are redeemable at par on 31 December 20Y0. The debentures are secured by a mortgage over land and buildings of C300 000. The effective interest rate on the debentures is 15.918% p.a.

Unsecured

Loan – Investments Bank
current portion

120 000
(30 000)
90 000

The loan bears interest at 13% p.a. payable annually in arrears and is repayable in annual installments of C30 000, with the last installment payable on 1 March 20X4.

3. Dividends

The directors declared an ordinary dividend of C32 500 (325 000 X C0.10) on 31 July 20Y0.

4. Authorisation of financial statements

The financial statements were authorised for issue by the board of directors on 5 August 20Y0.

Solution 20.4 continued ...

Workings

Debentures

Date	Interest	Effective interest	Discount	Balance discount	PV
1/7/20X7				10 000	190 000
31/12/20X7	14 000	15 122	1 122	8 878	191 122
30/06/20X8	14 000	15 211	1 211	7 666	192 334
31/12/20X8	14 000	15 308	1 308	6 359	193 641
30/06/20X9	14 000	15 412	1 412	4 947	195 053
31/12/20X9	14 000	15 524	1 524	3 422	196 578
30/06/20Y0	14 000	15 646	1 646	1 777	198 223
31/12/20Y0	14 000	15 777	1 777	0	200 000

Interest on bank loan

30/6/X9 to 28/2/Y0

$$C150\,000 \times 0.13 \times 8/12 = C13\,000$$

1/3/Y0 to 30/6/Y0

$$C120\,000 \times 0.13 \times 4/12 = C5\,200$$

Preference shares

Sec 83

Premium on redemption	(400 000 X 0,05)	20 000
- Share premium		18 750
- <i>Retained earnings</i>		1 250

Final dividend

$$200\,000 \times 15\% \times 6/12 = 15\,000$$

Solution 21.1

Part A:

a) Journals

	Debit	Credit
1 January 20X1		
Plant: cost	500 000	
Bank/ creditors		500 000
<i>Purchase of plant</i>		
31 December 20X1		
Depreciation – plant	100 000	
Plant: accumulated depreciation		100 000
<i>Depreciation of plant: 500 000 / 5 years</i>		
31 December 20X2		
Depreciation – plant	100 000	
Plant: accumulated depreciation		100 000
<i>Depreciation of plant: 500 000 / 5 years</i>		
Impairment loss – plant	90 000	
Plant: accumulated impairment losses		90 000
<i>Impairment of plant at year end:</i>		
<i>CA: (500 000 – 200 000) – RA: 210 000</i>		
31 March 20X3		
Depreciation – plant	17 500	
Plant: accumulated depreciation		17 500
<i>Depreciation of plant: 210 000 / 3 years remaining x 3/12</i>		
Impairment loss – plant	2 500	
Plant: accumulated impairment losses		2 500
<i>Impairment of plant before reclassification (IAS 36.8):</i>		
<i>CA: (210 000 – 17 500) – RA: 190 000 (being fair value less costs to sell = 200 000 – 10 000 = 190 000 being > VIU of 160 000)</i>		
Non-current asset held for sale	190 000	
Plant: accumulated impairment losses (90 000 + 2 500)	92 500	
Plant: accumulated depreciation (100 000 + 100 000 + 17 500)	217 500	
Plant: cost		500 000
<i>Transfer of plant to non-current asset held for sale at the carrying amount calculated in accordance with IAS 16 and IAS 36</i>		
31 December 20X3		
Non-current asset held for sale	92 500	
Impairment loss reversed – non-current asset held for sale		92 500
<i>IFRS 5 (p21): Re-measurement of asset 'held for sale' at year end:</i>		
<i>Previous FV less costs to sell (200 000 – 10 000) increased to the latest FV less costs to sell (300 000 – 10 000); increase of 100 000 limited to prior cumulative impairment losses of (90 000 + 2 500)</i>		

Solution 21.1 continued ...

Part A: continued ...

b) Disclosure

ERADICATE LTD
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X3

	<i>Calculations</i>	<i>Notes</i>	20X3 C	20X2 C
Non-current assets				
Property, plant and equipment		5	0	210 000
Non-current assets held for sale		6	282 500	0

ERADICATE LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X3

	<i>Calculations</i>	20X3 C	20X2 C
5 Property, plant and equipment			
5.1 Plant			
Net carrying amount: 1 January		210 000	400 000
Gross carrying amount: 1 January		500 000	500 000
Accumulated depreciation and impairment losses: 1 January		(290 000)	(100 000)
(Impairment loss)/ reversal		(2 500)	(90 000)
Depreciation		(17 500)	(100 000)
Classified as held for sale		(190 000)	0
Net carrying amount: 31 December		0	210 000
Gross carrying amount: 31 December		0	500 000
Accumulated depreciation and impairment losses: 31 Dec		0	(290 000)
6 Non-current assets held for sale			
6.1 Plant			
Net carrying amount: 1 January		0	0
Transfer from property, plant and equipment		190 000	0
Increase/ (decrease) in fair value less costs to sell			
- (impairment loss)/ reversal	100 000 limited to (90 000 + 2 500)	92 500	
Net carrying amount: 31 December		282 500	0

A decision was taken on 1 April 20X3 to dispose of the plant because of
It is expected to be sold for cash and that the sale will be completed by ... (date).
This asset is presented in the _____ segment.

10 Profit before tax

Profit before tax is stated after taking into account the following separately disclosable items:

• Depreciation – plant (IAS 16)	17 500	100 000
• Impairment loss (reversed) - plant (IAS 36)	2 500	90 000
• Impairment loss (reversed) - asset held for sale (IFRS 5)	(92 500)	0

Solution 21.1

Part B:

a) Journals

	Debit	Credit
1 January 20X1		
Plant: cost	500 000	
Bank/ creditors		500 000
<i>Purchase of plant</i>		
31 December 20X1		
Depreciation – plant	100 000	
Plant: accumulated depreciation		100 000
<i>Depreciation of plant: 500 000 / 5 years</i>		
Tax expense	7 500	
Deferred tax		7 500
<i>Deferred tax adjustment – see DT table</i>		
31 December 20X2		
Depreciation – plant	100 000	
Plant: accumulated depreciation		100 000
<i>Depreciation of plant: 500 000 / 5 years</i>		
Impairment loss – plant	90 000	
Plant: accumulated impairment losses		90 000
<i>Impairment of plant at year end:</i>		
<i>CA: (500 000 – 200 000) – RA: 210 000</i>		
Deferred tax	19 500	
Tax expense		19 500
<i>Deferred tax adjustment – see DT table (27 000 – 7 500)</i>		
31 March 20X3		
Depreciation – plant	17 500	
Plant: accumulated depreciation		17 500
<i>Depreciation of plant: 210 000 / 3 years remaining x 3/12</i>		
Impairment loss – plant	2 500	
Plant: accumulated impairment losses		2 500
<i>Impairment of plant before reclassification (IAS 36.8):</i>		
<i>CA: (210 000 – 17 500) – RA: 190 000 (being fair value less costs</i>		
<i>to sell = 200 000 – 10 000 = 190 000 being > VIU of 160 000)</i>		
Non-current asset held for sale	190 000	
Plant: accumulated impairment losses (90 000 + 2 500)	92 500	
Plant: accumulated depreciation (100 000 + 100 000 + 17 500)	217 500	
Plant: cost		500 000
<i>Transfer of plant to non-current asset held for sale at the carrying amount calculated in accordance with IAS 16 and IAS 36</i>		
31 December 20X3		
Non-current asset held for sale	92 500	
Impairment loss reversed – non-current asset held for sale		92 500
<i>IFRS 5 (p 21): Re-measurement of asset ‘held for sale’ at yr end:</i>		
<i>Previous FV less costs to sell (200 000 – 10 000) increased to the latest FV less costs to sell (300 000 – 10 000); increase of 100 000 limited to prior cumulative impairment losses of (90 000 + 2 500)</i>		
Tax expense	59 250	
Deferred tax		59 250
<i>Deferred tax adjustment – see DT table (32 250 – 750 + 27 750)</i>		

Solution 21.1 continued ...

Part B: continued ...

b) Disclosure

ERADICATE LTD
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X3

	<i>Calculations</i>	<i>Notes</i>	20X3 C	20X2 C
Non-current assets				
Property, plant and equipment		5	0	210 000
Deferred tax			0	12 000
Non-current assets held for sale		6	282 500	0
Liabilities				
Deferred Tax			47 250	0

ERADICATE LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X3

	<i>Calculations</i>	20X3 C	20X2 C
5 Property, plant and equipment			
5.1 Plant			
Net carrying amount: 1 January		210 000	400 000
Gross carrying amount: 1 January		500 000	500 000
Accumulated depreciation and impairment losses: 1 January		(290 000)	(100 000)
(Impairment loss)/ reversal		(2 500)	(90 000)
Depreciation		(17 500)	(100 000)
Classified as held for sale		(190 000)	0
Net carrying amount: 31 December		0	210 000
Gross carrying amount: 31 December		0	500 000
Accumulated depreciation and impairment losses: 31 Dec		0	(290 000)
6 Non-current assets held for sale			
6.1 Plant			
Net carrying amount: 1 January		0	0
Transfer from property, plant and equipment		190 000	0
Increase/ (decrease) in fair value less costs to sell			
- (impairment loss)/ reversal	<i>100 000 limited to (90 000 + 2 500)</i>	92 500	
Net carrying amount: 31 December		282 500	0

A decision to dispose the plant was taken on the 1st April 20X3 because of.....It is expected that this asset will be sold for cash and that the sale will be completed by(date). The asset is presented as part of the manufacturing segment. – see part A.

10 Profit before tax

Profit before tax is stated after taking into account the following separately disclosable items:

• Depreciation – plant (IAS 16)	17 500	100 000
• Impairment loss (reversed) - plant (IAS 36)	2 500	90 000
• Impairment loss (reversed) - asset held for sale (IFRS 5)	(92 500)	0

Solution 21.1 continued ...

Part B: continued ...

WORKINGS

W1. Deferred tax table

		CA	TB	TD	DT	
Opening balance	X1	0	0	0	0	
Purchase		500 000	500 000	0	0	
Depreciation/ W&T		(100 000)	(125 000)	(25 000)	(7 500)	Cr DT; Dr TE
Closing balance	X1	400 000	375 000	(25 000)	(7 500)	L
Depreciation/ W&T		(100 000)	(125 000)	(25 000)	(7 500)	Cr DT; Dr TE
Impairment (IAS 36)		(90 000)	0	90 000	27 000	Dr DT; Cr TE
Closing balance	X2	210 000	250 000	40 000	12 000	A
Depreciation/ W&T		(17 500)	(125 000)	(107 500)	(32 250)	Cr DT; Dr TE
Impairment (IAS 36)		(2 500)	0	2 500	750	Dr DT; Cr TE
<i>Non-current asset HFS</i>		190 000				
Impairment reversed (IFRS 5)		92 500	0	(92 500)	(27 750)	Cr DT; Dr TE
Closing balance	X3	282 500	125 000	(157 500)	(47 250)	L

Explanation: 92 500

IFRS 5.21 limits a reversal of impairment loss to the cumulative prior impairment losses. This means that the $FV - \text{Cost to sell}$ of 290 000 is limited by the previous accumulated losses of 92 500 (90 000 + 2 500). The carrying amount can only be increased to 282 500 (190 000 + 92 500).

Solution 21.2**Part A:****a) Journals**

	Debit	Credit
1 January 20X1		
Plant: cost	500 000	
Bank/ creditors		500 000
<i>Purchase of plant</i>		
31 December 20X1		
Depreciation – plant	100 000	
Plant: accumulated depreciation		100 000
<i>Depreciation of plant: 500 000 / 5 years</i>		
31 December 20X2		
Depreciation – plant	100 000	
Plant: accumulated depreciation		100 000
<i>Depreciation of plant: 500 000 / 5 years</i>		
Impairment loss – plant	90 000	
Plant: accumulated impairment losses		90 000
<i>Impairment of plant at year end: CA: (500 000 – 200 000) – RA: 210 000</i>		
31 March 20X3		
Depreciation – plant	17 500	
Plant: accumulated depreciation		17 500
<i>Depreciation of plant: 210 000 / 3 years remaining x 3/12</i>		
Plant: accumulated impairment losses	7 500	
Impairment loss reversed – plant		7 500
<i>Reversal of impairment of plant before reclassification: CA: (210 000 – 17 500) – RA: 200 000 (higher of value in use: 200 000 and fair value less costs to sell: 200 000 – 10 000)</i>		
Non-current asset held for sale (balancing)	200 000	
Plant: accum depr & imp loss	300 000	
<i>(100 000 + 100 000 + 90 000 + 17 500 – 7 500)</i>		
Plant: cost (given)		500 000
<i>Transfer of plant to non-current asset held for sale at the carrying amount calculated in accordance with IAS 16 and IAS 36</i>		
Impairment loss – non-current asset held for sale	10 000	
Non-current asset held for sale		10 000
<i>Impairment of non-current asset held for sale on reclassification: Lower of CA: (200 000) and Fair value less costs to sell: (200 000 – 10 000)</i>		
31 December 20X3		
Impairment loss – non-current asset held for sale	20 000	
Non-current asset held for sale		20 000
<i>Re-measurement of asset 'held for sale' at year end: Previous FV less costs to sell (200 000 – 10 000) decreased to the latest FV less costs to sell (180 000 – 10 000); decrease of 20 000</i>		

Solution 21.2 continued ...

Part A: continued ...

b) Disclosure

OUTAHERE LTD
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X3

	<i>Calculations</i>	<i>Notes</i>	20X3 C	20X2 C
Non-current assets				
Property, plant and equipment		5	0	210 000
Non-current assets held for sale		6	170 000	0

OUTAHERE LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X3

	<i>Calculations</i>	20X3 C	20X2 C
5 Property, plant and equipment			
5.1 Plant			
Net carrying amount: 1 January		210 000	400 000
Gross carrying amount: 1 January		500 000	500 000
Accumulated depreciation and impairment losses: 1 January		(290 000)	(100 000)
(Impairment loss)/ reversal		7 500	(90 000)
Depreciation		(17 500)	(100 000)
Classified as held for sale		(200 000)	0
Net carrying amount: 31 December		0	210 000
Gross carrying amount: 31 December		0	500 000
Accumulated depreciation and impairment losses: 31 Dec		0	(290 000)
6 Non-current assets held for sale			
6.1 Plant			
Net carrying amount: 1 January		0	0
Transfer from property, plant and equipment		200 000	0
Increase/ (decrease) in fair value less costs to sell			
- (impairment loss)/ reversal <i>10 000 + 20 000</i>		(30 000)	
Net carrying amount: 31 December		170 000	0

A decision was taken on 1 April 20X3 to dispose of the plant because of
It is expected to be sold for cash and that the sale will be completed by ... (date).
This asset is presented in the segment.

10 Profit before tax

Profit before tax is stated after taking into account the following separately disclosable items:

• Depreciation – plant (IAS 16)	17 500	100 000
• Impairment loss / (reversed) - plant (IAS 36)	(7 500)	90 000
• Impairment loss – non-current asset held for sale (IFRS 5)	30 000	0

Solution 21.2

Part B:

a) Journals

	Debit	Credit
1 January 20X1		
Plant: cost	500 000	
Bank/ creditors		500 000
<i>Purchase of plant</i>		
31 December 20X1		
Depreciation	100 000	
Plant: accumulated depreciation		100 000
<i>Depreciation of plant: 500 000 / 5 years</i>		
Tax expense	7 500	
Deferred tax		7 500
<i>Deferred tax adjustment – see deferred tax table</i>		
31 December 20X2		
Depreciation	100 000	
Plant: accumulated depreciation		100 000
<i>Depreciation of plant: 500 000 / 5 years</i>		
Impairment loss	90 000	
Plant: accumulated impairment losses		90 000
<i>Impairment of plant at year end:</i>		
<i>CA: (500 000 – 200 000) – RA: 210 000</i>		
Deferred tax	19 500	
Tax expense		19 500
<i>Deferred tax adjustment – see deferred tax table (27 000 – 7 500)</i>		
31 March 20X3		
Depreciation	17 500	
Plant: accumulated depreciation		17 500
<i>Depreciation of plant: 210 000 / 3 years remaining x 3/12</i>		
Plant: accumulated impairment losses	7 500	
Impairment loss reversed		7 500
<i>Reversal of impairment of plant before reclassification: CA: (210 000 – 17 500) – RA: 200 000 (higher of value in use: 200 000 and fair value less costs to sell: 200 000 – 10 000)</i>		
Non-current asset held for sale (balancing)	200 000	
Plant: accum depr & imp loss	300 000	
<i>(100 000 + 100 000 + 90 000 + 17 500 – 7 500)</i>		
Plant: cost (given)		500 000
<i>Transfer of plant to non-current asset held for sale at the carrying amount calculated in accordance with IAS 16 and IAS 36</i>		
Impairment loss – non-current asset held for sale	10 000	
Non-current asset held for sale		10 000
<i>Impairment of non-current asset held for sale:</i>		
<i>Lower of CA: (200 000) and Fair value less costs to sell: (200 000 – 10 000)</i>		
Tax expense	25 500	
Deferred tax		25 500
<i>Deferred tax adjustment – see deferred tax table:</i>		
<i>(32 250 + 2 250 – 3 000 – 6 000)</i>		
31 December 20X3		
Impairment loss – non-current asset held for sale	20 000	
Non-current asset held for sale		20 000
<i>Re-measurement of asset 'held for sale' at year end: Previous FV less costs to sell (200 000 – 10 000) decreased to the latest FV less costs to sell (180 000 – 10 000); decrease of 20 000</i>		

Solution 21.2 continued ...

Part B: continued ...

b) Disclosure

OUTAHERE LTD
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X3

	<i>Calculations</i>	<i>Notes</i>	20X3 C	20X2 C
<i>Non-current assets</i>				
Property, plant and equipment		5	0	210 000
Deferred Tax			0	12 000
<i>Non-current assets held for sale</i>		6	170 000	0
<i>Liabilities</i>				
Deferred Tax			13 500	0

OUTAHERE LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X3

	<i>Calculations</i>	20X3 C	20X2 C
5 Property, plant and equipment			
5.1 Plant			
Net carrying amount: 1 January		210 000	400 000
Gross carrying amount: 1 January		500 000	500 000
Accumulated depreciation and impairment losses: 1 Jan		(290 000)	(100 000)
(Impairment loss)/ reversal		7 500	(90 000)
Depreciation		(17 500)	(100 000)
Classified as held for sale		(200 000)	0
Net carrying amount: 31 December		0	210 000
Gross carrying amount: 31 December		0	500 000
Accumulated depreciation and impairment losses: 31 Dec		0	(290 000)

6 Non-current assets held for sale**6.1 Plant**

Net carrying amount: 1 January		0	0
Transfer from property, plant and equipment		200 000	0
Increase/ (decrease) in fair value less costs to sell			
- (impairment loss)/ reversal	<i>10 000 + 20 000</i>	(30 000)	
Net carrying amount: 31 December		170 000	0

A decision to dispose the plant was taken on the 1st April 20X3 because of.....It is expected that this asset will be sold for cash and that the sale will be completed by(date). The asset is presented as part of the manufacturing segment.

10 Profit before tax

Profit before tax is stated after taking into account the following separately disclosable items:

• Depreciation – plant (IAS 16)	17 500	100 000
• Impairment loss / (reversed) - plant (IAS 36)	(7 500)	90 000
• Impairment loss – non-current asset held for sale (IFRS 5)	30 000	0

Solution 21.2 continued ...

Part B: continued ...

WORKINGS

Deferred tax table					
	Year	CA	TB	TD	DT
Opening balance	X1	0	0	0	0
Purchase		500 000	500 000	0	0
Depreciation/ W&T		(100 000)	(125 000)	(25 000)	(7 500)
Closing balance	X1	400 000	375 000	(25 000)	(7 500)
Depreciation/ W&T		(100 000)	(125 000)	(25 000)	(7 500)
Impairment (IAS 36)		(90 000)	0	90 000	27 000
Closing balance	X2	210 000	250 000	40 000	12 000
Depreciation/ W&T		(17 500)	(125 000)	(107 500)	(32 250)
Imp reversed (IAS 36)		7 500	0	(7 500)	(2 250)
<i>Pre-classification as HFS</i>		200 000			
Impairment (IFRS 5)		(10 000)	0	10 000	3 000
<i>Non-current asset HFS</i>		190 000			
Impairment (IFRS 5)		(20 000)	0	20 000	6 000
Closing balance	X3	170 000	125 000	(45 000)	(13 500)

Solution 21.3

a)

	Debit	Credit
1 January 20X5		
Machine: cost	250 000	
Bank/ creditors		500 000
<i>Purchase of machine</i>		
31 December 20X5		
Depreciation – machine	50 000	
Machine: accumulated depreciation		50 000
<i>Depreciation of machine: 250 000 / 5 years</i>		
Tax expense	3 750	
Deferred tax		3 750
<i>Deferred tax adjustment – see DT table</i>		
31 December 20X6		
Depreciation – machine	50 000	
Machine: accumulated depreciation		50 000
<i>Depreciation of machine: 250 000 / 5 years</i>		
Impairment loss – machine	45 000	
Machine: accumulated impairment losses		45 000
<i>Impairment of machine at year end:</i>		
<i>CA: (250 000 – 100 000) – RA: 105 000</i>		
Deferred tax	9 750	
Tax expense		9 750
<i>Deferred tax adjustment – see DT table</i>		
31 March 20X7		
Depreciation – machine	8 750	
Machine: accumulated depreciation		8 750
<i>Depreciation of machine: 105 000 / 3 years remaining x 3/12</i>		
Impairment loss – machine	1 250	
Machine: accumulated impairment loss		1 250
<i>Impairment of machine before reclassification IAS 36 p8: CA: 96 250 – RA: 95 000 (FV-CtS 95 000 > VIU 90 000)</i>		
Non-current asset held for sale (balancing)	95 000	
Machine: accumulated impairment losses (45 000 + 1 250)	46 250	
Machine: accumulated depreciation (50 000 + 50 000 + 8 750)	108 750	
Machine: cost (given)		250 000
<i>Transfer of machine to non-current asset held for sale at the carrying amount calculated in accordance with IAS 16 and IAS 36</i>		
31 December 20X7		
Non-current asset held for sale	46 250	
Impairment loss reversed – non-current asset held for sale		46 250
<i>IFRS 5 (p 21): Re-measurement of asset 'held for sale' at yr end: Previous FV less costs to sell (95 000) increased to the latest FV less costs to sell (145 000); increase of 50 000 limited to prior cumulative impairment losses of (45 000 + 1 250)</i>		
Tax Expense	29 625	
Deferred tax liability		29 625
<i>Deferred tax adjustment – see DT table</i>		

Solution 21.3 continued ...

b)

JOVIAL LTD
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X7

	<i>Calculations</i>	<i>Notes</i>	20X7 C	20X6 C
Non-current assets				
Property, plant and equipment		5	0	105 000
Deferred tax			0	6 000
Non-current assets held for sale		6	141 250	0
Liabilities				
Deferred tax			23 625	0

JOVIAL LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X7

	<i>Calculations</i>	20X7 C	20X6 C
5 Property, plant and equipment			
5.1 Machine			
Net carrying amount: 1 January		105 000	200 000
Gross carrying amount: 1 January		250 000	250 000
Accumulated depreciation and impairment losses: 1 January		(145 000)	(50 000)
(Impairment loss)/ reversal		(1 250)	(45 000)
Depreciation		(8 750)	(50 000)
Classified as held for sale		(95 000)	0
Net carrying amount: 31 December		0	105 000
Gross carrying amount: 31 December		0	250 000
Accumulated depreciation and impairment losses: 31 Dec		0	(145 000)
6 Non-current assets held for sale			
6.1 Machine			
Net carrying amount: 1 January		0	0
Transfer from property, plant and equipment		95 000	0
Increase/ (decrease) in fair value less costs to sell			
- (impairment loss)/ reversal	<i>50 000 limited to (45 000 + 1 250)</i>	46 250	
Net carrying amount: 31 December		141 250	0

A decision to dispose the plant was taken on the 1st April 20X7 because of.....It is expected that this asset will be sold for cash and that the sale will be completed by(date). The asset is presented as part of the manufacturing segment.

10 Profit before tax

Profit before tax is stated after taking into account the following separately disclosable items:

• Depreciation – machine	8 750	50 000
• Impairment loss – machine (IAS 36)	1 250	45 000
• Impairment loss reversed – non current asset held for sale (IFRS 5)	(46 250)	0

Solution 21.3 continued ...

W1. Deferred tax table		CA	TB	TD	DT	
Opening balance	X5	0	0	0	0	
Purchase		250 000	250 000	(12 500)	(3 750)	Cr DT; Dr TE
Depreciation/ W&T		(50 000)	(62 500)			
Closing balance	X5	200 000	187 500	(12 500)	(3 750)	L
Depreciation/ W&T		(50 000)	(62 500)	32 500	9 750	Dr DT; Cr TE
Impairment (IAS 36)		(45 000)	0			
Closing balance	X6	105 000	125 000	20 000	6 000	A
Depreciation/ W&T		(8 750)	(62 500)			
Impairment (IAS 36)		(1 250)	0	(98 750)	(29 625)	Cr DT; Dr TE
<i>Non-current asset HFS</i>		95 000				
Impairment reversed (IFRS 5)		* 46 250	0			
Closing balance	X7	141 250	62 500	(78 750)	(23 625)	L

*: $145\,000 - 95\,000 = 50\,000$, limited to previous impairment losses: $45\,000 + 1\,250 = 46\,250$

Solution 21.4**Part A****a) Journals**

	Debit	Credit
1 January 20X1		
Plant: cost	500 000	
Bank/ creditors		500 000
<i>Purchase of plant</i>		
31 December 20X1		
Depreciation	100 000	
Plant: accumulated depreciation		100 000
<i>Depreciation of plant: 500 000 / 5 years</i>		
1 January 20X2		
Plant: accumulated depreciation	100 000	
Plant: cost		100 000
<i>Net method: set off accumulated depreciation against cost before revaluation</i>		
Plant: cost	400 000	
Revaluation surplus		400 000
<i>Revaluation surplus: FV 800 000 – CA (500 000 – 100 000)</i>		
31 December 20X2		
Depreciation	200 000	
Plant: accumulated depreciation		200 000
<i>Depreciation of plant: 800 000 / 4 years remaining</i>		
31 March 20X3		
Depreciation	50 000	
Plant: accumulated depreciation		50 000
<i>Depreciation of plant: 800 000 / 4 years remaining x 3/12</i>		
Plant: accumulated depreciation	250 000	
Plant: cost		250 000
<i>Net method: set off accumulated depreciation against cost before revaluation: 200 000 + 50 000</i>		
Revaluation surplus	50 000	
Plant: cost		50 000
<i>Revaluation to FV before reclassification as 'held for sale':</i>		
<i>Revaluation surplus: FV 500 000 – CA (800 000 – 250 000)</i>		
Non-current asset held for sale	500 000	
Plant: cost (500 000 – 100 000 + 400 000 – 250 000 – 50 000)		500 000
<i>Transfer of plant to non-current asset held for sale at the carrying amount calculated in accordance with IAS 16 and IAS 36</i>		
Impairment loss – non-current asset held for sale	50 000	
Non-current asset held for sale		50 000
<i>Re-measurement on reclassification as 'held for sale':</i>		
<i>Lower of CA (500 000) or FV less costs to sell (500 000 – 50 000)</i>		
31 December 20X3		
Non-current asset held for sale	50 000	
Impairment loss reversed – non-current asset held for sale		50 000
<i>Re-measurement of asset 'held for sale' at year end:</i>		
<i>Previous FV less costs to sell (450 000) increased to the latest FV less costs to sell (700 000 – 40 000); increase of 210 000 limited to prior cumulative impairment losses of 50 000</i>		

Solution 21.4 continued ...

Part A: continued ...

b) Disclosure

TOSSOUT LTD
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X3

	<i>Calculations</i>	<i>Notes</i>	20X3 C	20X2 C
Non-current assets				
Property, plant and equipment		5	0	600 000
Non-current assets held for sale		6	500 000	0

TOSSOUT LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X3

	<i>Calculations</i>	20X3 C	20X2 C
5 Property, plant and equipment			
5.1 Plant			
Net carrying amount: 1 January		600 000	400 000
Gross carrying amount: 1 January		800 000	500 000
Accumulated depreciation and impairment losses: 1 January		(200 000)	(100 000)
Increase/ (decrease) in value through			
- revaluation surplus		(50 000)	400 000
- (impairment loss)/ reversal			
Depreciation		(50 000)	(200 000)
Classified as held for sale		(500 000)	0
Net carrying amount: 31 December		0	600 000
Gross carrying amount: 31 December		0	800 000
Accumulated depreciation and impairment losses: 31 Dec		0	(200 000)
Carrying amount based on the cost model		0	300 000
6 Non-current assets held for sale			
6.1 Plant			
Net carrying amount: 1 January		0	0
Transfer from property, plant and equipment		500 000	0
Increase/ (decrease) in fair value less costs to sell			
- (impairment loss)/ reversal (50 000 – 50 000)		0	
Net carrying amount: 31 December		500 000	0

A decision was taken on 1 April 20X3 to dispose of the plant because of

It is expected to be sold for cash and that the sale will be completed by ... (date).

A total impairment loss of C50 000 was recognised on initial classification of the asset as held for sale. This was reversed on subsequent re-measurement at year-end. These amounts are included in 'other expenses' on the face of the statement of comprehensive income.

This asset is presented in the segment.

Solution 21.4 continued ...

Part A: continued ...

b) Disclosure continued ...

TOSSOUT LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X3 continued ...

10 Profit before tax

Profit before tax is stated after taking into account the following separately disclosable items:

• Depreciation – plant	50 000	200 000
• Impairment loss - non-current asset held for sale (IFRS 5)	0	0
(50 000 – 50 000)		

Solution 21.4**Part B:****a) Journals**

	Debit	Credit
1 January 20X1		
Plant: cost	500 000	
Bank/ creditors		500 000
<i>Purchase of plant</i>		
31 December 20X1		
Depreciation	100 000	
Plant: accumulated depreciation		100 000
<i>Depreciation of plant: 500 000 / 5 years</i>		
Tax Expense	7 500	
Deferred tax		7 500
<i>Deferred tax adjustment – see deferred tax table</i>		
1 January 20X2		
Plant: accumulated depreciation	100 000	
Plant: cost		100 000
<i>Net method: set off acc. deprec. against cost before revaluation</i>		
Plant: cost	400 000	
Revaluation surplus		400 000
Revaluation surplus	120 000	
Deferred tax		120 000
<i>Revaluation surplus: [FV800 000 – CA(500 000–100 000)] & [400Kx 30%]</i>		
31 December 20X2		
Depreciation	200 000	
Plant: accumulated depreciation		200 000
<i>Depreciation of plant: 800 000 / 4 years remaining</i>		
Deferred tax	22 500	
Tax expense		22 500
<i>Deferred tax adjustment – see deferred tax table</i>		
31 March 20X3		
Depreciation	50 000	
Plant: accumulated depreciation		50 000
<i>Depreciation of plant: 800 000 / 4 years remaining x 3/12</i>		
Tax Expense	22 500	
Deferred tax		22 500
<i>Deferred tax adjustment – see deferred tax table [22 500+ 15 000 – 15 000]</i>		
Plant: accumulated depreciation	250 000	
Plant: cost		250 000
<i>Net method: set off acc. depr. against cost before revaluation: 200K + 50K</i>		
Revaluation surplus	50 000	
Plant: cost		50 000
Deferred tax	15 000	

Revaluation surplus	15 000
<i>Revaluation to FV before reclassification as 'held for sale': Revaluation surplus: $[FV: 500\,000 - CA: (800\,000 - 250\,000)] \& [50\,000 \times 30\%]$</i>	

Solution 21.4 continued ...

Part B: continued ...

a) Journals continued ...

	Debit	Credit
31 March 20X3 continued ...		
Non-current asset held for sale	500 000	
Plant: cost (500 000 – 100 000 + 400 000 – 250 000 – 50 000)		500 000
<i>Transfer of plant to non-current asset held for sale at the carrying amount calculated in accordance with IAS 16 and IAS 36</i>		
Impairment loss – non-current asset held for sale	50 000	
Non-current asset held for sale		50 000
<i>Re-measurement on reclassification as 'held for sale':</i>		
<i>Lower of CA (500 000) or FV less costs to sell (500 000 – 50 000)</i>		
31 December 20X3		
Non-current asset held for sale	50 000	
Impairment loss reversed - non-current asset held for sale		50 000
<i>Re-measurement of asset 'held for sale' at year end: Previous FV less costs to sell (450K) increased to the latest FV less costs to sell (700K–40K); increase of 210 000 limited to prior cumulative impairment losses of 50 000</i>		

Solution 21.4 continued ...

Part B: continued ...

b) Disclosure

TOSSOUT LTD
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X3

<i>ASSETS</i>	<i>Calculations</i>	<i>Notes</i>	20X3 C	20X2 C
Non-current assets				
Property, plant and equipment		8	0	600 000
Non-current assets held for sale		9	500 000	0
EQUITY AND LIABILITIES				
Equity				
Revaluation surplus			0	280 000
Revaluation surplus relating to non-current assets held for sale	(280 000 – 35 000)		245 000	0
Non-current liabilities				
Deferred tax			112 500	105 000

TOSSOUT LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X3

	<i>Calculations</i>	20X3 C	20X2 C
7 Profit before tax			
Profit before tax is stated after taking into account the following separately disclosable items:			
• Depreciation – plant		50 000	200 000
• Impairment loss / (reversed) - non-current asset held for sale (IFRS 5) (50 000 – 50 000)		0	0
8 Property, plant and equipment			
8.1 Plant			
Net carrying amount: 1 January		600 000	400 000
Gross carrying amount: 1 January		800 000	500 000
Accumulated depreciation and impairment losses: 1 January		(200 000)	(100 000)
Increase/ (decrease) in value through			
- revaluation surplus		(50 000)	400 000
Depreciation		(50 000)	(200 000)
Classified as held for sale		(500 000)	0
Net carrying amount: 31 December		0	600 000
Gross carrying amount: 31 December		0	800 000
Accumulated depreciation and impairment losses: 31 Dec		0	(200 000)
Carrying amount based on the cost model		0	300 000

Solution 21.4 continued ...

Part B: continued ...

b) Disclosure continued ...

TOSSOUT LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X3 continued ...

	<i>Calculations</i>	20X3 C	20X2 C
9 Non-current assets held for sale			
9.1 Plant			
Net carrying amount: 1 January		0	0
Transfer from property, plant and equipment		500 000	0
Increase/ (decrease) in fair value less costs to sell			
- (impairment loss)/ reversal (50 000 – 50 000)		0	
Net carrying amount: 31 December		<u>500 000</u>	<u>0</u>

A decision to dispose the plant was taken on the 1st April 20X3 because of.....It is expected that this asset will be sold for cash and that the sale will be completed by(date).

A total impairment loss of C50 000 was recognised on initial classification of the asset as held for sale. The C50 000 impairment was reversed on subsequent re-measurement at the year end. These amounts have been included under “other expenses” on the face of the statement of comprehensive income.

The asset is presented as part of the manufacturing segment.

WORKINGS

Deferred tax table

		CA	TB	TD	DT	
Opening balance	X1	0	0	0	0	
Purchase		500 000	500 000	0	0	
Depreciation/ W&T		(100 000)	(125 000)	(25 000)	(7 500)	Cr DT; Dr TE
Closing balance	X1	400 000	375 000	(25 000)	(7 500)	L
Revaluation surplus		400 000	0	(400 000)	(120 000)	Cr DT; Dr RS
		<u>800 000</u>				
Depreciation/ W&T		(200 000)	(125 000)	75 000	22 500	Dr DT; Cr TE
Closing balance	X2	600 000	250 000	(350 000)	(105 000)	L
Depreciation/ W&T		(50 000)	(125 000)	(75 000)	(22 500)	Cr DT; Dr TE
		<u>550 000</u>				
Devaluation (RS)		(50 000)	0	50 000	15 000	Dr DT; Cr RS
Pre-classification as HFS		500 000				
Impairment (IFRS 5)		(50 000)	0	50 000	15 000	Dr DT; Cr TE
Non-current asset HFS		450 000				
Imp reversed (IFRS 5)		50 000	0	(50 000)	(15 000)	Cr DT; Dr TE
Closing balance	X3	500 000	125 000	(375 000)	(112 500)	L

Solution 21.5

Part A:

a) Journals

	Debit	Credit
1 January 20X1		
Plant: cost	500 000	
Bank/ creditors		500 000
<i>Purchase of plant</i>		
31 December 20X1		
Depreciation – plant	100 000	
Plant: accumulated depreciation		100 000
<i>Depreciation of plant: 500 000 / 5 years</i>		
1 January 20X2		
Plant: accumulated depreciation	100 000	
Plant: cost		100 000
<i>Net method: set off accumulated depreciation against cost before revaluation</i>		
Plant: cost	400 000	
Revaluation surplus		400 000
<i>Revaluation surplus: FV 800 000 – CA (500 000 – 100 000)</i>		
31 December 20X2		
Depreciation – plant	200 000	
Plant: accumulated depreciation		200 000
<i>Depreciation of plant: 800 000 / 4 years remaining</i>		
31 March 20X3		
Depreciation – plant	50 000	
Plant: accumulated depreciation		50 000
<i>Depreciation of plant: 800 000 / 4 years remaining x 3/12</i>		
Plant: accumulated depreciation	250 000	
Plant: cost		250 000
<i>Net method: set off accumulated depreciation against cost before revaluation: 200 000 + 50 000</i>		
Plant: cost	100 000	
Revaluation surplus		100 000
<i>Revaluation to FV before reclassification as 'held for sale':</i>		
<i>Revaluation surplus: FV 650 000 – CA (800 000 – 250 000)</i>		
Non-current asset held for sale	650 000	
Plant: cost (500 000 – 100 000 + 400 000 – 250 000 + 100 000)		650 000
<i>Transfer of plant to non-current asset held for sale at the carrying amount calculated in accordance with IAS 16 and IAS 36</i>		
Impairment loss – non-current asset held for sale	50 000	
Non-current asset held for sale		50 000
<i>Re-measurement of asset held for sale immed. after classification:</i>		
<i>Lower of CA (650 000) or FV less costs to sell (650 000 – 50 000)</i>		
31 December 20X3		
Impairment loss – non-current asset held for sale	130 000	
Non-current asset held for sale		130 000
<i>Re-measurement of asset held for sale: at year end:</i>		
<i>Previous FV less costs to sell (600 000) decreased to the latest FV less costs to sell (500 000 – 30 000)</i>		

Solution 21.5 continued ...

Part A: continued ...

b) Disclosure

CUTAWAY LTD
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X3

	<i>Calculations</i>	<i>Notes</i>	20X3 C	20X2 C
ASSETS				
Non-current assets				
Property, plant and equipment		5	0	600 000
Non-current assets held for sale		6	470 000	0
EQUITY AND LIABILITIES				
Revaluation surplus			500 000	400 000

CUTAWAY LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X3

	<i>Calculations</i>	20X3 C	20X2 C
5 Property, plant and equipment			
5.1 Plant			
Net carrying amount: 1 January		600 000	400 000
Gross carrying amount: 1 January		800 000	500 000
Accumulated depreciation and impairment losses: 1 January		(200 000)	(100 000)
Increase/ (decrease) in value through			
- revaluation surplus		100 000	400 000
Depreciation		(50 000)	(200 000)
Classified as held for sale		(650 000)	0
Net carrying amount: 31 December		0	600 000
Gross carrying amount: 31 December		0	800 000
Accumulated depreciation and impairment losses: 31 Dec		0	(200 000)
Carrying amount based on the cost model		0	300 000
6 Non-current assets held for sale			
6.1 Plant			
Net carrying amount: 1 January		0	0
Transfer from property, plant and equipment		650 000	0
Increase/ (decrease) in fair value less costs to sell			
- (impairment loss)/ reversal <i>(50 000 + 130 000)</i>		(180 000)	
Net carrying amount: 31 December		470 000	0

A decision was taken on 1 April 20X3 to dispose of the plant because of

It is expected to be sold for cash and that the sale will be complete by ... (date).

A total impairment loss of C50 000 was recognised on initial classification of the asset as held for sale. A further loss of C130 000 was recognised on subsequent re-measurement at year-end. These losses are included in 'other expenses' on the face of the statement of comprehensive income.

This asset is presented in the segment.

Solution 21.5 continued ...

Part A: continued ...

b) Disclosure continued ...

**CUTAWAY LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X3 continued**

10 Profit before tax

Profit before tax is stated after taking into account the following separately disclosable items:

• Depreciation – plant	50 000	200 000
• Impairment loss – non-current asset held for sale (IFRS 5) (50 000 + 130 000)	180 000	0

Solution 21.6

IFRS 5 describes a *component* of an entity as one that comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. In other words, a component of an entity will have been a cash-generating unit or a group of cash-generating units while being held for use.

IFRS 5 defines a discontinued operation as a component of an entity that either *has been disposed of*, or is *classified as held for sale*, and

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

The tyre-manufacturing unit of Bettenwood Limited is a separate cash-generating unit and therefore a component of the company. It represents a separate major line of business and geographical area of operation, being located in Richards Bay.

Since the tyre-manufacturing unit has not yet been disposed of at 31 October 20X1 (financial year end), it must first be classified as held for sale in order to be classified as a discontinued operation.

An entity shall classify a disposal group as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use (IFRS 5 p6).

For this to be the case, the disposal group must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such disposal groups and its sale must be *highly probable*.

Mr. Schuma, the MD of Bettenwood Limited, announced that negotiations to sell the entire tyre manufacturing division had been entered into with Suba Limited as part of the implementation of the disposal plan. This reveals the fact that:

- the appropriate level of management is committed to a plan to sell the disposal group;
- an active programme to locate a buyer and complete the plan must have been initiated by 25 August 20X1; and
- the price should be reasonable in relation to its current fair value due to negotiations being held.

Further, given the publicity surrounding the plan, it could be assumed that it is likely that the plan will not be withdrawn or materially altered. The sale is also expected to be made within a few months and thus, it should qualify for recognition as a completed sale within one year from the date of classification

On the 15th July 20X1, although a decision had been reached in principle to discontinue the division, no formal plan had been composed setting out the procedures of the sale. The above-mentioned facts reveal that the sale is “immediate” and highly probable and that the disposal group should therefore be classified as “held for sale” and consequently as a discontinued operation from 25 August 20X1.

Solution 21.7

- a) The initial date on which information on the discontinued operation will be disclosed for the first time, is the earlier of either the date of disposal or the date the component (disposal group) was classified as held for sale.

To be classified as held for sale, the following criteria must be met:

- Appropriate management must be committed to a plan for selling the asset
- A buyer must be actively sought
- The disposal group must be marketed at a reasonable price (fair value)
- The sale must be expected to be completed and recognised within one year from date of commitment
- There must be no intention to withdraw or change the plan of sale

On 18 December 20X6 the board formally decided to sell the soccer ball division to a large sporting goods manufacturer (buyer) at a fair price and within a reasonable time frame. The sale is therefore highly probable on the 18 December 20X6 and the discontinued operation should therefore be disclosed from that date.

- b) Evergreen Ltd will have to redraft the statement of comprehensive income and the statement of cash flows for the current year to present the information on the discontinued operation separately from the continuing operations as per IFRS 5 para 33. Comparatives should also be divided between continuing and discontinued operations (para 34).

In the statement of financial position, Evergreen Ltd will need to disclose the assets held for sale and any associated equity (eg revaluation surplus) and associated liabilities separately from other assets, equity and liabilities as required per IFRS 5 para 38. Comparatives are not necessary for a reclassification of assets in the statement of financial position (para 40).

Solution 21.7 continued ...

c)

EVERGREEN LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X6

IAS 1 p 117 **2. Accounting policies***2.5 Assets held for sale*

Non current assets and disposal groups are classified as held for sale when the inflow of economic benefits inherent in those assets are expected to be derived primarily through sale rather than use and the sale is highly probable. (The assets must be available for immediate sale subject only to terms and delays customary for sales of the type in question)

2.6 Discontinued operations

An entity presents the results of its operations as a discontinued operation when the operation represents a component of the entity that has been classified as held for sale or disposed of. Comparatives are restated in this regard.

35. Discontinued operations:

		20X6	20X5
p38	<i>Non-current assets held for sale</i>		
	Property, plant and equipment	1 695	
	Accounts Receivable	120	
	Inventory	600	
		<hr/>	
		2415	
	Bank Overdraft	(750)	
		<hr/>	
	Total per statement of financial position	1665	
p33 (b)	<i>Analysis of loss on discontinued operation</i>		
			p34
p33(b)(i)	Revenue	3 750	XX
p33(b)(i)	Expenses	(4 335)	XX
		<hr/>	
p33(b)(i)	Loss before tax	(585)	XX
p33(b)(ii)	Income tax expense	(75)	XX
		<hr/>	
	Loss for the period from discontinued operations	(660)	XX

p41 A decision to dispose of the soccer ball division was taken on 18 December 20X6 because the division was no longer profitable. It is expected that this division will be sold for cash and that the sale will be completed by the end of April 20X7.

Solution 21.8

a)

MANDOS LTD
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X8 (extract)

	Note	20X8 C
<i>Discontinued operations</i>	25	
Revenue	<i>Given</i>	1 180 000
Expenses	<i>W1</i>	(1 264 200)
Loss before tax		(84 200)
Income tax (income)	<i>W4</i>	27 360
Loss after tax		(56 840)
Gain after tax from re-measurement (impairment)		77 000
Loss from re-measuring the asset to fair value less costs to sell		(2 000)
Gain on disposal of asset: (420 000 – 305 000)		115 000
Net gain before tax		113 000
Income tax expense	<i>W4</i>	(36 000)
Profit for the period from discontinued operations		20 160
Profit for the period		XXX
<i>Other comprehensive income</i>		0
Total comprehensive income		XXX

Solution 21.8 continued ...

b)

**MANDOS LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X8 (EXTRACTS)**

2. Accounting policies

2.10 Assets held for sale

Non current assets and disposal groups are classified as held for sale when the inflow of economic benefits inherent in those assets are expected to be derived primarily through sale rather than use and the sale is highly probable. (The assets must be available for immediate sale subject only to terms and delays customary for sales of the type in question)

2.11 Discontinued operations

An entity presents the results of its operations as a discontinued operation when the operation represents a component of the entity that has been classified as held for sale or disposed of. Comparatives are restated in this regard

25 Discontinuing operations

On 29 November 20X5 the board of directors approved and announced a plan to dispose of its operations in Zimbabwe, by selling the assets through several transactions.

This division was previously reported in the Zimbabwe segment.

The company decided to dispose of its operations in Zimbabwe because profits have decreased as a result of economic and political uncertainty.

Non current assets classified as held for sale include furniture (C32 000) and buildings (C600 000).

The process of disposing of the Zimbabwe division is expected to be completed by (date).

The company recognised a provision for employee compensation of C90 000 (before income tax benefit of C27 000) to be paid during March 20X9 to employees whose jobs will be terminated as a result of the discontinuance of operations in Zimbabwe.

Solution 21.8 continued ...

Workings

W1: Total expenses

		C
Other expenses	Given	1 106 400
Doubtful debt	43 000 - 39 600	3 400
Inventory write-down	64 000 - 59 000	5 000
Depreciation	$[(600\,000 - 360\,000) / 4 \times 11/12] + [(48\,000 - 38\,400) / 2 \times 11/12]$	59 400
Compensation costs		90 000
		<u>1 264 200</u>

W2: Current normal tax calculation

		C	Tax at 30%
Loss before tax	1 180 000 – 1 264 200	(84 200)	
Add depreciation	W2: 55 000 + 4 400	59 400	
Less wear and tear	W2: 60 000 + 4 800	(64 800)	
Add compensation costs		90 000	
		400	120

W3: Deferred tax calculation

Equipment	CA	TB	TD	Deferred tax	Journal entries
Equipment 1 January 20X8 (600 000 / 10 years x 6 years)	360 000	360 000	0	0	
Depreciation: 600 000 / 10 x 11/12	(55 000)	(60 000)	(5 000)	(1 500)	Dr TE, Cr DTL
	305 000	300 000			
Sale Equipment 31 December 20X8	305 000	300 000	5 000	1 500	Dr DTL, Cr TE
	0	0	0	0	

Furniture

Furniture 1 January 20X8 (48 000 / 10 years x 8 years)	38 400	38 400	0	0	
Depreciation: 48 000 / 10 x 11/12	(4 400)	(4 800)	(400)	(120)	Dr TE, Cr DTL
Furniture classified as HFS	34 000	33 600			
IFRS 5 Impairment (balancing)	(2 000)	0	2 000	600	Dr DTL, Cr TE
Furniture 31 December 20X8 (given)	32 000	33 600	1 600	480	Asset

Provision for compensation to employees

1 January 20X8	0	0	0	0	
Compensation costs	(90 000)	0	90 000	27 000	Dr DTA, Cr TE
31 December 20X8	(90 000)	0	90 000	27 000	

Solution 21.8 continued ...

Workings continued . .

W4: Separate disclosure of tax

Tax relating to discontinued operations

Current Tax	W2	(27 360)
Deferred Tax	W3: 27 000 – 120 + 600	120
		(27 480)

Tax relating to disposal gains/losses and impairments/ reversals of impairments

Current Tax	W5	36 000
Deferred Tax		36 000
		-

Total tax		8 640
------------------	--	--------------

W5: Taxation on disposal

Pocceeds	420 000
Less:	
Tax base	(300 000)
	120 000
Tax @ 30%	<u>36 000</u>

Deferred taxation is nil as asset is sold

Solution 21.9

a)

The division was classified as held for sale at the date that the following was met:

‘The disposal group must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such disposal groups and its sale must be highly probable.’ (IFRS 5, p7-10).

For the sale to be highly probable, it must meet the following requirements:

- the *appropriate level of management* is *committed to a plan* to sell the disposal group;
- an active programme to *locate a buyer* and complete the plan must have been initiated;
- the price should be reasonable in relation to its current fair value; and
- the sale should be made within one year of classification as held for sale;
- there should be evidence that management intend to complete the plan as it stands. (i.e. with no significant changes to or withdrawal from the plan).

The division (disposal group) should thus be classified as held for sale on the 30th June 20X1, as this is the date where all of the above requirements were met:

- A formal plan was approved by the directors, and
- The division was expected to be sold within 6 months

As the division was sold within 6 months, it seems that an active program to locate a buyer have been initiated at that date and the price quoted was reasonable in relation to its fair value.

Solution 21.9 continued...

b)

TOYS AREN'T US LTD
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 SEPTEMBER 20X1

	Note	20X1 C	20X0 C
Continuing operations			
Revenue		7 500 000	XX
Cost of sales		(2 250 000)	(XX)
Gross profit		5 250 000	XXX
Operating expenses		(750 000)	(XX)
Profit before tax		4 500 000	XXX
Income tax expense	50	(1 350 000)	(XX)
Profit for the period from continuing operations		3 150 000	XXX
Discontinued operations	48		
Revenue	P33(b)(i)	75 000	XX
Other expenses ¹	P33(b)(i)	(77 500)	(XX)
Profit/(Loss) before tax	P33(b)(i)	(2 500)	XXX
Income tax expense (W2: all current tax)	P33(b)(ii)	(750)	(XX)
Loss after tax		(3 250)	
Loss after tax from re-measurement (impairment)		(2 450)	
Loss from re-measuring the disposal group to fair value less costs to sell (W3)	P33(b)(iii)	(3 500) ²	
Income tax expense (W1: all deferred tax)	P33(b)(iv)	1 050 ³	
Loss for the period from discontinued operations		(5 700)	XXX
Profit for the period		3 144 300	XXX
Other comprehensive income		0	XXX
Total comprehensive income		3 144 300	XXX

Solution 21.9 continued...

b) continued ...

ALTERNATE DISCLOSURE:

- TOTAL ON FACE OF STATEMENT OF COMPREHENSIVE INCOME
- WITH A SUPPORTING NOTE

TOYS AREN'T US LTD
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 SEPTEMBER 20X1

	Note	20X1 C	20X0 C
<i>Continuing operations</i>			
Revenue		7 500 000	XXX
Total expense (2 250 000 + 750 000)		(3 000 000)	(XXX)
Profit before tax		4 500 000	XXX
Income tax expense	50	(1 350 000)	(XXX)
Profit for the period from continuing operations		3 150 000	XXX
<i>Discontinued operations</i>			
Profit for the period from discontinued operations	48	(5 700)	
Profit for the period		3 144 300	XXX
<i>Other comprehensive income</i>		0	XXX
Total comprehensive income		3 144 300	XXX

TOYS AREN'T US LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 SEPTEMBER 20X1

48. Analysis of profit for the period from discontinued operations

Revenue	75 000	XXX
Other expenses ¹	(77 500)	(XXX)
Profit/(loss) before tax	(2 500)	XXX
Income tax expense (W2: all current tax)	(750)	(XXX)
Loss after tax	(3 250)	
Loss after tax from re-measurement (impairment)	(2 450)	
Loss from re-measuring the disposal group to fair value less costs to sell	(3 500) ²	
Income tax expense (W1: all deferred tax)	1 050 ³	
Loss for the period from discontinued operations	(5 700)	XXX

Solution 21.9 continued....

b) continued ...

TOYS AREN'T US LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 SEPTEMBER 20X1

48 Discontinued operation p41

A decision to dispose of the toys division was taken on the 30th June 20X1 because the division was no longer profitable. It is expected that this division will be sold for a net selling price of C54 000 and that the sale will be completed by the end of November 20X1.

50 Tax

	Continuing operations	Discontinued operations (note 1)
	C	C
20X1		
Normal tax		
• Current	1 350 000	750
• Deferred	-	(1 050)
Tax expense per statement of comprehensive income	1 350 000	(300)
<i>Tax rate reconciliation</i>		
20X1		
Standard tax at 30%	1 350 000	(1 800) *
Provision for termination costs – not tax deductible in the future		1 500
Tax expense per statement of comprehensive income	1 350 000	(300)
Effective tax rate	(Continuing: 1 350 000/4 500 000) (Discontinuing: 300 000/ 6 000 000)	30% 5%

*: (loss from re-measurement: 3 500 + loss from discontinued operations: 2 500) x 30%

Note: The tax –“discont ops” includes tax on discont ops + tax on impmnt to FV- costs)

Explanatory notes:

¹ 50 000 (cost of sales) + 20 000 (other expenses-already includes depreciation upto date classified as HFS) + 5 000 (termination benefits expense)⁴ + 1 250 (bad debt write-off) + 1 250 (obsolete inventory write-off) = 77 500

² Loss from re-measuring the disposal group to fair value less costs to sell refers to the impairment of the disposal group as a whole to FV – costs to sell: 57 500 – 54 000.

³ The credit tax expense is as a result of a deferred tax asset that arose through a temporary difference relating to impairments.

If the toys division was a separate legal entity (company) then a deferred tax asset could only be accounted for to the extent of future probable taxable income. If however, the division forms a “branch” or “segment” of a single legal entity [as does this one], then the full deferred tax asset can be accounted for as it is then probable that future taxable income will be generated by the rest of the company.

⁴ IAS 36(p28) lists some examples of disposal costs, viz. legal costs, stamp duty and similar transaction taxes (income taxes and finance costs excluded), costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale.

However, termination benefits (as defined in IAS 19 Employee Benefits) and costs associated with reducing or reorganising a business following the disposal of an asset are not direct incremental costs to dispose of the asset.

Solution 21.9 continued....

b) continued ...

Workings

W1: Deferred normal tax

Equipment	CA	TB	TD	Def tax	
Balance: 1 October 20X0 (47 250 + depr: 6 750)	54 000	54 000	-	-	
Depreciation to date classified as HFS (90 000 x 10% x 9 / 12)	(6 750)	(6 750)	-	-	
Impairment	(3 500)	-	3 500	1 050	
Balance: 30 September 20X1	43 750	47 250	3 500	1 050	Asset

W2: Current normal tax

		Taxable income
Revenue		75 000
Total expenses	50 000 + 20 000 + 5 000 + 1 250 + 1 250	(77 500)
Profit before tax (before impairment)		(2 500)
Add back termination benefits	Not allowed as a deduction	5 000
Accounting profits that are taxable		2 500
		0
+ Depreciation	90 000 x 10% x 9 / 12	6 750
- Wear and Tear	90 000 x 10% x 9 / 12	(6 750)
Bad debts and inventory write-down	Allowed in the year incurred	-
Taxable profit		2 500
		750
Current normal tax at 30%		

W3: Re-measurement adjustments

	Carrying amount per trial balance	Para 19 adjustment	CA after first re-measurement (pre IFRS 5 measurement)	Para: 20 & 23 adjustm ent	CA after second re-measurement (IFRS 5 Measurement)
Assets	67 250		64 750		61 250
Equipment	47 250		47 250	(3 500) ⁽²⁾	43 750
Inventory	12 500	(1 250) : Given	11 250		11 250
Accounts receivable	7 500	(1 250) : Given	6 250		6 250
Liabilities	(7 250)		(7 250)		(7 250)
Accounts payable	(7 250)	-	(7 250)	-	(7 250)
	60 000		57 500		54 000 ⁽¹⁾

(1) 55 000 – 1 000 = 54 000

(2) 57 500 – 54 000 = 3 500 (we know the impairment 3 500 is an impairment of equipment purely by a process of deduction: we have adjusted the inventory and accounts receivable already – and the impairment of 3 500 to the disposal group can't possibly be an increase in accounts payable, so it must be a decrease in equipment).

Solution 21.10

a)

- i) A component of an entity comprises operations and cash flows that can be clearly distinguished operationally and for financial reporting purposes from the rest of the entity. In other words, a component of an entity will have been a cash generating unit (the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets) while being held for use.

A discontinued operation is a **component** of an entity that ***either has been disposed of***, or is classified as held for sale, and represents a separate major line of business or geographical area of operations.

The bicycle division that is being disposed of is a cash generating unit that represents a separate major line of business. It can therefore be classified as a discontinued operation even though the sale of the cash generating unit is not in a single transaction, when it is classified as held for sale.

- ii) A disposal group is a group of assets to be disposed of, by sale or otherwise, ***together as a group in a single transaction***, and liabilities directly associated with those assets that will be transferred in the transaction.

Because the component is not disposed of in a single transaction it cannot be classified as a ***disposal group held for sale***. The non-current asset that was disposed of at year end would have been classified as held for sale (by itself) when the plan to sell the asset was formulated (30 September 20X4). However, the other assets and liabilities forming part of the component would not be classified or presented as held for sale as they do not fall within the definition of a non-current asset or disposal group per IFRS 5.

Solution 21.10 continued.....

b)

VOETSTOETS LTD
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X4

			20X4 C	20X3 C
Continuing operations				
Revenue			2 700 000	1 732 800
Total expenses (W3)			(2 100 000)	(1 300 500)
Profit before tax			600 000	432 300
Income tax expense	3.3		(180 000)	(129 690)
Profit for the period from continuing operations			420 000	302 610
Discontinued operations				
Revenue	p33(b)(i)	5	582 000	601 200
Other expenses (W4)	p33(b)(i)		(516 300)	(379 200)
Profit before tax	p33(b)(i)		65 700	222 000
Income tax expense	p33(b)(ii)	3.1	(19 710)	(66 600)
Profit after tax			45 990	155 400
Gain after tax on re-measurement			16 100	0
Loss on re-measuring the asset to fair value less costs to sell	p33(b)(iii)		(3 000)	0
Gain on disposal of asset			26 000	
			23 000	
Income tax expense	p33(b)(iv)	3.2	(6 900)	0
Profit for the period from discontinued operations			62 090	155 400
Profit for the period			482 090	458 010
Other comprehensive income			0	0
Total comprehensive income			482 090	458 010

VOETSTOETS LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X4
5 Discontinuing operation (p41)

A decision to dispose of the bicycle division was taken on the 30th September 20X4 because the division was no longer profitable. The equipment was sold on the 31st December 20X4 for C168 000 cash. It is expected that the remaining assets in the division will be sold by February 20X5.

Solution 21.10 continued.....

b) continued ...

ALTERNATE DISCLOSURE:

- TOTAL ON FACE OF STATEMENT OF COMPREHENSIVE INCOME
- WITH SUPPORTING NOTE

VOETSTOETS LTD
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X4

	Note	20X4 C	20X3 C
<i>Continuing operations</i>			
Revenue		2 700 000	1 732 800
Total expenses (W3)		(2 100 000)	(1 300 500)
Profit before tax		600 000	432 300
Income tax expense	3.3	(180 000)	(129 690)
Profit for the period from continuing operations		420 000	302 610
<i>Discontinued operations</i>			
Profit for the period from discontinued operations	5	62 090	155 400
Profit for the period		482 090	458 010
<i>Other comprehensive income</i>		0	0
Total comprehensive income		482 090	458 010

VOETSTOETS LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X4

	Note	20X4 C	20X3 C
5 Discontinuing operation (p41)			
A decision to dispose of the bicycle division was taken on the 30th September 20X4 because the division was no longer profitable. The equipment was sold on the 31 st December 20X4 for C168 000 cash. It is expected that the remaining assets in the division will be sold by February 20X5.			
<i>Analysis of profit for the period from discontinued operations</i>			
Revenue	p33(b)(i)	582 000	601 200
Other expenses (W4)	p33(b)(i)	(516 300)	(379 200)
Profit before tax	p33(b)(i)	65 700	222 000
Income tax expense	p33(b)(ii)	(19 710)	(66 600)
Profit after tax		45 990	155 400
Gain after tax on re-measurement/ sale		16 100	0
Loss on re-measuring the asset to fair value less costs to sell	p33(b)(iii)	(3 000)	0
Gain on disposal of asset		26 000	
Income tax expense	p33(b)(iv)	23 000	0
Profit for the period from discontinued operations		62 090	155 400

Solution 21.10 continued.....

b) continued ...

VOETSTOETS LTD
STATEMENT OF CHANGES IN EQUITY
AS AT 31 DECEMBER 20X4

	Share capital	Retained income	Total
	C	C	C
Balance: 1 January 20X3	600 000	171 885	771 885
Total comprehensive income		458 010	458 010
Dividends declared		(120 000)	(120 000)
Balance: 31 December 20X3	600 000	509 895	1 109 895
Total comprehensive income		482 090	482 090
Dividends declared		(180 000)	(180 000)
Balance: 31 December 20X4	600 000	811 985	1 411 985

VOETSTOETS LTD
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X4

		20X4 C	20X3 C
ASSETS			
Non Current Assets			
Property, plant and equipment	813 150 – 142 000: sold	671 150	720 000
Current Assets			
Inventory	263 685 – (42 000 – 33 000): write-down to NRV	254 685	156 000
Accounts receivable	(168 000 – (168 000 – 156 000): further bad debts	156 000	192 000
Cash	(229 650 + 168 000: proceeds on sale)	397 650	116 895
		1 479 485	1 184 895
EQUITY AND LIABILITIES			
Capital and reserves			
	(from statement of changes in equity)	1 411 985	1 109 895
Current liabilities			
Accounts payable		67 500	75 000
		1 479 485	1 184 895

Please also note: since the assets are not sold off in a single transaction, there is no disposal group. Thus, only the PPE – as a non current asset - is classified as held for sale. Had there been a disposal group, it would have been necessary to separately disclose the current assets and liabilities as held for sale under IFRS 5 as well.

Solution 21.10 continued.....

c)

VOETSTOETS LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X4

	Note	20X4 C	20X3 C
2 Accounting Policies (IAS 1 p 113)			
2.1 Assets held for sale			
Non current assets and disposal groups are classified as held for sale when the inflow of economic benefits inherent in those assets are expected to be derived primarily through sale rather than use and the sale is highly probable. (The assets must be available for immediate sale subject only to terms and delays customary for sales of the type in question)			
2.2 Discontinued operations			
An entity presents the results of its operations as a discontinued operation when the operation represents a component of the entity that has been classified as held for sale or disposed of. Comparatives are restated in this regard			
2.3 Tax			
Deferred tax is provided for on a balance sheet liability method at 30 % on all temporary differences. Deferred tax assets are raised only to the extent probable sufficient taxable profits will be available against which such assets can be utilised.			
3 Tax		20X4	20X3
<i>3.1 Tax relating to discontinued operations</i>		19 710	66 600
Current tax W2.1		18 210	66 600
Deferred tax W1: 1 500 DT on depreciation		1 500	0
<i>3.2 Tax relating to disposal gains/losses and impairments/ reversals of impairments</i>		6 900	0
Current Tax W2.2		8 400	0
Deferred tax W1: 900 DT on impairment + 600 DT on sale		(1 500)	0
<i>Total tax relating to discontinued operation</i>		26 610	66 600
Current Tax 20X4: 18 210 + 8 400; 20X3: 66 600 + 0		26 610	66 600
Deferred tax 20X4: 1 500 – 1 500; 20X3: 0 + 0		0	0
<i>3.3 Tax relating to continuing operations</i>		180 000	129 690
Current Tax W2.3		180 000	129 690
Deferred tax W1: all temporary differences were caused by an asset that fell within the discontinued operation		0	0
Total tax		206 610	196 290

3 Discontinued operations

See part (b): note 5

Solution 21.10 continued.....

Workings

W1: Deferred tax

Equipment	CA	TB	TD	DT	Journal entries
Balance: 1 January 20X4	160 000	160 000	-	-	
Depreciation /Wear and tear to 30 September 20X4: $200\,000 \times 10\% \times 9/12$ $200\,000 \times 10\%$	(15 000)	(20 000)	(5 000)	(1 500)	Cr DTL; Dr TE
Impairment $160\,000 - 15\,000 - 142\,000$	(3 000)	-	3 000	900	Dr DTL; Cr TE
CA of asset before sale	142 000	140 000			
CA of asset sold	(142 000)	(140 000)	2 000	600	Dr DTL; Cr TE
Balance: 31 December 20X4	-	-	-	-	

W2: Current normal tax

		20X4	20X3
<i>W2.1 Current tax – discontinued operations</i>			
Profit before tax per statement of comprehensive income		65 700	222 000
Add depreciation		15 000	20 000
Less wear and tear		(20 000)	(20 000)
Taxable profit		60 700	222 000
Current tax at 30%	A	18 210	66 600
<i>W2.2 Current tax – gains/ losses on re-measurement and sales re discontinued operations</i>			
Profit on sale		26 000	
Less impairment loss W2.3		(3 000)	
Profit per statement of comprehensive income		23 000	
Less profit per statement of comprehensive income		(23 000)	
Add Taxable gain (168 000 – 140 000)		28 000	
Taxable profit		28 000	
Current tax at 30%	B	8 400	
<i>W2.3 Current tax – continued operations</i>			
Profit before tax per statement of comprehensive income		600 000	432 300
Current tax at 30%	C	180 000	129 690
Total current tax			
	A + B + C	206 610	196 290
<i>W2.3 Impairment loss</i>			
Accounting depreciation for 9 months $(200\,000 \times 10\% \times 9 / 12)$		15 000	
Decrease in BV $(160\,000 - 142\,000)$		(18 000)	
Impairment loss		(3 000)	

Solution 21.10 continued.....**Workings continued.....****W3: Expenses of the continuing operation**

Total cost of sales	<i>Given</i>	2 100 000	1 400 000
Total other expenses	<i>Given</i>	498 300	279 700
Less cost of sales	<i>Discontinued operation</i>	(420 000)	(350 000)
Less other expenses	<i>Discontinued operation</i>	(78 300)	(29 200)
		<u>2 100 000</u>	<u>1 300 500</u>

W4: Expenses of the discontinued operation

Cost of sales	<i>Given</i>	420 000	350 000
Other expenses	<i>Given</i>	78 300	29 200
Less IFRS 5 impairment	<i>To be separately disclosed</i>	(3 000)	
Bad debts (further)	<i>168 000 – 156 000</i>	12 000	
Inventory write down to NRV	<i>42 000 – 33 000</i>	9 000	
		<u>516 300</u>	<u>379 200</u>

Please note: IAS 36(p28) lists some examples of disposal costs, viz. legal costs, stamp duty and similar transaction taxes (income taxes and finance costs excluded), costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale.

However, termination benefits (as defined in IAS 19 Employee Benefits) and costs associated with reducing or reorganising a business following the disposal of an asset are not direct incremental costs to dispose of the asset.

Solution 21.11

a)

BIG NIC LTD
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X5

			Note 25	20X5 C
<i>Discontinued operations</i>				
Revenue	<i>Given</i>	p33(b)(i)		590 000
Expenses	<i>W1</i>	p33(b)(i)		(602 400)
Loss before tax		p33(b)(i)		(12 400)
Income tax (income)		p33(b)(ii)	3	3 720
Loss after tax				(8 680)
Gain after tax from re-measurement (impairment)				39 550
Loss from re-measuring the asset to fair value less costs to sell (17 000 – 16 000)				(1 000)
Gain on disposal of asset (210 000 – 152 500)				57 500
Net gain before tax		p33(b)(iii)		56 500
Income tax expense		p33(b)(iv)	3	(16 950)
Profit for the period from discontinued operations				30 870
Profit for the period				XXX
Other comprehensive income				0
Total comprehensive income				XXX

Solution 21.11 continued ...

b)

BIG NIC LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X5 (EXTRACTS)

2. Accounting policies*2.10 Assets held for sale*

Non current assets and disposal groups are classified as held for sale when the inflow of economic benefits inherent in those assets are expected to be derived primarily through sale rather than use and the sale is highly probable. (The assets must be available for immediate sale subject only to terms and delays customary for sales of the type in question)

2.11 Discontinued Operations

An entity presents the results of its operations as a discontinued operation when the operation represents a component of the entity that has been classified as held for sale or disposed of. Comparatives are restated in this regard

3 Tax

	20X4	20X3
<i>3.1 Tax relating to discontinued operations</i>	(3 720)	xxx
Current tax W2.1	8 970	xxx
Deferred tax W3: 750 + 60 – 13 500	(12 690)	xxx
<i>3.2 Tax relating to disposal gains/losses and impairments/ reversals of impairments</i>	16 950	xxx
Current Tax W2.2	18 000	xxx
Deferred tax W3: 300 DT on impairment + 750 DT on sale	(1 050)	xxx
<i>Total tax relating to discontinued operation</i>	13 230	xxx
Current Tax 20X4: 8 970 + 18 000	26 970	xxx
Deferred tax 20X4: 12 690 + 1 050	(13 740)	xxx
<i>3.3 Tax relating to continuing operations</i>	xxx	xxx
Current tax	xxx	xxx
Deferred tax	xxx	xxx
Total tax	xxx	xxx

25 Discontinuing operations

On 1 November 20X5 the board of directors approved and announced a plan to dispose of its operations in Azad Jammu an Kashmir, by selling the assets through several transactions.

This division was previously reported in the Kashmir segment.

The company decided to dispose of its operations in Kashmir because profits have decreased as a result of economic and political uncertainty.

Non current assets classified as held for sale include furniture (C16 000) and buildings (C300 000).

The process of disposing of the Kashmir division is expected to be completed by 30 June 20X6.

The company recognised a provision for employee compensation of C45 000 (before income tax benefit of C13 500) to be paid during March 20X6 to employees whose jobs will be terminated as a result of the discontinuance of operations in Kashmir.

Solution 21.11 continued ...

Workings

W1: Total expenses

C

Other expenses	Given	553 200
Doubtful debt	21 500 – 19 800	1 700
Inventory write-down	32 000 – 29 500	2 500
Compensation costs		45 000
		<u>602 400</u>

W2: Current normal tax calculation

20X5

W2.1 Current tax – discontinued operations

C

Loss before tax per statement of comprehensive income		(12 400)
Add depreciation	W2: 27 500 + 2 200	29 700
Less wear and tear	W2: 30 000 + 2 400	(32 400)
Add compensation costs	Given	45 000
Taxable profit		<u>29 900</u>
Current tax at 30%	A	8 970

W2.2 Current tax – gains/ losses on re-measurement and sales of discontinued operations

Profit on sale	210 000 – 152 500 (W2)	57 500
Less impairment loss	17 000 – 16 000	<u>(1 000)</u>
Profit per statement of comprehensive income		56 500
Less profit per statement of comprehensive income		(56 500)
Add Taxable gain	210 000 – 150 000 (W2)	<u>60 000</u>
Taxable profit		60 000
Current tax at 30%	B	18 000

W2.3 Current tax – continued operations

Profit before tax per statement of comprehensive income		xxx
Current tax at 30%	C	xxx
		<u> </u>
Total current tax	A + B + C	<u>xxx</u>

Solution 21.11 continued ...

Workings

W3: Deferred tax calculation

	Carrying amount	Tax base	Temporary difference	Deferred tax	Journal entries
Equipment					
Balance: 1 January 20X5 (check: $300\,000 / 10 \text{ years} \times 6 \text{ years}$)	180 000	180 000	0	0	
Depreciation: ($300\,000 / 10 \times 11 / 12$)	(27 500)	(30 000)	(2 500)	(750)	Cr DT, Dr TE
	152 500	150 000			
Carrying amount of asset sold	(152 500)	(150 000)	2 500	750	Dr DT, Cr TE
Balance: 31 December 20X5	0	0	0	0	
Furniture					
Balance: 1 January 20X5 (check: $24\,000 / 10 \text{ years} \times 8 \text{ years}$)	19 200	19 200	0	0	
Depreciation: $24\,000 / 10 \times 11 / 12$	(2 200)	(2 400)	(200)	(60)	Cr DT, Dr TE
	17 000	16 800			
Furniture classified as HFS					
IFRS 5 Impairment (balancing)	(1 000)	0	1 000	300	Dr DT, Cr TE
Balance: 31 December 20X5 (given)	16 000	16 800	800	240	Asset
Provision for compensation to employees					
Balance: 1 January 20X5	0	0	0	0	
Compensation costs	(45 000)	0	45 000	13 500	Dr DT, Cr TE
Balance: 31 December 20X5	(45 000)	0	45 000	13 500	Asset

Solution 21.11 continued.....

c)

If the land and buildings had been “investment property” they would still be classified and presented as ***held for sale*** (because they are non-current assets). However, they would not be measured in accordance with IFRS 5 as they fall outside the measurement requirements of this standard. Instead, they would be measured in terms of IAS 40 (investment properties).

Consequently, the gain made on measuring the asset to fair value (mark to market) (C50 000) should be processed through *the statement of comprehensive income* under “discontinued operation”.

It should be remembered that this exception applies only if the investment property was carried under the fair value model per IAS 40. Had the cost model been used, depreciation would need to cease and the asset would, in terms of IFRS 5:

- be carried at fair value less costs to sell; and
- be presented as held for sale.

Solution 21.12

The issue faced by the accountant of Drummer is whether, in terms of IFRS s/he is allowed to provide for the C10 million of retrenchment costs, as a result of the sale of one of the divisions of the company.

A sale or termination of a line of business falls within the definition of restructuring and should be accounted for in terms of IAS 37, p 70-83.

A provision is a liability of uncertain timing or amount. A provision shall be recognised when:

- an entity has a present obligation (legal or constructive) as a result of a past event;
- it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- a reliable estimate can be made of the amount of the obligation.
- If these conditions are not met, no provision shall be recognised.

In the scenario, it is firstly important to determine whether the retrenchment packages are indeed a *present obligation*.

No legal obligation arises for the sale of an operation until the entity is committed to the sale, ie there is a *binding* sale agreement. However, there may be a constructive obligation that could give rise to a provision

A constructive obligation to restructure arises only when an entity:

- has a detailed formal plan for the restructuring identifying at least;
 - the business or part of a business concerned;
 - the principal locations affected;
 - the location, function, and approximate number of employees who will be compensated for terminating their services;
 - the expenditures that will be undertaken; and
 - when the plan will be implemented; and
- has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

Evidence that an entity has started to implement a restructuring plan would be provided, for example, by dismantling plant or selling assets or by the public announcement of the main features of the plan.

In this situation, although a detailed plan has been agreed upon in a directors' meeting, no public announcement has yet been made and no assets have been sold. This means that there is no legal obligation (no binding sale agreement) and no constructive obligation (since it is unlikely that the non-communicated plan will raise a valid expectation on the part of others that the entity is at present committed to restructuring).

This means that no provision may be recognised since there is no present obligation.

Had there been a present obligation, a provision would only be recognised if :

- it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- the amount of the obligation can be reliably estimated.

Solution 21.12 continued . . .

However it is important to note that a restructuring provision shall include only the direct expenditures arising from the restructuring, which are those that are both:

- necessarily entailed by the restructuring; and
- not associated with the ongoing activities of the entity.

Conclusion

No provision should be made since the definition of a liability is not met. If the amount of C10 million is considered to be material to the business, then this should be disclosed as a contingent liability (where there is a possible obligation as opposed to a present obligation).

Solution 22.1

- a) Debenture discount is written off against profit before tax, but has no cash flow implications. Hence, the cash actually received on the issue of the debentures is reflected under financing activities in the year of issue and the amount of debenture discount written off is adjusted for under non-cash items in the notes to the Statement of cash flows every year.
- b) As for debenture discount written off, the impairment of goodwill must be added back to profit before tax as an adjustment for non-cash flow items.
- c) Deferred tax is a book entry with no cash flow implications. The tax paid amount per the Statement of cash flows should therefore only consist of the payments made for the year.
- d) An under-provision of tax in the previous year will have to be made good in the current year. It is therefore normally included in the payments for the year and must be considered when calculating these payments.
- e) The actual cash flow for the year is C2 000. This is therefore the amount that must be included on the Statement of cash flows.

Solution 22.2

a)

HICKORY LIMITED
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED 31 JULY 20X6

		C
Cash flows from operating activities		
Cash receipts from customers	W3	2 950 000
Cash paid to suppliers and employees	W4	(2 274 500)
<i>Cash generated from operations</i>		675 500
Taxation paid	W5	(259 500)
Net cash inflow from operating activities		416 000

b)

Profit before tax (from SOCI)	W1	650 000
<i>Adjusted for non-cash and non-operating items</i>		30 000
Depreciation	W2	35 000
Profit on sale of plant		(5 000)
<i>Working capital changes</i>		(4 500)
Decrease in inventories		8 500
Increase in accounts receivable		(43 000)
Increase in accrued expense		15 000
Increase in accounts payable		15 000
Cash generated from operations		675 500

or

Profit before tax (from SOCI)	W1	650 000
<i>Adjusted for non-cash and non-operating items</i>		37 000
Depreciation	W2	35 000
Doubtful debt allowance		7 000
Profit on sale of plant		(5 000)
<i>Working capital changes</i>		(11 500)
Decrease in inventories		8 500
Increase in accounts receivable		(50 000)
Increase in accrued expense		15 000
Increase in accounts payable		15 000
Cash generated from operations		675 500

Workings**W1 Profit before tax**

$$C390\,000/0.6 = C650\,000$$

Solution 22.2 continued ...

W2 Plant and equipment

PLANT AND EQUIPMENT				ACCUMULATED DEPRECIATION: PLANT AND EQUIPMENT			
<i>Description</i>	<i>C</i>	<i>Description</i>	<i>C</i>	<i>Description</i>	<i>C</i>	<i>Description</i>	<i>C</i>
Balance	450	<i>Disposal...1</i>	40	<i>Disposal...2</i>	30	Balance	45
Cash	90	Balance	500	Balance	50	<i>Depreciation</i>	35
	540		540		80		80

W3.Cash receipts from customers

ACCOUNTS RECEIVABLE			
<i>Description</i>	<i>C</i>	<i>Description</i>	<i>C</i>
Balance	400 000	Bank	2 950 000
Sales	3 000 000	Balance	450 000
	3 400 000		3 400 000

W4 Payments to suppliers and employees

Turnover less Profit before tax = COS plus expenses	2 350 000
Non-cash items	(37 000)
Depreciation	(35 000)
Profit on sale	5 000
Doubtful debts allowance	(7 000)
Working capital changes	(38 500)
Inventory	(8 500)
Trade payables and accruals	(30 000)
	<u>2 274 500</u>

or

ACCOUNTS PAYABLE				INVENTORY			
<i>Description</i>	<i>C</i>	<i>Description</i>	<i>C</i>	<i>Description</i>	<i>C</i>	<i>Description</i>	<i>C</i>
Bank	1 976.5	Balance	235	Balance	348.5	Cost of sales	2 000
		Inventory	1 991.5	<i>Accounts payable</i>	1 991.5		
Balance	250					Balance	340
	2 226.5		2 226.5		2 340		2 340

Solution 22.2 continued ...

Revenue	3 000 000
Cost of sales	(2 000 000)
Gross profit	1 000 000
Expenses	(350 000)
Profit before tax	650 000
Net expenses	350 000
Non-cash items	
Depreciation	(35 000)
Profit on sale	5 000
Doubtful debt allowance	(7 000)
Increase in accrued expenses	(15 000)
Cash paid for operating expenses	298 000

Therefore: 1 976.5 (cash paid to suppliers of goods for resale) + 298 (cash paid for operating expenses) = 2 274.5 (cash paid to suppliers and employees)

W5 Tax paid

CURRENT TAX PAYABLE			
<i>Description</i>	<i>C</i>	<i>Description</i>	<i>C</i>
Bank	259 500	Balance (o/b)	1 500
Balance (c/b)	2 000	Current tax	*260 000
	261 500		261 500
		Balance (c/b)	2 000

*Profit before tax: 650 000 x 40% = 260 000

Solution 22.3

a)

OLBAS LIMITED

STATEMENT OF CASH FLOWS

FOR THE YEAR ENDED 30 SEPTEMBER 20X7

		C
Cash flows from operating activities		
Cash receipts from customers	(153 333 + 3 500 000 - 140 990)	3 512 343
Cash paid to suppliers and employees	W1	(2 826 183)
<i>Cash generated from operations</i>		686 160
Investment income received		3 200
Interest paid	[(136 268 - 96 268) + 100 000]	(140 000)
Taxation paid	[(6 440) + 177 888 - 12 888]	(158 560)
Dividends paid	(125 000 + 225 000 - 150 000) + 25 000	(225 000)
<i>Net cash inflow from operating activities</i>		165 800
Cash flows from investing activities		
Proceeds from sale of land and buildings		520 000
Proceeds from sale of investments	(125 000 + 12 450)	137 450
Purchase of equipment	(480 000 - 400 000)	(80 000)
Purchase of vehicles		(360 000)
Purchase of investments	(250 000 - 125 000 - 370 000)	(245 000)
<i>Net cash outflow from investing activities</i>		(27 550)
Cash flows from financing activities		
Issue of preference shares	(250 000 + 22 700)	272 700
Repayment of mortgage bond	(625 000 - 250 000)	(375 000)
<i>Net cash inflow from financing activities</i>		(102 300)
Net increase in cash		35 950
Cash at beginning of period		84 300
Cash at end of period		120 250

Solution 22.3 continued ...

Note 1

Non-cash financing and investing activities	
Profit on sale of land and buildings	70 000
Profit on sale of investments	12 450
Depreciation	108 000

b)

Profit before tax	(from SOCI)	576 982
Adjusted for non-cash and non-operating items		158 618
Dividend income	(from SOCI)	(3 200)
Finance cost	(from SOCI)	136 268
Depreciation expense		108 000
Profit on sale of land and buildings		(70 000)
Profit on sale of investments		(12 450)
<i>Operating cash flow before working capital changes</i>		735 600
Working capital changes		(49 440)
Inventory		(14 800)
Accounts receivable		11 850
Prepaid expenses		(340)
Account payable		(46 150)
Cash generated from operations		686 160

Workings

W1 Payments to suppliers and employees

Revenue less profit before tax = COS + net expenses	(3 500 000 - 576 982)	2 923 018
Non- operating items		(133 068)
Finance costs		(136 268)
Dividend income		3 200
Non-cash items :		
Depreciation	(168 000 - 120 000 + 60 000)	(108 000)
Profit on sale of land & buildings		70 000
Profit on sale investments		12 450
Decrease in doubtful debts allowance	(6 133 - 5 640)	493
Working capital changes		
Inventory (increase)	(146 000 - 131 200)	14 800
Prepaid expenses (increase)	(6 300 - 5 960)	340
Accounts payable (decrease)	(142 500 - 96 350)	46 150
		2 826 183

Solution 22.3 continued ...

Alternative workings:

Payments to suppliers for goods for resale 2 510 950

= Opening accounts payable + purchases - closing accounts payable (142 500 + 2 464 800* - 96 350)

opening inventory + **purchases** * – closing inventory = cost of sales (131 200 + **2 464 800** – 146 000 = 2 450 000)

Operating expenses paid 315 233

Operating expenses per the Statement of comprehensive income 339 950

Non-cash items:

Depreciation (168 000 - 120 000 + 60 000 - 0) (108 000)

Profit on sale of land & buildings (520 000 – 450 000) (also the transfer to NDR) 70 000

Profit on sale investments 12 450

Doubtful debts allowance (6 133 - 5 640) 493

Increase in prepayments (6 300 - 5 960) 340

2 826 183

Following not required as part of answer:

Amortisation table Date	Nominal interest	Effective interest	Premium	Premium balance	PV
1/10/X5				30 000	530 000
1/10/X6	100 000	96 844	3 155	26 845	526 844
1/10/X7	100 000	96 268	3 732	23 113	523 112
1/10/X8	100 000	95 586	4 414	18 699	518 698
1/10/X9	100 000	94 779	5 221	13 478	513 478
1/10/Y0	100 000	93 825	6 175	7 303	507 303
1/10/Y1	100 000	92 697	7 303	-	500 000

Cash flow					
1/10/X5		530 000			
1/10/X6		(100 000)			
1/10/X7		(100 000)			
1/10/X8		(100 000)			
1/10/X9		(100 000)			
1/10/Y0		(100 000)			
1/10/Y1		(600 000)	(500 000) + (100 000)		

Effective interest rate = 18.2725377

Solution 22.3 continued ...

c)

Return on assets (ROA/ROI)

$$\frac{\text{Profit for period} + \text{interest expense} (1 - \text{tax rate})}{\text{Average total assets}} \times 100 = \frac{399\,094 + (136\,268 \times 0.65)}{(3\,139\,900 + 3\,105\,100)/2}$$
$$= 15.6\%$$

Return on equity (ROE)

$$\frac{\text{Profit for period} - \text{preference dividends}}{\text{Average ordinary shareholders equity}} \times 100 = \frac{399\,094 - 25\,000}{((2\,007\,549 - 272\,700) + (1\,585\,755))/2}$$
$$= 22.5\%$$

The return on equity exceeds the return on investment, which indicates that the company is effectively geared. The after tax cost of debt is less than the return on investment.

Solution 22.4

**MT GRACE
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED 30 JUNE 20X5**

		C
Cash flows from operating activities		
Cash receipts from customers	W1	5 057 000
Cash paid to suppliers and employees	W2	(4 263 922)
<i>Cash generated from operations</i>		<u>793 078</u>
Interest paid	W3	(24 000)
Dividends paid	W4	(30 000)
Taxation paid	W5	(252 043)
Net cash inflow from operating activities		<u>487 035</u>

Workings

W1 Cash received from customers

Accounts receivable				Doubtful debts allowance			
Description	C	Description	C	Description	C	Description	C
Balance	720 000	Bad debts	[^] 18 000			Balance	34 000
Sales	5 200 000	Cash	5 057 000			Bad debts	37 500
		Balance	845 000	Balance	71 500		
	<u>5 920 000</u>		<u>5 920 000</u>		<u>71 500</u>		<u>71 500</u>

[^](55 500 – 37 500)

W2 Cash paid to suppliers and employees

Revenue from sales	5 200 000	
Profit before tax	680 000	
Net expenses (including COS)	(4 520 000)	Debit
<i>Items shown separately on face of CFS</i>		
Interest expense	25 578	
<i>Non-cash items</i>		
Bad debts	18 000	
Increase in doubtful debts allowance	37 500	
Depreciation	100 000	
	(4 338 922)	Debit
<i>Accrual basis of accounting</i>		
Increase in inventory	95 000	
Increase in accounts payable	(170 000)	
	<u>(4 263 922)</u>	

Solution 22.4 continued ...

W3 Interest

Effective interest rate = 12.621908%

Date	Interest	Dividend	Premium	Premium balance	PV
01/07/X2					200 000
30/06/X3	25 241	24 000	1 244	1 244	201 244
30/06/X4	25 401	24 000	1 401	2 645	202 645
30/06/X5	25 578	24 000	1 578	4 223	204 223

W4 Ordinary dividend

Ordinary dividend liability			
Description	C	Description	C
<i>Bank</i>	30 000	Balance	30 000
		Dividend	35 000
Balance	35 000		
	65 000		65 000

W5 Taxation

X 0.29			
Profit before tax	680 000	197 200	
<i>Permanent differences</i>			
Interest on preference shares	25 578		
	705 578	204 618	Dr TE
<i>Temporary differences</i>	(60 000)	17 400	Cr DT
Depreciation	100 000		
Tax allowances	(160 000)		
Taxable income	645 578	187 218	Cr CTP

Taxation expense				Current tax payable			
Description	C	Description	C	Description	C	Description	C
Current tax payable	187 218	Retained earnings	204 618	<i>Bank</i>	252 043	Balance	190 000
Deferred tax	17 400					Tax expense (NT)	187 218
	204 618		204 618	Balance	125 175		
					377 218		377 218
Deferred tax							
Description	C	Description	C				
		Balance	81 200				
		Tax expense	17 400				
Balance	98 600						
	98 600		98 600				

* (35 000 + 24 000) X 0,125

Solution 22.5

SHINE LIMITED
EXTRACT FROM STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED 30 JUNE 20X4

		C
Cash in/ (out)flows from operating activities		(28 550)
Cash receipts from customers		180 500
Cash paid to suppliers and employees	(102 + 48.5)	150 500
<i>Cash generated from operations</i>		30 000
Taxation paid		(19 050)
Interest paid	[15.784 – (64.716 x 11.255% - 60.000 x 10%)]	(14 500)
Dividends paid		(25 000)
Cash in/ (out)flows from financing activities		(66 000)
Redemption of preference shares		(66 000)

Workings:

Figure in 000 s

Accounts receivable				Inventory			
Balance	20	Bad debts	1.5	Balance	131.5	Cost of sales	120
Sales	*252	Cash	180.5	Purchases	100	Balance	111.5
		Balance	90		231.5		231.5
	272		272				
Accounts payable				Administration expenses accrued			
Cash	102	Balance	10			Balance	-
Balance	8	Purchases	100	Balance	2	Expenses	2
	110		110		2		2
Preference share liability				Distribution expenses prepaid			
Cash	66	Balance	64.716	Balance	2		
Balance	-	Finance cost	^1.284	Cash	1	Balance	3
	66		66		3		3

* (120 X 210 / 100)

^ ((64 716 X 0.11255) – 6 000)

Solution 22.5 continued ...

Figure in 000 s

Retained earnings				Shareholders for dividends			
CRRF	60	Balance	80			Balance	2
Dividends	23	Profit and loss (profit)	33.741	Cash	25	Dividends	23
Balance	30.741			Balance	-		
	113.741		113.741		25		25

Deferred tax asset				Current tax payable			
Balance	20					Balance	10
Tax expense	2.5			Cash	19.050	Tax expense	~ 21.975
		Balance	22.5	Balance	12.925		
	22.5		22.5		31.975		31.975

~ (19.475 TE + 2.5DT)

Calculation of "Supplier" operating costs

Sales (COS: 120 000 + Mark-up: 120 000 x 110%)	252 000
Cost of sales (Given)	(120 000)
Gross profit	132 000
Operating costs (balancing figure)	(78 784)
Profit before tax (given)	53 216

Operating costs (above) 78 784

Adjusted for non-cash items included:

Profit on sale of plant	3 000
Bad debts	(1 500)
Depreciation	(15 000)

Adjusted for items shown separately on face of statement of cash flows

Finance charges (15 784)

Adjusted for related accruals and prepayments:

Admin expenses accrued	(2 000)
Distribution expenses prepaid	1 000

Cash operating expenses relating to suppliers 48 500

Profit before tax	53 216
Less: profit on sale of plant	(3 000)
Add: bad debts	1 500
Add: depreciation	15 000
Add: finance costs	15 874
	82 500

Changes in Working Cap:

Less increase in trade and other receivables	(71 000)
Add decrease in inventory	20 000
Increase/ (decrease) in trade/ other payables	0
Cash generated from operations	31 500

Solution 22.6

a)

MEADOWVALE MANUFACTURERS LIMITED		
STATEMENT OF CASH FLOWS		
FOR THE YEAR ENDED 30 SEPTEMBER 20X7		
		C000
Cash flows from operating activities		
Cash receipts from customers	W1	4 625
Cash paid to suppliers and employees	W2	(4 484)
<i>Cash generated from operations</i>		<u>141</u>
Investment income received	Given	18
Interest paid	Given	(92)
Taxation paid	(470 + 800 – 600)	(670)
Dividends paid	(180 + 295 – 150)	(325)
Net cash inflow from operating activities		<u>(928)</u>
Cash flows from investing activities		
Purchase of land and buildings	W3	(265)
Proceeds on sale of land and buildings	W3	140
Purchase of plant and machinery	W6: 71 + 279	(350)
Proceeds on sale of plant and machinery	W6	144
Purchase of investments	W5: 20 + 12	(32)
Net cash outflow from investing activities		<u>(363)</u>
Cash flows from financing activities		
Redemption of preference shares	100 000 x C1 x 1.04	(104)
Issue of ordinary shares	W4	125
Long-term loan raised	970 - 180	790
Net cash inflow from financing activities		<u>811</u>
Net increase in cash		(480)
Cash at beginning of period		620
Cash at end of period		<u>140</u>

NOTE TO THE STATEMENT OF CASH FLOWS

Non-cash financing and investing activities

1. Land and buildings were revalued by C20 000 during the year.
2. An amount of C100 000 was transferred during the year to the capital redemption reserve fund as a result of the redemption of preference shares.
3. A capitalisation issue to the value of C125 000 was made out of the capital redemption reserve fund.
4. The company acquired plant and machinery of C100 000 during the year, of which C29 000 was financed by the trade-in of old plant and machinery.

Solution 22.6 continued ...

b)

Figure in 000 s

Reconciliation

Profit before tax (from SOCI)	1 519
Adjusted for non-cash and non-operating items	223
Investment income (from SOCI)	(18)
Interest expense (from SOCI)	92
Depreciation – plant	90
Profit on sale of land and buildings	(50)
Profit on sale of plant and machinery	(4)
Writedown of listed investments	7
Goodwill	100
Loss on trade-in of plant and machinery	6
<i>Operating cash flow before working capital changes</i>	1 742
Working capital changes	(1601)
Accounts receivable	(370)
Inventory	(1 591)
Accounts payable	360
Cash generated from operations	141

Workings**W1. Cash receipts from customers**

Opening accounts receivable	500 000
Sales	5 000 000
Closing accounts receivable	(870 000)
Bad debts	(5 000)
	4 625 000

W2. Cash paid to suppliers and employees

Sales	5 000 000
Profit before tax	(1 519 000)
Net expenses for year	3 481 000
<i>Elimination of items shown separately on face of Statement of cash flows</i>	
Dividends received	18 000
Interest	(92 000)
<i>Elimination of non-cash items</i>	
Bad debts	(5 000)
Depreciation	(90 000)
Profit - sales of land and buildings	50 000
Profit - sale of plant and machinery	4 000
Write down of investment	(7 000)
Goodwill	(100 000)
Loss on trade - in of plant & machinery	(6 000)
<i>Elimination of the effects of accrual accounting</i>	3 253 000
Increase inventory	1 591 000
Increase in accounts payable	(360 000)
	4 484 000

Solution 22.6 continued ...

W3

Figure in 000 s

LAND AND BUILDINGS				DISPOSAL LAND AND BUILDINGS			
Description	C	Description	C	Description	C	Description	C
Balance	2 405	Disposal	90	Land and buildings	90	Bank	140
NDR / DT	20			Profit on sale of land and buildings	50		
Bank	265	Balance	2 600		140		140
	2 690		2 690				

W4

ORDINARY SHARE CAPITAL				CAPITAL REDEMPTION RESERVE FUND			
Description	C	Description	C	Description	C	Description	C
		Balance	450	Ordinary share capital (Cap issue)	125	Balance	50
		CRRF (Cap issue)	125			Retained earnings (Redemption of preference shares)	100
Balance	700	Bank (issued shares)	125	Balance	25		
	700		700		150		150

W5

UNLISTED INVESTMENTS				LISTED INVESTMENTS			
Description	C	Description	C	Description	C	Description	C
Balance	44			Balance	84	Writedown	7
Bank	20			Bank	12		
		Balance	64		96	Balance	89
	64		64				96

Solution 22.6 continued ...

W6

Figure in 000 s

PLANT AND MACHINERY				ACCUMULATED DEPRECIATION PLANT AND MACHINERY			
Description	C	Description	C	Description	C	Description	C
Balance	426	Disposal (machine)	60	Disposal (machine)	25	Balance	180
Disposal (trade in)	29	Disposal (plant) (140 + 15)	155	Disposal (plant)	15	Depreciation	90
Bank (100 – 29)	71						
Bank (purchases)	279	Balance	590	Balance	230		
	805		805		270		270

DISPOSAL: PLANT AND MACHINERY			
Description	C	Description	C
Plant and machinery	60	Accumulated depreciation: plant and machinery	25
		Loss on trade in	6
		Plant and machinery (trade in)	29
	60		60
Plant and machinery...1	155	Accumulated depreciation: plant and machinery	15
Profit on sale of plant and machinery	4	Bank...2	144
	159		159

W7

NON DISTRIBUTABLE RESERVE			
Description	C	Description	C
		Balance	120
		Retained earnings	30
Balance	164,2	Land & buildings	14,2
	164,2		164,2

Solution 22.6 continued ...

Figure in 000 s

DEFERRED TAXATION			
<i>Description</i>	<i>C</i>	<i>Description</i>	<i>C</i>
		Balance	0
		<i>Land & buildings</i>	5.8
Balance	5.8		
	5.8		5.8

c)

The company's cash management does not appear satisfactory. Cash from operating activities was negative (an amount of C603 000 after investment income, interest and tax), yet the company still paid out dividends of C250 000 to the ordinary shareholders during the year. These dividends appear to have been financed by the long term loan raised during the year, which is not good business practice.

The company's gearing increased from 6% to 28% over the two years. Although the level is not excessive, the purpose for which the loan was used, namely to finance operations and pay dividends is concerning. Purchases of non-current assets only amounted to C331 000 after recoveries from sales, which means that C480 000 of the long term financing (borrowings plus share capital issued) financed the dividends and the shortfall from operations.

There has been a substantial increase in inventory holdings in 20X7. This increase has not been accompanied by similar increases in accounts receivable and payable, which would appear to indicate excessive inventory holdings, tying up cash resources.

The increase in accounts receivable has also been greater than the increase in accounts payable, which is further aggravating the cash outflow from operating activities. It appears from the above that the company needs to address its working capital management.

It is also interesting to note that the provisional payments made for the year (C200 000) are very low in comparison to the previous year's provision for tax (C470 000). This probably resulted in penalties being incurred, which were an unnecessary drain on resources.

Solution 22.7

**SPENDEE LIMITED
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED 30 JUNE 20Y0**

		20Y0
		C
Cash effects of operating activities		102 344
Cash receipts from customers	(30+1750-20)	1 760 000
Cash Payments to suppliers and employees	W1	(1 561 856)
Cash generated from operations	See part (b)	198 144
Interest paid		(20 000)
Tax paid	[39 800 - (DT: 45 000 – 37 000) + (Current tax payable: 19 000 – 12 000)]	(38 800)
Dividends paid	(12 000 + 30 000 – 5 000)	(37 000)
Cash effects of investing activities		(212 144)
Plant purchased for expansion	W3 or (300 000 – 75000 – 22000 + 15 000 – 400 000 – 1 644)	(183 644)
Proceeds from sale of machinery	(22 000 + 8 000)	30 000
Development costs paid	W2	(58 500)
Cash effects of financing activities		68 356
Proceeds from issue of debentures		8 356
Proceeds from issue of ordinary shares (50 000 + 10 000)		60 000
Net cash outflow		(41 444)
Opening cash and cash equivalents		900
Closing cash and cash equivalents		(40 544)

**SPENDEE LIMITED
NOTES TO THE STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED 30 JUNE 20Y0**

Non cash investing and financing activities	C
Revaluation of land and buildings	15 000

b)

Reconciliation between cash generated from operations and profit before tax	20Y0
	C
Profit before tax	106 000
Add finance costs	20 000
Less profit on sale of machinery	(8 000)
Add depreciation on plant	75 000
Add amortisation of development costs 70000/10*6/12	3 500
Add depreciation on equipment	1 644
	198 144
Increase in trade accounts payable	10 000
Increase in inventories	(20 000)
Decrease in accounts receivable	10 000
	198 144

Solution 22.7 continued ...

Workings

W1

Figures in 000s

Accounts payable				Inventory			
Description	C	Description	C	Description	C	Description	C
Balance	1 402	Balance	42	Balance	50	COS	1 392
		Inventory	1 412	Accounts payable	1 412		
Balance	52					Balance	70
	1 454		1 454		1 462		1 462

Current tax payable				Deferred tax			
Description	C	Description	C	Description	C	Description	C
Bank	38.8	Balance	19	Balance	45	Balance	37
		Tax expense	31.8			Tax expense	8
Balance	12				45		45
	50.8		50.8				

Tax expense			
Description	C	Description	C
Balance	0		
Deferred tax	8		
Current tax payable	31.8		
	39.8	Balance	39.8
			39.8

Cash paid to suppliers and employees			C
Cash paid to suppliers for goods for resale			*1 402 000
Cash paid for other operating expenses	(240 – 75 – 1.644 -3.5)		159 856
			1 561 856

W2 Development costs

	A	B	Total
Opening balance	20 000	30 000	50 000
Incurred during year	50 000	8 500	58 500
Total	70 000	38 500	108 500
Less amortisation /10*6/12	3 500		3 500
Closing balance	66 500	38 500	105 000

Solution 22.7 continued ...

W3 Property, plant and equipment

Opening balance	300 000 given
Sale	(22 000) given
Revaluation of land	15 000 given
Depreciation - plant	(75 000) given
Depreciation - equip	(1 644) given
<i>Purchase of machinery</i>	<u>183 644</u> <i>balancing</i>
Closing balance	<u>400 000</u> given

Solution 22.8

**BIG FOOT LIMITED
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED 31 DECEMBER 20X8**

		20X8
		C
Cash effect of operating activities		(41 130)
Cash receipts from customers	$45\,000 + 654\,000 - 110\,000$	589 000
Cash payments to suppliers and employees	Balancing or W2	585 130
Cash generated from operations	W1	3 870
Interest paid	$9\,000 + 17\,000 - 4\,500$	(21 500)
Tax paid	$[5\,000 + (3\,000 + 21\,000 - 15\,000) - 12\,000]$	(2 000)
Dividends paid	$29\,000 + 10\,000 - 17\,500$	(21 500)
Cash effects of investing activities		(283 834)
Expansion/ purchase of land and buildings	$(320\,000 - 300\,000)/2$	(10 000)
Purchase of plant and machinery	$(312\,964 + 15\,866 + 20\,222 + 10\,648 - 110\,000)$	(249 700)
Sale of plant and machinery	$15\,866 + 20\,000$	35 866
Development costs paid		(60 000)
Cash effects of financing activities		297 036
Proceeds from issue of shares	$(32\,000 \times 1.25)$	40 000
Repayments of long-term loan	given	(80 000)
Proceeds from raising of long-term loan	$(527\,036 - 260\,000 + 80\,000 - 10\,000)$	337 036
Net cash in/ (out) flow		(27 928)
Opening cash and cash equivalents		159 000
Closing cash and cash equivalents		131 072

Solution 22.8 continued ...

Workings

W1. Cash generated by operations		20X8 C
Profit before tax		16 000
Adjust for non-cash flow and separately disclosable items:		
Add interest expense		17 000
Add depreciation		20 222
Add write-down on plant and machinery		10 648
Less profit on sale of P&M		(20 000)
Add amortisation of Dev Costs	$(100\,000 + 20\,000) \times 6 / 24$	30 000
		<u>73 870</u>
Adjust for changes in working capital		
Less increase in inventories	$(-120\,000 + 80\,000)$	(40 000)
Less increase in debtors	$(-110\,000 + 45\,000)$	(65 000)
Add increase in creditors	$(55\,000 - 20\,000)$	35 000
		<u>3 870</u>
Cash generated by operations		<u>3 870</u>

W2 Cash payments to suppliers and employees:

<i>Payments to suppliers of goods for resale</i>		299 000
= Opening accounts payable + purchases - closing accounts payable	$(20\,000 + 334\,000 - 55\,000)$	
*Purchases = COS + CI - OI	$(294\,000 + 120\,000 - 80\,000 = 334\,000)$	
<i>Operating expenses paid</i>		286 130
Operating expenses		347 000
Non-cash items:		
Depreciation		(20 222)
Write down on plant and machinery		(10 648)
Amortisation of development costs		(30 000)
		<u>585 130</u>
Cash payments to suppliers and employees		<u>585 130</u>

Solution 22.9

a)

SAURON STEEL
EXTRACT FROM NOTES TO THE FINANCIAL STATEMENTS

Taxation expense

Normal income tax

- Current tax
 - Current year
 - Over-provision in prior year
- Deferred normal tax

Tax expense

C	
	21 000
	6 000
	8 000
	(2 000)
	15 000
	21 000

Tax rate reconciliation

Normal tax at applicable rate

Exempt item: Dividend income [taxed @ 10% (5 000 x 20%)]

Overprovision in prior year

Income tax expense at effective rate

C	%
24 000	30.0
(1 000)	(1.25)
(2 000)	(2.5)
22 375	26.25

Deferred tax liability

Revaluation surplus

Plant

Machinery

45 000
40 500
10 500
96 000

Solution 22.9 continued ...

b)

SAURON STEEL LIMITED
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED 31 DECEMBER 20X2

Profit before tax		80 000
<i>+/- Non cash items</i>		
Depreciation	(65 000+15 000+5 000)	85 000
<i>+/- Non operating items</i>		115 000
Dividends received		(5 000)
Interest paid	(800 000 x 15%)	120 000
<i>+/- Changes in working capital</i>		95 625
Increase in accounts receivable		(90 000)
Decrease in inventories	(300 000 - 55 000 - 100 000)	145 000
Decrease in accounts payable		(150 625)
Cash generated from operations		184 375
Dividends received		5 000
Interest paid		(120 000)
Normal tax paid	(7 000 - 2 000 + 8 000)	(13 000)
Dividends paid		(20 000)
Cash generated from operating activities		36 375
Cash flows from investing activities		
Purchase of land and buildings		(50 000)
Purchase of investments in listed companies		(60 000)
Purchase of Machinery		(20 000)
Cash flows from financing activities		
Issue of ordinary shares at a premium	(110 000 - 5 000)	105 000
Movements in cash and cash equivalents for the year		11 375
Balance in cash and cash equivalents at the beginning of the year		55 000
Balance in cash and cash equivalents at the end of the year		66 375

Solution 22.9 continued . . .

Workings

Depreciation and deferred tax

Plant

		CA	TB	TD	DT
01/01/X0	Cost	600 000	600 000		
01/01/X0 – 31/12/X1	Depreciation / W&T	(100 000)	(200 000)		
31/12/X1	Balance	500 000	400 000	100 000	30 000Cr
01/01/X2	Revaluation	150 000	-	150 000	45 000Cr
31/12/X2	Depreciation / W&T	(65 000)	(100 000)	35 000	10 500Cr
		585 000	300 000	285 000	85 500Cr
Depreciation / W&T		65 000	100 000		

Machinery

		CA	TB	TD	DT
01/01/X0	Cost	120 000	120 000		
	Depreciation/ W&T	(20 000)	(40 000)		
31/12/X1	Balance	100 000	80 000	20 000	6 000Cr
30/06/X2	Acquisition	120 000	120 000		
31/12/X2	Depreciation/ W&T (10 000 + 5 000) (20 000 + 10 000)	15 000	30 000	15 000	4 500Cr
		205 000	170 000	35 000	10 500Cr
Depreciation / W&T		15 000	30 000		

Furniture

Depreciation W&T	5 000	5 000
Total depreciation / W&T	85 000	135 000

Deferred tax

Opening balance	36 000
Revaluation	45 000
Taxable TD on plant	10 500
Taxable TD on machinery	4 500
	<u>96 000</u>

Solution 22.9 continued ...

Prior year tax

Amount assessed	60 000
Amount provided	62 000
Over provision	<u>2 000</u>
Amount assessed	60 000
Amount paid	<u>55 000</u>
Amount owing to taxation authorities	<u>5 000</u>

Tax calculation 20X2**X 0.30**

Profit before tax	80 000	24 000	
Dividends received	<u>(5 000)</u>		
	75 000	22 500	Dr TE
<i>Temporary differences</i>	<u>(50 000)</u>	(15 000)	Cr DT
+ depreciation	85 000		
- wear and tear	<u>(135 000)</u>		
Taxable profit	25 000	7 500	Cr CTP
Dividends (taxed @ 10%)	5 000	<u>500</u>	
		8 000	

c)

Interest cover

Interest cover measures the amount of times the profit exceeds the interest payment, and this provides information to lenders of money regarding the company's ability to repay interest from profits. The interest-cover of Sauron Steel Limited is calculated as follows:

$$\text{Interest cover} = (80\,000 + 120\,000) / 120\,000 = 1.67$$

This is a relatively healthy interest cover as the company does generate enough profits to cover its interest payments.

Solution 23.1**Specific loan****a) Borrowing costs to be capitalised***W1. Interest incurred during construction:*

$$1\,900\,000 \times 25\% \times 10 / 12 \\ = 395\,833$$

Note:

- Any interest incurred during January 20X5 may not be capitalised because construction had not yet begun.
- Any interest incurred after 30 November 20X5 may not be capitalised because construction is complete.

W2 Interest earned to end of construction:

$$(1\,900\,000 - 500\,000) \times 20\% \times 5/12 + (1\,900\,000 - 500\,000 - 600\,000) \times 20\% \times 4/12 \\ = 170\,000$$

Note:

- Interest earned during construction is the only interest we consider in this calculation.

W3 Interest capitalised:

Interest incurred during construction	395 833
Less investment income earned during construction	(170 000)
Costs capitalised	<u>225 833</u>

b) Depreciation in 20X5*Total cost:*

Construction costs	500 000 + 600 000 + 800 000	1 900 000
Borrowing costs capitalised	Part (a)	<u>225 833</u>
Carrying amount		<u>2 125 833</u>

Depreciation:

$$2\,125\,833 / 10 \text{ years} \times 1 / 12 \text{ months} \\ = 17\,715$$

c) Carrying amount at 31 December 20X5

Cost		2 125 833
Accumulated depreciation	Part (b)	<u>(17 715)</u>
Carrying amount		<u>2 108 118</u>

Solution 23.2

General loan

a) Borrowing costs to be capitalised

Capitalisation rate (weighted average rate of interest):

$$\frac{2\,600\,000}{20\,000\,000} = 13\%$$

Interest to be capitalised

Date	Accumulated expenses: opening bal A	Expenses incurred during period B	Cumulative Expenses C = A + B ⁽²⁾	Interest capitalised D = C x % x m/12	Accumulated expenses: closing bal E = A + B + D ⁽¹⁾
	C	C	C	C	C
1 January	0	300 000	300 000	9 750 ⁽³⁾	300 000
1 April	300 000	200 000	500 000	16 250 ⁽⁴⁾	500 000
1 July	500 000	250 000	750 000	16 250 ⁽⁵⁾	750 000
1 September	750 000	150 000	900 000	9 750 ⁽⁶⁾	900 000
1 October	900 000	200 000	1 100 000	35 750 ⁽⁷⁾	1 187 750 ⁽¹⁾
		<u>1 100 000</u>		<u>87 750</u>	

Note the following:

- 1) Interest (column D) is only added if the interest is compounded at that date. Since the interest is payable at year-end, the interest incurred is not included in the 'accumulated expenses' closing/opening balances (i.e. interest is effectively not compounded during the year).
The total interest of 87 750 would, however, be included in the accumulated opening balance on 1 January 20X6 since it amounts to a payment that was necessary for the construction of the stadium: $1\,100\,000 + 35\,750 = 1\,187\,750$
- 2) Since the expenses are incurred at the beginning of each period (e.g. not evenly during the period), the expenses are not averaged.
- 3) $300\,000 \times 13\% \times 3/12 = 9\,750$
- 4) $500\,000 \times 13\% \times 3/12 = 16\,250$
- 5) $750\,000 \times 13\% \times 2/12 = 16\,250$
- 6) $900\,000 \times 13\% \times 1/12 = 9\,750$
- 7) $1\,100\,000 \times 13\% \times 3/12 = 35\,750$

Alternative layout: Interest to be capitalised:

Payments ⁽¹⁾	Capitalisation rate	Months outstanding	Related interest	Calculation
300 000	13%	12	39 000	$300\,000 \times 13\% \times 12/12$
200 000	13%	9	19 500	$200\,000 \times 13\% \times 9/12$
250 000	13%	6	16 250	$250\,000 \times 13\% \times 6/12$
150 000	13%	4	6 500	$150\,000 \times 13\% \times 4/12$
200 000	13%	3	6 500	$200\,000 \times 13\% \times 3/12$
<u>1 100 000</u>			<u>87 750</u>	

1) Since the interest is payable at year-end, the interest incurred is not included in the 'payments' column. In other words, interest is effectively not compounded during the year.

Solution 23.2 General loan

a) Borrowing costs to be capitalised continued ...

Alternative layout: Interest to be capitalised:

Average costs:

$$(300\,000 \times 12/12) + (200\,000 \times 9/12) + (250\,000 \times 6/12) + (150\,000 \times 4/12) + (200\,000 \times 3/12) \\ = 675\,000$$

Interest eligible for capitalisation:

$$13\% \times 675\,000 = 87\,750$$

b) Depreciation in 20X5

Since the asset is not yet available for use (still under construction) there is no depreciation.

c) Carrying amount at 31 December 20X5

Cost	$1\,100\,000 + 87\,750$	1 187 750
Accumulated depreciation		<u>0</u>
Carrying amount		<u>1 187 750</u>

Solution 23.3

General loan

a) Borrowing costs to be capitalised

Capitalisation rate (weighted average rate of interest):

$$2\,600\,000 / 20\,000\,000$$

$$= 13\%$$

Interest to be capitalised:

Period	Accumulated expenses: opening bal A C	Expenses incurred during period B C	Average cumulative expenses C = A + B/2 ⁽⁷⁾ C	Interest capitalised D = C x % x m/12 C	Accumulated expenses: closing bal E = A + B + D C	
1 Jan – 30 April	0	600 000	300 000 ⁽¹⁾	13 000 ⁽⁴⁾	613 000	
1 May – 31 Aug	613 000	300 000	763 000 ⁽²⁾	33 063 ⁽⁵⁾	946 063	
1 Sept – 31 Dec	946 063	900 000	1 396 063 ⁽³⁾	60 496 ⁽⁶⁾	1 906 559	
		<u>1 800 000</u>		<u>106 559</u>		

Notes:

1) $0 + 600\,000 / 2 = 300\,000$

2) $613\,000 + 300\,000 / 2 = 763\,000$

3) $946\,063 + 900\,000 / 2 = 1\,396\,063$

4) $300\,000 \times 13\% \times 4/12 = 13\,000$

5) $763\,000 \times 13\% \times 4/12 = 33\,063$

6) $1\,396\,063 \times 13\% \times 4/12 = 60\,496$

7) B is divided by 2 when the expenses are incurred evenly during the period

Alternative layout: Interest to be capitalised:

Interest eligible for capitalisation: (average cumulative expenditure x interest rate x period)

January to April	$(0 + 600\,000 / 2) \times 13\% \times 4/12$	13 000
May to August	$(613\,000^{(1)} + 300\,000 / 2) \times 13\% \times 4/12$	33 063
September to December	$(946\,063^{(2)} + 900\,000 / 2) \times 13\% \times 4/12$	60 496
Total		<u>106 559</u>

Notes:

1) $0 + 600\,000 + 13\,000 = 613\,000$

2) $613\,000 + 300\,000 + 33\,063 = 946\,063$

b) Depreciation in 20X5

Since the asset is not yet available for use (still under construction) there is no depreciation.

c) Carrying amount at 31 December 20X5

Cost	1 800 000 + 106 559	1 906 559
Accumulated depreciation	Part (b)	<u>0</u>
Carrying amount		<u>1 906 559</u>

Solution 23.4

General loan

Journals in 20X5:

	Debit	Credit
Building: cost (asset)	740 000	
Bank/ liability		740 000
<i>Construction costs incurred: $70\,000 \times 7 + 40\,000 \times 4 + 90\,000 \times 1$</i>		
<i>This journal would actually be processed separately for each and every payment but is shown here as a cumulative journal for ease</i>		
<hr/>		
Interest expense (finance costs)	140 000	
Bank/ liability		140 000
<i>Finance costs incurred: $800\,000 \times 10\% + 400\,000 \times 15\%$</i>		
<hr/>		
Bank	45 000	
Interest income		45 000
<i>Finance income earned: given</i>		
<hr/>		
Building: cost (asset)	98 098	
Interest expense (finance costs)		98 098
<i>Finance costs capitalised: (W1)</i>		
<hr/>		
Journals in 20X6:		
Interest expense (finance costs)	140 000	
Bank/ liability		140 000
<i>Finance costs incurred: $800\,000 \times 10\% + 400\,000 \times 15\%$</i>		
<hr/>		
Bank	92 000	
Interest income		92 000
<i>Finance income earned: given</i>		
<hr/>		
Building: cost (asset)	12 523	
Interest expense (finance costs)		12 523
<i>Finance costs capitalised to 31 January 20X6: (W1)</i>		
<hr/>		
Depreciation	119 224	
Building: accumulated depreciation		119 224
<i>Depreciation from date asset first became available for use:</i>		
<i>1 February 20X6: (o/bal: $450\,000 + 740\,000 + 98\,098 + 12\,523$) / 10</i>		
<i>years x 11 / 12 (asset available for use from 1 February 20X6)</i>		

Comment:

- There are two loans, both of which are general borrowings and therefore the borrowing costs to be capitalised are based on expenditures incurred multiplied by the weighted average interest rate.
- Since the expenditures are incurred evenly, average expenditures are used.
- Since the borrowings are general, one does not consider interest income in the calculation of the amount to be capitalised.

Solution 23.4 continued ...

W1: Borrowing costs to be capitalised

The loans are general loans and therefore the formula is:
 'Capitalisation rate x Average expenditure'.

W1.1: Capitalisation rate (weighted average interest rate):

$$\begin{aligned}
 &= \text{interest incurred on general borrowings/ borrowings outstanding during the period} \\
 &= \frac{[(C800\,000 \times 10\% \times 12 / 12) + (C400\,000 \times 15\% \times 12 / 12)] \text{ total interest}}{(800\,000 + 400\,000) \text{ total borrowings}} \\
 &= 11.667\%
 \end{aligned}$$

W1.2A: Interest to be capitalised

Period	Accumulated expenses: opening bal A C	Expenses incurred during period B C	Average cumulative expenses C = A + B/2 C	Interest capitalised D = C x % x m/12 C	Accumulated expenses: closing bal E = A + B + D ⁽⁴⁾ C	
20X5:						
1 Jan – 31 July	450 000		490 000	695 000	47 299 ⁽¹⁾	940 000 ⁽⁴⁾
1 Aug – 30 Nov	940 000		160 000	1 020 000	39 667 ⁽²⁾	1 100 000
1 Dec – 31 Dec	1 100 000		90 000	1 145 000	11 132 ⁽³⁾	1 288 098
			740 000		98 098	
20X6:						
1 Jan – 31 Jan	1 288 098		0	1 288 098	12 523 ⁽⁵⁾	End of constr

Notes:

- 1) 695 000 x 11.667% x 7/12
- 2) 1 020 000 x 11.667% x 4/12
- 3) 1 145 000 x 11.667% x 1/12
- 4) D is included in E only when the interest becomes payable (compounded). Therefore the cumulative expenses on 31/12/X5: 1 100 000 + 90 000 + 98 098 = 1 288 098; OR 450 000 + 740 000 + 98 098 = 1 288 098
- 5) 1 288 098 x 11.667% x 1/12 = 12 523

Solution 23.4 continued ...

Yoodle Limited

Statement of comprehensive income (Extracts)
For the year ended 31 December 20X6

		20X6	20X5
	Note	C	C
Profit before finance charges		xxx	xxx
Finance charges	35.	(127 47	(41 90
Profit before tax	36.	xxx	xxx

Yoodle Limited

Statement of financial position (Extracts)
As at the year ended 31 December 20X6

		20X6	20X5
	Note	C	C
<i>Non-current assets</i>			
Property, plant and equipment	2.	xxx	xxx

Yoodle Limited

Notes to the financial statements
For the year ended 31 December 20X6

1. Accounting Policies

1.1 Borrowing costs

Borrowing costs are recognised as an expense in the period in which they are incurred, except to the extent to which they meet the criteria for capitalisation, in which case they are capitalised.

2. Property, plant and equipment (extracts)

Property, plant and equipment comprises:

- Buildings
- Other classes *Given*

	20X6	20X5
	C	C
	1 18	1 28
	xxx	xxx
	xxx	xxx

Buildings:

Net carrying amount: 1/1	1 28	450 00
Gross carrying amount: 1/1	1 28	450 00
Accumulated depreciation & impairment losses: 1/1	0	0

Construction costs capitalised *Given*
Borrowing costs capitalised *Per calculations/ journals above*
Depreciation *See journals*

	0	740 00
	12 52	98 09
	(119 22	0

Net carrying amount: 31/12
Gross carrying amount: 31/12
Accumulated depreciation & impairment losses: 31/12

	1 18	1 28
	1 30	1 28
	(119 22	0

35. Finance charges

Interest expensed	127 47	41 90
Total interest incurred	140 00	140 00
Less capitalised	(12 52	(98 09

36. Profit before tax (extracts)

Profit before tax is stated after taking the following separately disclosable items into account:

- Depreciation *See journals* 119 22 0

Solution 23.4 continued ...

W1.2B Alternative: Interest to be capitalised (using average expenditures)

Capitalisation rate x average expenditure:		C
Jan – July 20X5	$\{450\,000 + (70\,000 \times 7 \text{ months}) / 2\} \times 11.667\% \times 7 / 12 \text{ months}$	47 299
Aug – Nov 20X5	$\{940\,000 + (40\,000 \times 4 \text{ months}) / 2\} \times 11.667\% \times 4 / 12$	39 667
December 20X5	$\{1\,100\,000 + (90\,000 \times 1) / 2\} \times 11.667\% \times 1 / 12$	11 132
Total to be capitalised in 20X5		<u>98 098</u>
January 20X6	$\{1\,288\,098 + 0/2\} \times 11.667\% \times 1 / 12$	12 523
Total to be capitalised in 20X6		<u>12 523</u>

Notes:

1) $1\,190\,000 + 98\,098$ (interest payable at 31/12/20X5) = $1\,288\,098$ total expenses to 31/12/20X5

W1.2C Alternative: Interest to be capitalised (using balances)

20X5 Cumulative expenditure		C
1 January 20X5	Opening balance	450 000
January – July	$70\,000 \times 7 \text{ months}$	<u>490 000</u>
31 July 20X5	Closing balance	940 000
August - November	$40\,000 \times 4 \text{ months}$	<u>160 000</u>
30 November 20X5	Closing balance	1 100 000
December	$90\,000 \times 1 \text{ month}$	<u>90 000</u>
31 December 20X5	Closing balance	1 190 000
31 December	Annual interest payable/ compounded	<u>98 098</u>
1 January 20X6	Opening balance	1 288 098

Capitalisation rate x average expenditure:		C
Jan – July 20X5	$(450\,000 + 940\,000) / 2 \times 11.667\% \times 7 / 12 \text{ m}$	47 299
Aug – Nov 20X5	$(940\,000 + 1\,100\,000) / 2 \times 11.667\% \times 4 / 12 \text{ m}$	39 667
December 20X5	$(1\,100\,000 + 1\,190\,000) / 2 \times 11.667\% \times 1 / 12 \text{ m}$	11 132
Total to be capitalised in 20X5	$40\,000 \times 4 \text{ months}$	<u>98 098</u>

20X6 Cumulative expenditure		C
31 December 20X5	Closing balance	1 190 000
31 December	Annual interest payable/ compounded	<u>98 098</u>
1 January 20X6	Opening balance	1 288 098
31 January 20X6	No payments	<u>0</u>
1 January 20X6	Opening balance	<u>1 288 098</u>

Capitalisation rate x average expenditure:		C
January 20X6	$(1\,288\,098 + 1\,288\,098^{(1)}) / 2 \times 11.67\% \times 1 / 12 \text{ m}$	12 523
Total to be capitalised in 20X6		<u>12 523</u>

Solution 23.4 continued ...

W1.2D Alternative: Interest to be capitalised

The above calculation can be done the long way around, if preferred (obviously this is not recommended due to time constraints in tests/ exams, but if you are battling to understand the previous calculations, it may help to cast your eyes over the following full-length calculation):

Interest on expenses incurred during 20X5 (evenly during each month)						
	Balance (A)	Expense (B)	Balance (C)	Balance (D)	Interest %	Months
20X5						
January	450 000	70 000	520 000	485 000	11.67%	1
February	520 000	70 000	590 000	555 000	11.67%	1
March	590 000	70 000	660 000	625 000	11.67%	1
April	660 000	70 000	730 000	695 000	11.67%	1
May	730 000	70 000	800 000	765 000	11.67%	1
June	800 000	70 000	870 000	835 000	11.67%	1
July	870 000	70 000	940 000	905 000	11.67%	1
August	940 000	40 000	980 000	960 000	11.67%	1
September	980 000	40 000	1 020 000	1 000 000	11.67%	1
October	1 020 000	40 000	1 060 000	1 040 000	11.67%	1
November	1 060 000	40 000	1 100 000	1 080 000	11.67%	1
December	1 100 000	90 000	1 190 000	1 145 000	11.67%	1
		<u>740 000</u>				
20X6						
January	1 288 098 ⁽¹⁾	0	1 288 098	1 288 098	11.67%	1
		<u>0</u>				

Balance (A): first day of the month

Expense (B): incurred during the month

Balance (C): last day of the month

Balance (D): average balance = $(A + C) / 2$

Capitalise: interest expense that may be capitalised: Balance (A) x interest rate x 1 / 12

Capitalisation rate (weighted average interest rate): see calculation above

Calculations:

1) $1\,190\,000 + 98\,098 = 1\,288\,098$

Solution 23.5 **Specific loan****a) Borrowing costs to be capitalised***W1 Interest incurred:*

$$2\,000\,000 \times 14\% \times 1 \text{ year} \\ = 280\,000$$

W2 Interest earned:

$$(1\,400\,000 \times 10\% \times 6 / 12) + (200\,000 \times 10\% \times 2 / 12) \\ = 73\,333$$

You may find it easier to understand the calculation of the interest earned by looking at the following tabular calculation:

From	Total borrowings	Used	Available for investment	Interest on investment	
01-Jan	2 000 000	600 000	1 400 000	70 000	$1\,400\,000 \times 10\% \times 6/12$
01-Jul		1 200 000	200 000	3 333	$200\,000 \times 10\% \times 2/12$
01-Sep		200 000	0	0	
				<u>73 333</u>	

W3 Interest to be capitalised:

Interest incurred during construction	280 000
Less investment income during construction	<u>(73 333)</u>
	<u>206 667</u>

Please note: capitalisation of borrowing costs does not cease during a temporary delay in construction.

b) Borrowing costs to be capitalised when there is an extended delay in construction

Borrowing costs may only be capitalised when all three of the following criteria are met:

- expenditure is being incurred;
- activities to bring the asset to its intended use have begun; and
- interest is being incurred.

Since construction has not yet started (the activities have not yet begun), none of the interest incurred is eligible for capitalisation (i.e. the interest incurred must be expensed).

Solution 23.6

Specific borrowings

	Debit	Credit
1 January 20X5		
Bank	5 000 000	
Debentures (liability)		5 000 000
<i>Issue of debentures</i>		
31 December 20X5		
Finance cost (expense)	881 595	
Bank		600 000
Debentures (liability)		281 595
<i>Interest on debentures expensed (1 000 000 x C5 x 17.6319%) or W1</i>		
<i>Payment of debenture interest (1 000 000 x C5 x 12%) or W1</i>		
<i>Increase in debenture liability (balancing or W1)</i>		
Bank	250 000	
Interest income		250 000
<i>Interest earned on surplus funds: given</i>		
Head office building: cost	578 962	
Finance cost (expense)		578 962
<i>Capitalisation of specific debenture interest (W2)</i>		
Depreciation	18 991	
Head office building: accumulated depreciation		18 991
<i>Depreciation of the building for the month of December (W3)</i>		

Workings:

W1: Effective interest table for debentures

Year	O/bal	Interest at 17.6319%	Payments	C/bal
20X5	5 000 000	881 595	(600 000)	5 281 595
20X6	5 281 595	931 246	(600 000)	5 612 841
20X7	5 612 841	989 650	(600 000)	6 002 491
20X8	6 002 491	1 058 353	(600 000)	6 460 844
		1 139 170		
20X9	6 460 844	-14 rounding	(600 000)	7 000 000
			(7 000 000)	0
		5 000 000	(10 000 000)	

W2: Interest to be capitalised

Interest expense during construction to 30 November	881 595 x 11 / 12 *	808 129
Less investment income during construction	250 000 x 11 / 12 *	(229 167)
		<u>578 962</u>

* Construction complete on 30 November, therefore 11 months only

W3: Depreciation

Cost	Construction costs: 2 700 000 + Borrowing costs: 578 962	3 278 962
Residual value	Given	(1 000 000)
Depreciable amount		<u>2 278 962</u>
Depreciation	2 278 962 / 10 x 1/12	18 991

Solution 23.7

a) Borrowing costs on a qualifying asset

W1: Interest incurred:

Period	Calculations	Interest incurred E
1 Jan – 30 Sept	$\$1\,500\,000 \times 15\% \times 9 / 12 \times (E6 + E4 + E7)/3^*$	956 250
1 Oct – 31 Dec	$\$1\,500\,000 \times 15\% \times 3 / 12 \times E8$	450 000**
Total	$\$1\,500\,000 \times 15\% \times 12 / 12 \times E6.25$	<u>1 406 250</u>

*: average exchange rate between January – 30 September 20X5

**: interest incurred after September 20X8 may not be capitalised because construction is complete.

W2: Surplus funds available for investment:

Details	Date	\$
Borrowed	1/1/20X8	1 500 000
Used	1/1/20X8	(200 000)
Surplus	1 Jan – 31 Mar	<u>1 300 000</u>
Used	1/4/20X8	(300 000)
Surplus	1 Apr – 30 June	<u>1 000 000</u>
Used	1/7/20X8	(550 000)
Surplus	1 July – 30 Sept	<u>450 000</u>
Used	30/9/20X8	(350 000)
Surplus	1 Oct – 31 Dec	<u>100 000</u>

W3: Interest income earned

Date	Surplus (W2) \$	Interest @ 10% \$	For 3 months (x3/12) \$	Exchange rate Euro: \$1	Income Euro's Euro
1 Jan – 31 Mar	1 300 000	130 000	32 500	6	195 000
1 Apr – 30 June	1 000 000	100 000	25 000	4	100 000
1 July – 30 Sept	450 000	45 000	11 250	7	78 750
1 Oct – 31 Dec	100 000	10 000	2 500	8	20 000**
Total interest income earned from surplus funds			<u>\$71 250</u>		<u>E393 750</u>

**: interest income earned during the period 1 October – 31 December, is not taken into consideration when calculating the interest to be capitalised.

W4: Interest to be capitalised.

	Calculations	Euro
Interest incurred during construction	W1: 1 Jan – 30 Sept	956 250
Forex loss on interest incurred	$1\,500\,000 \times 15\% \times 9 / 12 \times 7.20^{(1)}$ – 956 250	258 750
Investment income during construction	W3: 195 000 + 100 000 + 78 750	(373 750)
Forex gain on interest income	$(\$32\,500 + \$25\,000 + \$11\,250) \times$ 7.20 – 373 750	(121 250)
		<u>720 000</u>

(1) spot rate on date construction ends

Note:

The foreign exchange differences on the loan balance may not be capitalised since it is only the foreign exchange differences on the interest costs that are defined as borrowing costs.

Solution 23.7 continued ...

b) Journals

		Debit	Credit
<i>1 January 20X8</i>			
Bank account (\$)	1 500 000 x 5	7 500 000	
Loan liability			7 500 000
Dollar denominated loan is raised; spot rate is E5: \$1			
<hr/>			
Building: cost	\$200 000 x 5	1 000 000	
Bank account (\$)			1 000 000
Progress payment (in dollars) paid out of dollar denominated call a/c			
<hr/>			
<i>1 April 20X8</i>			
Building: cost	\$300 000 x 5	1 500 000	
Bank account (\$)			1 500 000
Progress payment (in dollars) paid out of dollar denominated call a/c			
<hr/>			
<i>1 July 20X8</i>			
Building: cost	\$550 000 x 5	2 750 000	
Bank account (\$)			2 750 000
Progress payment (in dollars) paid out of dollar denominated call a/c			
<hr/>			
<i>30 September 20X8</i>			
Building: cost	\$350 000 x 5	1 750 000	
Bank account (\$)			1 750 000
Progress payment (in dollars) paid out of dollar denominated call a/c			
<hr/>			
<i>31 December 20X8</i>			
Interest expense	\$1 500 000 x 15% x 12/12 x 6.25	1 406 250	
Interest payable			1 406 250
Interest expense on loan liability measured at average exchange rate for year: E6.25: \$1			
<hr/>			
Forex loss	\$1 500 000 x 15% x 12/12 x 7 – E1 406 250	168 750	
Interest payable			168 750
Translation of interest payable to spot exchange rate at year-end: E7:\$1			
<hr/>			
Forex loss	\$1 500 000 x 7 – E7 500 000	3 000 000	
Loan liability			3 000 000
Translation of loan liability to spot exchange rate at year-end: E7:\$1			
<hr/>			
Loan liability	\$1 500 000 x 7	10 500 000	
Interest payable	\$1 500 000 x 15% x 12/12 x 7	1 575 000	
Bank (Euro)			12 075 000
Repayment of loan and related interest at spot exchange rate on 31 Dec 20X8: E7:\$1			
<hr/>			
Interest receivable	W2 and W3	393 750	
Interest income			393 750

Solution 23.7 continued ...

Interest income on surplus funds measured at the average **b)**

Journals continued ...

exchange rate per period during which a different amount was invested (E6; E4; E7 and E8 : \$1)

Interest receivable	W2 and W3: \$71 250 x 7 – E393 750	105 000	
Forex gain			105 000
Translation of interest receivable to spot exchange rate at year-end: E7:\$1			

		Debit	Credit
<i>31 December 20X8 continued ...</i>			
Bank account (\$)	W2: \$100 000 x 7 – \$100 000 x 5	200 000	
Forex gain			200 000
Translation of the balance in the dollar denominated call account to spot exchange rate at year-end: E7:\$1			
Bank account (\$)	\$71 250 x 7	498 750	
Interest receivable			498 750
Receipt of interest in \$ into the dollar denominated call account on 31 December 20X8 (E7: \$1)			
Bank (Euro)	Bal of capital \$100 000 x 7 + Interest	1 198 750	
Bank account (\$)	income \$71 250 x 7		1 198 750
Transfer from the dollar denominated call account to Euro bank account on 31 December 20X8 (E7: \$1)			
Building: cost	W4	720 000	
Interest expense			720 000
Interest expense partially capitalised to the cost of the building ito IAS23			

Please note that this is an investment property. The question did not give us sufficient information to determine whether the cost model was used (in which case it would be depreciated from 30 September 20X8) or fair value model (in which case a fair value adjustment would be processed at 31 December 20X8) was used.

c) Borrowing costs on a NON-qualifying asset

Since the shopping mall is not a qualifying asset, the borrowing costs must be expensed. The construction costs, however, will still be capitalised to the shopping mall.

The investment income earned will be included as income in the statement of comprehensive income. This must be disclosed separately from the borrowing cost expense (i.e. the interest income may not be set-off against the borrowing costs incurred).

Since Jellyvog Limited had a foreign loan, foreign exchange differences may have arisen on changes in the Euro/Dollar exchange spot rates.

Borrowing costs expensed:

(Same working as in part a) = = E1 406 250

Interest for the entire year is expensed regardless of when the shopping mall was completed.

Interest expense should be measured at average rates during the period.

Interest income:

(Same working as in part a) = E 393 750

Interest income should be measured at average rates during the period.

Foreign exchange loss on the capital portion of the liability:

$\$1\,500\,000 \times (E7 - E5) = E3\,000\,000$

Foreign exchange loss on the interest income payable:

$\$1\,500\,000 \times 15\% \times E7 - \$1\,406\,250 = E168\,750$

Foreign exchange gain on the interest income receivable:

$\$71\,250 \times E7 - \$393\,750 = E105\,000$

Solution 23.8

Comment: this example shows:

- that interest income is used to reduce the amount of borrowings that may be capitalised when the borrowing is a specific borrowing
- only interest incurred during construction can be capitalised (March – August = $50\,000 \times 6 / 12 = 25\,000$)
- only interest income from the surplus funds from the specific loan are used to reduce the amount of interest to be capitalised (i.e. $30\,000 - 9\,000 = 21\,000$ interest income on other funds is ignored/ does not reduce the amount to be capitalised)
- only interest income earned during the period of construction is used to reduce the amount to be capitalised (i.e. $9\,000 / 3 \text{ months} = 3\,000$ per month; $3\,000$ is earned in September after construction is complete and therefore this $3\,000$ is ignored/ does not reduce the amount to be capitalised; $9\,000 - 3\,000 = 6\,000$ interest income is used to reduce the amount of interest expense to be capitalised)
- the tax effects of the capitalisation of borrowing costs

a) Calculations

Interest to be capitalised:	Calculations:	C
Interest incurred during construction: March - August	$50\,000 \times 6/12 \text{ (March – August)}$	25 000
Less investment income during construction: March - Aug	$9\,000 / 3 \times 2 \text{ months (July \& Aug)}$	(6 000)
Total to be capitalised		<u>19 000</u>

b) Journals

1 January 20X5

		Debit	Credit
Bank	<i>Given</i>	500 000	
Loan liability			500 000
<i>Loan raised and received on 1 January 20X5</i>			

31 December 20X5

Building: cost (asset)	<i>Given</i>	410 000	
Bank/ liability			410 000
<i>Progress payments made during the year</i>			

Finance costs (expense)	<i>Given</i>	50 000	
Bank/ liability			50 000
<i>Interest incurred on the loan is first expensed</i>			

Bank/ liability	<i>Given</i>	30 000	
Interest income			30 000
<i>Interest income earned on investment of surplus loan funds</i>			

Building: cost (asset)	<i>Part (a)</i>	19 000	
Finance costs (expense)			19 000
<i>Portion of interest on the loan capitalised to the cost of the building</i>			

Depreciation	<i>CA o/b 420 000 – CA c/b 370 000</i>	50 000	
Equipment: accum. depreciation			50 000
<i>Depreciation on equipment</i>			

Depreciation	$(410\,000 + 19\,000) \times 10\% \times 4/12^{(1)}$	14 300	
Building: accumulated depreciation			14 300
<i>Depreciation on building from 1 September 20X5 (first avail for use)</i>			

Tax expense	<i>W1</i>	7 560	
Deferred tax	<i>W1</i>		7 560
<i>Deferred tax on building</i>			

⁽¹⁾ Building was available for use from 1st September

Solution 23.8 continued ...

W1. Deferred tax

Deferred tax table caused by buildings

	CA	TB	TD	DT
O/balance 20X5	0	0	0	0
Construction	410 000	410 000		
Borrowing costs	19 000	0		
Depreciation 429 000 x 10% x 4/12	(14 300)	0		
Wear and tear 410 000 x 5% x 1 year	0	(20 500)		
C/balance 20X5	414 700	389 500	(25 200)	(7 560) L

* wear and tear was not apportioned for part of a year (given in the question).

c) Disclosure

Company Name
Statement of comprehensive income (Extracts)
For the year ended 31 December 20X5

	Note	20X5 C	20X4 C
Profit before finance charges		xxx	Xxx
Finance charges	35.	(31 00	Xxx
Profit before tax	36.	xxx	Xxx

Company Name
Statement of financial position (Extracts)
As at the year ended 31 December 20X5

	Note	20X5 C	20X4 C
<i>Non-current assets</i>			
Property, plant and equipment	2.	784 70	420 00
<i>Non-current liabilities</i>			
Deferred tax	15.	7 56	0

Notes continued overleaf

Solution 23.8 continued ...

Company Name
Notes to the financial statements
For the year ended 31 December 20X5

1. Accounting Policies

1.1 Borrowing costs

Borrowing costs are recognised as an expense in the period in which they are incurred, except to the extent to which they meet the criteria for capitalisation, in which case they are capitalised.

2. Property, plant and equipment (extracts)

Property, plant and equipment comprises:

- Buildings
- Equipment *Given*

20X5 C	20X4 C
414 70	0
370 00	420 00
<u>784 70</u>	<u>420 00</u>

Buildings:

Net carrying amount: 1/1

Gross carrying amount: 1/1

Accumulated depreciation & impairment losses: 1/1

0	0
0	0
0	0

Construction costs capitalised *Given*

Borrowing costs capitalised *Journals above*

Depreciation *Journals (NOTE 1)*

410 00	0
19 00	0
(14 30)	0

Net carrying amount: 31/12

Gross carrying amount: 31/12

Accumulated depreciation & impairment losses: 31/12

414 70	0
429 00	0
(14 30)	0

Note 1:

Depreciation is calculated from the day on which the asset was first available for use (1 September) – not from the date on which it was actually brought into use (1 October).

15. Deferred tax asset/ (liability)

Deferred tax is caused by temporary differences related to:

- Property, plant and equipment

(7 56)	0
<u>(7 56)</u>	<u>0</u>

33. Other income ⁽²⁾

Interest income

30 00	xxx
-------	-----

Note 2:

If the interest income is considered to be material, it would be included in the revenue line item on the face of the statement of comprehensive income and in the revenue note instead. IAS 18 Revenue requires that each class of significant revenue be separately disclosed. If the interest income is considered insignificant, however, the Companies Act requires that interest income be separately disclosed. In other words, interest income must be disclosed somewhere: either in the 'revenue note' or in the 'other income note'.

35. Finance charges

Interest expensed

Total interest incurred

Less capitalised

31 00	xxx
50 00	xxx
<u>(19 00)</u>	<u>xxx</u>

36. Profit before tax (extracts)

Profit before tax is stated after taking the following separately disclosable items into account:

- Depreciation Equip: 420 000 – 370 000 + Buildings: 14 300

64 30	xxx
-------	-----

Solution 23.9

Specific loan

Comment: this example shows:

- How to calculate interest expense when part of the loan capital is repaid; and
- How to calculate interest income from surplus funds, by first calculating how much of the specific loan is surplus to requirements and when the loan balances decrease on specific days when specific payments are made sporadically (in other words, *not evenly*).
- This example does not include compound interest.

W1 Interest incurred	Calculations:	C
Loan A: Jan - Dec	$500\,000 \times 10\% \times 12/12$	50 000
Loan B: June - Dec	$400\,000 \times 15\% \times 2/12 + (400\,000 - 100\,000) \times 15\% \times 5/12$	28 750
Total interest incurred		<u>78 750</u>

W2 Interest earned	Dates:	Surplus C	Calculations:	Interest income at 6% C
Loan A funds received	1 January – 31 March	500 000	$500\,000 \times 6\% \times 3/12$	7 500
Payment made	31 March	(300 000)		
Loan A funds available	1 April – 31 April	200 000	$200\,000 \times 6\% \times 1/12$	1 000
Payment made	31 April	(100 000)		
Loan A funds available	1 May – 31 May	100 000	$100\,000 \times 6\% \times 1/12$	500
Loan B funds received	1 June	400 000		
Loan A&B funds available	1 June – 31 July	500 000	$500\,000 \times 6\% \times 2/12$	5 000
Payment made	31 July	(220 000)		
Repayment made	31 July	(100 000)		
Loan A&B funds available	1 August – 31 August	180 000	$180\,000 \times 6\% \times 1/12$	900
Loan A&B funds available	1 Sept – 31 December		$180\,000 \times 6\% \times 4/12$	3 600
Total interest earned				<u>18 500</u>

W3 Interest to be capitalised	Calculations:	C
Interest incurred during construction:		38 750
Loan A:		
• 1 March – 31 August	$500\,000 \times 10\% \times 6/12$	25 000
Loan B:		
• 1 June – 31 July	$400\,000 \times 15\% \times 2/12$	10 000
• 1 August – 31 August	$300\,000 \times 15\% \times 1/12$	3 750
Less investment income during construction: W2: $7\,500/3 \times 1 + 1\,000 + 500 + 5\,000 + 900$		(9 900)
Total interest to be capitalised		<u>28 850</u>

Solution 23.9 continued ...

		Debit	Credit
Finance costs (expense)	W1	78 750	
Bank/ liability			78 750
<i>Interest incurred on the loan first expensed</i>			
Bank/ investment account	W2	18 500	
Interest income			18 500
<i>Interest income earned on investment of surplus loan funds</i>			
Building: cost (asset)	W3	28 850	
Finance costs (expense)			28 850
<i>Portion of interest on the loan capitalised to the cost of the building</i>			

Solution 23.10

Specific loan

Comment: this example shows:

- How to calculate interest expense when part of the loan capital is repaid; and
- How to calculate interest income from surplus funds, by first calculating how much of the specific loan is surplus to requirements when the loan balances decrease evenly (i.e. when payments are made *evenly* over a period of time).
- How to calculate interest expense and interest income assuming that the interest for the month is calculated on the opening balances and not on a daily rate.

W1. Interest incurred

	Calculations:	C
Loan A: Jan - Dec	$500\,000 \times 10\% \times 12/12$	50 000
Loan B: June - Dec	$400\,000 \times 15\% \times 2/12 + (400\,000 - 100\,000) \times 15\% \times 5/12$	28 750
Total interest incurred		<u>78 750</u>

W2. Interest earned

	Dates:	Surplus o/bal C	Calculations:	Int income 6% C
Loan A funds received	<i>1 January</i>	500 000	$500\,000 \times 6\% \times 1/12$	2 500
Payments/ receipts	<i>January (nothing)</i>	0		
	<i>1 February</i>	500 000	$500\,000 \times 6\% \times 1/12$	2 500
Payments/ receipts	<i>February (nothing)</i>	0		
Loan funds available	<i>1 March</i>	500 000	$500\,000 \times 6\% \times 1/12$	2 500
Payments	<i>March (evenly)</i>	(105 000)	*	
Loan funds available	<i>1 April</i>	395 000	$395\,000 \times 6\% \times 1/12$	1 975
Payments	<i>April (evenly)</i>	(105 000)	*	
Loan funds available	<i>1 May</i>	290 000	$290\,000 \times 6\% \times 1/12$	1 450
Payments	<i>May (evenly)</i>	(105 000)	*	
Loan funds available	<i>1 June</i>	185 000		
Loan B funds received	<i>1 June</i>	400 000		
Loan funds available	<i>1 June</i>	585 000	$585\,000 \times 6\% \times 1/12$	2 925
Payments	<i>June (evenly)</i>	(105 000)	*	
Loan funds available	<i>1 July</i>	480 000	$480\,000 \times 6\% \times 1/12$	2 400
Payments	<i>July (evenly)</i>	(105 000)	*	
Loan repayment made	<i>31 July</i>	(100 000)	<i>given</i>	
Loan A&B funds available	<i>1 August</i>	275 000	$275\,000 \times 6\% \times 1/12$	1 375
Payments	<i>August (evenly)</i>	(105 000)	*	
Loan funds available	<i>1 Sept</i>	170 000	$170\,000 \times 6\% \times 1/12$	850
Payments/ receipts	<i>September (nothing)</i>	0		
Loan funds available	<i>1 October</i>	170 000	$170\,000 \times 6\% \times 1/12$	850
Payments/ receipts	<i>October (nothing)</i>	0		
Loan funds available	<i>1 November</i>	170 000	$170\,000 \times 6\% \times 1/12$	850
Payments/ receipts	<i>November (nothing)</i>	0		
Loan funds available	<i>1 December</i>	170 000	$170\,000 \times 6\% \times 1/12$	850
Payments/ receipts	<i>December (nothing)</i>	0		
Loan funds available	<i>31 December</i>	170 000		<u>21 025</u>
Total interest earned				

*: $630\,000 / 6$ months (1 March – 31 August)

Solution 23.10 continued ...

Alternative W2. Interest income – the much shorter calculation

Dates	Calculations	Interest income C
1 January – 28 Feb	(Jan o/b: 500 000 + Feb o/b: 500 000) / 2 x 6% x 2/12	5 000
1 March – 31 May	(March o/b: 500 000 + May o/b: 500 000 – 210 000 ^{NOTE 1}) / 2 x 6% x 3/12	5 925
1 June – 31 July	(June o/b: 290 000 + 400 000 – 105 000 + July o/b: 585 000 – 105 000) / 2 x 6% x 2/12	5 325
1 August – 31 August	(Aug o/b: 480 000 – 105 000 – 100 000) x 6% x 1/12	1 375
1 Sept – 31 December	(Sept o/b: 275 000 – 105 000 + Dec o/b: 170 000) / 2 x 6% x 4/12	3 400
		<u>21 025</u>

Note:

1) 630 000 / 6 x 2 (March and April)

W3. Interest to be capitalised

Calculations:	C
Interest incurred during construction:	38 750
Loan A: Jan - Dec	
• 1 March – 31 August 500 000 x 10% x 6/12	25 000
Loan B: June - Dec	
• 1 June – 31 July 400 000 x 15% x 2/12	10 000
• 1 August – 31 August 300 000 x 15% x 1/12	3 750
Less investment income earned during construction: per above:	
5 925 + 5 325 + 1 375 (i.e. excluding interest from 1 January – 28 February and 1 September – 31 December)	(12 625)
Total interest to be capitalised	<u>26 125</u>

	Debit	Credit
Finance costs (expense)	78 750	
Bank/ liability		78 750
<i>Interest incurred on the loan first expensed</i>		
Bank/ liability	21 025	
Interest income		21 025
<i>Interest income earned on investment of surplus loan funds</i>		
Building: cost (asset)	26 125	
Finance costs (expense)		26 125
<i>Portion of interest on the loan capitalised to the cost of the building</i>		

Solution 23.11

General loans

a) Interest incurred for the year

Loan	Calculations	Interest incurred C
A Bank	$300\,000 \times 15\% \times 12 / 12 =$ (1 Jan – 31 Dec)	45 000
B Bank	$200\,000 \times 10\% \times 6 / 12 =$ (1 April – 30 Sept)	10 000
C Bank	$100\,000 \times 12\% \times 7 / 12 =$ (1 June – 31 Dec)	7 000
		<u>62 000</u>

b) Capitalisation rate

W1 Interest incurred during the period of construction (1 March – 30 November):

Loan	Calculations	C
A Bank	$300\,000 \times 15\% \times 9 / 12 =$ (1 March – 30 Nov)	33 750
B Bank	$200\,000 \times 10\% \times 6 / 12 =$ (1 April – 30 Sept)	10 000
C Bank	$100\,000 \times 12\% \times 6 / 12 =$ (1 June – 30 Nov)	6 000
		<u>49 750</u>

W2 Weighted average loan balances outstanding during the period of construction:

	Calculations	C
A Bank	$300\,000 \times 9 / 12 =$	225 000
B Bank	$200\,000 \times 6 / 12 =$	100 000
C Bank	$100\,000 \times 6 / 12 =$	50 000
		<u>375 000</u>

Weighted average interest rate:

Interest incurred during construction / Average general loans outstanding during construction

$49\,750 / 375\,000 =$ 13.2667%

Part c) Interest to be capitalised

Date	Accumulated expenses: opening bal A	Expenses incurred during period B	Cumulative Expenses C = A + B Or = A + B/2 ⁽³⁾	Interest capitalised D = C x % x m/12	Accumulated expenses: closing bal E = A + B + D ⁽⁸⁾
	C	C	C	C	C
1– 31 March	0	60 000	60 000 ⁽³⁾	663 ⁽⁵⁾	60 000 ⁽⁸⁾
1– 30 April	60 000	161 250 ⁽¹⁾	221 250 ⁽³⁾	2 446 ⁽⁶⁾	221 250 ⁽⁸⁾
1 May – 30 Nov	221 250	288 750 ⁽²⁾	386 250 ⁽³⁾⁽⁴⁾	29 892 ⁽⁷⁾	386 250 ⁽⁸⁾
				<u>33 001</u>	

Notes:

1) $120\,000$ (purchase of material) + $330\,000 / 8$ (labour for April) = $161\,250$

2) $330\,000 - 41\,250$ (April) = $288\,750$

3) if the expenses are incurred during the period, then calculate the average expenses during the period (i.e. B/2); if incurred at the beginning of the month, then just add B

4) $221\,250 + 41\,250$ (pd 1 May) + $(288\,750 - 41\,250 \text{ May}) / 2 = 386\,250$

5) $60\,000 \times 13.2667\% \times 1/12 = 663$

6) $221\,250 \times 13.2667\% \times 1/12 = 2\,446$

7) $386\,250 \times 13.2667\% \times 7/12 = 29\,892$

8) Interest is only added when the interest is compounded by/ payable to the bank.

Solution 23.11 continued ...

Part c) Interest to be capitalised continued ...

Dates	Calculations	Interest income C
The one 60 000 payment affects interest in:		
• 1 March – 30 November (9 months)	$60\,000 \times 13.2667\% \times 9/12$	5 970
The one 120 000 payment affects interest in:		
• 1 April – 30 November (8 months)	$120\,000 \times 13.2667\% \times 8/12$	10 613
The eight 41 250 payment affects interest in:		
• 1 April – 30 November (8 months)	$[41\,250 \times 1 + (41\,250 \times 7)/2] \times 13.266\% \times 8/12$	16 418
		<u>33 001</u>

Note: interest income is ignored in this calculation because the loans were general loans.

Part d) Journals

		Debit	Credit
Finance costs (expense)	<i>Part (a)</i>	62 000	
Bank/ liability			62 000
<i>Interest incurred on the loan first expensed</i>			
Bank/ liability	<i>Given</i>	30 000	
Interest income			30 000
<i>Interest income earned on investment of surplus loan funds</i>			
Building: cost (asset)	<i>Part (b) and (c)</i>	33 001	
Finance costs (expense)			33 001
<i>Portion of interest on the loan capitalised to the cost of the building</i>			

Solution 23.11 continued...

Part e) Disclosure

Yipdeedoo Limited
Notes to the financial statements
For the year ended 31 December 20X1
1. Accounting Policies*1.1 Borrowing costs*

Borrowing costs are recognised as an expense in the period in which they are incurred, except to the extent to which they meet the criteria for capitalisation, in which case they are capitalised.

		20X1 C
2. Property, plant and equipment (extracts)		
Property, plant and equipment comprises:		
• Buildings		539 309
• Other classes	Given	xxx
		xxx
<i>Buildings:</i>		
Net carrying amount: 1/1		0
Gross carrying amount: 1/1		0
Accumulated depreciation & impairment losses: 1/1		0
Construction costs capitalised	60 000 + 120 000 + 330 000	510 000
Borrowing costs capitalised	Per calculations/ journals above	33 001
Depreciation	(510 000 + 33 001 – 100 000) x 10% x 1/12 ⁽¹⁾	(3 692)
Net carrying amount: 31/12		539 309
Gross carrying amount: 31/12	510 000 + 33 001	543 001
Accumulated depr & imp losses: 31/12		(3 692)

Borrowing costs were capitalised using a capitalisation rate of 13.2667% ⁽²⁾

Notes:

- Depreciation is calculated from the day on which the asset was first available for use (1 December) – not from the date on which it was actually brought into use (1 January 20X2).
- IAS 23 requires that, where interest on general borrowings is capitalised, the capitalisation rate be disclosed. This could be disclosed in the accounting policy note on borrowing costs or in the note to the finance costs instead if preferred.

33. Other income ⁽³⁾

Interest income	30 000
-----------------	--------

Note :

- If the interest income is considered to be material, it would be included in the revenue line item on the face of the statement of comprehensive income and presented separately in the revenue note instead. IAS 18 Revenue requires that each class of significant revenue be separately disclosed.

35. Finance charges

Interest expensed		28 999
Total interest incurred	Part (a)	62 000
Less capitalised	Part (b) and (c)	(33 001)

36. Profit before tax (extracts)

Profit before tax is stated after taking the following separately disclosable items into account:

- | | | |
|----------------|----------------|-------|
| • Depreciation | Per note above | 3 692 |
|----------------|----------------|-------|

Solution 23.12 Specific loans and general loans

Journals

		Debit	Credit
31 December 20X5			
Interest expense	W1	37 656 250	
Bank/ liability			37 656 250
<i>Interest incurred</i>			
Bank/ liability	W2 (calculation 4)	123 000	
Interest income			123 000
<i>Interest earned on the investment of surplus funds from Bank of Oz</i>			
Head office building: cost	W2	20 654 159	
Interest expense			20 654 159
<i>Capitalisation of interest (W2)</i>			

W1 Interest incurred

Period	Calculations	Opening balance	Interest expense	Closing balance
		C	C	C
Overdraft:	Given	fluctuating	24 000 000	fluctuating
Loan with Bank of Oz				
• 1 July – 30 September	250 000 000 x 10% x 3 / 12	250 000 000	6 250 000	256 250 000
• 1 October – 31 December	256 250 000 x 10% x 3 / 12	256 250 000	6 406 250	262 656 250
Loan with Bank of Wizardry				
• 1 October – 31 December	50 000 000 x 8% x 3 / 12	50 000 000	1 000 000	51 000 000
			<u>37 656 250</u>	

W2 Interest to be capitalised

Date	Accumulated expenses: opening bal A = E ⁽¹⁾	Expenses incurred during period B	Cumulative Expenses C = A + B Or A + B/2	Interest to be capitalised D = C x % x m/12	Accumulated expenses: closing bal E = A + B + D ⁽¹⁾
	C	C	C	C	C
2 January	0	100 000 000	100 000 000	4 000 000 ⁽²⁾	104 000 000
1 April	104 000 000	50 000 000	154 000 000	6 160 000 ⁽³⁾	160 160 000
1 July	160 160 000	80 000 000	240 160 000	6 127 000 ⁽⁴⁾	246 287 000
1 October	246 287 000	200 000 000	446 287 000	4 367 159 ⁽⁵⁾	459 388 480
				<u>20 654 159</u>	

Solution 23.12 continued ...

Calculations:

- 1) The accumulated closing balance includes interest (column C) if and when the interest is capitalised. In this example, the interest was compounded every quarter and therefore the closing balance *includes* the interest at the end of every quarter.
- 2) $100\,000\,000 \times 16\% \times 3/12 = 4\,000\,000$ (no specific loans were available, therefore: expenditure x CR)
- 3) $154\,000\,000 \times 16\% \times 3/12 = 6\,160\,000$ (no specific loans were available, therefore: expenditure x CR)
- 4) 240 160 000 needed (i.e. to clear the overdraft balance of 160 160 000 and pay the 80 000 000 in July):
*Specific borrowings:**

Loan (10%)	250 000 000*	$250\,000\,000 \times 10\% \times 3/12$	6 250 000
Less interest income	(9 840 000)	Surplus: $9\,840\,000 \times 5\% \times 3/12$	(123 000)
	240 160 000		6 127 000
- 5) 446 287 000 ^{NOTE 3}
Specific

Loan (8%)	50 000 000	$50\,000\,000 \times 8\% \times 1/12$ ^{NOTE 1}	333 333
Loan (10%)	250 000 000	$250\,000\,000 \times 10\% \times 1/12$ ^{NOTE}	2 083 333
Less interest income	0	Surplus is zero ^{NOTE 2}	(0)

General

Overdraft (16%)	146 287 000*	$146\,287\,000 \times 16\% \times 1/12$ ⁽⁶⁾	1 950 493
	446 287 000		4 367 159

Notes:

- 1) All criteria for capitalisation were met in October, but not in November or December because construction was completed by 31 October. Therefore only interest for 1 out of the 3 months (October) may be capitalised.
- 2) There was no surplus – all specific borrowings were utilized
- 3) *Imagine!*
 If the costs from 1 October had been *greater* than the specific and general borrowings available (i.e. the borrowings had been completely exhausted), it would have meant that the company must have been using other cash funds available to it to pay the extra costs. E.g. if the cumulative costs as at 1 October were 480 000 000 (and not 446 287 000), then the following would have been the calculation of the interest to be capitalised:

Loan (10%)	250 000 000	$250\,000\,000 \times 10\% \times 1/12$	2 083 333
Loan (8%)	50 000 000	$50\,000\,000 \times 8\% \times 1/12$	333 333
Overdraft (16%)	160 000 000	$160\,000\,000 \times 16\% \times 1/12$	2 133 334
Other cash funds	20 000 000	No interest were surplus cash is used	
	480 000 000		4 550 000

* It is assumed when both general and specific borrowings are available to the construction project that the specific borrowings would be used first. Any further borrowings required (where applicable) would therefore come from the general (and often more expensive) borrowings.

- 6) The capitalisation rate used for the general borrowings was easy (there was only one general borrowing: the overdraft, and both the interest expense and the weighted average balance was provided to you):

$$\frac{\text{Interest expense on the general borrowings}}{\text{WA loan balance of the general borrowings}} = \frac{24\,000\,000}{150\,000\,000} = 16\%$$

Solution 24.1

	Debit	Credit
15 July 20X5		
Vehicles: cost	185 000	
Foreign creditor		185 000
<i>Importation of 16 cartwheels: GBP 20 000 x 9.25 (spot rate on transaction date)</i>		
31 July 20X5		
Vehicles: cost	55 000	
Bank		55 000
<i>Further costs incurred on construction of the ox-wagons</i>		
31 August 20X5		
Foreign creditor	185 000	
Bank		198 000
Foreign exchange loss (expense)	13 000	
<i>Payment of foreign creditor: GBP 20 000 x 9.90 (spot rate on payment date); foreign exchange loss 198 000 – 185 000 = 13 000</i>		
31 December 20X5		
Depreciation	7 000	
Vehicles: accumulated depreciation		7 000
<i>Depreciation of ox wagons from date first available for use: (185 000 + 55 000 – 30 000) / 10 years x 4/12</i>		

Note:

When goods are shipped on a FOB basis (free on board), the risks and rewards of ownership transfer on the date that the goods are loaded onto the ship:

- in this case, it means that the transaction date is 15 July 20X5.

Comment:

This is a basic example that deals with the IMPORT of property plant and equipment, payable in a foreign currency. Depreciation (IAS 16) is also recognised.

Solution 24.2

	Debit	Credit
25 July 20X5		
Inventory	760 000	
Foreign creditor		760 000
<i>Importation of advanced monitoring devices: USD 100 000 x 7.60 (spot rate on transaction date)</i>		
31 December 20X5		
Foreign creditor	50 000	
Foreign exchange gain		50 000
<i>Translation of foreign creditor at year-end: 100 000 x 7.10 (spot rate at year-end) – 760 000</i>		
Cost of inventory expense	608 000	
Inventory		608 000
<i>Cost of goods sold (760 000 x 80%)</i>		
Debtors/ Bank	729 600	
Sales		729 600
<i>Revenue from sale of goods (608 000 x 120%)</i>		
2 February 20X6		
Foreign creditor	710 000	
Bank		690 000
Foreign exchange gain		20 000
<i>Payment of foreign creditor: 100 000 x 6.90 (spot rate on payment date); gain made 710 000 – 690 000</i>		

Note:

When goods are shipped on a CIF basis (customs, insurance and freight), the risks and rewards of ownership transfer on the date that the goods arrive safely at their destination:

- in this case, it means that the transaction date is 25 July 20X5.

Had the transaction been FOB, the risks and rewards of ownership would have transferred on the date that the goods were shipped – in which case the transaction date would have been 15 July 20X5.

Comment:

This is a basic example dealing with the IMPORT of inventory and the subsequent sale thereof (IAS2)

Solution 24.3

	US Dollars	
	Debit	Credit
	\$	
15 July 20X5		
Foreign debtor	110 000	
Sales		110 000
<i>Export of sheets to British company: GBP 50 000 x 2.20 (spot rate on the FOB transaction date) see note 1</i>		
Cost of inventory expense	20 000	
Inventory		20 000
<i>Cost of goods sold (given: 20 000)</i>		
31 October 20X5		
Foreign debtor	22 500	
Foreign exchange gain		22 500
<i>Translation of foreign debtor on payment date: 50 000 x 2.65 (spot rate on payment date) – 110 000</i>		
Bank	66 250	
Foreign debtor		66 250
<i>Receipt of cash from British company (25 000 x 2.65: spot rate on payment date)</i>		
31 December 20X5		
Foreign exchange loss	6 250	
Foreign debtor		6 250
<i>Translation of foreign debtor at year-end: (50 000 - 25 000) x 2.40: spot rate at year-end – (110 000 + 22 500 – 66 250)</i>		
31 January 20X6		
Foreign debtor	12 500	
Foreign exchange gain		12 500
<i>Translation of foreign debtor on payment date: (50 000 - 25 000) x 2.90 (spot rate on payment date) – 60 000 where: (50 000 – 25 000) x 2.40 = 60 000</i>		
Bank	72 500	
Foreign debtor		72 500
<i>Receipt of cash from British company (25 000 x 2.90: spot rate on payment date)</i>		

Note 1:

If the goods had been shipped on a CIF basis (customs, insurance and freight), the risks and rewards of ownership would have transferred on the date that the goods arrive safely at their destination, in which case the transaction date would have been 25 July 20X5.

Comment:

This is an example dealing with the EXPORT of inventory and neither companies are South African. Settlement is also unusual as it takes place in two instalments.

Solution 24.4

	Debit	Credit
1 July 20X5		
Bank	2 000 000	
Long term loan (liability)		2 000 000
<i>Received loan from bank. 30 000 000 / 15 (spot rate on date cash received)</i>		
30 April 20X6		
Finance cost (expense)	142 857	
Interest payable (liability)		142 857
<i>Accrued interest: $P30\,000\,000 \times 8\% \times 10 / 12 = P2\,000\,000$ $P2\,000\,000 / 14$ (average exchange rate over period that interest accrued)</i>		
Foreign exchange loss (expense)	10 989	
Interest payable (liability)		10 989
<i>Translate interest payable at year end: $(P2\,000\,000 / 13)$: spot rate at year end – E142 857</i>		
Foreign exchange loss (expense)	307 692	
Long term loan (liability)		307 692
<i>Translating loan at year end: $(P30\,000\,000 / 13)$: spot rate at year end – E2 000 000</i>		
30 June 20X6		
Finance cost (expense)	28 169	
Interest payable (liability)		28 169
<i>Interest for May and June accruing: $P30\,000\,000 \times 8\% \times 2/12 = P400\,000$ $P400\,000 / 14.2 = 28\,169$</i>		
Long term loan (liability)	238 727	
Foreign exchange gain (income)		238 727
<i>Translating loan at payment date: $(P30\,000\,000 / 14.5) - (2\,000\,000 + 307\,692)$</i>		
Interest payable (liability)	16 498	
Foreign exchange gain (income)		16 498
<i>Translating interest payable at payment date: $(P30\,000\,000 \times 0.08) / 14.5 - (142\,857 + 10\,989 + 28\,169)$</i>		
Interest payable	165 517	
Long term loan	41 379	
Bank		206 896
<i>Payment of capital and interest: E41 379 + E165 517 Capital: $P600\,000 / 14.5 = 41\,379$ Interest: $P2\,400\,000 / 14.5 = 165\,517$</i>		
30 April 20X7		
Finance cost (expense)	138 028	
Interest payable (liability)		138 028
<i>Accrued interest: $(P30\,000\,000 - P600\,000) \times 8\% \times 10 / 12 = P1\,960\,000$ $P1\,960\,000 / 14.2$ (average rate over period that interest accrued)</i>		
Interest payable (liability)	5 596	
Foreign exchange gain (income)		5 596
<i>Translate interest payable at year end: $(P1\,960\,000 / 14.8)$: spot rate at YE – E138 028</i>		
Long term loan (liability)	41 100	
Foreign exchange gain (income)		41 100
<i>Translate loan at year end: $(P30\,000\,000 - 600\,000) / 14.8$: spot rate at YE – E2 027 586 $E2\,027\,586 (P30\,000\,000 - 600\,000) / 14.5$ (loan balance at previous translation date) $E2\,027\,586 = E2\,000\,000 + 307\,692 - 238\,727 - 41\,379$ (prior journal entries)</i>		

Comment:

This is an example dealing with a LOAN RECEIVED by a local company from a foreign financier. Note how interest is translated at average rates, thus creating exchange differences when interest is paid at spot rates.

Solution 24.5

		Debit	Credit
1 July 20X7			
Foreign loan asset	$20\,000 / 0.2$	100 000	
Bank			100 000
<i>Issue of loan</i>			
31 December 20X7			
Foreign loan asset	$(W1: 20\,000 \times 4.24\% \times 6/12) / 0.19$	2 232	
Interest income			2 232
<i>Interest for the year</i>			
Foreign loan asset	$(W1: c/b\ 20\,424 / 0.17) - (capital\ 100\,000 + interest\ 2\,232)$	17 909	
Forex gain (P/L)			17 909
<i>Exchange difference on translation of loan balance at year-end</i>			
30 June 20X8			
Foreign loan asset	$(W1: 20\,000 \times 4.24\% \times 6/12) / 0.21$	2 019	
Interest income			2 019
<i>Interest for 6 months</i>			
Bank	$3\,000 / 0.22$	13 636	
Foreign loan asset			13 636
<i>1st instalment received</i>			
31 December 20X8			
Foreign loan asset	$(W1: 17\,848 \times 4.24\% \times 6/12) / 0.24$	1 577	
Interest income			1 577
<i>Interest for 6 months</i>			
Forex loss (expense)	$(W1: c/b\ 18\,227 / 0.24) - (o/b\ 120\,141 + int\ 2\,019 - rec\ 13\,636 + int\ 1\,577)$	34 155	
Foreign loan asset			34 155
<i>Exchange difference on translation of loan balance at year-end</i>			

Solution 24.5 continued ...

W1: Amortisation Table (extract: for the first 3 years)						
		Effective Interest (4.24%) AUS \$	Instalment Received AUS \$	Balance AUS \$	Rate	Balance Rand
Year 1	1 July 20X7			20 000	0.20	100 000
Year 1: 1 st 6 months	31 December 20X7	424	0	20 424	0.17	120 141
Year 1: 2 nd 6 months	30 June 20X8	424	(3 000)	17 848	0.22	81 127
Year 2: 1 st 6 months	31 December 20X8	379		18 227	0.24	75 946
Year 2: 2 nd 6 months	30 June 20X9	378	(3 000)	15 605	(a)	(a)
Year 3: 1 st 6 months	31 December 20X9	424		15 936	(a)	(a)
Year 3: 2 nd 6 months	30 June 20X9	424	(3 000)	13 267	(a)	(a)

(a) the loan balances could not be calculated in Rands since the relevant exchange rates were not given.

The table (in Aus Dollars) could also have been done on an annual basis if preferred (the complete table for the entire 8 years is shown for your interest):

W1: ALTERNATIVE Amortisation Table			
Year of the loan agreement	Interest @ 4.24% AUS \$	Instalment AUS \$	Balance AUS \$
			20 000
Year 1 (to 30 June 20X8)	848	(3 000)	17 848
Year 2 (to 30 June 20X9)	757	(3 000)	15 605
Year 3 (to 30 June 20Y0)	662	(3 000)	13 267
Year 4 (to 30 June 20Y1)	563	(3 000)	10 830
Year 5 (to 30 June 20Y2)	459	(3 000)	8 289
Year 6 (to 30 June 20Y3)	351	(3 000)	5 640
Year 7 (to 30 June 20Y4)	239	(3 000)	2 879
Year 8 (to 30 June 20Y5)	122	(3 000)	1
	<u>4 001</u>	<u>(24 000)</u>	

Solution 24.6

a)

	<i>Calculations</i>	<u>Debit/ (Credit)</u>
30 September 20X3: transaction date		
Plant: cost	$(200\,000 \times 8.05)$	1 610 000
Foreign creditor		(1 610 000)
<i>Acquisition of plant</i>		
<hr/>		
31 December 20X3: year-end		
Forex loss	$200\,000 \times (8.15 - 8.05)$	20 000
Foreign creditor		(20 000)
<i>Restatement of creditor at year end</i>		
<hr/>		
Depreciation	$1\,610\,000 / 10 \times 1/12$	13 417
Plant: accumulated depreciation		(13 417)
<i>Depreciation of plant</i>		
<hr/>		
29 Feb 20X4: settlement date		
Forex loss	$200\,000 \times (8.20 - 8.15)$	10 000
Foreign creditor		(10 000)
<i>Restatement of creditor on settlement date</i>		
<hr/>		
Foreign creditor	$200\,000 \times 8.20$	1 640 000
Bank		(1 640 000)
<i>Settlement of the creditor</i>		
<hr/>		
31 December 20X4: year-end		
Depreciation	$1\,610\,000 / 10$	161 000
Plant: accumulated depreciation		(161 000)
<i>Depreciation of plant</i>		
<hr/>		

Spot:	8.05	8.15	8.20
	TD 30 Sept	Y/E 31 Dec	Settle 29 Feb
	_____	_____	_____

Solution 24.6 continued ...

b)

		Debit/ (Credit)
30 September 20X3: transaction date		
Plant: cost	(200 000 x 8.05)	1 610 000
Foreign creditor		(1 610 000)
<i>Acquisition of plant</i>		
31 December 20X3: year-end		
Forex loss	(200 000 x 8.15 – 200 000 x 8.05)	20 000
Foreign creditor		(20 000)
<i>Restatement of the foreign creditor at year end</i>		
FEC asset	(200 000 x 8.40 – 200 000 x 8.10)	60 000
Forex gain: FEC		(60 000)
<i>Forex gain on the fair value hedge</i>		
Depreciation	1 610 000 / 10 x 1/12	13 417
Plant: accumulated depreciation		(13 417)
<i>Depreciation of plant</i>		
29 February 20X4: settlement date		
Forex loss	(200 000 x 8.20 – 200 000 x 8.15)	10 000
Foreign creditor		(10 000)
<i>Restatement of the creditor at settlement date</i>		
FEC loss	(200 000 x 8.20 – 200 000 x 8.40)	40 000
FEC asset		(40 000)
<i>Forex loss on the fair value hedge</i>		
Foreign creditor	(Spot rate: 8.20 x 200 000)	1 640 000
FEC asset	(Balance: 60 000 – 40 000)	(20 000)
Bank	(FEC rate: 8.10 x 200 000)	(1 620 000)
<i>Settlement of the foreign creditor</i>		
31 December 20X4: year-end		
Depreciation	1 610 000 / 10	161 000
Plant: accumulated depreciation		(161 000)
<i>Depreciation of plant</i>		

Spot:	8.05	8.15	8.20
	FEC TD 30 Sept	YE 31 Dec	Settle 29 Feb
	8.10	8.40	N/A

FEC – Forward Exchange Contract

Comment:

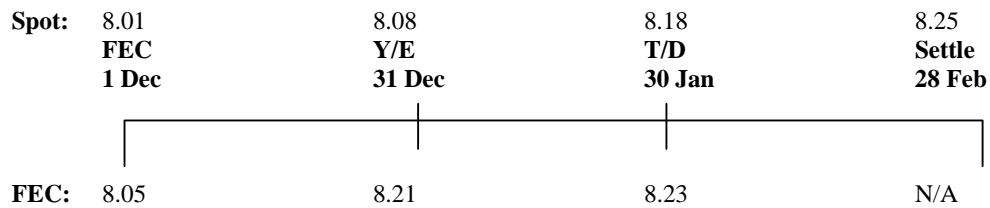
This question tests import of plant (a) without an FEC and then (b) with an FEC. Note the additional journals for the FEC and how it hedges forex movements in spot rates.

Solution 24.7

		Basis adjust (a) Debit/ (Credit)	Reclassification (b) Debit/ (Credit)
1 Dec 20X4: FEC entered into	<i>Calculations</i>		
<i>No entries</i>			
31 Dec 20X4: year-end			
FEC asset	$(150\,000 \times 8.21 - 150\,000 \times 8.05)$	24 000	24 000
FEC equity (OCI)		(24 000)	(24 000)
<i>Gain on the cash flow hedge of a forecast transaction recognised as equity (disclosed as OCI)</i>			
30 Jan 20X5: transaction date			
FEC asset	$(150\,000 \times 8.23 - 150\,000 \times 8.21)$	3 000	3 000
FEC equity (OCI)		(3 000)	(3 000)
<i>Gain on the cash flow hedge of a forecast transaction recognised as equity (disclosed as OCI)</i>			
Inventory	$8.18 \times 150\,000$	1 227 000	1 227 000
Foreign creditor		(1 227 000)	(1 227 000)
<i>Import of the inventory</i>			
FEC equity (OCI)	$24\,000 + 3\,000$	27 000	N/A
Inventory		(27 000)	N/A
<i>Basis adjustment of the equity gain: OCI to non-financial asset</i>			
28 Feb 20X5: payment date			
FEC asset	$(150\,000 \times 8.25 - 150\,000 \times 8.23)$	3 000	3 000
Forex gain (P/L)		(3 000)	(3 000)
<i>Gain on the Fair Value hedge of a past transaction take directly to profit or loss</i>			
Forex loss (P/L)	$(150\,000 \times 8.25 - 150\,000 \times 8.18)$	10 500	10 500
Foreign creditor		(10 500)	(10 500)
<i>Restating the foreign creditor at spot rate on settlement date</i>			
Foreign creditor	$8.25 \times 150\,000$	1 237 500	1 237 500
Bank	$8.05 \times 150\,000$	(1 207 500)	(1 207 500)
FEC asset	$24\,000 + 3\,000 + 3\,000$	(30 000)	(30 000)
<i>Settlement of the foreign creditor</i>			
30 June 20X5: first sale of inventory			
Debtor		4 000 000	4 000 000
Sales		(4 000 000)	(4 000 000)
COS	$A: (1\,227\,000 - 27\,000) \times 50\%$	600 000	613 500
Inventory	$B: 1\,227\,000 \times 50\%$	(600 000)	(613 500)
<i>Sale of the inventory</i>			
FEC equity (OCI)		N/A	13 500
Forex gain	$(24\,000 + 3\,000) \times 50\%$	N/A	(13 500)
<i>Reclassification adjustment: OCI (deferred gain on FEC in equity) to P/L when underlying asset affects profit or loss: 50% of inventory sold</i>			
31 July 20X5: second sale of inventory			
Debtor		2 900 000	2 900 000
Sales		(2 900 000)	(2 900 000)
Cost of sales	$A: (1\,227\,000 - 27\,000) \times 50\%$	600 000	613 500
Inventory	$B: 1\,227\,000 \times 50\%$	(600 000)	(613 500)
<i>Sale of inventory</i>			
FEC equity (OCI)		N/A	13 500
Forex gain (P/L)	$(24\,000 + 3\,000) \times 50\%$	N/A	(13 500)
<i>Reclassification adjustment: OCI (deferred gain on FEC in equity) to P/L when underlying asset affects profit or loss: 50% of inventory sold</i>			

Solution 24.7 continued ...

A timeline that you may find useful:



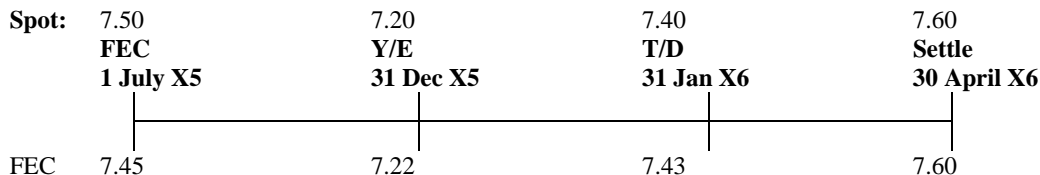
Comment:

This question shows the difference in method for accounting for cash flow hedges on FECs. The ultimate effect on profit or loss is the same amount under both the basis adjustment and reclassification methods.

Solution 24.8

		Debit	Credit
31 December 20X5: year-end			
FEC equity (OCI)	$500\,000 \times (7.22 - 7.45)$	115 000	
FEC liability			115 000
<i>Pre-transaction FEC movement from date FEC entered into to year-end</i>			
31 January 20X6: transaction date			
FEC liability	$500\,000 \times (7.43 - 7.22)$	105 000	
FEC equity (OCI)			105 000
<i>Pre-transaction FEC movement from year-end to transaction date</i>			
Equipment: cost	$500\,000 \times 7.40$	3 700 000	
Foreign creditor			3 700 000
<i>Acquisition of computer equipment at spot rate on transaction date</i>			
Equipment: cost		10 000	
FEC equity (OCI)	$115\,000 - 105\,000$		10 000
<i>Basis adjustment on transaction date: OCI to non-financial asset</i>			
28 February 20X6: payment of installation and other costs			
Equipment: cost	$100\,000 \times 8.10$	810 000	
Bank			810 000
<i>Capitalisation of installation fee (IAS 16)</i>			
Equipment: cost		20 000	
Bank			20 000
<i>Capitalise cost necessarily incurred to bring asset to usable condition (hotel)</i>			
30 April 20X6: payment date and FEC expiry			
FEC liability	$115\,000 - 105\,000$	10 000	
FEC asset	$85\,000 - 10\,000$	75 000	
FEC gain (P/L)	$500\,000 \times (7.60 - 7.43)$		85 000
<i>FEC gain between transaction date and settlement date</i>			
Forex loss (P/L)	$500\,000 \times (7.60 - 7.40)$	100 000	
Foreign creditor			100 000
<i>Translation of creditor on payment date</i>			
Foreign creditor	$(3\,700\,000 + 100\,000)$	3 800 000	
FEC asset	(above)		75 000
Bank	$(500\,000 \times 7.45)$		3 725 000
<i>Settlement of foreign creditor</i>			
31 December 20X6: year-end			
Depreciation	$(3\,700\,000 + 810\,000 + 10\,000 + 20\,000) / 5 \text{ years} \times 10 / 12$	756 667	
Equipment: accum. depreciation			756 667
<i>Depreciation charge for the year</i>			

A timeline that you may find useful:

**Comment:**

This question integrates foreign exchange, FEC's and accounting for property plant and equipment. Note the effects of the basis adjustment method and other directly attributable costs on the cost of the equipment and subsequent depreciation.

Solution 24.9

		(a): CFH Debit (Credit)	(b): FVH Debit (Credit)
30 November X4: date FEC entered into			
No entries			
31 December X4: year-end			
FEC asset $(450\,000 \times 6.21 - 450\,000 \times 6.12)$		40 500	40 500
FEC equity (OCI)		(40 500)	(40 500)
<i>Gain on the cash flow hedge of a forecast transaction recognised in equity (disclosed as OCI)</i>			
31 January X5: firm commitment			
FEC equity (OCI) $(450\,000 \times 6.05 - 450\,000 \times 6.21)$		72 000	72 000
FEC asset		(40 500)	(40 500)
FEC liability		(31 500)	(31 500)
<i>Loss on the cash flow hedge of a forecast transaction recognised in equity (disclosed as OCI)</i>			
14 February X5: transaction date			
FEC loss (P/L) $(450\,000 \times 6.01 - 450\,000 \times 6.05)$		0	18 000
FEC liability		0	(18 000)
<i>Loss on the hedge of a firm commitment recognised in profit or loss</i>			
Firm commitment asset $(450\,000 \times 5.99 - 450\,000 \times 6.00)$		0	4 500
Forex gain (P/L)		0	(4 500)
<i>Gain on the firm commitment recognised in profit or loss</i>			
FEC equity (OCI) $(450\,000 \times 6.01 - 450\,000 \times 6.05)$		18 000	0
FEC liability		(18 000)	0
<i>Loss on the cash flow hedge of a forecast transaction recognised in equity (disclosed as OCI)</i>			
Equipment: cost $5.99 \times 450\,000$		2 695 500	2 695 500
Foreign creditor		(2 695 500)	(2 695 500)
<i>Import of the equipment</i>			
Equipment: cost		0	4 500
Firm commitment asset		0	(4 500)
<i>Firm commitment transferred to the asset base on transaction date.</i>			
31 May X5: payment date			
Forex loss (P/L) $(450\,000 \times 5.96 - 450\,000 \times 6.01)$		22 500	22 500
FEC liability		(22 500)	(22 500)
<i>Loss on the fair value hedge of a past transaction recognised in profit & loss</i>			
Foreign creditor $(450\,000 \times 5.96 - 450\,000 \times 5.99)$		13 500	13 500
Forex gain (P/L)		(13 500)	(13 500)
<i>Restating the foreign creditor at spot rate on settlement date</i>			
Foreign creditor $5.96 \times 450\,000$		2 682 000	2 682 000
Bank $6.12 \times 450\,000$		(2 754 000)	(2 754 000)
FEC liability $(A: 40\,500 - L (40\,000 + 31\,500 + 18\,000 + 22\,500))$		72 000	72 000
<i>Settlement of the foreign creditor</i>			
31 December X5: year-end			
Depreciation $A: (2\,695\,500)/10\text{yrs} \times 10.5/12\text{ months}$		235 856	236 250
Equipment: accum. depr. $B: (2\,695\,500 + 4\,500)/10\text{ yrs} \times 10.5/12$		(235 856)	(236 250)
<i>Depreciation of equipment</i>			
FEC loss (P/L) $A: 49\,500/10 \times 10.5/12$		4 331	2 756
FEC equity (OCI) $B: 31\,500/10 \times 10.5/12$		(4 331)	(2 756)
<i>Reclassification adjustment of the FEC loss in equity: OCI to profit and loss (this transfer from OCI to P/L happens over the useful life of the equipment)</i>			

Solution 24.9 continued ...

The balance sitting in equity just before reclassification on 31 December 20X5 can be checked as follows:

(a)

firm commitment treated as a cash flow hedge (i.e. the entire pre-transaction period is treated as a CFH):

- $(6.01 - 6.12) \times 450\,000 = 49\,500$ (deferred loss, therefore a debit equity balance)

(b)

firm commitment treated as a fair value hedge (pre-transaction period to firm commitment date is still a cash flow hedge):

- $(6.05 - 6.12) \times 450\,000 = 31\,500$ (deferred loss, therefore a debit equity balance)

A timeline that you may find useful:

Spot:	6.10	6.19	6.00	5.99	5.96
	FEC	YE	Firm C	TD	Settlement
	30 Nov X4	31 Dec X4	31 Jan X5	14 Feb X5	31 May X5
FEC:	6.12	6.21	6.05	6.01	N/A

Comment:

This question compares the alternative accounting treatments of a firm commitment. Note how a firm commitment asset or a liability is only created under the fair value hedge option (FVH) owing to changes in FEC rates. If the cash flow hedge option (CFH) is chosen, the entire pre-transaction date period is treated as a normal cash flow hedge with gains/ losses taken to other comprehensive income (equity).

Solution 24.10

		Debit	Credit
1 October 20X7			
No entry			
31 December 20X7			
FEC Equity (OCI)	$(200\,000 \times (12.30 - 11.20))$	220 000	
FEC Liability			220 000
<i>Gain or loss on FEC at year-end</i>			
31 January 20X8			
Foreign Debtor	$(200\,000 \times 13.10)$	2 620 000	
Revenue			2 620 000
<i>Sale of machine</i>			
Cost of Sales	(Given)	1 500 000	
Inventory			1 500 000
<i>Cost of goods sold</i>			
FEC Equity (OCI)	$(200\,000 \times (12.90 - 12.30))$	120 000	
FEC Liability			120 000
<i>Gain or loss on FEC on transaction date</i>			
Revenue	$(220\,000 + 120\,000)$	340 000	
FEC Equity (OCI)			340 000
<i>Reversal of CFH equity:</i>			
28 February 20X8			
Forex Loss (P/L)	$(200\,000 \times (11.90 - 13.10))$	240 000	
Foreign Debtor			240 000
<i>Translation of debtor on settlement date</i>			
FEC Liability	$(200\,000 \times (12.90 - 11.90))$	200 000	
Forex Gain (P/L)			200 000
<i>Gain or loss on FEC on settlement date</i>			
FEC Liability	$(220\,000 + 120\,000 - 200\,000)$	140 000	
Bank	$(200\,000 \times 11.20)$	2 240 000	
Foreign Debtor	$(200\,000 \times 11.90)$		2 380 000
<i>Settlement received from debtor</i>			

Solution 24.11

a) Journals: 20X8 and 20X9

		Debit	Credit
31 March 20X8			
FEC asset	$20\,000 \times (9.34 - 9.15)$	3 800	
FEC equity (OCI)			3 800
<i>Measurement of FEC asset on transaction date</i>			
Vehicles: cost	$20\,000 \times 9.17$	183 400	
Foreign creditor			183 400
<i>Purchase of vehicle</i>			
30 June 20X8			
Forex loss: FEC (P/L)	$20\,000 \times (9.21 - 9.34)$	2 600	
FEC asset			2 600
<i>Measurement of FEC asset at year-end</i>			
Foreign creditor	$20\,000 \times (9.07 - 9.17)$	2 000	
Forex gain: creditor (P/L)			2 000
<i>Translation of creditors at year-end</i>			
Depreciation - vehicles	$(183\,400 - 0) / 5\text{yrs} \times 1/12$	3 057	
Vehicles: accumulated depreciation			3 057
<i>Depreciation of vehicles from date first available for use (1 June)</i>			
FEC equity (OCI)	$3\,800 / 5\text{yrs} \times 1/12$	63	
Forex gain: FEC (P/L)			63
<i>Reclassification adjustment (one month of asset's life used up)</i>			
31 July 20X8			
Forex loss: FEC (P/L)	$20\,000 \times (9.21 - 8.83)$	7 600	
FEC asset/liability			7 600
<i>Measurement of FEC asset</i>			
Foreign creditor	$20\,000 \times (9.07 - 8.83)$	4 800	
Forex gain: creditor (P/L)			4 800
<i>Translation of foreign creditor on transaction date</i>			
FEC liability	$3\,800 - 2\,600 - 7\,600$	6 400	
Foreign creditor	$20\,000 \times 8.83$	176 600	
Bank	$20\,000 \times 9.15$		183 000
<i>Settlement of creditor</i>			
30 June 20X9			
Depreciation – vehicles	$(183\,400 - 0) / 5\text{ yrs}$	36 680	
Vehicles: accumulated depreciation			36 680
<i>Depreciation of vehicles:</i>			
FEC Equity (OCI)	$3\,800 / 5\text{ yrs}$	760	
Forex gain: FEC(P/L)			760
<i>Reclassification adjustment (one year of asset's life used up)</i>			

Solution 24.11

b) Note disclosure

KANGA LTD
NOTES TO FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 JUNE 20X8

		20X8
		C
7. Cash flow hedge reserve		
Gains taken to equity		3 800
Transferred to deferred tax	$3\,800 \times 30\%$	(1 140)
Reclassified to profit/loss		(63)
Transferred from deferred tax	$63 \times 30\%$	<u>19</u>

8. Profit before tax

Profit before tax is stated after taking the following into account:

Income:

- | | |
|--|-------|
| • Foreign exchange gain on creditors | 2 000 |
| • FEC gain (reclassification adjustment) | 63 |

Expenses:

- | | |
|----------------------------|-------|
| • FEC loss | 2 600 |
| • Depreciation on vehicles | |

Solution 24.12

Journals

		Debit	Credit
1 February 20X8 (date FEC entered into)			
No journal entry			
10 February 20X8 (transaction date)			
Plant: cost	$1\,000\,000 \times 5.80$	5 800 000	
Foreign creditor			5 800 000
<i>Purchase of plant from a foreign creditor</i>			
<hr/>			
FEC asset	$1\,000\,000 \times (6.00 - 5.50)$	500 000	
Plant: cost			500 000
<i>Recognition of FEC on transaction date (CFH – basis adjustment)</i>			
<hr/>			
28 February 20X8 (year-end)			
Foreign exchange loss	$1\,000\,000 \times (7.00 - 5.80)$	1 200 000	
Foreign creditor			1 200 000
<i>Re-measurement of foreign creditor at year-end</i>			
<hr/>			
FEC asset	$1\,000\,000 \times (7.30 - 6.00)$	1 300 000	
Forex gain: FEC (P/L)			1 300 000
<i>Re-measurement of FEC at year-end</i>			
<hr/>			
31 March 20X8 (payment date)			
Foreign exchange loss	$1\,000\,000 \times (8.80 - 7.00)$	1 800 000	
Foreign creditor			1 800 000
<i>Re-measurement of foreign creditor on payment date</i>			
<hr/>			
FEC asset	$1\,000\,000 \times (8.80 - 7.30)$	1 500 000	
Forex gain: FEC (P/L)			1 500 000
<i>Re-measurement of FEC on payment date</i>			
<hr/>			
Foreign creditor	$1\,000\,000 \times 8.80$	8 800 000	
FEC asset	$500\,000 + 1\,300\,000 + 1\,500\,000$		3 300 000
Bank	$1\,000\,000 \times 5.50$		5 500 000
<i>Settlement of creditor</i>			
<hr/>			
28 February 20X9 (year-end)			
Depreciation - plant	$(5\,800\,000 - 300\,000 - RV: 0) / 10 \times 12/12$	550 000	
Plant: accum. depreciation			550 000
<i>Re-measurement of foreign creditor on payment date</i>			
<hr/>			

Solution 25.1

a)

		C
Drivers	$123\,000^1 / (365 \times 5 / 7)^2 \times 4^3 \times (500^4 - 50^5)$	849 205
Managers	$212\,000^1 / (365 \times 5 / 7)^2 \times 3^3 \times (50 - 3^5)$	114 654
Directors	$500\,000^1 / (365 \times 5 / 7)^2 \times 2^3 \times (10^4 - 0^5)$	38 356
		<u>1 002 215</u>

¹ Annual salary² Number of working days in a year³ Expected leave days taken⁴ Number of employees at 31 December 20X6⁵ Number of employees expected to leave

b)

	Debit	Credit
31 December 20X6		
Employee benefit expense	1 002 215	
Provision for leave pay		1 002 215
<i>Provision for leave expected to be taken in 20X7</i>		

Solution 25.2

31 December 20X6	Debit	Credit
Employee benefit expense: current service cost Defined benefit plan: plan obligation <i>Current service cost</i>	100 000	100 000
Defined benefit plan: plan asset Bank <i>Contributions paid during the year</i>	200 000	200 000
Defined benefit plan: plan asset Employee benefit expense: expected return on assets <i>Return on plan assets (300 000 x 10%)</i>	30 000	30 000
Employee benefit expense: interest cost Defined benefit plan: plan obligation <i>Finance cost on plan obligation (400 000 x 15%)</i>	60 000	60 000
Defined benefit plan: plan obligation Defined benefit plan: plan asset <i>Benefits paid during the year</i>	100 000	100 000
Defined benefit plan: unrecognised actuarial loss Defined benefit plan: plan asset <i>Unrecognised loss in the plan assets (400 – 300 + 100 – 200 – 30)</i>	30 000	30 000
Defined benefit plan: unrecognised actuarial loss Defined benefit plan: plan obligation <i>Unrecognised loss in the plan obligation (500 – 400 – 100 – 60 + 100)</i>	40 000	40 000
Employee benefit expense: actuarial loss Defined benefit plan: unrecognised actuarial loss <i>Realising amount above the corridor</i> <i>10% of the greater of</i> <ul style="list-style-type: none"> • Plan assets C300 000, or • Plan obligation C400 000 <i>The corridor is C40 000 (C400 000 x 10%)</i> <i>The difference C15 000 (C55 000 – C40 000), is recognised over the remaining working life of employees of 15 years (C15 000 / 15)</i>	1 000	1 000

Solution 25.3

a)

		C
Actual gross profit	$(1\,000\,000 \times 2)$	2 000 000
Target gross profit		1 000 000
Excess		<u>1 000 000</u>
To be distributed	$(1\,000\,000 \times 20\%)$	200 000
Representatives who left in 20X3	$(200\,000 \times 10\%)$	(20 000)
Representatives expected to leave in 20X4	$(200\,000 \times 10\%)$	(20 000)
Provision		<u><u>160 000</u></u>

OR: $(2\,000\,000 - 1\,000\,000) \times 0.2 \times (40 - 4 - 4) / 40 = 160\,000$

b)

31 December 20X3

	Debit	Credit
Employee benefit expense: bonus	160 000	
Provision for bonuses		160 000
<i>Recording the provision for bonuses</i>		

Solution 25.4**W1: Leave pay**

$$\begin{aligned}\text{Cost per day} &= \frac{\text{C}250\,000}{250 \text{ days}} \\ &= \text{C}1\,000 \text{ per day}\end{aligned}$$

Total leave earned and unused in 20X6	320	days
Leave earned in 20X6 that will not be taken in the future (40 days – 20 days)	(20)	days
Leave to be taken in the future	300	days

Charged to statement of comprehensive income (300 days x C1 000)	<u>C300 000</u>
--	-----------------

Adjustment to 20X5 provision:

Leave earned in prior years that will not be taken in the future	(20) days
--	-----------

Reduction in provision (reduces expense) (20 days x C1 000)	<u>C(20 000)</u>
---	------------------

Net adjustment (credit provision; debit expense)	<u>C280 000</u>
--	-----------------

$$\text{OR: } 250\,000 / 250 \times (320 - 40) = 280\,000$$

W2: Bonuses**C**

To be distributed (5 000 000 x 10%)	500 000
5 new employees (500 000 x / 80 x 5)	(31 250)
Charge to the statement of comprehensive income (500 000 x / 80 x 75)	<u>468 750</u>

W3: Defined benefit pension plan**C**

Current service cost	250 000
Return on plan assets	(50 000)
Finance charges on plan obligation	90 000
Actuarial gain now realised	(10 000)
Charged to statement of comprehensive income	<u>280 000</u>

W4: Total charge to statement of comprehensive income**C**

Leave pay	300 000
Leave pay (reduction in 20X5 provision)	(20 000)
Bonuses	468 750
Defined benefit pension plan	280 000
	<u>1 028 750</u>

Solution 25.5

Scenario 1

Salary	$C100\,000 \times 120\%$	C120 000
Working days per annum	$365 / 7 \times 5 \text{ days}$	260.714 days
Daily salary	$C120\,000 / 260.7 \text{ days}$	C460.274
Number of employees	Given	50 000
Days provided for		16
- days brought forward from 20X5		10
- days earned in 20X6		20
- less days used in 20X6		(14)
Total provision requires		<u>*C368 219 200</u>

* This provision includes rounding adjustments.

Scenario 2

Salary	$C100\,000 \times 120\%$	C120 000
Working days per annum	$365 / 7 \times 5 \text{ days}$	260.714 days
Daily salary	$C120\,000 / 260.7 \text{ days}$	C460.274
Number of employees	Given	50 000
Days provided for		3
Unused leave at 31/12/20X5 not taken in 20X6 will expire on 31/12/20X6. Thus we only provide for unused leave from 20X6 (20 – 9), but because the leave is non-vesting we only provide for those 20X6 days that are expected to be used in 20X7 (3)		
Total provision requires		<u>*C69 041 100</u>

* This provision includes rounding adjustments.

Scenario 3

The leave pay is non-accumulating and non-vesting and thus no provision is made. Unused leave is not owed (either as days or as cash) to the employee.

Solution 25.6

a) Pension fund subsidiary ledger accounts

Defined benefit plan: Assets						
1/1	O/ balance	<i>Given</i>	6 000 000	30/6	Plan obligation	<i>Given</i> 1 100 000
30/6	EB expense	$(6m \times 12\% \times 6/12)$	360 000	31/12	Unrecognised actuarial gains	<i>Balancing</i> 135 600
30/6	Bank	<i>Given</i>	1 000 000			
31/12	EB expense	$(o/b\ 6m + return\ 0.36m + contr\ 1m - benefits\ 1.1m) \times 12\% \times 6/12$	375 600	31/12	C/ balance c/f	<i>Given</i> 6 500 000
			<u>7 735 600</u>			<u>7 735 600</u>
31/12	C/ balance b/f		6 500 000			
Defined benefit plan: Obligation						
30/6	Plan assets	<i>Given</i>	1 100 000	1/1	O/ balance	<i>Given</i> 7 000 000
31/12	Unrecognised actuarial gains	<i>Balancing</i>	500 000	30/6	EB expense	$(7m \times 10\% \times 6/12)$ 350 000
				30/6	EB expense	$(1.5m \times 6/12)$ 750 000
				31/12	EB expense	$(o/b\ 7m + int\ 0.35m + current\ .75m - oblig\ 1.1m) \times 10\% \times 6/12$ 350 000
31/12	C/ balance c/f	<i>Given</i>	7 600 000	31/12	EB expense	$(1.5m \times 6/12)$ 750 000
			<u>9 200 000</u>			<u>9 200 000</u>
				31/12	C/ balance b/f	7 600 000
Defined benefit plan: Unrecognised actuarial gains						
31/12	Plan asset	<i>Contra entry</i>	135 600	1/1	O/ balance	<i>Given</i> 750 000
31/12	EB expense	<i>WI</i>	5 000	31/12	Plan oblig.	<i>Contra entry</i> 500 000
31/12	C/ balance c/f	<i>Balancing</i>	1 109 400			
			<u>1 250 000</u>			<u>1 250 000</u>
				31/12	C/ balance b/f	<i>Balancing</i> 1 109 400
Defined benefit plan: Past service costs						
1/1	O/ balance	<i>Given</i>	400 000	31/12	EB expense	$(0.4m \times 1 / 4\ yrs)$ 100 000
			<u>400 000</u>	31/12	C/ balance	<i>Balancing</i> 300 000
						<u>400 000</u>
31/12	C/ balance	<i>Balancing</i>	300 000			
Employee benefit expense						
30/6	Plan oblig.	<i>Contra entry</i>	350 000	30/6	Plan assets	<i>Contra entry</i> 360 000
30/6	Plan oblig.	<i>Contra entry</i>	750 000	31/12	Plan assets	<i>Contra entry</i> 375 600
31/12	Plan oblig.	<i>Contra entry</i>	350 000	31/12	Unrecognised actuarial gains	<i>Contra entry</i> 5 000
31/12	Plan oblig.	<i>Contra entry</i>	750 000			
31/12	Past service costs	<i>Contra entry</i>	100 000	Profit and loss		1 559 400
			<u>2 300 000</u>			<u>2 300 000</u>

Solution 25.6 continued ...

b) General ledger accounts

Pension fund liability			
30/06	Bank	<i>Given</i>	1 000 000
31/12	C/ balance c/f	W2	1 909 400
			<u>2 909 400</u>
1/1	O/ balance	W2	1 350 000
31/12	EB expense	<i>See part (a)</i>	1 559 400
			<u>2 909 400</u>
31/12	C/ balance b/f		1 909 400

Workings:

W1: IAS 19: corridor approach

<i>W1.1: Actuarial gain or loss to be recognised: total</i>		C
Net cumulative actuarial gain at the beginning of the year		750 000
The corridor: greater of:		700 000
• 10% of the plan obligation at the beginning of 20X6	$10\% \times 7\,000\,000$	700 000
• 10% of the plan assets at the beginning of 20X6	$10\% \times 6\,000\,000$	600 000
Excess over the corridor: total gain/ (loss) to be recognised		<u>50 000</u>

W1.2: Actuarial gain or loss to be recognised: in the current year (amortised portion)

$$\begin{aligned}
 &= \frac{\text{Total gain or loss to be recognised (calculation 1)}}{\text{Average expected remaining working life of the employees}} \\
 &= \frac{50\,000}{10 \text{ years}} \\
 &= 5\,000
 \end{aligned}$$

W2: Calculation of opening balance and closing balance of pension fund liability:

Opening balance:

Plan obligation	(7 000 000)
Plan assets	6 000 000
Unrecognised actuarial gains	(750 000)
Past service costs	400 000
	<u>(1 350 000)</u>

Closing balance:

Plan obligation	(7 600 000)
Plan assets	6 500 000
Unrecognised actuarial gains	(1 109 400)
Past service costs	300 000
	<u>(1 909 400)</u>

Solution 25.6 continued ...

c) Disclosure

RYAN LIMITED
NOTES TO THE FINANCIAL STATEMENTS (EXTRACTS)
FOR THE YEAR ENDED 31 DECEMBER 20X6

2. Accounting policies*Defined benefit plan*

Actuarial gains and losses arising from the company's defined benefit plan are recognised in income to the extent that they exceed IAS 19 corridor limits, over the average remaining working life of the employees. The corridor limits apply to the cumulative unrecognised actuarial gains and losses at the end of the previous reporting period to the extent that they exceed the greater of:

- 10% of the present value of the gross defined obligation at that date, and
- 10% of the fair value of any plan asset at that date

4. Pension fund liability

	20X6
	C
Present value of liability	7 600 000
Fair value of plan assets	(6 500 000)
Net plan obligation	<u>1 100 000</u>
Unrecognised actuarial gains	1 109 400
Past service costs	(300 000)
Pension liability	<u>1 909 400</u>
<i>Reconciliation: plan obligation</i>	
Opening balance of obligation	7 000 000
Interest cost	700 000
Current service cost	1 500 000
Past service cost	0
Actuarial losses / (gains)	(500 000)
Benefits paid	<u>(1 100 000)</u>
Closing balance of net plan liability	<u>7 600 000</u>
<i>Reconciliation: plan assets</i>	
Opening balance of assets	6 000 000
Expected return on assets	735 600
Contributions to fund	1 000 000
Actuarial (losses) / gains	(135 600)
Benefits paid	<u>(1 100 000)</u>
Closing balance of net plan liability	<u>6 500 000</u>
<i>Expected return on plan asset:</i>	<i>360 000 + 375 600</i>
Actuarial loss on plan asset	<u>(135 600)</u>
Actual return on plan asset	<u>600 000</u>

The principal actuarial assumptions applied in the determination of the fair values, expressed as weighted averages, include

Discount rate	10%
Expected return on plan assets	12%
Expected future salary increases	xx%
Expected proportion to take early retirement	xx%
Proportion of employee covered by groups retirement benefit plans	xx%

Solution 25.6 continued ...

c) Disclosure continued ...

RYAN LIMITED
NOTES TO THE FINANCIAL STATEMENTS (EXTRACTS)continued ...
FOR THE YEAR ENDED 31 DECEMBER 20X6

8. Employee benefit expense		20X6
		C
Current service costs	<i>Given</i>	1 500 000
Interest expense	$(7m \times 12\% \times 6 / 12) +$ $(7m + 0.35m + .75m - 1.1m) \times 10\% \times 6 / 12$	700 000
Expected return on plan assets	$(6m \times 12\% \times 6 / 12) +$ $(6m + 0.36m + 1m - 1.1m) \times 12\% \times 6 / 12$	(735 600)
Recognised actuarial gain	<i>W1</i>	(5 000)
Past service cost recognised	$400\,000 / 4 \text{ years} \times 1 \text{ year}$	100 000
Pension funds expense		<u>1 559 400</u>

Solution 25.7

a)

Employee benefit expense		20X6
		C
Current service costs	<i>Given</i>	295 000
Interest expense	$700\,000 \times 11.5\%$	80 500
Expected return on plan assets	$1\,000\,000 \times 12\%$	(120 000)
Recognised actuarial (gain)/loss	<i>W3</i>	39 500
Past service cost (benefits reduced)	$(150\,000 / 3)$	(50 000)
Pension funds expense		<u>245 000</u>

W1: Plan obligation		C
Opening balance	<i>Given</i>	700 000
Current service cost	<i>Given</i>	295 000
Interest on obligation	$700\,000 \times 11.5\%$	80 500
Past service cost		0
Benefits paid	<i>Given</i>	(450 000)
<i>Present value of obligation at ye expected to be</i>		<u>625 500</u>
Actuarial loss on obligation	<i>Balancing</i>	169 500
<i>Present value of obligation at year-end is</i>	<i>Given</i>	<u>795 000</u>

W2: Plan assets		C
Opening balance at fair value	<i>Given</i>	1 000 000
Expected return on plan assets	$1\,000\,000 \times 12\%$	120 000
Contributions to fund	<i>Given</i>	300 000
Benefits paid	<i>Given</i>	(450 000)
<i>Fair value of plan assets at yr-end expected to be</i>		<u>970 000</u>
Actuarial Gain	<i>Balancing</i>	130 000
<i>Fair value of plan assets at year end is</i>	<i>Given</i>	<u>1 100 000</u>

W3: Net actuarial (gain)/loss		C
Actuarial gain on assets	<i>W2</i>	(130 000)
Actuarial loss on obligation	<i>W1</i>	169 500
Net Actuarial loss	<i>Balancing</i>	<u>39 500</u>

Solution 25.7 continued ...**b)****Employee benefit expense: total at 31 December 20X8****C**

Current service cost		295 000
Interest on obligation		80 500
Past service cost		(50 000)
Expected return on plan assets		(120 000)
Net actuarial (gains)/losses recognized in current year	<i>Part (b): W2</i>	10 000
Employee benefit expense		<u>215 500</u>

Unrecognised actuarial (gain)/loss: balance at 31 December 20X8**C**

Unrecognized actuarial (gain)/loss: beginning of year	<i>Given</i>	200 000
Actuarial gain on assets	<i>Part (a): W1</i>	(130 000)
Actuarial loss on obligation	<i>Part (a): W2</i>	169 500
Recognised due to corridor	<i>Part (b): W2</i>	(10 000)
Unrecognized actuarial loss: end of year		<u>229 500</u>

W1: Actuarial gain or loss to be recognised: total**C**

Net cumulative actuarial loss / (gain) at the beginning of the year		200 000
Less the corridor: greater of:		100 000
• 10% of the plan obligation at the beginning of 20X6	<i>10% x 700 000</i>	70 000
• 10% of the plan assets at the beginning of 20X6	<i>10% x 1 000 000</i>	100 000
Excess over the corridor: total loss / (gain) to be recognised		<u>100 000</u>

W2: Actuarial gain or loss to be recognised: in the current year (amortised portion)

$$\begin{aligned}
 &= \frac{\text{Total gain or loss to be recognised (W1)}}{\text{Average expected remaining working life of the employees (given)}} \\
 &= \frac{100\,000}{10 \text{ years}} \\
 &= 10\,000
 \end{aligned}$$

Solution 25.8

a)

There are 4 types of employee benefits specified under IAS 19:

- Short term benefits,
- Long term benefits,
- Post employment benefits and
- Termination benefits.

With regard to this question:

- the employee is still employed and thus there are no termination benefits,
- the benefits provided are for current service and thus there are no post employment benefits,
- the benefits are all for a period of less than 12 months and thus there are no long term benefits

This leads to the conclusion that the benefits are all short term benefits.

Sub categories of short term benefits evident above include: wages/salaries/medical aid contribution etc, short term paid leave, profit sharing/bonuses.

b) Comment:

- IAS 19.9 states that short term employee benefits are recognized on an undiscounted basis. The discount rate that is provided is therefore irrelevant
- Personal tax is NOT a cost to the business but rather a cost to the employee in their own capacity. This information is also therefore irrelevant

29 February 20X8	Debit	Credit
Employee benefit expense: salary	150 000	
UIF liability		3 000
Pension fund liability		15 000
Current tax payable: employee's tax		33 000
Workers Union liability		1 000
Medical Aid liability		7 000
Salary payable		91 000
<i>Recognition of employee salary</i>		
Employee benefit expense: salary	14 500	
Medical Aid liability $7\,000 \times 1/1$		7 000
Pension fund liability <i>Given</i>		7 500
<i>Employers contribution for employee's benefit</i>		
UIF liability	3 000	
Pension fund liability $(15\,000 + 7\,500)$	22 500	
Current tax payable: employees tax	33 000	
Workers Union liability	1 000	
Medical Aid liability $(7\,000 + 7\,000)$	14 000	
Salary payable	91 000	
Bank		164 500
<i>Liability accounts cleared (paid)</i>		
Employee benefit expense: bonus	30 000	
Bonus payable $10\% \times (1\,200\,000 - 900\,000)$		30 000
<i>Provision for bonus</i>		
Employee benefit expense: leave pay	4 417	
Provision for leave pay $164\,500 \div 365 \times 7/5 \times 7 \text{ days leave}$		4 417
<i>Recognition of paid leave: accumulating and non-vesting</i>		

Solution 25.8 continued ...

c)

30 April 20X8		Debit	Credit
Employee Benefits Expense: Salary	<i>(150 000 ÷ 12)</i>	12 500	
UIF liability	<i>(3 000 ÷ 12)</i>		250
Pension fund liability	<i>(15 000 ÷ 12)</i>		1 250
SARS: Employee's Tax	<i>(33 000 ÷ 12)</i>		2 750
Workers Union liability	<i>(1 000 ÷ 12)</i>		83
Medical Aid liability	<i>(7 000 ÷ 12)</i>		583
Salary Payable	<i>(91 000 ÷ 12)</i>		7 583
<i>Recognition of employee salary</i>			
<hr/>			
Provision for leave pay		4 417	
Employee Benefit Expense: Leave Pay			4 417
<i>Utilisation of leave owed</i>			
<hr/>			

Solution 25.9

Leave Pay:

- Directors
 $350\,000 / 365 \times 7/5 \times 8 \text{ employees} \times 15 \text{ days (W1)} \times 40\% = 64438$
- Laboratory Workers
 $180\,000 / 365 \times 7/5 \times (55-5) \text{ employees} \times (18-11) \text{ days} \times 90\% = 217479$
- Office Workers
 $110\,000 / 365 \times 7/5 \times 25 \text{ employees} \times (16-10) \text{ days} \times 90\% = 56959$
- Total Provision
 $64438 + 217479 + 56959 = 338876$

Maternity:

- No journal entry. This is due to the maternity leave being non-accumulating and non-vesting. When one of the female employees takes the maternity leave due to them, the leave will be recorded as part of the salary expense.

W1:

- $20 - 4 = 16$ but limited per company policy to 15 (see table).

Solution 26.1

a)

ESPRESSO LIMITED
NOTES TO THE FINANCIAL STATEMENTS

1. Accounting policies**1.1 Plant and equipment**

Plant and equipment is stated in the statement of financial position at its revalued amount, being the fair value at the date of revaluation, less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations are performed with sufficient regularity such that the carrying amounts do not differ materially from those that would be determined using fair values at the end of the reporting period.

The company has changed its accounting policy for plant. Previously plant was carried at cost less accumulated depreciation and impairment.

Depreciation is charged so as to write off the valuation of the plant and equipment over their estimated useful lives of eight years using the straight line method. The estimated useful lives, residual values and depreciation method are reviewed at each year end, with the effect of any changes in estimate accounted for on a prospective basis.

2. Plant

	C
Net carrying amount on 01/01/X6	150 000
Gross carrying amount	250 000
Accumulated depreciation	(100 000)
Revaluation	90 000
Depreciation	(30 000)
Net carrying amount on 31/12/X6	210 000
Gross carrying amount	240 000
Accumulated depreciation	(30 000)
Net carrying amount based on the cost model	131 250

3. Deferred taxation liability

	C
Temporary differences on plant & equipment	(29 000 + 26 100 + 5 800) 60 900

4. Change in estimate

The company changed the estimated useful life of the plant from ten years to twelve years. The effect of the change in estimate is as follows:

	C
- Current profits (before tax)	10 000
- Future profits (before tax)	(10 000)

Solution 26.1 continued ...

b)

ESPRESSO LIMITED
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X6

	Retained earnings	Revaluation surplus	Total
	R	R	R
Balance at 01 January 20X6	X	X	X
Total comprehensive income	X	63 900	X + 63 900
Transfer of realised portion	7 988	(7 988)	0
Balance at 31 December 20X6	X	55 912	X + 55 912

Workings

Deferred tax

		HCA	ACA	TB	TD	DT	RS	RE
01/01/X2	Cost		250 000	250 000				
01/01/X2	Depreciation		(100 000)	(200 000)				
-	/							
31/12/X5	tax allowances^							
31/12/X5	Balance	150 000	150 000	50 000	100 000	29 000		
01/01/X6	Revaluation		90 000	-	90 000	26 100	63 900	
		150 000	240 000					
01/01/X6	Depreciation	(18 750)	(30 000)	(50 000)	20 000	5 800		
-	/							
31/12/X6	tax allowances*							
	Transfer of realised surplus~						(7 988)	7 988
		131 250	210 000	0	210 000	60 900	55 912	

^ Depreciation and tax allowances from 01/01/X2 – 31/12/X5

- Depreciation = R250 000 X 0,10 X 4 yrs = R100 000
- Tax allowances = R250 000 X 0,20 X 4 yrs = R200 000

* Depreciation and tax allowances from 01/01/X6 – 31/12/X6

- HCA Depreciation = R150 000 / 8 yrs = R18 750
- ACA Depreciation = R240 000 / 8 yrs = R30 000
- Tax allowances = R250 000 X 0,20 = R50 000

~ Transfer of realised surplus

- R63 900 / 8 yrs or [(R30 000 – R18 750) X],71] = R7 988

Change in estimate

		Was	Is	Effect on current / future profits
01/01/X6	Balance	150 000	150 000	
	Revaluation	90 000	90 000	
		240 000	240 000	
31/12/X6	Remaining useful life	6 yrs	8 yrs	
	Depreciation	(40 000)	(30 000)	10 000 Increase
		200 000	210 000	
Future periods	Depreciation	(200 000)	(210 000)	(10 000) Decrease

Solution 26.2

a)

TECHNOWIZ LIMITED
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 30 SEPTEMBER 20X8

	Note	Ordinary share capital C	Share premium account	Preference share capital C	Retained earnings C	Total
Balance at 1/10/20X7		750 000	622 500	200 000	126 200	1 698 700
Shares issued for cash	4	250 000	437 500			687 500
Total comprehensive income					163 373	151 623
Dividends - preference	5				(24 000)	(24 000)
ordinary	5				(70 000)	(70 000)
Balance at 30/9/20X8		1 000 000	1 060 000	200 000	195 573	2 455 573

Workings

* Stated capital		Qty A	C B	Premium B – A
Balance at 30/9/X7		750 000	1 372 500	
Rights issue	[1 for 3 (1 000 000 / 4)] (250 000 X C2,75)	250 000	687 500	622 500
Balance at 30/9/X8	(Given)	1 000 000	2 060 000	437 500

Profit		C
Gross profit		1 509 140
Operating expenses		(800 000)
Depreciation	(35 000 + 225 750 + 122 500)	(383 250)
Impairment		(26 000)
Adjustment to loss on sale of MV		~32 500
Interest	[(600 000 X 0,16 X 9/12) + (600 000 X 0,18 X 3/12)]	(99 000)
		233 390
Taxation	(28 042 + 41 975)	(70 017)
		163 373

~ Adjustment to loss on sale of MV

Cost		60 000
Accumulated depreciation	(60 000 X 0,25 X 2 2/12)	(32 500)
Carrying amount		27 500
Proceeds		20 750
Loss		6 750
Recorded		39 250
Reverse		32 500

Tax computation		X 0,30
PBT	233 390	70 017 (Dr Tax E)
Temporary differences	139 917	41 975 (Cr D/T)
Depreciation	225 750	
Impairment	26 000	
Tax allowance	(391 667)	
Taxable profit	93 473	28 042 (Cr ROR)

STC (R94 000 X 0,125 = 11 750)

Solution 26.2 continued . .

a) continued ...

The statement of financial position would appear as follows. It is shown here for completeness:

TECHNOWIZ LIMITED
STATEMENT OF FINANCIAL POSITION
AS AT 30 SEPTEMBER 20X8

	Note	C
ASSETS		
Non-current assets		3 171 500
Property, equipment and vehicles	8	3 078 500
Investments	9	93 000
Current assets		233 500
Inventory	10	68 750
Accounts receivable		51 200
Bank		113 550
		<hr/> 3 405 000 <hr/>
EQUITY AND LIABILITIES		
Share capital and reserves		2 455 573
Ordinary stated capital	4	1 000 000
Share Premium		1 060 000
12% Preference share capital	4	200 000
Retained earnings		195 573
Non-current liabilities		721 175
Loan from bank	6	600 000
Deferred tax	7	121 175
Current liabilities		228 252
Accounts payable		49 210
Interest payable		99 000
Current tax payable ^		28 042
Shareholders for dividends		52 000
		<hr/> 3 405 000 <hr/>

Solution 26.2 continued

b)

TECHNOWIZ LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 SEPTEMBER 20X8

1. Accounting policies

1.1 Statement of compliance

These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as notified under the Companies Ordinance, 1984, provisions of and directives issued under the Companies Ordinance, 1984. In case the requirements differ, the provisions or directives of the Companies Ordinance shall prevail.

1.2 Basis of preparation

The financial statements are prepared in accordance with the historical cost basis. These policies are consistent in all material respects with those applied in the previous year.

1.3 Property, plant and equipment

Property, plant and equipment are stated in the statement of financial position at cost less accumulated depreciation and any accumulated impairment losses. Depreciation is charged so as to write off the cost of assets over their estimated useful lives using the straight line method. The estimated useful lives, residual values and depreciation method are reviewed at each year end, with the effect of any changes in estimate accounted for on a prospective basis.

Land is not depreciated.

Buildings are depreciated on the straight line method at 2% p.a.

Plant and equipment is depreciated at 20% p.a. on the straight line method.

Motor vehicles are depreciated at 25% p.a. on the straight line method.

1.4 Inventory

Inventory is valued at the lower of cost or net realisable value. Cost is determined on the weighted average basis. Net realisable value represents the estimated selling price for inventories less all estimated costs of completion and costs necessary to make the sale.

1.5 Deferred tax

Deferred tax is provided using the balance sheet liability method, on all temporary differences at the balance sheet date between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred tax assets are recognized for all deductible temporary differences, carry forward of unused tax assets and unused tax losses, to the extent that it is probable that the taxable profit will be available against which the deductible temporary differences, carry forward of unused tax assets and unused tax losses can be utilized.

The carrying amount of deferred tax asset is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the deferred income tax asset to be utilized.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply to the period when the asset is realized or the liability is settled, based on the tax rate (and tax loss) that have been enacted or substantially enacted at the balance sheet date.

4. Share capital

Authorised:

1 200 000 ordinary shares of no par value
400 000 12% preference shares of C0,50 each

Issued:

	Ordinary stated capital	Preference share capital
Number of shares in issue 1 October 20X7	750 000	400 000
Number of shares issued during the year	250 000	-
Number of shares in issue 30 September 20X8	<u>1 000 000</u>	<u>400 000</u>
The directors have unconditional authority until the next AGM to issue the remaining unissued shares of the company.		

5. Dividends

Paid (12 000+30 000)	42 000
Declared (12 000+40 000)	<u>52 000</u>
	<u>94 000</u>

Solution 26.2 continued . .**b) continued ...****6. Non-current liability***Secured:*

Loan from bank	600 000
----------------	---------

The loan bears interest at prime less 2%, payable on 1 October each year, and is repayable on 30 September 20Y1. The loan is secured over land with a carrying value of R850 000.

7. Deferred tax liability

Deferred tax comprises temporary differences resulting from:

- Property plant and equipment 121 175

8. Property, plant and equipment

		Land	Buildings	Equipment	Motor vehicles	Total
Cost						
1/10/X7	Balance	850 000	1 750 000	990 000	470 000	4 060 000
	Additions			185 000	120 000	305 000
	Disposal				(60 000)	(60 000)
30/9/X8	Balance	<u>850 000</u>	<u>175 000</u>	<u>1 175 000</u>	<u>530 000</u>	<u>4 305 000</u>
Accumulated depreciation						
1/10/X7	Balance		218 750	396 000	235 000	849 750
	Depreciation		35 000	225 750	122 500	383 250
	Impairment			26 000		26 000
	Disposal				(32 500)	(32 500)
30/9/X8	Balance		<u>253 750</u>	<u>647 750</u>	<u>325 000</u>	<u>1 226 500</u>
	Carrying amount	<u>850 000</u>	<u>1 496 250</u>	<u>527 250</u>	<u>205 000</u>	<u>3 078 500</u>

Land and buildings comprise a factory situated on stand 674 Edenvale township.

Cost of land 1 September 20X0	850 000
Factory 30 June 20X1	<u>1 750 000</u>
	<u>2 600 000</u>

An impairment loss has been recognised during the year for equipment. The equipment's recoverable amount of R40 000 is its net selling price that declined significantly due to major technological advances in this type of machinery.

9. Investment in subsidiary*Unlisted:*

Investment in Data (Pvt) Ltd	30 000 ordinary shares	60 000
Loan to Data (Pvt) Ltd		<u>33 000</u>
		<u>93 000</u>

Directors valuation of investment	60 000
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Solution 26.2 continued . .**b) continued ...****10. Inventory**

Inventory comprises:

Raw materials	15 150
Work-in-progress	12 600
Finished goods	41 000
	<u>68 750</u>

Finished goods with a carrying amount of R36 000 are carried at net realisable value.

Workings

Equipment: opening cost: (1 175 000 – 185 000)

Equipment: depreciation: (990 000 X 0,20) + (185 000 X 0,20 X 0,75)

Motor vehicles: opening cost: (530 000 – 120 000 + 60 000)

Motor vehicles: depreciation [(530 000 - 120 000) X 0,25] + [60 000 X 0,25 X 2/12] + [120 000 X 0,25 X 7/12]

Buildings: depreciation: 1 750 000 X 0,02

Deferred tax on equipment

		CA	TB	TD	DT
30/9/X7	(^990 000 – 396 000) (990 000 – *660 000)	594 000	330 000	264 000	79 200
Purchase		185 000	185 000	-	-
Depreciation W&T	(198 000 + 27 750) (330 000 + 61 667)	(225 750)	391 667	165 917	(49 775)
Impairment	(66 000 – 40 000)	(26 000)	-	(26 000)	(7 800)
30/9/X8		527 250	123 333	403 917	121 175

^ (1 175 000 – 185 000)

* (990 000 x 0.20 = 198 000Equipment two years old . . .990 000 x 0.33 x 2yrs = 660 000)

Solution 26.3

a)

General Journal	Debit	Credit
Plant: accumulated depreciation	60 000	
Plant: cost		60 000
<i>Set-off of acc depreciation against cost (NRVM)</i>		
Plant: cost	10 000	
Revaluation surplus		10 000
<i>Revaluation of plant</i>		
Revaluation surplus	3 000	
Deferred tax		3 000
<i>Deferred tax on revaluation surplus</i>		
Depreciation	12 500	
Plant: accumulated depreciation		12 500
<i>Depreciation on plant</i>		
Revaluation surplus (10 000 x 70%)/ 4 yrs	1 750	
Retained earnings		1 750
<i>Transfer from revaluation surplus to retained earnings</i>		
Depreciation	25 000	
Buildings: accumulated depreciation		25 000
<i>Depreciation on plant</i>		
Buildings: accumulated depreciation 200 000 – 60 000	140 000	
Buildings: cost		200 000
Bank	300 000	
Profit on sale		240 000
<i>Sale of a building</i>		
Telephone expenses	20 000	
Telephone prepaid		20 000
<i>Expensing of prepaid telephone expense</i>		
Bank	15 000	
Rental income received in advance		15 000
<i>Rental income received in advance as at 31 December 20X6</i>		
Deferred tax (750 + 3 000 + 6 000 + 6 000 + 4 500)	20 250	
Tax expense		20 250
<i>Deferred tax adjustment for 20X6</i>		

Solution 26.3 continued ...

b)

TISSOT LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X6

C

8. Deferred taxation asset/ (liability)

The deferred tax balance comprises temporary differences caused by:

• Property, plant and equipment	<i>Given</i>	30 750
• Year-end accruals	$(0 + 4\,500)$	4 500
		<u>35 250</u>

Reconciliation

Opening balance	$24\,000 - 6\,000$	18 000
Deferred tax on revaluation surplus	<i>Given</i>	(3 000)
Deferred tax in statement of comprehensive income	<i>Balancing or per journal</i>	20 250
Closing balance	$30\,750 + 4\,500$	<u><u>35 250</u></u>

9. Property, plant and equipment

Property, plant and equipment comprises:

• Plant	$40\,000 + 10\,000 - 12\,500$	37 500
• Buildings	$360\,000 - 25\,000 - 60\,000$	275 000
		<u>312 500</u>

Reconciliation: plant

Net carrying amount – 1 January	<i>Given</i>	40 000
Gross carrying amount – 1 January	<i>Given</i>	100 000
Accumulated depreciation – 1 January	<i>Given</i>	(60 000)
Revaluation surplus	<i>Given</i>	10 000
Depreciation	<i>Given</i>	(12 500)
Net carrying amount – 31 December	<i>Balancing</i>	37 500
Gross carrying amount – 31 December	$100\,000 - 60\,000 + 10\,000$	50 000
Accumulated depreciation – 31 December	<i>Given</i>	(12 500)

Plant is measured using the revaluation model, with revaluations recorded using the net replacement value method. Plant is revalued every three years, with the last revaluation performed on 1 January 20X6 by an independent sworn appraiser and member of the institute of valuers in Pakistan. Had the cost model been applied instead, the carrying amounts would have been as follows:

Net carrying amount – 31 December	$(CA: 40\,000 - 40\,000 / RUL: 4\,years)$	<u>30 000</u>
<i>Reconciliation: buildings</i>		
Net carrying amount – 1 January	<i>Given</i>	360 000
Gross carrying amount	<i>Given</i>	500 000
Accumulated depreciation	<i>Given</i>	(140 000)
Depreciation	<i>Given</i>	(25 000)
Sale	<i>Given</i>	(60 000)
Net carrying amount – 31 December	<i>Balancing</i>	275 000
Gross carrying amount	$500\,000 - 200\,000$	300 000
Accumulated depreciation	$140\,000 + 25\,000 - (200\,000 - 60\,000)$	(25 000)

Solution 26.3 continued ...

c)

TISSOT LIMITED				
STATEMENT OF CHANGES IN EQUITY				
FOR THE YEAR ENDED 31 DECEMBER 20X6				
	Share capital	Revaluation surplus	Retained earnings	Total
	C	C	C	C
Balance – 1 January 20X6	210 000	0	235 000	445 000
Total comprehensive income		[^] 7 000	197 000	204 000
Transfer to retained earnings		(1 750)	1 750	0
Dividends declared			(17 000)	(17 000)
Balance – 31 December 20X6	210 000	5 250	416 750	632 000

[^] (10 000 – 3 000)

Solution 26.4

a)

WODEN LIMITED		
STATEMENT OF COMPREHENSIVE INCOME		
FOR THE YEAR ENDED 28 FEBRUARY 20X2		
		C
Profit before interest and tax		263 763
Finance cost	(50 000 + 5 763 ^{W1})	(55 763)
Profit before tax		208 000
Income tax expense	(62 400 ^{W2/1} + 2 900 ^{W2/2})	(65 300)
Profit for the period		142 700
<i>Other comprehensive income</i>		
Revaluation surplus		280 000
Total comprehensive income		422 700
Earnings per share	(R142 700 – 21 000 ^{W5} / 159 000 ^{W3})	0.765

W1 Effective interest		
		C
Premium	(3 634 X 6/12)	1 817
Discount	(1 817 X 6/12)	909
(Accrual of premium and amortisation of discount for 01/03/X1 - 31/08/X1)		
Premium	(4 050 X 6/12)	2 025
Discount	(2 025 X 6/12)	1 012
(Accrual of premium and amortisation of discount for 01/09/X1 - 28/02/X2)		
		5 763

W2.1 Tax computation			
	C	C	
Profit before tax	208 000	62 400	Dr Tax expense
Temporary differences	(100 000)	30 000	Cr Deferred tax
- Depreciation	150 000		
- Tax allowance	(250 000)		
Taxable income	108 000	32 400	Cr ROR

W2.2 Underprovision		C
Assessment for 20X1 year		30 200
Provided for 20X1 year		(27 300)
Under provision		2 900

W3 EPS				
		Total	20X2	20X1
28/02/X1	Balance	100 000	100 000	100 000
31/05/X1	Cash issue (on preference share redemption)	8 000	6 000	-
		108 000	106 000	100 000
28/02/X2	Capitalisation issue	54 000	53 000	50 000
		162 000	159 000	150 000

Solution 26.4 continued . .

b)

WODEN LIMITED
STATEMENT OF CHANGES IN EQUITY FOR THE PERIOD ENDED 28 FEBRUARY 20X2

	Ordinary share capital	Share premium	Preference share capital	Revaluation surplus	Retained earnings	Total
Balance	1 000 000	20 000	400 000		610 450	2 030 450
Issue of shares	80 000	8 000				88 000
Preference shares redeemed ^{W4}		(7 500)	(300 000)			(307 500)
Share issue expenses		(4 000)				(4 000)
Capitalisation issue ^{W5}	540 000	(16 500)			(523 500)	
Preference dividend ^{W6}					(21 000)	(21 000)
Total comprehensive income				*280 000	142 700	422 700
	1 620 000	-	100 000	280 000	208 650	2 208 650

* Dr Land & Buildings	400 000	
Cr Revaluation surplus		280 000
Cr Deferred tax		120 000

W4 Capitalisation issue

Number of shares before capitalisation issue	(W3)	108 000
		C
Capitalisation issue	(54 000 X R10)	540 000
- Share premium	(20 000 + 8 000 - 7 500 - 4 000)	(16 500)
. . Retained earnings		523 500

W5 Preference dividend

		C
Dividend on preference shares redeemed	(300 000 X 0,12 X 3/12)	9 000
Dividend on remaining preference shares	(100 000 X 0,12 X 12/12)	12 000
		21 000

Solution 26.4 continued . .

c)

WODEN LIMITED
NOTES TO THE FINANCIAL STATEMENTS
AT 28 FEBRUARY 20X2

1 Accounting policies (not required)**1.1 Statement of compliance**

These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 198, provisions of and directives issued by under the Companies Ordinance, 1984. In case the requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

1.2 Basis of preparation

The financial statements have been prepared on the historical cost basis, except for the revaluation of the property. These policies are consistent in all material respects with those applied in the previous year.

1.3 Property, plant and equipment

Property, plant and equipment is stated at cost less accumulated depreciation and any accumulated impairment losses. Depreciation is charged so as to write off the cost of assets over their estimated useful lives using the straight line method. The estimated useful lives, residual values and depreciation method are reviewed at each year end, with the effect of any changes in estimate accounted for on a prospective basis.

Land and buildings are depreciated. Plant and equipment is depreciated at 20% per annum on the straight line basis.

1.4 Deferred tax

Deferred tax is provided using the balance sheet liability method, on all the temporary differences at the balance sheet date between the tax base of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred tax asset are recognized for all deductible temporary differences, carry forward of unused tax losses, to the extent that is probable that future taxable profit will be available against which the deductible temporary difference, unused tax losses and tax credits can be utilized.

Carrying amount of deferred tax asset is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that the related tax benefit will be realized. Deferred tax is calculated at the rates that are expected to apply to the period when differences reverse based on the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.

2. Taxation

Normal tax	C
- Current tax	32 400
- Deferred tax	30 000
- Under-provision prior year	2 900
Income tax expense	<u>65 300</u>

Tax rate reconciliation	%	C
Tax expense on profit / applicable rate	30.0	62 400
- Under-provision prior year	1.4	2 900
Tax expense / effective rate	31.4	65 300
3. Deferred taxation		
Temporary differences on plant and equipment		60 000
Revaluation of property		120 000
		180 000

Solution 26.4 continued . .**c) continued ...****4..Earnings per share**

The calculation of earnings per share is based on basic earnings as shown below and on the weighted average number of ordinary shares in issue of 159 000 (20X1 : 150 000)

The calculation of the weighted average number of shares is after a cash issue on 31 May as well as a capitalisation issue on 28 February 20X2. Comparatives have been restated accordingly.

Reconciliation of earnings with profit for the period

Profit for the period	142 700
Preference dividend	(21 000)
Basic earnings	121 700

5. Share capital (not required)**C****Authorised**

200 000 ordinary shares of R10 each	2 000 000
50 000 12% redeemable preference shares of R10 each	500 000

Issued

162 000 ordinary shares of R10 each
10 000 12% redeemable preference shares of R10 each

	Ordinary shares	Preference shares
Number of shares in issue at 28/02/X1	100 000	40 000
Preference shares redeemed		(30 000)
Shares issued for cash	8 000	
Capitalisation issue	54 000	
Number of shares in issue at 28/02/X2	162 000	10 000

The redeemable preference shares are redeemable on 30 May 20X5 at the option of the company.

6. Non-distributable reserve

Revaluation surplus on property	200 000
---------------------------------	---------

7. 10% Debentures

50 000 10% debentures of R10 each		500 000
Premium on redemption	[9 821 (at 31/08/01) + 2 025 (4 050 X 6/12)]	11 846
Discount on issue	[20 090 (at 31/08/01) – 1 012 (2 225 X 6/12)]	(19 078)
		492 768

The debentures are secured over the fixed property of the company and are redeemable at a premium of 10% on 30 August 20X8.

Solution 26.4 continued . .

c) continued ...

8. Property, plant and equipment

	Property	Plant and equipment	Total
Cost / Revaluation			
Balance at 28/02/X1	2 200 000	750 000	2 950 000
Revaluation	(600 000)	-	(600 000)
	400 000		400 000
Balance at 28/02/X2	2 000 000	750 000	2 750 000
Accumulated depreciation			
Balance at 28/02/X1	400 000	150 000	550 000
Depreciation expense	200 000	150 000	350 000
Revaluation	(600 000)	-	(600 000)
Balance at 28/02/X2	-	300 000	300 000
Carrying amount	2 000 000	450 000	2 450 000

Land and buildings were revalued at the end of the current year by an independent valuer.

9. Post reporting period event

A dividend of C0,10 per share, amounting to R16 200 was declared on 21 March 20X2 in respect of the year ending 28 February 20X2

W7

Taxation expense				Receiver of Revenue			
Description	C	Description	C	Description	C	Description	C
ROR	2 900	Retained earnings	65 300	Balance	1 200	Tax expense	2 900
Deferred Tax / ROR	62 400			Bank	1 700		
				Bank	14 700	Tax expense	32 400
				Bank	15 300		
				Balance	3 000		
	65 300		65 300		35 300		35 300
						Balance	3 000

Deferred tax

	Carrying amount	Tax base	Temporary difference	Deferred tax	
01/03/X0	750 000	750 000			
28/02/X1	(150 000)	(250 000)	100 000	30 000	Cr
	600 000	500 000	100 000	30 000	Cr
28/02/X2	(150 000)	(250 000)	100 000	30 000	
	450 000	250 000	200 000	60 000	Cr

Solution 26.5

COULTREAD CARS LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 MARCH 20X1

		C
Profit before taxation	(398 600 - 10 500 - 127 500 - 34 875 + 119 500 + 250 000)	595 225
Taxation	(99 068 + 1 500)	(100 567)
Profit for the period		494 658
<i>Other comprehensive income</i>		0
Total comprehensive income		494 658

COULTREAD CARS LIMITED
STATEMENT OF FINANCIAL POSITION AS AT 30 MARCH 20X1

		C
ASSETS		
Non-current assets		
Property, plant and equipment		177 625
EQUITY AND LIABILITIES		
Non-current liabilities		
Deferred tax	[53 288 – 625 (5 000 X 0,125)]	53 288
Current liabilities		
Receiver of Revenue		59 055

COULTREAD CARS LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 MARCH 20X1

1. Accounting policies

1.1 Statement of compliance

These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 198, provisions of and directives issued by under the Companies Ordinance, 1984. In case the requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

1.2 Basis of preparation

The financial statements have been prepared on the historical cost basis. These policies are consistent in all material respects with those applied in the previous year.

1.3 Property, plant and equipment

Property, plant and equipment is stated at cost less accumulated depreciation and any accumulated impairment losses. Depreciation is charged so as to write off the cost of assets over their estimated useful lives using the straight line method. The estimated useful lives, residual values and depreciation method are reviewed at each year end, with the effect of any changes in estimate accounted for on a prospective basis.

Plant and machinery is depreciated at 15% p.a. on the straight-line basis.

1.4 Deferred tax

Deferred tax is provided using the balance sheet liability method, on all the temporary differences at the balance sheet date between the tax base of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred tax asset are recognized for all deductible temporary differences, carry forward of unused tax losses, to the extent that it is probable that future taxable profit will be available against which the deductible temporary difference, unused tax losses and tax credits can be utilized.

Carrying amount of deferred tax asset is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that the related tax benefit will be realized. Deferred tax is calculated at the rates that are expected to apply to the period when differences reverse based on the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.

Solution 26.5 continued . . .**2. Profit before tax includes:**

	C
Depreciation - Factory buildings	10 500
- Plant and machinery	127 500
Impairment loss on plant and machinery	34 875
Profit on expropriation on land and factory buildings (250 000 + 119 500)	369 500

3. Taxation

Normal Tax	
Current tax	110 955
Deferred tax	(11 888)
Under provision in prior year	1 500
Income tax expense	<u>100 567</u>

No secondary tax on companies is payable due to an STC credit of C5 000 available for set-off in the future.

Tax reconciliation		C	%
Tax effect at applicable rate on profit before tax	(595 225 X 0.3)	178 568	30.00
Tax effect of:			
Permanent differences	(265 000 X 0.3)	(79 500)	(13.36)
Under provision		1 500	0.25
Tax expense/ effective rate		<u>100 568</u>	<u>16.89</u>

4. Property, plant and equipment

	Plant and machinery C	Land C	Factory buildings C	Total C
Cost				
Balance 31/3/20X0	850 000	400 000	630 000	1 880 000
Expropriation		(400 000)	(630 000)	1 030 000
Balance 31/3/20X1	<u>850 000</u>	<u>-</u>	<u>-</u>	<u>850 000</u>
Accumulated depreciation				
Balance 31/3/20X0	510 000	-	189 000	699 000
Depreciation	127 500	-	10 500	138 000
Impairment loss	34 875	-		34 875
Expropriation			(199 500)	(199 500)
Balance 31/3/20X1	<u>672 375</u>	<u>-</u>	<u>-</u>	<u>672 375</u>
Carrying amount	<u>177 625</u>	<u>-</u>	<u>-</u>	<u>177 625</u>

The impairment loss of R34 875 results from plant and machinery becoming obsolete. The recoverable amount is based on the net selling price of the scrap value.

Solution 26.5 continued . .

Workings

W1 Factory buildings			Carrying amount	Tax base
1/10/19X2	Cost		630 000	630 000
31/3/20X0	Accumulated depreciation / Tax allowance	(630 000 / 25 X 7,5) (630 000 X 0,05 X 7,5)	(189 000)	(236 250)
			441 000	393 750
31/8/20X0	Depreciation	(630 000 / 25 X 5/12) (630 000 X 0,05 X 5/12)	(10 500)	(13 125)
			430 500	380 625
	Expropriation proceeds		550 000	550 000
	Profit/ recoupment		119 500	169 375

W2 Plant and machinery			Carrying amount	Tax base
	Cost		850 000	850 000
31/3/20X0	Accumulated depreciation / Tax allowances	(Given) (850 000 X 0,20 X *4)	(510 000)	(680 000)
			340 000	170 000
31/3/20X1	Depreciation	(850 000 X 0,15) (850 000 X 0,20)	(127 500)	(170 000)
			212 500	-
	Impairment	(212 500 / 4 = 53 125) (53 125 - 18 250)	(34 875)	-
			177 625	-

* (850 000 X 0,15 = 127 500 . . . 510 000 / 127 500 = 4 years at beginning of year)

W3 Deferred tax calculation	Carrying amount	Tax base	Temporary difference	Deferred tax	
Factory buildings					
31/3/20X0	441 000	393 750	47 250	14 175.00	Cr
	(10 500)	(13 125)	2 625	787.50	Cr
31/8/20X0	430 500	380 625	49 875	14 962.50	Cr
Expropriation	(430 500)	(380 625)	(49 875)	^(14 962.50)	Dr
After Expropriation	0	0	0	0.00	
Plant & machinery					
31/3/20X0	340 000	170 000	170 000	51 000.00	Cr
	(127 500)	(170 000)			
	(34 875)		7 625	^2 287.50	Cr
31/3/20X1	177 625	0	177 625	53 287.50	Cr

^ (14 962,50 – 2 287,50 = net 11 888 Dr to deferred tax)

Solution 26.5 continued . .

W4 Profit before tax

Profit before depreciation and tax		398 600
Depreciation – factory building		(10 500)
– plant and machinery		(127 500)
– impairment loss		(34 875)
Profit on expropriation of factory buildings		119 500
Profit on expropriation of land	(650 000 – 400 000)	250 000
		<u>595 225</u>

W5 Tax computation

X 0.30

Profit before tax		595 225		
<i>Permanent difference</i>				
Dividends received		(15 000)		
Profit on expropriation of land		(250 000)		
		<u>330 225</u>	99 068	Dr T/E
<i>Temporary differences</i>		39 625	11 888	Dr D/T
Depreciation / impairment	(10 500 + 127 500 + 34 875)	172 875		
Tax allowances	(13 125 + 170 000)	(183 125)		
Accounting gain on expropriation of factory buildings (W1)		(119 500)		
Tax gain on expropriation of factory building		169 375		
		<u>369 850</u>	110 955	Cr CTP

W6 Underprovision / amount owing

Per assessment	51 900	51 900
Per statement of comprehensive income 31/3/X0 / Provisional payments	50 400	46 000
Under provision / Amount owing	<u>1 500</u>	<u>5 900</u>

CURRENT TAX PAYABLE				DEFERRED TAX			
Description	C	Description	C	Description	C	Description	C
Bank (3 rd)	5 900	Balance	4 400	Tax expense	11 888	Balance	65 175
Bank (1 st)	23 000	Under provision	1 500	Balance	53 287		
Bank (2 nd)	28 900	Tax expense	110 955				
Balance	59 055						
	<u>116 855</u>		<u>116 855</u>		<u>65 175</u>		<u>65 175</u>
						Balance	53 287

Solution 26.6

**ACE OF SPADES (PRIVATE) LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 MARCH 20X9**

	Note	20X9 C	20X8 C
Profit before tax	2	376 400	568 500
Income tax expense	3	(130 105)	(193 725)
Profit for the period		246 295	374 775
<i>Other comprehensive income</i>		0	0
Total comprehensive income		246 295	374 775

**ACE SPADES (PRIVATE) LIMITED
EXTRACT FROM STATEMENT OF FINANCIAL POSITION
AS AT 31 MARCH 20X9**

	20X9 C	20X8 C
ASSETS		
Non-current assets		
Property, plant and equipment	796 500	504 000
Current assets		
Tax receivable	15 745	-
EQUITY AND LIABILITIES		
Non-current liabilities		
Deferred taxation	89 775	92 400
Current liabilities		
Shareholders for dividends	90 000	-
Tax payable	-	3 500

Solution 26.6 continued ...

ACE SPADES (PRIVATE) LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 MARCH 20X9
1. Accounting policies**1.1 Statement of compliance**

These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 198, provisions of and directives issued by under the Companies Ordinance, 1984. In case the requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

1.2 Basis of preparation

The financial statements have been prepared on the historical cost basis. These policies are consistent in all material respects with those applied in the previous year.

1.3 Deferred tax

Deferred tax is provided using the balance sheet liability method, on all the temporary differences at the balance sheet date between the tax base of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred tax asset are recognized for all deductible temporary differences, carry forward of unused tax losses, to the extent that is probable that future taxable profit will be available against which the deductible temporary difference, unused tax losses and tax credits can be utilized.

Carrying amount of deferred tax asset is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that the related tax benefit will be realized. Deferred tax is calculated at the rates that are expected to apply to the period when differences reverse based on the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.

2. Profit before tax

Profit before tax includes

	20X9	20X8
	C	C
Depreciation	133 500	144 000
Loss of plant and machinery due to earthquake (tax saving: R134 400)	(384 000)	

3. Taxation

		20X9	20X8
		C	C
Normal tax			
• Current tax	20X9: W1 and 20X8: 193 725 – 33 600	127 855	160 125
• Deferred tax	20X9: W3/ W1 & 20X8: 92 400 – 58 800	(2 625)	33 600
• Under provision prior year	20X9: W4 & 20X8: assumed	4 875	0
Tax expense		<u>130 105</u>	<u>193 725</u>

Tax rate reconciliation

	20X9		20X8	
	C	%	C	%
Tax at applicable rate	131 740	35.0	198 975	35.0
Exempt income	(6 510)	(1.7)	x	x

Under provision prior year	4 875	1.3	-	-
Per statement of comprehensive income / effective rate	130 105	34.6	193 725	34.1

x = Not enough information available.

Solution 26.6 continued ...

4. Deferred tax asset/ (liability)

Deferred tax liability

Property, plant and equipment

20X9

C

89 775

Workings

W1 Tax computation

	20X9 C	X 0.35	
Profit before tax	376 400		
Permanent difference			
Dividends received	(18 600)		
	357 800	125 230	Dr Tax expense
Temporary differences	7 500	2 625	Dr Deferred tax
Depreciation (120 + 13.5)	133 500		
Tax allowance (240 + 270)	(510 000)		
Loss on plant destroyed	384 000		
Taxable profit	365 300	127 855	Cr CTP

W2 Balance owing to taxation authorities

CURRENT TAX PAYABLE			
Description	C	Description	C
Bank	8 375	Balance	3 500
		Taxation (under-provision)	4 875
Bank	84 250		
Bank	59 350	Taxation	127 855
		Balance	15 745
	151 975		151 975
Balance	15 745		

Solution 26.6 continued ...

W3 Deferred tax:

	Carrying amount	Tax base	Temporary difference	Deferred tax
Old plant				
Opening balance	0	0	0	0
Purchase	720 000	720 000	0	0
Depreciation/ wear & tear (6/12)	(72 000)	(240 000)	(168 000)	(58 800)
31/3/X7	648 000	480 000	(168 000)	(58 800)
Depreciation/ wear & tear	(144 000)	(240 000)	(96 000)	(33 600)
31/3/X8	504 000	240 000	(264 000)	(92 400)
Depreciation/ wear & tear (10/12)	(120 000)	(240 000)		(42 000)
Before plant destroyed	384 000	-	(384 000)	(134 400)
Impairment loss	(384 000)		384 000	134 400
After plant destroyed	-	-	-	-
New plant				
1/3/20X9	810 000	810 000	-	-
Depreciation/wear & tear (1/12)	(13 500)	(270 000)	(256 500)	(89 775)
31/3/X9	796 500	540 000	(256 500)	(89 775)

W4 Under provision:

Tax expense X8	given	193 725
Deferred tax charge X8	(92 400 – 58 800)	(33 600)
Current tax provided for in X8		160 125
Current tax per assessment X8	given	(165 000)
Under provision		(4 875)

Solution 26.7

a) Journals

	Debit	Credit
Year ended 31 December 20X1:		
<i>1 July 20X1</i>		
Cost: nuclear plant – physical structure (80%)	6 400 000	
Cost: nuclear plant – major inspection (20%)	1 600 000	
Bank/ liability		8 000 000
<i>Purchase of nuclear plant: 20% relates to 20X1 inspection</i>		
<i>1 July 20X1</i>		
Cost: nuclear plant – dismantling costs	453 942	
Provision for future dismantling costs		453 942
<i>Purchase of nuclear plant: 20% relates to 20X1 inspection</i>		
<i>31 December 20X1</i>		
Finance costs	27 237	
Provision for future dismantling costs		27 237
<i>Notional finance charges due to the unwinding of the discount:</i> <i>12% x 453 942 x 6/12 (or see W1)</i>		
<i>31 December 20X1</i>		
Depreciation - nuclear plant (expense)	1 178 727	
Accumulated depreciation: nuclear plant – physical structure		600 000
Accumulated depreciation: nuclear plant – major inspection		533 333
Accumulated depreciation: nuclear plant – dismantling costs		45 394
<i>Depreciation of nuclear plant components:</i> <i>physical structure = (6 400 000 – 400 000) / 5 years x 6/12</i> <i>major inspection = (1 600 000 – 0) / 18 months x 6 months</i> <i>dismantling costs = (453 942 – 0) / 5 years x 6/12</i>		
Year ended 31 December 20X2:		
<i>1 July 20X2</i>		
Repairs and maintenance (expense) (60%)	300 000	
Cost: nuclear plant – new part (40%)	200 000	
Bank/ liability		500 000
<i>Repair of central shaft (60%) and fitment of new part (40%) that increases future economic benefits</i>		
<i>31 December 20X2</i>		
Finance costs	57 742	
Provision for future dismantling costs		57 742
<i>Notional finance charges due to the unwinding of the discount:</i> <i>(453 942 + 27 237) x 12%; or see W1: 27 237 + 30 505</i>		
<i>31 December 20X2</i>		
Depreciation - nuclear plant (expense)	2 382 455	
Accumulated depreciation: nuclear plant – physical structure		1 200 000
Accumulated depreciation: nuclear plant – major inspection		1 066 667
Accumulated depreciation: nuclear plant – dismantling costs		90 788
Accumulated depreciation: nuclear plant – new part		25 000
<i>Depreciation of nuclear plant components:</i> <i>physical structure = (6 400 000 – 400 000) / 5 years</i> <i>major inspection = (1 600 000 – 0) / 18 months x 12 months</i> <i>dismantling costs = (453 942 – 0) / 5 years</i> <i>new part = (200 000 – 0) / 4 years x 6/12</i>		

Solution 26.7 continued ...**a) Journals continued ...**

	Debit	Credit
Year ended 31 December 20X3:		
<i>2 January 20X3</i>		
Cost: nuclear plant major inspection	1 500 000	
Bank/ liability		1 500 000
<i>Major inspection on 2 January 20X3</i>		
<i>2 January 20X3</i>		
Accumulated depreciation: nuclear plant – major inspection	1 600 000	
Cost: nuclear plant major inspection		1 600 000
<i>Derecognition of 20X1 major inspection (carrying amount: nil)</i>		
<i>31 December 20X3</i>		
Finance costs	64 670	
Provision for future dismantling costs		64 670
<i>Notional finance charges due to the unwinding of the discount:</i> <i>(453 942 + 27 237 + 57 742) x 12%; or see W1: 30 505 + 34 165</i>		
<i>31 December 20X3</i>		
Depreciation - nuclear plant (expense)	2 090 788	
Accumulated depreciation: nuclear plant – physical structure		1 200 000
Accumulated depreciation: nuclear plant – major inspection		750 000
Accumulated depreciation: nuclear plant – dismantling costs		90 788
Accumulated depreciation: nuclear plant – new part		50 000
<i>Depreciation of nuclear plant components:</i> <i>physical structure = (6 400 000 – 400 000) / 5 years</i> <i>major inspection = (1 500 000 – 0) / 2 years</i> <i>dismantling costs = (453 942 – 0) / 5 years</i> <i>new part = (200 000 – 0) / 4 years</i>		

Comments:

- Although there are 2 years between each major inspection, there are only 18 months left on the cost of the 20X1 inspection until the next inspection (as at the date of the purchase of the nuclear plant: 1 July 20X1). Therefore, the remaining useful life of the 20X1 major inspection is 18 months.
- The useful life of the future dismantling cost is dictated by the date of the future dismantling (30 June 20X6) together with the date on which the asset became available for use (1 July 20X1): 60 months or 5 years.
- Part of the repair invoice relates to the purchase of a new part that results in an increase in expected future economic benefits through a 20% increase in the power supply and should therefore be capitalised.
- Although the new part (installed on 1 July 20X2) has the same remaining useful life as the original physical structure to which it has been fitted, its cost is significant and should therefore be recognised as a separate component. On the date of fitment, the nuclear plant structure – and therefore the new part – has a remaining useful life of 4 years (until the date of dismantling).
- Notice that the major inspection is fully depreciated by 31 December 20X2. If there had been a balance on this account on the date of the next major inspection, the remaining carrying amount would first have had to be written off before capitalisation of the next inspection. Do, however, remember that even if the carrying amount is C0, (as in this case), the cost and accumulated depreciation must still be reversed (derecognised).
- Notice that the cost of the dismantling (part of the nuclear plant asset) does not change as time goes by, but rather the provision for dismantling costs (the liability) changes: increases with the notional interest caused by the ‘unwinding of the discount’.

Solution 26.7 continued ...

b) Disclosure

BLUE TIDE LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X3
4 Property, plant and equipment

	20X3 C	20X2 C	20X1 C
Total net carrying amount:			
Other assets listed per classification	xxx	xxx	xxx
Nuclear plant	4 501 972	5 092 760	7 275 215
	xxx	xxx	xxx

Nuclear plant

Net carrying amount: 1 January	5 092 760	7 275 215	0
Gross carrying amount:	8 653 942	8 453 942	0
Accumulated depreciation and impairment losses:	(3 561 182)	(1 178 727)	0
Additions	1 500 000	200 000	8 453 942
Depreciation	(2 090 788)	(2 382 455)	(1 178 727)
Net carrying amount: 31 December	4 501 972	5 092 760	7 275 215
Gross carrying amount:	8 553 942	8 653 942	8 453 942
(20X3: 8 653 942 – 1 600 000 + 1 500 000)			
Accumulated depreciation and impairment losses:	(4 051 970)	(3 561 182)	(1 178 727)
(20X3: 3 561 182 – 1 600 000 + 2 090 788)			

Workings**W1 Present value table: future dismantling costs (the entire table is not required)**

Date	O/balance	Finance costs	Obligation	C/balance
1 July 20X1	0		453 942	
31 December 20X1	453 942	27 237		481 179
31 July 20X2		27 237		508 415
notional interest – first 12 month period		54 473		
31 December 20X2	508 415	30 505		538 920
31 July 20X3		30 505		569 425
notional interest – second 12 month period		61 010		
31 December 20X3	569 425	34 165		603 590
31 July 20X4		34 165		637 756
notional interest – third 12 month period		68 331		
31 December 20X4	637 756	38 265		676 021
31 July 20X5		38 265		714 287
notional interest – fourth 12 month period		76 531		
31 December 20X5	714 287	42 857		757 144
31 July 20X6		42 857		800 001
notional interest – fifth 12 month period		85 714		
difference due to rounding		(1)		(1)
				800 000
Total notional finance costs		346 058		

Solution 27.1

a)

		Debit	Credit
1 January 20X6			
Bank	Given	150 000	
Deferred grant income			150 000
<i>Recognition of government grant</i>			
31 December 20X6			
Staff costs	Given	200 000	
Bank			200 000
<i>Wages paid during the year</i>			
31 December 20X6			
Deferred grant income	200 000 x 20%	40 000	
Grant income			40 000
<i>Recognising grant income to the extent payments made</i>			
31 December 20X7			
Staff costs	Given	250 000	
Bank			250 000
<i>Wages paid during the year</i>			
31 December 20X7			
Deferred grant income	250 000 x 20%	50 000	
Grant income			50 000
<i>Recognising grant income to the extent payments made</i>			
31 December 20X8			
Staff costs	Given	400 000	
Bank			400 000
<i>Wages paid during the year</i>			
31 December 20X8			
Deferred grant income	(400 000 x 20%) but limited to the balance in the	60 000	
Grant income	deferred income account: 150 000 – 40 000 – 50 000		60 000
<i>Recognising grant income to the extent payments made</i>			

P.S. Staff costs are an employee benefit. The account could therefore also be called employee benefit expense: wages, if preferred.

Solution 27.1 continued ...

b)

		Debit	Credit
1 January 20X6			
Bank	Given	150 000	
Deferred grant income			150 000
<i>Recognition of government grant</i>			
31 December 20X6			
Staff costs	Given	200 000	
Bank			200 000
<i>Wages paid during the year</i>			
31 December 20X6			
Deferred grant income	200 000 x 20%	40 000	
Staff costs			40 000
<i>Recognising grant income to the extent payments made</i>			
31 December 20X7			
Staff costs	Given	250 000	
Bank			250 000
<i>Wages paid during the year</i>			
31 December 20X7			
Deferred grant income	250 000 x 20%	50 000	
Staff costs			50 000
<i>Recognising grant income to the extent payments made</i>			
31 December 20X8			
Staff costs	Given	400 000	
Bank			400 000
<i>Wages paid during the year</i>			
31 December 20X8			
Deferred grant income	(400 000 x 20%) but limited to the balance in the	60 000	
Staff costs	deferred income account: 150 000 – 40 000 – 50 000		60 000
<i>Recognising grant income to the extent payments made</i>			

P.S. Staff costs are an employee benefit. The account could therefore also be called employee benefit expense: wages, if preferred.

Solution 27.2

a)

		Debit	Credit
1 January 20X5			
Bank	Given	400 000	
Deferred grant income			400 000
<i>Recognition of government grant</i>			
<hr/>			
Equipment: cost	Given	1 500 000	
Bank			1 500 000
<i>Purchase of equipment</i>			
<hr/>			
31 December 20X5			
Depreciation	$(1\,500\,000 - 0) / 4$	375 000	
Equipment: accumulated depreciation			375 000
<i>Depreciation charge for the year</i>			
<hr/>			
Deferred grant income	$(400\,000 / 4)$	100 000	
Grant income			100 000
<i>Grant income recognised on the same basis as depreciation on the equipment</i>			
<hr/>			
31 December 20X6			
Depreciation	$(1\,500\,000 - 0) / 4$	375 000	
Equipment: accumulated depreciation			375 000
<i>Depreciation charge for the year</i>			
<hr/>			
Deferred grant income	$(400\,000 / 4)$	100 000	
Grant income			100 000
<i>Grant income recognised on the same basis as depreciation on the equipment</i>			
<hr/>			
31 December 20X7			
Depreciation	$(1\,500\,000 - 0) / 4$	375 000	
Equipment: accumulated depreciation			375 000
<i>Depreciation charge for the year</i>			
<hr/>			
Deferred grant income	$(400\,000 / 4)$	100 000	
Grant income			100 000
<i>Grant income recognised on the same basis as depreciation on the equipment</i>			
<hr/>			
31 December 20X8			
Depreciation	$(1\,500\,000 - 0) / 4$	375 000	
Equipment: accumulated depreciation			375 000
<i>Depreciation charge for the year</i>			
<hr/>			
Deferred grant income	$(400\,000 / 4)$	100 000	
Grant income			100 000
<i>Grant income recognised on the same basis as depreciation on the equipment</i>			
<hr/>			

Solution 27.2 continued ...

b)

		Debit	Credit
1 January 20X5			
Bank	<i>Given</i>	400 000	
Deferred grant income			400 000
<i>Recognition of government grant</i>			
<hr/>			
Equipment: cost	<i>Given</i>	1 500 000	
Bank			1 500 000
<i>Purchase of equipment</i>			
<hr/>			
Deferred grant income		400 000	
Equipment: cost			400 000
<i>Recognizing grant as reduction of equipment's cost</i>			
<hr/>			
31 December 20X5			
Depreciation	$(1\,500\,000 - 400\,000 - 0) / 4$	275 000	
Equipment: accumulated depreciation			275 000
<i>Depreciation on equipment</i>			
<hr/>			
31 December 20X6			
Depreciation	$(1\,500\,000 - 400\,000 - 0) / 4$	275 000	
Equipment: accumulated depreciation			275 000
<i>Depreciation on equipment</i>			
<hr/>			
31 December 20X7			
Depreciation	$(1\,500\,000 - 400\,000 - 0) / 4$	275 000	
Equipment: accumulated depreciation			275 000
<i>Depreciation on equipment</i>			
<hr/>			
31 December 20X8			
Depreciation	$(1\,500\,000 - 400\,000 - 0) / 4$	275 000	
Equipment: accumulated depreciation			275 000
<i>Depreciation on equipment</i>			
<hr/>			

Solution 27.3

a)

		Debit	Credit
1 January 20X5			
Bank	<i>Given</i>	500 000	
Deferred grant income			500 000
<i>Recognition of government grant</i>			
Deferred grant income	<i>Given</i>	200 000	
Grant income			200 000
<i>Portion of the grant received for immediate financial support is recognised as income immediately</i>			
Harvester: cost (asset)	<i>Given</i>	900 000	
Bank			900 000
<i>Purchase of harvester</i>			
31 December 20X5			
Depreciation	$(900\,000 - 50\,000) / 5$	170 000	
Harvester: accumulated depreciation			170 000
<i>Depreciation for the year</i>			
Deferred grant income	$(500\,000 - 200\,000) / 5$	60 000	
Grant income			60 000
<i>Grant income recognised on the same basis as depreciation</i>			
31 December 20X6			
Depreciation	$(900\,000 - 50\,000) / 5$	170 000	
Harvester: accumulated depreciation			170 000
<i>Depreciation for the year</i>			
Deferred grant income	$(500\,000 - 200\,000) / 5$	60 000	
Grant income			60 000
<i>Grant income recognised on the same basis as depreciation</i>			
31 December 20X7			
Depreciation	$(900\,000 - 50\,000) / 5$	170 000	
Harvester: accumulated depreciation			170 000
<i>Depreciation for the year</i>			
Deferred grant income	$(500\,000 - 200\,000) / 5$	60 000	
Grant income			60 000
<i>Grant income recognised on the same basis as depreciation</i>			
31 December 20X8			
Depreciation	$(900\,000 - 50\,000) / 5$	170 000	
Harvester: accumulated depreciation			170 000
<i>Depreciation for the year</i>			
Deferred grant income	$(500\,000 - 200\,000) / 5$	60 000	
Grant income			60 000
<i>Grant income recognised on the same basis as depreciation</i>			
31 December 20X9			
Depreciation	$(900\,000 - 50\,000) / 5$	170 000	
Harvester: accumulated depreciation			170 000
<i>Depreciation for the year</i>			
Deferred grant income	$(500\,000 - 200\,000) / 5$	60 000	
Grant income			60 000
<i>Grant income recognised on the same basis as depreciation</i>			

Solution 27.3 continued ...

b)

		Debit	Credit
1 January 20X5			
Bank	<i>Given</i>	500 000	
Deferred grant income			500 000
<i>Recognition of government grant</i>			
Deferred grant income	<i>Given</i>	200 000	
Grant income			200 000
<i>Portion of grant for immediate financial support is recognised as income immediately</i>			
Harvester: cost (asset)	<i>Given</i>	900 000	
Bank			900 000
<i>Purchase of harvester</i>			
Deferred grant income	$(500\,000 - 200\,000)$	300 000	
Harvester: cost (asset)			300 000
<i>Grant set off against cost of harvester</i>			
31 December 20X5			
Depreciation	$(900\,000 - 300\,000 - 50\,000) / 5$	110 000	
Harvester: accumulated depreciation			110 000
<i>Depreciation for the year</i>			
31 December 20X6			
Depreciation	$(900\,000 - 300\,000 - 50\,000) / 5$	110 000	
Harvester: accumulated depreciation			110 000
<i>Depreciation for the year</i>			
31 December 20X7			
Depreciation	$(900\,000 - 300\,000 - 50\,000) / 5$	110 000	
Harvester: accumulated depreciation			110 000
<i>Depreciation for the year</i>			
31 December 20X8			
Depreciation	$(900\,000 - 300\,000 - 50\,000) / 5$	110 000	
Harvester: accumulated depreciation			110 000
<i>Depreciation for the year</i>			
31 December 20X9			
Depreciation	$(900\,000 - 300\,000 - 50\,000) / 5$	110 000	
Harvester: accumulated depreciation			110 000
<i>Depreciation for the year</i>			

Solution 27.4

a)

		Debit	Credit
1 January 20X6			
Bank	<i>Given</i>	250 000	
Deferred grant income			250 000
<i>Recognition of government grant</i>			
<hr/>			
Machinery: cost (asset)	<i>Given</i>	500 000	
Bank			500 000
<i>Purchase of machinery</i>			
<hr/>			
31 December 20X6			
Depreciation	$(500\,000 - 0) / 4$	125 000	
Machinery: accumulated depreciation			125 000
<i>Depreciation for the year</i>			
<hr/>			
Deferred grant income	$(250\,000 / 4)$	62 500	
Grant income			62 500
<i>Recognised on same basis as depreciation</i>			
<hr/>			
31 December 20X7			
Depreciation	$(500\,000 - 0) / 4$	125 000	
Machinery: accumulated depreciation			125 000
<i>Depreciation for the year</i>			
<hr/>			
Deferred grant income	$(250\,000 / 4)$	62 500	
Grant income			62 500
<i>Recognised on same basis as depreciation</i>			
<hr/>			
1 December 20X8			
Deferred grant income	$(250\,000 - 62\,500 - 62\,500)$	125 000	
Grant forfeited expense	<i>Balancing</i>	125 000	
Bank	<i>Given</i>		250 000
<i>Grant forfeited, first reduce deferred grant income then expense rest</i>			
<hr/>			
31 December 20X8			
Depreciation	$(500\,000 - 0) / 4$	125 000	
Machinery: accumulated depreciation			125 000
<i>Depreciation for the year</i>			
<hr/>			
31 December 20X9			
Depreciation	$(500\,000 - 0) / 4$	125 000	
Machinery: accumulated depreciation			125 000
<i>Depreciation for the year</i>			
<hr/>			

Solution 27.4 continued ...

b)

		Debit	Credit
1 January 20X6			
Bank	Given	250 000	
Deferred grant income			250 000
<i>Recognition of government grant</i>			
<hr/>			
Machinery: cost (asset)	Given	500 000	
Bank			500 000
<i>Purchase of machinery</i>			
<hr/>			
Deferred grant income	Given	250 000	
Machinery: cost (asset)			250 000
<i>Recognising grant as a reduction of asset's cost</i>			
<hr/>			
31 December 20X6			
Depreciation	$(500\,000 - 250\,000 - 0) / 4$	62 500	
Machinery: accumulated depreciation			62 500
<i>Depreciation for the year</i>			
<hr/>			
31 December 20X7			
Depreciation	$(500\,000 - 250\,000 - 0) / 4$	62 500	
Machinery: accumulated depreciation			62 500
<i>Depreciation for the year</i>			
<hr/>			
1 December 20X8			
Machinery: cost		250 000	
Bank	Given		250 000
Depreciation		125 000	
Machinery: accumulated depreciation	W1: $(250\,000 - 125\,000)$		125 000
<i>Repayment of government grant and change in estimated depreciation</i>			
<hr/>			
31 December 20X8			
Depreciation	$(500\,000 - 0) / 4$	125 000	
Machinery: accumulated depreciation			125 000
<i>Depreciation for the year</i>			
<hr/>			
31 December 20X9			
Depreciation	$(500\,000 - 0) / 4$	125 000	
Machinery: accumulated depreciation			125 000
<i>Depreciation for the year</i>			
<hr/>			

Solution 27.4 continued ...

b) continued ...

Working 1: change in estimate

	Date	Calculations	Was	Is	Difference
Cost	1/1/20X6	$500\,000 - 250\,000$	250 000	500 000	250 000
Depreciation	20X6 & 20X7	$(250\,000 - 0) / 4 \times 2$ $(500\,000 - 0) / 4 \times 2$	(125 000)	(250 000)	(125 000)
Carrying amount	31/12/20X7		125 000	250 000	125 000
Depreciation	20X8	$(250\,000 - 0) / 4 \times 1$ $(500\,000 - 0) / 4 \times 1$	(62 500)	(125 000)	(62 500)
Depreciation	Future	$(250\,000 - 0) / 4 \times 1$ $(500\,000 - 0) / 4 \times 1$	(62 500)	(125 000)	(62 500)
Residual value	31/12/20X9	Given	0	0	0

It is interesting to note that the change in estimate is calculated on a *cumulative catch-up basis*, rather than a reallocation basis suggested by IAS 8. This cumulative approach is required in IAS 20.32.

Solution 27.5**a)**

	Debit	Credit
30 June 20X8		
Weapons licence: cost (FV)	900 000	
Bank		50 000
Deferred grant income		850 000
<i>Recognising the licence granted by the government at fair value</i>		
31 December 20X8		
Amortisation - licence (900 000/ 5 x 6/ 12)	90 000	
Licence: accumulated amortisation		90 000
<i>Amortisation of weapons licence for 6 months</i>		
Deferred grant income (850 000/ 5 x 6/ 12)	85 000	
Grant income		85 000
<i>Recognised on the same basis as amortisation</i>		

b)

	Debit	Credit
30 June 20X8		
Weapons licence: cost	50 000	
Bank		50 000
<i>Recognising the licence granted by the government at nominal amount</i>		
31 December 20X8		
Amortisation - licence (50 000/ 5 x 6/ 12)	5 000	
Licence: accumulated amortisation		5 000
<i>Amortisation of weapons licence for 6 months</i>		

c)

ANTHONY LIMITED
NOTES TO THE FINANCIAL STATEMENTS (EXTRACTS)
FOR THE YEAR ENDED 31 DECEMBER 20X8

25. Government assistance

Anthony Limited received free advice from government experts. This advice included technical manufacturing advice as well as marketing advice for the company's weapons manufacturing operations. The company received this assistance because of its excellent BEE rating.

Solution 27.6

The subsidy granted by the government would meet the definition of a government grant as defined by IAS 20.3.

Government grants are assistance by government:

- in the form of transfers of resources:
The amount of C800 000 is a resource – and equates to a transfer of these resources even if the grant has not yet been received in cash: the government's obligation and Trailblazer Limited's asset would be recognized on the basis that the flow of future economic benefits were expected (if there was any risk that the company would not complete the building, being a condition of the grant, then this grant would not be recorded until either the cash were received or the condition was met);
- to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity:
A condition was attached to the grant requiring that a building be erected in Themiddleofnowhere.
- They exclude those forms of government assistance which:
 - cannot reasonably have a value placed upon them:
this grant clearly has a value since it will equal half of the costs of construction, limited to a grant of C1 000 000. If Trailblazer Limited has no reliable estimate of the costs of construction, then the definition of a grant would not be met: the grant would need to be recognized as and when it was received or as soon as a reliable estimate became possible
 - cannot be distinguished from the normal trading transactions of the entity:
the grant is clearly related to the normal trading transactions of the entity since the grant relates to the building of a factory that is essential to the manufacture of its only product: shoes.

The subsidy also meets the definition of a grant related to an asset as defined by IAS 20.3:

- a grant whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets.
The grant was conditional upon the construction of a factory in a specific area, thus a condition to the grant exists.

The government grant therefore exists. Whether or not to *recognize* this grant, however, depends on whether there is reasonable assurance that the entity will comply with the conditions attaching to it, and that the grant will be received (IAS 20.8). Receipt of a grant does not of itself provide conclusive evidence that the conditions attaching to the grant have been or will be fulfilled.

Trailblazer Limited should therefore use professional judgement and be prudent in recognizing this grant and only recognize the grant when the building is significantly complete, feasibility studies have been done to ensure sufficiently cash is available to complete the building etcetera. The terms of the agreement would need to be thoroughly assessed before recognizing this grant and determining how much of the grant may be recognized..

As the grant was provided for the construction of a factory that would be depreciated, Trailblazer would have the choice of recognising the grant of C800 000 as either:

- Deferred income and periodically amortising the grant on a rational and consistent basis, e.g. the useful life of the factory, to profit or loss; or
- A reduction against the cost of the factory. This would have the same effect on profit or loss as the depreciation expense will be reduced.

Solution 27.7

a)

	Debit	Credit
1 January 20X8		
Bank	300 000	
Deferred income: government grant		300 000
<i>Government grant received</i>		
PPE: glass blower: cost	500 000	
Bank		500 000
<i>Purchase of glass blower</i>		
31 December 20X8		
Depreciation – glass blower $(500\,000 - 0) \div 5$	100 000	
PPE: glass blower: accumulated depreciation		100 000
<i>Depreciation for 20X8</i>		
Deferred income: government grant	60 000	
Grant income $300\,000 \div 5$		60 000
<i>Portion of grant income realised</i>		
31 December 20X9		
Depreciation – glass blower $(500\,000 - 0) \div 5$	100 000	
PPE: glass blower: cost accumulated depreciation		100 000
<i>Depreciation for 20X9</i>		
Deferred income: government grant	60 000	
Grant income		60 000
<i>Grant income realised</i>		
Deferred income: government grant	60 000	
Bank $300\,000 \times (2\,000 \div 10\,000)$		60 000
<i>Portion of grant repaid</i>		
Grant income $W1 \text{ or } (60\,000 + 60\,000) \times 20\%$		
Deferred income: government grant	24 000	
<i>Grant income restated due to repayment (change in estimate)</i>		24 000

W1: Change in estimate

Deferred income	Was	Should have been	Difference	
1/1/20X8 (1)	300 000	240 000	60 000	
Movement (2)	(60 000)	(48 000)	(12 000)	Less grant income
(3)				
31/12/20X8	240 000	192 000	48 000	
Movement	(60 000)	(48 000)	(12 000)	Less grant income
31/12/20X9	180 000	144 000	36 000	

(1) Amount originally received: 300 000 – Amount forfeited (repaid): 60 000 = 240 000

(2) $300\,000 / 5 \text{ years} = 60\,000$ (3) $240\,000 / 5 \text{ years} = 48\,000$

Solution 27.7

b)

	Debit	Credit
1 January 20X8		
Bank	300 000	
Deferred income: government grant		300 000
<i>Government grant received</i>		
PPE: glass blower: cost	500 000	
Bank		500 000
<i>Purchase of glass blower</i>		
Deferred income: government grant	300 000	
PPE: glass blower: cost		300 000
<i>Grant written off against asset</i>		
31 December 20X8		
Depreciation $(500\,000 - 300\,000 - 0) \div 5$	40 000	
PPE: glass blower: accumulated depreciation		40 000
<i>Depreciation for 20X8</i>		
31 December 20X9		
Depreciation $(500\,000 - 300\,000 - 0) \div 5$	40 000	
PPE: glass blower: accumulated depreciation		40 000
<i>Depreciation for 20X9</i>		
PPE: glass blower: cost $300\,000 \times (2\,000 \div 10\,000)$	60 000	
Bank		60 000
<i>Portion of grant repaid</i>		
Depreciation $W1 \text{ or } 60\,000 / 5 \text{ yrs} \times 2 \text{ yrs}$	24 000	
PPE: glass blower: accumulated depreciation		24 000
<i>Accumulated depreciation restated due to repayment of grant</i>		

W1: Change in estimate

Glass blower	Was	Should have been	Difference
1/1/20X8 (1) (2)	200 000	260 000	60 000
Movement (3) (4)	(40 000)	(52 000)	12 000
31/12/20X8	160 000	208 000	(48 000)
Movement	(40 000)	(52 000)	12 000
31/12/20X9	120 000	156 000	(36 000)

(1) Cost: $500\,000 - \text{Original grant: } 300\,000 = 200\,000$ (2) Cost: $500\,000 - \text{Reduced grant: } (300\,000 - 60\,000) = 260\,000$ (3) $(200\,000 - 0) / 5 \text{ years} = 40\,000$ (4) $(260\,000 - 0) / 5 \text{ years} = 52\,000$

Solution 28.1

The S.A. Furniture Company Limited experienced financial difficulties because, essentially, its sales growth exceeded its sustainable growth rate. As a result, cash generated by operating activities became negative in 20X0 and 20X1. A company which consistently fails to generate positive cash from operations is most likely to land up in financial difficulties.

As regards working capital an increase therein is a function of increased scale of operations (e.g. sales growth) and slacker control of stocks and debtors and creditors demanding quicker payments. Therefore the constant and significant increases in working capital are a function of growth in sales and the net trade cycle (i.e. inventory period plus accounts receivable period less accounts payable period).

With regards to dividends paid, notwithstanding the negative 'cash available from operating activities', the company paid out dividends, resulting in negative cash retained from operating activities. From the information given, it would appear that it did not have the cash income to pay such dividends and the company had to borrow to finance the payment of dividends, an extremely undesirable and dangerous policy.

Heavy use was made in 20W9 and 20X0 of preference shares and long-term loans in 20X0 to 20X2. The results of the above were that finance costs and dividends on preference shares increased a great deal and resulted in a very large loss in 20X2 and caused delisting in 20X3.

Solution 28.2

		20X3 C000s	20X4 C000s	20X5 C000s
Accounts receivable collection period	W1	60 days	76 days	80 days
Inventory holding period	W2	91 days	105 days	110 days
Accounts payable payment period	W3	63 days	60 days	61 days
Current ratio	W4	3.1	3.3	3.2
Acid test ratio	W5	1.6	1.6	1.6

Although the company's liquidity position, as evidenced by the current ratio and the acid test ratio, appears to be growing stronger, the ratios appear to indicate a problem with the working capital management of the company. Industry ratios would be useful to compare with the company but at first glance the company appears to have excessive funds tied up in non-interest bearing current assets.

Debtors are taking longer to pay and the provision for bad debts may need to be examined. The increase in turnover may be a result of more lenient credit terms but it may also be a result of more lenient credit controls which may result in bad debts arising.

Cash is also being tied up in inventory holdings which have been increasing substantially over the period examined. The stock should be examined to identify any obsolete or slow moving items and purchasing should be monitored to improve the efficiency of holdings.

Creditors' days have remained steady around 60 days. Where possible, efforts should be made to increase the use of this interest free funding and no early payments should be made unless adequately compensated for by settlement discounts.

Solution 28.2 continued ...

Workings

W1 Accounts receivable collection period

		20X3		20X4		20X5	
<u>Average debtors balance</u>	X 365	<u>16 500</u>	X 365	<u>25 000</u>	X 365	<u>29 600</u>	X 365
Credit sales		100 000		120 000		135 000	
		= 60 days		= 76 days		= 80 days	

W2 Inventory holding period

		20X3		20X4		20X5	
<u>Average inventory balance</u>	X 365	<u>18 750</u>	X 365	<u>26 000</u>	X 365	<u>30 400</u>	X 365
Cost of sales		75 000		90 000		101 250	
		= 91 days		= 105 days		= 110 days	

W3 Accounts payable payment period

		20X3		20X4		20X5	
<u>Average creditors balance</u>	X 365	<u>13 000</u>	X 365	<u>14 700</u>	X 365	<u>17 000</u>	X 365
Cost of sales		75 000		90 000		101 250	
		= 63 days		= 60 days		= 61 days	

W4 Current ratio

	20X3	20X4	20X5
<u>Current assets</u>	<u>40 250</u>	<u>51 000</u>	<u>60 000</u>
Current liabilities	13 000	15 200	19 000
	= 3 : 1	= 3,3 : 1	= 3,2 : 1

W5 Acid test ratio

	20X3	20X4	20X5
<u>Current assets - inventory</u>	<u>21 500</u>	<u>25 000</u>	<u>29 600</u>
Current liabilities	13 000	15 200	19 000
	= 1,6 : 1	= 1,6 : 1	= 1,6 : 1

Solution 28.3**a) Purpose of financial statement analysis**

- Financial reporting provides information about the financial position, changes in the financial position and the performance of a business entity that is useful to a wide range of users in making economic decisions.
- The users need to evaluate the financial position of a business entity and the results of its business operations, when making economic decisions. This evaluation is the overall objective of financial statement analysis.

b) Current and quick ratios**20X1**

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}} = \frac{1\,290}{315} = 4.1 : 1$$

$$\text{Quick ratio} = \frac{\text{Current assets} - \text{inventory}}{\text{Current liabilities}} = \frac{1\,290 - 836}{315} = 1.4 : 1$$

20X0

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}} = \frac{1\,124}{281} = 4.0 : 1$$

$$\text{Quick ratio} = \frac{\text{Current assets} - \text{inventory}}{\text{Current liabilities}} = \frac{1\,124 - 715}{281} = 1.5 : 1$$

- The current ratio for both 20X0 and 20X1 are above the industry ratio, which indicates comfortable liquidity
- The quick ratio is also above the industry ratio. This also indicates a comfortable level of liquidity
- However the difference between the current and quick ratios indicates that the inventory comprises a large proportion of the current assets, which is not as liquid as accounts receivable and cash.

c) Return on equity

$$\begin{aligned} \text{Return on Equity} &= \frac{\text{Profit for the period} - \text{preference dividend}}{\text{Average ordinary shareholders' equity}} \\ &= \frac{51\,590 - 0}{(680 + 663)/2} = 7.7\% \end{aligned}$$

- This ratio measures the percentage of net profit after tax and preference dividends which is available to ordinary shareholders
- This ratio is important to ordinary shareholders because it represents the return they earn on their ordinary share investment. They would compare this return to the return they could obtain from other investments.

Solution 28.3 continued ...**d) Debt to Equity ratio**

$$\text{Debt : Equity} = \frac{\text{Total Debt}}{\text{Total Equity}}$$

20X1

$$= \frac{(225 + 430 + 315)}{(460 + 220)} = 142.6\%$$

20X0

$$= \frac{(200 + 324 + 281)}{(460 + 203)} = 121.4\%$$

- This ratio is useful in assessing the risk that the company faces by utilising debt relative to its equity. The main risk facing a company with a high debt to equity ratio is the inability to repay the debt and interest thereon. This risk could lead to the liquidation of the company.

e) PE ratio**20X1**

$$\text{PE} = \frac{\text{MP}}{\text{EPS}} = \frac{\text{C12.00}}{\text{C0.5159}} = 23.3$$

20X0

$$\text{PE} = \frac{\text{MP}}{\text{EPS}} = \frac{\text{C30.00}}{\text{C1.0252}} = 29.3$$

- The PE ratio is an indication of the number of years earnings that investors are buying.
- A high PE ratio is usually an indication of confidence in the company and an expectation that profits will increase. It also represent future growth opportunities within a company. However, if the ratio is too high compared to the industry or market, this may indicate an overpriced share.
- A low PE ratio is usually an indication of a lack of confidence in the company and an expectation that profits will decrease.

f) Problems and limitations of financial statement analysis

- Sometimes the information needed to calculate ratios is not disclosed in the financial statements.
- In the interpretation of results, it is difficult to generalize about whether a particular ratio is good or bad. For example a high quick ratio may show a strong liquidity position, which is good, or an excessive amount of cash, which is bad, because cash does not bring high returns compared to other assets.
- If there are no comparative amounts, the usefulness of the analysis may be limited.

Solution 28.3 continued ...

- Different accounting practices can distort ratio comparisons. For example inventory has two valuation methods: (1) first-in, first-out; (2) weighted average. Therefore two firms in the industry could use different valuation methods. (Another example would be redeemable preference shares, redeemable after a certain period)
- Companies sometimes employ creative accounting methods to make their financial statements look better to analysts.

g) Recommendation

- The liquidity ratios indicate a comfortable level of liquidity, even though the inventory seems a bit high
- The profitability ratios indicate a decreasing trend
 - In 20X1 the net profit percentage was 1.34% (20X0: 3%), which is way below the industry average
 - The gross profit margin has decreased to 15.5% from 16.5% in 20X0
- The solvency ratios also indicate an increase in the liabilities which would put the company at the risk of not being able to meet its commitment. The debt to equity ratio increased. There is a risk that if the company is unable to meet its commitments the ordinary shareholders will lose all their investment in the company. The company is however technically solvent.
- The return on the equity has decreased to 7.7% in 20X1 from 15.5% in 20X0. Therefore the company is generating less returns for the ordinary shareholders.
- The company's share price has gone down, thus its PE ratio has decreased. However the company's press release relating to the new anti-aging electronic device was issued after year-end, the share price does not reflect the effect of the press release.
- The new anti-aging electronic device, which has been patented, has the potential of reversing the downward trend that the company has been facing. If there is sufficient demand for the device, the company would generate more profits and thus increase the returns to the ordinary shareholders.
- More information is required to give a comprehensive recommendation. However based on the given information, MedTech Limited should go ahead and purchase a majority shareholding in Computronic Limited on the basis of the potential growth opportunities from the electronic device provided that the company receives approval from the FDA..

Solution 29.1

- A (Private) Limited is not a subsidiary because P Limited has relinquished its voting power and therefore does not control the company.
- B Limited is a subsidiary of P Limited. P Limited owns more than 50% of the voting rights in B Limited and therefore it controls the company.
- C Limited is a subsidiary of P Limited. P Limited controls 60% of the voting rights in C Limited indirectly through its control of B Limited. The fact that it is a foreign company makes no difference.
- S Limited is a subsidiary of P Limited. Although P Limited does not own more than 50% of the voting rights in S Limited, P Limited controls S Limited through its power to appoint or remove the majority of the board of directors.
- R Limited is a subsidiary of P Limited. P Limited controls 35% of R Limited directly as it owns 35% of the share capital and 30% of R Limited together with the shares owned by S Limited, which P Limited controls. Therefore P Limited controls 65% of the voting power of R Limited.
- D Limited is not a subsidiary, as P Limited has no control through A Limited and only controls 20% through B Limited.

Solution 29.2

a) Pre-acquisition and post-acquisition dividends

A **pre-acquisition dividend** is a dividend paid by a subsidiary company out of profits that have been earned by the subsidiary prior to the parent company acquiring control of the subsidiary.

A **post-acquisition dividend** is a dividend paid by a subsidiary company out of profits that have been earned subsequent to the parent company acquiring control of the subsidiary.

The dividend paid on 3 April 20X8 is a pre-acquisition dividend

The dividend declared on 30 September 20X8 is a post acquisition dividend

b) Accounting for pre-acquisition and post-acquisition dividends

Prior to the 2008 amendment to IAS 27, parent entities recognised income from investments in subsidiaries only to the extent that dividends were paid out of post-acquisition accumulated profits; distributions received out of pre-acquisition profits were regarded as a recovery of the investment and were deducted from its cost.

The amendment requires all dividends, received and receivable to be recorded as income. However, IAS 36 'Impairment of Assets' has also been amended to include a dividend in excess of the investee's comprehensive income for the period as an indicator of possible impairment of the investment. The Amendments are effective for annual periods beginning on or after 1 January 2009.

Solution 29.3

**PARENT LIMITED
JOURNAL**

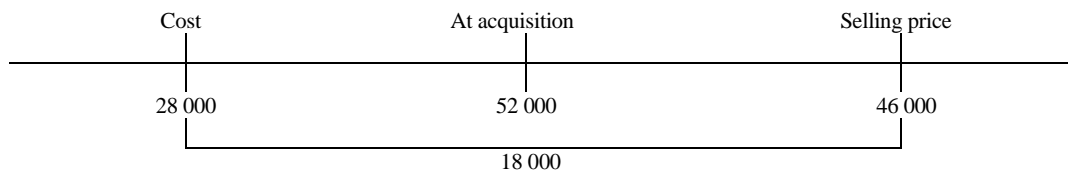
Date	Description	Debit	Credit
Jan 1	Investment in Subsidiary Limited	50 000	
	Bank		50 000
<i>Purchase of 20 000 shares in Subsidiary Limited as per directors resolution dated ...</i>			
Jan 3	Bank	1 000	
	Dividend income		1 000
<i>Dividend received from subsidiary company.</i>			
June 30	Bank	3 000	
	Dividend received from subsidiary		3 000
<i>Dividend received from subsidiary company</i>			
Jan 2	Bank	5 000	
	Dividends income		5 000
<i>Dividends received from Subsidiary Limited</i>			
June 30	Bank	10 000	
	Dividend income		10 000
<i>Dividend received from subsidiary company</i>			
June 30	Impairment of investment	1 500	
	Investment in Subsidiary Limited		1 500
<i>Investment written down to recoverable amount</i>			

Solution 29.3 continued ...

Workings

Purchase consideration		
Fair value of consideration transferred		50 000
Fair value of identifiable net assets		47 780
Share capital		20 000
Retained earnings 30.6.20X3		8 000
Profit to 31.12.20X3		2 500
Land		24 000
Deferred tax	(24 000 X 0,28)	(6 720)
Gain on acquisition / Goodwill		2 220

Sale of land	S Ltd	Group
Selling price	46 000	46 000
Cost	(28 000)	(52 000)
Profit / (loss)	18 000	(6 000)



Solution 29.4

a)

P LIMITED JOURNAL				
Date		Description	Debit	Credit
20X5				
July	1	Investment in S Limited	115 000	
		Bank		115 000
<i>Purchase of all the shares in S Limited</i>				
20X6				
June	30	Bank	20 000	
		Dividend income		20 000
<i>Dividend received from subsidiary</i>				
20X7				
June	30	Impairment loss	3 000	
		Investment in S Limited		3 000
<i>Impairment of investment in S Limited</i>				
20X8				
June	30	Bank	12 000	
		Dividend income		12 000
<i>Dividend received from subsidiary company</i>				
June	30	Investment in S Limited	1 000	
		Recovery of impairment loss		1 000
<i>Reversal of impairment in S Limited</i>				

Solution 29.4 continued ...

b)

P LIMITED
EXTRACT FROM STATEMENT OF FINANCIAL POSITION
AT 30 JUNE 20X6

Investment in subsidiary	C 115 000
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P LIMITED
EXTRACT FROM STATEMENT OF FINANCIAL POSITION
AT 30 JUNE 20X7

Investment in subsidiary	C 112 000
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P LIMITED
EXTRACT FROM STATEMENT OF FINANCIAL POSITION
AT 30 JUNE 20X8

Investment in subsidiary	C 113 000
--------------------------	--------------

Workings

Purchase consideration	C
Fair value of consideration transferred	115 000
Fair value of identifiable net assets	115 000
Share capital	100 000
Retained earnings	15 000
Goodwill	-

Analysis of retained earnings (not needed for answer)

	Total	Before	Since
Balance 1.7.20X5	15 000	15 000	
Profit 30.6.20X6	16 000		16 000
Dividend 30.6.20X6	(20 000)	(4 000)	(16 000)
	11 000	11 000	-
Loss 30.6.20X7	(3 000)		(3 000)
	8 000	11 000	(3 000)
Profit 30.6.20X8	14 000		14 000
Dividend 30.6.20X8	(12 000)		(12 000)
Balance 30.6.20X8	10 000	11 000	(1 000)

Investment in S			
Description	C	Description	C
Bank	115 000	Impairment	3 000
Balance	112 000		
Impairment reversal	1 000		
Balance	113 000		

Solution 29.5

a) Journal entries in the accounting records of Pasta Limited

		Dr	Cr
01/01/X5	Investment in S (Pvt) Limited	1 460 000	
	Bank		1 460 000
	<i>Purchase of 100% of shares</i>		
03/01/X5	Bank	10 000	
	Dividend income		10 000
	<i>Dividend received from pre-acquisition reserves</i>		
30/06/X5	Bank	40 000	
	Dividend income		40 000
	<i>Dividend received from pre and post acquisition reserves</i>		
30/06/X6	Bank	90 000	
	Dividend income		90 000
	<i>Pre-acquisition dividend on sale of property</i>		
	Impairment of investment	60 000	
	Investment in S (Pvt) Limited		60 000
	<i>Impairment of investment in S (Pvt) Limited</i>		

Solution 29.5 continued ...

b) Journal entries in the accounting records of Sauce (Pty) Ltd

		Dr	Cr
01/01/X5	Accumulated depreciation Equipment	35 000	35 000
	<i>Reversal of accumulated depreciation</i>		
	Equipment	10 000	
	Deferred tax		2 900
	Revaluation reserve		7 100
	<i>Revaluation of equipment</i>		
30/06/X6	Depreciation	5 625	
	Accumulated depreciation		5 625
	<i>Depreciation for the year (45 000 / 4 yrs X 6/12)</i>		
	Tax expense	906	
	Deferred tax		906
	<i>Originating temporary difference on equipment</i>		
	Revaluation reserve	888	
	Retained earnings		888
	<i>Transfer of realised portion to retained earnings</i> <i>[(5 625 – *4 325) X 0.71] or (7 100 / 4 X 6/12)</i> <i>*(35 000 / 4 yrs X 6/12)</i>		
30/06/X6	Depreciation	11 250	
	Accumulated depreciation		11 250
	<i>Depreciation for the year (45 000 / 4 yrs)</i>		
	Tax expense	1 813	
	Deferred tax		1 813
	<i>Originating temporary difference on equipment</i>		
	Revaluation reserve	1 775	
	Retained earnings		1 775
	<i>Transfer of realised portion to retained earnings</i> <i>[(11 250 – *8 750) X 0.71] or (7 100 / 4)</i> <i>*(35 000 / 4 yrs)</i>		
	Cash	1 600 000	
	Property		1 500 000
	Profit on disposal		100 000
	<i>Sale of property</i>		

Solution 29.5 continued ...

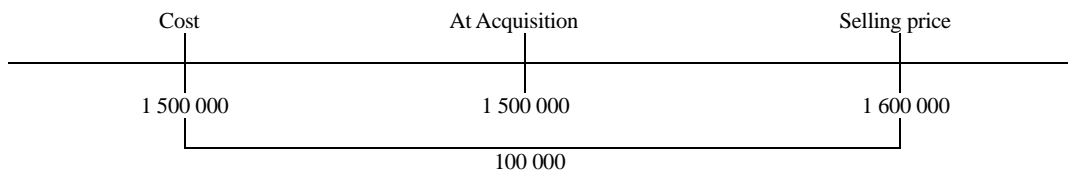
Workings

W1 Purchase consideration

Fair value of consideration transferred		1 460 000
Fair value of identifiable net assets:		1 210 000
Share capital		1 000 000
Retained earnings at acquisition	(152 900 + 50 000)	202 900
Equipment		10 000
Deferred tax		(2 900)
Goodwill		250 000

W2 Sale of property

	Sauce Limited	Group
Selling price	1 600 000	1 600 000
Cost	(1 500 000)	(1 500 000)
	100 000	100 000



W3 Analysis of retained earnings of Sauce Limited (not required for answer)

				Total	Before	Since
01/07/X4	Balance			152 900	152 900	
01/07/X4	- Profit	(75 000	-	50 000	50 000	
31/12/X4		25 000)				
	At acquisition			202 900	202 900	
03/01/X5	Dividend			(10 000)	(10 000)	
				192 900	192 900	
01/01/X5	- Profit	(45 000	-	30 000		30 000
30/06/X5		15 000)				
30/06/X5	Dividend			(40 000)	(10 000)	(30 000)
	Transfer from RS			888	888	
				183 788	183 788	0
01/07/X5	- Loss			(60 000)		(60 000)
30/06/X6						
30/06/X6	Profit on sale of property			100 000	100 000	
	Dividend			(90 000)	(90 000)	
	Transfer from RS			1 775	1 775	
30/06/X6	Balance			135 563	195 563	(60 000)

Solution 29.5 continued ...

W4 Equipment

			CA	TB	TD	DT (29%)	NDR	RE
01/07/X2			70 000	70 000				
01/07/X2 -	Accumulated	(70 000 X 0.20 X 2.5) /	(35 000)	(43 750)				
31/12/X4	depreciation /	(70 000 X 0.25 X 2.5)						
	Tax allowance							
			35 000	26 250	8 750	2 538		
01/01/X5	Revaluation		10 000		10 000	2 900	7 100	
			45 000	26 250	18 750	5 438		
01/01/X5 -	Accumulated	(45 000 / *4 yrs X 6/12)	(5 625)		3 125	906		
30/06/X5	depreciation /	*(2.5 + 1.5) /		(8 750)				
	Tax allowance	(70 000 X 0.25 X 6/12)						
	Transfer to RE	^(7 000/4yrs X 6/12)					^(888)	888
			39 375	17 500	21 875	6 344		
01/07/X5 -	Accumulated	(45 000 / 2.5 yrs) /	(11 250)	(17 500)	6 250	1 813	(1 775)	1 775
30/06/X6	depreciation /	(70 000 X 0.25)						
	Tax allowance							
			28 125	0	28 125	8 157	4 437	

Solution 30.1

**PENGUIN LIMITED AND ITS SUBSIDIARY
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 JUNE 20X4**

		C
Gross profit		80 000
Other income		
Rent income	(22 000 – 15 000)	7 000
Operating expenses		(38 300)
Property expenses		12 000
Selling and administration expenses		25 000
Depreciation		800
Audit fees		500
Profit before tax		48 700
Income tax expense	(11 060 + 2 576)	(13 636)
Profit for the period		35 064
<i>Other comprehensive income</i>		0
Total comprehensive income		35 064

**PENGUIN LIMITED AND ITS SUBSIDIARY
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 30 JUNE 20X4**

	Share capital C	Retained earnings C	Total C
Balance at 30 June 20X3	200 000	[^] 40 000	240 000
Total comprehensive income	-	35 064	35 064
Balance at 30 June 20X4	200 000	75 064	275 064

[^] (40 000 + 10 000 – 10 000)

Solution 30.1 continued ...

**PENGUIN LIMITED AND ITS SUBSIDIARY
CONSOLIDATED STATEMENT OF FINANCIAL POSITION
AT 30 JUNE 20X4**

C

ASSETS

Non-current assets

Property, at cost	(35 000 + 110 000)	145 000
Furniture		5 600
- Cost	(6 000 + 2 000 - 400)	7 600
- Accumulated depreciation	(1 800 + 600 - 400)	(2 000)
Goodwill		10 000

Current assets

Inventory		80 000
Accounts receivable		33 600
Cash and cash equivalents		40 300
		<u>314 500</u>

EQUITY AND LIABILITIES

Capital and reserves

Share capital	(200 000 + 100 000 – 100 000)	200 000
Retained earnings	(68 440 + 16 624 – 10 000)/ (from SOCIE)	75 064

Current liabilities

Accounts payable	(31 060 + 8 376)	39 436
		<u>314 500</u>

Workings

Analysis of equity

At acquisition

Share capital	100 000
Retained earnings	10 000
	<u>110 000</u>
Fair value of consideration transferred	120 000
Goodwill	<u>10 000</u>

Retained earnings at beginning of year

At 01/07/X3	10 000
At acquisition	<u>(10 000)</u>
	<u>-</u>

Pro forma consolidating journal entries

	<i>Debit</i>	<i>Credit</i>
1. Share capital	100 000	
Retained earnings	10 000	
Goodwill	10 000	
Investment in S Limited		120 000
2. Accumulated depreciation	400	
Furniture		400
3. Rent received	15 000	
Rent paid		15 000
4. Interest received	500	
Interest paid		500
5. Loan from P Limited	10 000	

Loan to S Limited	10 000
-------------------	--------

Solution 30.1 continued ...

	Penguin Ltd	Sardine Ltd		Consolidated adjustments		Consolidated balances
				Dr	Cr	
Share capital	200 000	100 000	1)	100 000		200 000
Retained earnings 1/7/20X3	40 000	10 000	1)	10 000		40 000
Gross profit	80 000	-				80 000
Rent received	-	22 000	3)	15 000		7 000
Interest received	500	-	4)	500		-
Loan from Penguin Ltd	-	10 000	5)	10 000		-
Accounts payable	31 060	8 376				39 436
Accumulated depreciation	1 800	600	2)	400		2 000
	<u>353 360</u>	<u>148 400</u>				<u>368 436</u>
Land and buildings	35 000	110 000	1)	10 000		155 000
Furniture	6 000	2 000			2) 400	7 600
Shares in Sardine Ltd	120 000	-			1) 120 000	-
Loan to Sardine Ltd	10 000	-			5) 10 000	-
Inventories	80 000	-				80 000
Accounts receivable	30 000	3 600				33 600
Cash	20 300	20 000				40 300
Property expenses	-	12 000				12 000
Selling & admin expenses	25 000	-				25 000
Rent paid	15 000	-			3) 15 000	-
Depreciation	600	200				800
Audit fees	400	100				500
Interest paid	-	500			4) 500	-
Tax expense	11 060	2 576				13 636
	<u>353 360</u>	<u>148 400</u>				<u>368 436</u>

Solution 30.2

PARDON LIMITED AND SORRY LIMITED GROUP
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X5

	C
Revenue	119 000
Cost of sales (34 000 + 35 000)	69 000
Gross profit	50 000
Operating expenses	(20 000)
Profit before tax	30 000
Income tax expense	(5 000)
Profit for the period	25 000
<i>Other comprehensive income</i>	0
Total comprehensive income	25 000

PARDON LIMITED AND SORRY LIMITED GROUP
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X5

	Share capital	Retained earnings	Total
	C	C	C
Balance at 31 December 20X4	200 000	[^] 101 000	301 000
Total comprehensive income		25 000	25 000
Dividends		[*] (10 000)	(10 000)
Balance at 31 December 20X5	200 000	116 000	316 000

[^][71 000 + (45 000 – 15 000)]

^{*}[10 000 + (5 000 – 5 000)]

PARDON LIMITED AND SORRY LIMITED GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION
AT 31 DECEMBER 20X5

	C
ASSETS	
Non-current assets	
Goodwill	35 000
Land and buildings, at carrying amount	105 000
Plant and equipment, at carrying amount	85 000
Current assets	
Inventories	63 000
Accounts receivable	47 000
Cash and cash equivalents	40 000
	375 000
EQUITY AND LIABILITIES	
Capital and reserves	
Share capital [200 000 + (75 000 – 75 000)]	200 000
Retained earnings	116 000
Current liabilities	
Accounts payable	59 000
	375 000

Solution 30.2 continued ...

Workings

	Pardon Limited	Sorry Limited		Consolidated adjustments		Consolidated balances
				Dr	Cr	
Share capital	200 000	75 000	1)	75 000		200 000
Retained earnings 1/1/20X5	71 000	45 000	1)	15 000		101 000
Sales	64 000	55 000				119 000
Dividend income	5 000	-	2)	5 000		-
Accounts payable	39 000	20 000				59 000
	<u>379 000</u>	<u>195 000</u>				<u>479 000</u>
Cash	25 000	15 000				40 000
Accounts receivable	27 000	20 000				47 000
Inventories	38 000	25 000				63 000
Investment	125 000	-		1)	125 000	-
Plant and equipment – net	45 000	40 000				85 000
Land and buildings - net	60 000	45 000				105 000
Dividends	10 000	5 000		2)	5 000	10 000
COS	34 000	35 000				69 000
Operating expenses	12 000	8 000				20 000
Taxation	3 000	2 000				5 000
Goodwill			1)	35 000		35 000
	<u>379 000</u>	<u>195 000</u>				<u>479 000</u>

Analysis of equity

At acquisition

Share capital	75 000
Retained earnings 1/1/20X1	15 000
	<u>90 000</u>
Fair value of consideration transferred	125 000
Goodwill	<u>35 000</u>

Retained earnings at beginning of year

At 01/01/X5	45 000
At acquisition	(15 000)
	<u>30 000</u>

Pro forma consolidation journal entries

	Dr	Cr
1) Share capital	75 000	
Retained earnings	15 000	
Goodwill	35 000	
Investment in Sorry Ltd		125 000
2) Dividend income	5 000	
Dividends paid		5 000

Solution 30.3

a)

PLUM LIMITED AND ITS SUBSIDIARY
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 28 FEBRUARY 20X7

	C
Revenue	840 000
Cost of sales	[(45 + 270) + (98 + 561) – (55 + 285)]
Gross profit	<u>634 000</u>
Operating expenses	206 000
Depreciation	1 000
Rent	19 000
Advertising	6 000
Wages and salaries	<u>27 000</u>
Profit before tax	153 000
Income tax expense	<u>61 200</u>
Profit for the period	91 800
<i>Other comprehensive income</i>	<u>0</u>
Total comprehensive income	<u>91 800</u>

PLUM LIMITED AND ITS SUBSIDIARY
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 28 FEBRUARY 20X7

	Share capital	Retained earnings	Total
	C	C	C
Balance at 28 February 20X6	155 000	^50 000	205 000
Total comprehensive income		91 800	91 800
Balance at 28 February 20X7	<u>155 000</u>	<u>141 800</u>	<u>296 800</u>

^ [41 000 + (19 000 – 10 000)]

b)

PLUM LIMITED AND ITS SUBSIDIARY
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AT 28 FEBRUARY 20X7

	C
Plant at cost	(10 000 – 3 000)
Accumulated depreciation	(4 000 – 3 000 + 1 000)
	<u>7 000</u>
	<u>(2 000)</u>
	<u>5 000</u>

Solution 30.3 continued ...

Workings

Analysis of equity of Seed (Pvt) Limited	
At acquisition	
Share capital	10 000
Retained earnings	10 000
	20 000
Fair value of consideration transferred	25 000
Goodwill	5 000
Retained earnings at beginning of year	
At 01/03/X6	19 000
At acquisition	(10 000)
	9 000

Adjusting entries in the accounting records of Seed (Pvt) Ltd		
	<i>Dr</i>	<i>Cr</i>
Depreciation expense	1 000	
Accumulated depreciation		1 000
^ Advertising expense	3 000	
Current a/c – Plum Limited		3 000
^ Administration fee	6 000	
Current a/c – Plum Limited		6 000
Taxation expense	46 800	
Current tax payable		46 800
Dividend	10 000	
Shareholders for dividend		10 000

Adjusting entries in the accounting records of Plum Limited		
Taxation expense	14 400	
Current tax payable		14 400
Dividend receivable	10 000	
Dividend income		10 000

^

Ledger of Plum Limited

Ledger of Seed Limited

Current a/c Seed				Current a/c Plum			
Description	C	Description	C	Description	C	Description	C
Balance	21 000					Balance	12 000
						Advertising expense	3 000
		Balance	21 000	Balance	21 000	Administration fee	6 000
	21 000		21 000		21 000		21 000
Balance	21 000					Balance	21 000

Solution 30.3 continued ...

Pro forma consolidating journal entries		
	<i>Debit</i>	<i>Credit</i>
1. Share capital	10 000	
Retained earnings	10 000	
Goodwill	5 000	
Investment in subsidiary		25 000
2. Accumulated depreciation	3 000	
Plant		3 000
(4 000 – 1 000)		
3. Loan account - Plum Ltd	120 000	
Loan account - Seed Ltd		120 000
4. Current account - Plum Ltd	21 000	
Current account - Seed Ltd		21 000
5. Interest received	12 000	
Interest paid		12 000
6. Administration fee income	6 000	
Administration fee expense		6 000
7. Dividend income	10 000	
Dividend paid		10 000
8. Shareholders for dividend	10 000	
Dividend receivable		10 000

Solution 30.4

PINK LIMITED AND SCARLET LIMITED GROUP
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X4

	C
Gross profit	232 000
Operating expenses	
Depreciation – plant	(12 000 + 5 000 + 1 000)
Audit fees	(4 000)
Profit before tax	210 000
Income tax expense	(40 650)
Profit for the period	169 350
<i>Other comprehensive income</i>	0
Total comprehensive income	169 350

PINK LIMITED AND SCARLET LIMITED GROUP
CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X4

	Share capital	Retained earnings	Total
	C	C	C
Balance at 1 January 20X4	400 000	^185 000	585 000
Total comprehensive income		169 350	169 000
Dividends		*(65 000)	(65 000)
Balance at 31 December 20X4	400 000	289 350	689 000

^ (185 000 + 50 000 – 50 000)

* (65 000 + 30 000 – 30 000)

Solution 30.4 continued ...

**PINK LIMITED AND SCARLET LIMITED GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION
AT 31 DECEMBER 20X4**

		C
ASSETS		
Non-current assets		
Goodwill, at cost		6 100
Land, at cost		260 000
Plant		114 000
- Cost	(120 000 + 50 000 – 20 000 + 6 000)	156 000
- Accumulated depreciation	(36 000 + 25 000 – 20 000 + 1 000)	(42 000)
Current assets		
Inventories		170 000
Accounts receivable		110 000
Cash and cash equivalents		98 000
		<u>758 100</u>
EQUITY AND LIABILITIES		
Capital and reserves		
Share capital		400 000
Retained earnings		289 350
Non-current liabilities		
Deferred tax	(2 100 – 350)	1 750
Current liabilities		
Accounts payable		67 000
		<u>758 100</u>

Solution 30.4 continued ...

Workings

Analysis of equity

At acquisition

Share capital		60 000
Retained earnings		50 000
		<u>110 000</u>
Plant (36 000 – 30 000)		6 000
Deferred tax	(6 000 X 0.35)	<u>(2 100)</u>
		113 900
Fair value of consideration transferred		<u>120 000</u>
Goodwill		6 100

Plant	Years	Scarlet Ltd	Consolidation adjustment	Group
Cost	10	50 000		
Accumulated depreciation 1/1/X4	(4)	<u>(20 000)</u>		
Carrying amount 1/1/X4	6	30 000	6 000	36 000
Depreciation 31/12/X4		<u>(5 000)</u>	<u>(1 000)</u>	<u>(6 000)</u>
		25 000	5 000	30 000

		Group CA	TB	TD	DT	
1/1/X4	Carrying amount	30 000				
	Group adjustment	<u>6 000</u>				
		36 000	30 000	6 000	2 100	Cr
31/12/X4	Depreciation / Tax allowance	<u>(6 000)</u>	<u>(5 000)</u>	<u>(1 000)</u>	350	Dr
		30 000	25 000	5 000	1 750	Cr

Solution 30.4 continued ...

Pro forma consolidation journal entries		Debit	Credit
(1)	Share capital	60 000	
	Retained earnings	50 000	
	Plant	6 000	
	Goodwill	6 100	
	Deferred tax		2 100
	Investment in Scarlet Limited		120 000
(2)	Dividend income	30 000	
	Dividends paid		30 000
(3)	Interest income	3 000	
	Interest expense		3 000
(4)	Loan from Pink Limited	60 000	
	Loan to Scarlet Limited		60 000
(5)	Accumulated depreciation - plant	20 000	
	Plant		20 000
(6)	Depreciation	1 000	
	Accumulated depreciation - plant		1 000
(7)	Deferred tax	350	
	Taxation		350

	Pink Limited	Scarlet Limited		Consolidated adjustments		Conso- lidated balances
				Dr	Cr	
Taxation	30 000	11 000		7)	350	40 650
Depreciation	12 000	5 000	6)	1 000		18 000
Interest		3 000		3)	3 000	-
Audit fees	3 000	1 000				4 000
Dividends	65 000	30 000		2)	30 000	65 000
Land and buildings	200 000	60 000				260 000
Plant	120 000	50 000	1)	6 000	5)	156 000
Investment in Scarlet Limited	120 000			1)	120 000	
Loan to Scarlet Limited	60 000			4)	60 000	-
Inventories	140 000	30 000				170 000
Accounts receivable	80 000	30 000				110 000
Cash	70 000	28 000				68 000
Goodwill			1)	6 100		6 100
	<u>900 000</u>	<u>248 000</u>				<u>927 750</u>
Trading profit	192 000	40 000				232 000
Dividend income	30 000		2)	30 000		
Interest	3 000		3)	3 000		-
Retained earnings (1 January 20X4)	215 000	50 000	1)	50 000		185 000
Share capital	400 000	60 000	1)	60 000		400 000
Loan from Pink Limited		60 000	4)	60 000		-
Accounts payable	54 000	13 000				67 000
Accumulated depreciation	36 000	25 000	5)	20 000	6)	42 000
Deferred tax			7)	350	1)	1 750
	<u>900 000</u>	<u>248 000</u>				<u>927 750</u>

Solution 30.5

**PLANE LIMITED AND SHIP LIMITED GROUP
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 JUNE 20X9**

		C
Profit before tax	(44 750 + 25 000 – 1 000 – 10 000)	58 750
Income tax expense	(27 400 – 400)	(27 000)
Profit for the period		31 750
<i>Other comprehensive income</i>		0
Total comprehensive income		31 750

**PLANE LIMITED AND SHIP LIMITED GROUP
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 30 JUNE 20X9**

	Share capital C	Retained earnings C	Total C
Balance at 30 June 20X8	225 000	*39 400	264 400
Total comprehensive income	-	31 750	31 750
Dividends - paid	-	(11 000)	(11 000)
Balance at 30 June 20X9	225 000	60 150	285 150

* [37 000 + (28 000 – 25 000 – 1000 + 400)]

**PLANE LIMITED AND SHIP LIMITED GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION
AT 30 JUNE 20X9**

		C
ASSETS		
Non-current assets		
Goodwill, at cost		9 200
Land and buildings, at cost		125 800
Plant and machinery		142 500
- Cost	(135 000 + 70 000 – 14 000 + 8 000) / (135 000 + 64 000)	199 000
- Accumulated depreciation	(40 500 + 28 000 – 14 000 + 2 000) / (40 500 + 16 000)	(56 500)
Current assets		
Inventories		99 800
Accounts receivable		36 300
Cash and cash equivalents		2 000
		415 600
EQUITY AND LIABILITIES		
Capital and reserves		
Share capital		225 000
Retained earnings		60 150
Non-current liabilities		
10% Debentures		15 000
Deferred tax	(3 200 – 800)	2 400
Current liabilities		
Accounts payable		89 050
Current tax payable		24 000
		415 600

Solution 30.5 continued ...

Workings

Analysis of equity of Ship Limited

At acquisition	
Share capital	50 000
Retained earnings	25 000
Plant and machinery	8 000
Deferred tax	(3 200)
	<u>79 800</u>
Fair value of consideration transferred	89 000
Goodwill	<u>9 200</u>
Retained earnings at beginning of year	
At 30/6/20X8	28 000
On acquisition	<u>(25 000)</u>
	3 000
Additional depreciation	(1 000)
Deferred tax	400
	<u>2 400</u>
Current year	
Profit for the period	15 500
Additional depreciation	(1 000)
Deferred tax	400
	<u>14 900</u>
Dividends	<u>(10 000)</u>

Plant	Years	Ship Limited	Consolidation adjustment	Group
Cost	10	70 000		
Accumulated depreciation 1/7/20X7	*(2)	<u>(14 000)</u>		
Balance 1/7/20X7	8	56 000	8 000	64 000
Depreciation 30/6/20X8		(7 000)	(1 000)	(8 000)
Depreciation 30/6/20X9		<u>(7 000)</u>	<u>(1 000)</u>	<u>(8 000)</u>
		42 000	6 000	48 000

*C28 000 accumulated depreciation at 30/06/X9
 . .Plant 2 years old at 01/07/X7

Solution 30.5 continued ...

Pro forma consolidation journal entries		<i>Debit</i>	<i>Credit</i>
1)	Share capital	50 000	
	Retained earnings	25 000	
	Plant and machinery	8 000	
	Goodwill	9 200	
	Deferred tax		3 200
	Investment in Ship Limited		89 000
	Accumulated depreciation - P&M	14 000	
	Plant and machinery		14 000
2)	Retained earnings	1 000	
	Accumulated depreciation - P&M		1 000
	Deferred tax	400	
	Retained earnings		400
3)	Profit before tax	1 000	
	Accumulated depreciation – P&M		1 000
	Deferred tax	400	
	Taxation		400
	Profit before tax	10 000	
	Dividends paid		10 000
	10% debentures	10 000	
	Debentures in Ship Limited		10 000
	Interest income	1 000	
	Interest expense		1 000

Solution 30.5 continued ...

	Plane Limited	Ship Limited		Consolidation adjustments		Conso- lidated balances
				Dr	Cr	
Share capital	225 000	50 000	1)*	50 000		225 000
Retained earnings 1/7/20X8	37 000	28 000	1)*	25 000	2) 400	
			2)*	1 000		39 400
Net profit before tax	44 750	25 000	3)	1 000		
			3)	10 000		58 750
10% debentures	-	25 000	3)	10 000		15 000
Accumulated depreciation - P&M	40 500	28 000	1)	14 000	2) 1 000	
					3) 1 000	56 500
Accounts payable	61 350	27 700				89 050
Current tax payable	14 500	9 500				24 000
			2)	400	1) 3 200	2 400
Deferred tax			3)	400		
	<u>423 100</u>	<u>193 200</u>				<u>510 100</u>
Land and buildings	83 000	42 800				125 800
Plant and machinery	135 000	70 000	1)	8 000	1) 14 000	199 000
Shares in Ship Limited	89 000	-			1) 89 000	-
Debentures in Ship Limited	10 000	-			3) 10 000	-
Inventories	54 800	45 000				99 800
Accounts receivable	21 300	15 000				36 300
Cash	1 100	900				2 000
Taxation	17 900	9 500			3) 400	27 000
Dividends paid	11 000	10 000			3) 10 000	11 000
Goodwill			1)	9 200		9 200
	<u>423 100</u>	<u>193 200</u>				<u>510 100</u>

*Entry reference no. of consolidation entries on previous page.

Solution 30.6

**PRODUCTION LIMITED AND STRIKE LIMITED GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION
AT 30 JUNE 20X9**

		C
ASSETS		
Non-current		
Land at cost	(500 000 + 20 000 – 20 000)	500 000
Plant and equipment at carrying amount		2 500 000
Goodwill		5 600
Current assets		
Inventories		250 000
Accounts receivable		400 000
Cash and cash equivalents		155 000
		<u>3 810 600</u>
EQUITY AND LIABILITIES		
Capital and reserves		
Share capital		2 000 000
Non-distributable reserves	(59 500 – 14 400)	45 100
Retained earnings	(P: 450 000 + S: 140 500 – 30 000 – 20 000 + 5 600 + 14 400)	560 500
Non-current liabilities		
Long term liabilities	(600 000 + 24 500 – 100 000)	745 000
Current liabilities		
Accounts payable		460 000
		<u>3 810 600</u>

Workings

Analysis of equity of Strike Ltd

At acquisition		
Share capital		50 000
Retained earnings		30 000
Increase in land	(125 000 – 105 000)	20 000
Deferred tax	(20 000 X 0.28)	(5 600)
		<u>94 400</u>
Fair value of consideration transferred		100 000
Goodwill		<u>5 600</u>

Solution 30.6 continued ...

Pro forma consolidation journal entries		Debit	Credit
1.	Share capital	50 000	
	Retained earnings	30 000	
	Land	20 000	
	Deferred tax		5 600
	Goodwill	5 600	
	Investment in subsidiary		100 000
2.	Long-term loan	100 000	
	Loan to subsidiary		100 000
3.	Profit on sale of land	20 000	
	Land		20 000
4.	Deferred tax	5 600	
	Tax expense		5 600
5.	NDR	14 400	
	Retained earnings		14 400

	Production	Strike	Consolidation adjustments				Consolidated balances
			Dr		Cr		
Land		500 000	20 000	1)	20 000	3)	500 000
Plant & equipment.	2 500 000						2 500 000
Investment in subsidiary	100 000				100 000	1)	
Loan to subsidiary	100 000				100 000	2)	
Goodwill			5 600	1)			5 600
Inventories	250 000						250 000
Accounts receivable	400 000						400 000
Cash	150 000	5 000					155 000
	<u>3 500 000</u>	<u>505 000</u>					<u>3 810 600</u>
Share capital	2 000 000	50 000	50 000	1)			2 000 000
NDR		59 500	14 400	5)			45 100
Retained earnings	450 000	140 500	30 000	1)	5 600	4)	560 500
			20 000	3)			
Long term loan	600 000	245 000	100 000	2)			745 000
Accounts payable	450 000	10 000					460 000
Deferred tax			5 600	4)	5 600	1)	5 600
	<u>3 500 000</u>	<u>505 000</u>					<u>3 810 600</u>

Sale of land and buildings during the year

	Subsidiary	Group
Selling price	175	175
Cost	105	125
	<u>70</u>	<u>50</u>

Solution 30.7**a) Journal entries in accounting records of Peanut Limited**

GENERAL JOURNAL OF PEANUT LIMITED		<i>Debit</i>	<i>Credit</i>
01/07/20X5	Investment in Salt Limited Bank	1 763 000	1 763 000
15/06/20X7	Bank Dividend income	10 000	10 000

b) Proforma consolidation journal entries:

	<i>Debit</i>	<i>Credit</i>
<i>At acquisition</i>		
1 Share capital (500 000+1 000 000)	1 500 000	
Retained earnings (1 650 000+550 000)	2 200 000	
Non-distributable reserve	550 000	
Plant	300 000	
Deferred tax		87 000
Goodwill	95 000	
Investment in Salt Limited		1 763 000
Investment in Smooth Limited		2 795 000
<i>Elimination of share capital and reserves at acquisition</i>		
2. Accumulated depreciation - Building	315 000	
Buildings		315 000
<i>Reversal of accumulated depreciation at acquisition</i>		
<i>Beginning of year</i>		
3 Retained earnings	150 000	
Accumulated depreciation - Plant		150 000
<i>Additional depreciation to boy due to revaluation of Salt's plant at acquisition (75 000 X 2)</i>		
4 Deferred tax	43 500	
Retained earnings		43 500
<i>Deferred tax to beginning of year on additional depreciation due to revaluation (21 750 X 2)</i>		

Solution 30.7 continued ...

		<i>Debit</i>	<i>Credit</i>
	<i>Current year</i>		
5	Profit before tax	75 000	
	Accumulated depreciation - Plant		75 000
	<i>Additional depreciation in current year due to revaluation at acquisition</i>		
6	Deferred tax	21 750	
	Taxation		21 750
	<i>Deferred tax in current year on additional depreciation due to revaluation</i>		
	<i>Current year – sale of plant</i>		
7	Accumulated depreciation - Plant	225 000	
	Plant		225 000
	<i>Reversing additional depreciation as asset sold (150 000 + 75 000)</i>		
8	Profit before tax	75 000	
	Plant		75 000
	<i>Group adjustment to profit on sale of plant</i>		
9	Deferred tax	21 750	
	Taxation		21 750
	<i>Deferred tax on group adjustment to profit on sale of plant</i>		
10	Investment in Salt Limited	35 000	
	Profit before tax		35 000
	<i>Reversing parent impairment of investment</i>		
	<i>Current year – inter-company transactions</i>		
11	Profit before tax	110 000	
	Dividend paid		110 000
	<i>Eliminating inter-company dividend</i>		
12	Interest received	65 000	
	Profit before tax		65 000
	<i>Eliminating inter-company interest</i>		
13	Loan from Pepper Limited	500 000	
	Loan to Smooth Limited		500 000
	<i>Eliminating inter-company loan</i>		

(Note that there is no journal entry eliminating the C460 000 accumulated depreciation on the plant at acquisition, as the plant is now sold).

Solution 30.7 continued ...

c) Extracts from consolidated statement of financial position

PEANUT LIMITED AND ITS SUBSIDIARY COMPANIES		
EXTRACTS FROM THE CONSOLIDATED STATEMENT OF FINANCIAL POSITION		
AT 30 JUNE 20X7		
		C
EQUITY AND LIABILITIES		
Equity		
Share capital		1 000 000
Non-distributable reserve	(1 400 000 + 1 500 000 – 550 000)	2 350 000
Non-current liabilities		
Long term loan	(1 500 000 + 900 000)	2 400 000
Current liabilities		
Accounts payable	(182 500 + 190 000 + 167 900)	540 400

Workings

Plant	Salt Ltd	Consolidation adjustment	Group
Cost 1/7/X3	2 300 000		
Depreciation to 30/6/X4	(460 000)		
At acquisition	1 840 000	300 000	2 140 000
Depreciation 30/6/X5	(460 000)	(75 000)	(535 000)
Depreciation 30/6/X6	(460 000)	(75 000)	(535 000)
	920 000	150 000	1 070 000
Depreciation 30/6/X7	(460 000)	(75 000)	(535 000)
CA at date of sale	460 000	75 000	535 000

	Salt Ltd	Group
Selling price	500 000	500 000
Carrying amount	460 000	535 000
Profit/ (loss)	40 000	(35 000)

Solution 30.7 continued ...

Analysis of equity at 30 June 20X7	Salt Ltd	Smooth Ltd
1. At acquisition:	1 July 20X3	1 July 20X4
Share capital	1 000 000	500 000
Retained earnings	550 000	1 650 000
Non-distributable reserve	0	550 000
Plant	300 000	0
Deferred tax	(87 000)	0
	<hr/>	<hr/>
	1 763 000	2 700 000
Fair value of consideration	1 763 000	2 795 000
Goodwill	<hr/>	<hr/>
	0	95 000
 2. Beginning of year:		
NDR 1 July 20X6	0	1 500 000
- on acquisition	0	(550 000)
	<hr/>	<hr/>
	0	950 000
 Retained earnings 1 July 20X6	930 000	4 400 000
- on acquisition	(550 000)	(1 650 000)
	<hr/>	<hr/>
	380 000	2 750 000
Additional depreciation	(150 000)	0
Deferred tax	43 500	0
	<hr/>	<hr/>
	273 500	2 750 000
 3. Current year:		
Profit before tax	197 350	2 985 900
- taxation	(57 232)	(865 911)
- additional depreciation	(75 000)	
+ Deferred tax	21 750	0
- group adjustment on sale of plant	(75 000)	0
+ Deferred tax	21 750	0
	<hr/>	<hr/>
	33 618	2 119 989
 Dividends	10 000	100 000

Solution 30.8

a) Pro-forma consolidating journal entries for the year ended 30/12/X4

	<i>Debit</i>	<i>Credit</i>
Ordinary share capital	200 000	
Retained earnings	80 000	
Non-distributable reserve	36 000	
Investment in Salt Limited		342 500
Goodwill	26 500	
Investment in Salt Limited	7 500	
Retained earnings		7 500
Profit before taxation (Dividend income)	40 000	
Dividend declared		40 000
Dividend payable	40 000	
Dividend receivable		40 000
Loan from Pepper Limited	50 000	
Loan to Salt Limited		50 000
Profit before tax (Interest income)	2 250	
Profit before tax (Interest expense)		2 250

c) Consolidated SOCIE

**CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X4**

	Ordinary share capital C	NDR C	Retained earnings C	Total C
01/01/X4 Balance	450 000	-	112 500	562 500
Total comprehensive income			109 500	109 500
Revaluation of land		7 200		7 200
Dividend			(50 000)	(50 000)
31/12/X4	450 000	7 200	172 000	629 200

ˆ (450 000 + 200 000 – 200 000)

^ (112 500 + 72 500 – 80 000 + 7 500)

* (132 142 – 40 000 + 64 285 – 27 642 – 19 285)

(10 000 X 0.72)

~ (50 000 + 40 000 – 40 000)

Solution 30.8 continued . . .

d) Extract from consolidated statement of financial position

CONSOLIDATED STATEMENT OF FINANCIAL POSITION			
AT 31 DECEMBER 20X4			
			C
ASSETS			
Non-current assets			275 000
Goodwill			26 500
Land			150 000
Plant and equipment			105 000
Current assets			
Accounts receivable	(64 000 + 42 000)		106 000
Cash			318 000

Workings

Analysis of equity of Salt Limited at 31 December 20X4

At acquisition			
Ordinary share capital		200 000	
Retained earnings		80 000	
NDR	(50 000 X 0.72)	36 000	
		<u>316 000</u>	
Fair value of consideration		342 500	
Goodwill		<u>26 500</u>	
Beginning of year			
Retained earnings / NDR at 01/01/X4		72 500	36 000
Retained earnings / NDR at acquisition		<u>80 000</u>	<u>36 000</u>
		(7 500)	0

Analysis of retained earnings of Salt Limited (not needed for solution)

		Total	Before	Since
01/01/X3	At acquisition	80 000	80 000	-
31/12/X3	Profit	32 500		32 500
	Dividend	<u>(40 000)</u>	<u>(7 500)</u>	<u>(32 500)</u>
		72 500	72 500	-
31/12/X4	Profit	45 000		45 000
	Dividend	<u>(40 000)</u>		<u>(40 000)</u>
		77 500	72 500	5 000

Solution 31.1

a) Shortcomings of consolidated financial statements

Unprofitable companies are set off against profitable companies and are thus concealed

Intra group transactions may represent a substantial portion of a company's activities. The reversal of inter-company transactions, whether these are at "arm's length" or not, may result in figures such as reported turnover, not representing the true level of the group's activities.

The statement of financial position gives no indication of individual companies' assets and liabilities and ratios calculated on consolidated statements of financial position are merely group averages. As such they cannot highlight problem areas in individual companies.

The holding company is not legally bound to honour the obligation of its subsidiaries. This further invalidates the use of ratios such as the current ratio, or the debt : equity ratio.

The results and financial position reported per the consolidated financial statements are difficult to evaluate where the group consists of various operations (eg manufacturing and banking). The different constituent parts would have different profiles of profitability, risk and growth.

b) Non-controlling shareholders

An excess purchase price over equity paid by the holding company on acquisition of the subsidiary is not apportioned to outside shareholders. If the premium is paid in order to acquire control of the subsidiary, benefit accrues only to the holding company. As it is difficult to determine exactly what goodwill comprises, it is all deemed to be the cost of control.

Applying the entity method, the premium paid due to a tangible asset being undervalued is grossed up and outside shareholders credited with their share of the increase in value. Outside shareholders have an interest in the resources of the subsidiary and they would be entitled to their share of any profit on the sale of the asset.

The full transaction would be reversed and the full profit therefore removed from the subsidiary's net profit before tax. The holding company is deemed to control all the subsidiary's activities and the group is seen to be one entity. No profit can be made within the same entity. It must also be borne in mind that consolidated financial statements are drawn up mostly for the benefit of the holding company's members and for creditors. Outside shareholders will look to the subsidiary's financial statements for information on which to base their decision-making.

The interest will still be deducted as an expense for the purpose of calculating Non-controlling shareholder's share of profits. It would however not be included in the amount of interest paid disclosed in the consolidated financial statements

...

Solution 31.2

**PRAGUE LIMITED AND SALTZBURG LIMITED GROUP
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 SEPTEMBER 20X5**

		C
Revenue		750 000
Cost of sales		(600 000)
Gross profit		150 000
Operating expenses		(82 000)
Administration	(87 500 – 10 000 + 8 000 – 6 000 – 15 000)	64 500
Depreciation		10 000
Selling		7 500
Profit before tax		68 000
Income tax expense	(22 000 + 5 200)	(27 200)
Profit for the period		40 800
<i>Other comprehensive income</i>		0
Total comprehensive income		40 800
<i>Attributable to</i>		
Equity holders of parent		39 240
Non-controlling interest	(7 800 x 20%)	1 560
		40 800

**PRAGUE LIMITED AND SALTZBURG LIMITED GROUP
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 30 SEPTEMBER 20X5**

	Share capital C	Retained earnings C	Attributable to equity holders of parent C	Non- controlling interest C	Total C
Balance at 30 September 20X4	100 000	47 000	147 000	-	147 000
Acquisition of subsidiary				16 360	16 360
Total comprehensive income		39 240	39 240	1 560	40 800
Dividends		(10 000)	(10 000)	(3 000)	(13 000)
Balance at 30 September 20X5	100 000	76 240	176 240	14 920	191 160

Solution 31.2 continued ...

PRAGUE LIMITED AND SALTZBURG LIMITED GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION
AS AT 30 SEPTEMBER 20X5

	C
ASSETS	
Non-current assets	154 280
Land	83 000
Equipment	70 000
Goodwill	2 560
Current assets	62 600
Inventories	43 000
Accounts receivable	15 000
Cash and cash equivalents	4 600
	<u>218 160</u>
EQUITY AND LIABILITIES	
Equity	191 160
Share capital	100 000
Retained earnings	76 240
Equity attributable to equity holders of the parent	176 240
Non-controlling interest	14 920
Non-current liability	
Deferred tax	3 200
Current liabilities	23 800
Accounts payable	8 000
Current tax payable	4 800
Shareholders for dividends (10 000 + 1 000)	11 000
	<u>218 160</u>

Workings

Allocation of income and expenses in Saltzburg Limited

	Total	1/10-30/6 (9 months)	1/7-30/9 (3 months)
Rent received	37 500	22 500	15 000
Admin expenses	(8 000)	(6 000)	(2 000)
PBT	29 500	16 500	13 000
Tax at 40 %	11 800	6 600	5 200
PAT	17 700	9 900	7 800

Calculation of tax in Prague Ltd

Gross profit	150 000
Expenses	(95 000)
Admin	87 500
Selling	7 500
PBT	55 000
Tax at 40 %	22 000

Solution 31.2 continued ...

Analysis of equity of Salzburg Limited	Total	20%	80%
At acquisition			
Share capital	50 000		
Share premium	5 000		
Retained earnings	12 100		
Profit after tax (1/10X4 – 30/6/X5)	9 900		
Land and buildings	8 000		
Deferred tax (8 000 X 0.40)	(3 200)		
	<u>83 400</u>	16 360	65 440
Fair value of consideration transferred	68 000		
NCI (81 800 X 0.20)	<u>16 360</u>		
	84 360		
Fair value of identifiable net assets	<u>81 800</u>		
Goodwill	<u>2 560</u>		
Current year			
Profit after tax (1/7/X5 – 30/9/X5)	7 800	1 560	6 240
Dividend paid 2/7/20X5	(10 000)	(2 000)	(8 000)
Dividend declared 31/12/X5	(5 000)	<u>(1 000)</u>	<u>(4 000)</u>
Non-controlling interest		<u>14 920</u>	

Pro forma consolidation journal entries		Debit	Credit
1.	Share capital	50 000	
	Share premium	5 000	
	Retained earnings	12 100	
	Profit for the period	9 900	
	Land and buildings	8 000	
	Goodwill	2 560	
	Deferred tax		3 200
	Non-controlling interest (FP)		16 360
	Investment in Salzburg Ltd		68 000
2.	Rent received	22 500	
	Admin expenses		6 000
	Taxation		6 600
	Profit after tax		9 900
3.	Dividend income	8 000	
	Non-controlling interest (FP)	2 000	
	Dividends		10 000
6.	Non-controlling interest (CI)	1 560	
	Non-controlling interest (FP)		1 560
7.	Dividend income	4 000	
	Non-controlling interest (FP)	1 000	
	Dividends		5 000
8.	Shareholders for dividend	4 000	
	Dividends receivable		4 000
9.	Rent received	15 000	
	Admin expenses		15 000

Solution 31.2 continued ...

Prague Limited			
4.	Taxation	22 000	
	Current tax payable		22 000

Saltzburg Limited			
5.	Taxation	11 800	
	Current tax payable		11 800

	Prague Ltd	Saltzburg Ltd		Consolidation adjustment		Consolidated balances
				Debit	Credit	
Share capital	100 000	50 000	1)	50 000		100 000
Share premium	-	5 000	1)	5 000		-
Retained earnings 1/10/X4	47 000	12 100	1)	12 100		47 000
Rent received	-	37 500	2)	22 500		-
			9)	15 000		
Dividend income	4 000		7)	4 000		
Gross profit	150 000	-				150 000
Accumulated depreciation	30 000	-				30 000
Accounts payable	8 000	-				8 000
Profit for the period			1)	9 900	2) 9 900	-
Non-controlling interest (FP)			3)	2 000	1) 17 000	
			7)	1 000	6) 1 560	15 560
Shareholders for dividends	10 000	5 000	8)	5 000	8) 5 000	11 000
	<u>349 000</u>	<u>109 600</u>				<u>361 560</u>
Land & buildings at cost	-	75 000	1)	8 000		83 000
Equipment at cost	100 000	-				100 000
Invest in Saltzburg Ltd	60 000	-	3)	8 000	1) 68 000	-
Admin expenses	87 500	8 000			2) 6 000	
					9) 15 000	74 500
Selling expenses	7 500	-				7 500
Current tax payable	19 000	10 000			4) 22 000	(4 800)
					5) 11 800	
Inventories	43 000	-				43 000
Accounts receivable	15 000	-				15 000
Dividends receivable	4 000				8) 4 000	
Cash and cash equivalents	3 000	1 600				4 600
Dividend paid 2/7/X5	-	10 000			3) 10 000	-
Taxation			4)	22 000	2) 6 600	
			5)	11 800		27 200
Non-controlling interest (CI)			6)	1 560		1 560
Dividends declared	10 000	5 000			7) 5 000	10 000
	<u>349 000</u>	<u>109 600</u>				<u>361 560</u>

Solution 31.3

a)

Investment in Seal Ltd					
<i>Date</i>	<i>Description</i>	<i>C</i>	<i>Date</i>	<i>Description</i>	<i>C</i>
1/8/X5	Cash	120 000	30/12/X7	Impairment of investment	2 400
			31/12/X7	Balance	117 600
		120 000			120 000
1/1/X8	Balance	117 600			

b)

		Debit	Credit
Share capital		100 000	
Retained earnings		30 000	
Land & buildings		20 000	
Goodwill	(Analysis of equity at acquisition)	4 800	
Deferred tax			6 000
Investment in Seal			120 000
Non-controlling interest (FP)			28 800
Retained earnings	(Analysis of equity at beginning of year)	2 400	
Non-controlling interest (FP)			2 400
Profit on sale of land & buildings	(Adjusting the C17 000 profit to Seal to give a 3 000 loss to the group)	20 000	
Land and buildings			20 000
Deferred tax	(Reversal of group deferred tax on sale of L&B)	6 000	
Tax expense			6 000
Non-controlling interest (CI)	(Analysis of equity for the current year – NCI share of profits)	2 288	
Non-controlling interest (FP)			2 288
Investment in Seal	(Reversal of Penguin's loss on writedown) (3 000 X 0.80)	2 400	
Impairment of investment			2 400
Dividend income	(17 000 X 0.80)	13 600	
Non-controlling interest (FP)	(17 000 X 0.20)	3 400	
Dividends paid & declared			17 000
Dividend income	(3 000 X 0.80)	2 400	
Non-controlling interest (FP)	(3 000 X 0.20)	600	
Dividends paid & declared			3 000
Shareholders for dividend		2 400	
Current assets	(reversing Penguin's dividends receivable)		2 400

Solution 31.3 continued ...

c)

**PENGUIN LIMITED AND SEAL LIMITED
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X7**

		C
Rental income	(62 400 + 26 000)	88 400
Loss on sale of buildings	(17 000 – 20 000)	(3 000)
Operating expenses	(7 600 + 10 300)	(17 900)
Profit before tax		67 500
Income tax expense	(16 400 + 7 260 – 6 000)	(17 660)
Profit for the period		49 840
<i>Other comprehensive income</i>		0
Total comprehensive income		49 840
<i>Attributable to:</i>		
Equity holders of the parent		47 552
Non-controlling interest		2 288
		49 840

Workings

Analysis of equity of Seal	Total	(20%)	(80%)
At acquisition			
Share capital	100 000		
Retained earnings	30 000		
	130 000		
Land & buildings	20 000		
Deferred tax (200 000 x 30%)	(6 000)		
	144 000	28 800	115 200
Fair value of consideration transferred	120 000		
NCI (144 000 X 0.20)	28 800		
	148 800		
Fair value of identifiable net assets	144 000		
Goodwill	4 800		
Beginning of year			
Retained earnings at beginning of year	42 000		
Retained earnings at acquisition	30 000		
	12 000	2 400	9 600
Current year			
Profit before tax (26 000 – 10 300)	15 700		
Tax	(7 260)		
Group adjustment (Reversal of DT on sale of L&B)	6 000		
Profit on sale of L & B	17 000		
Group adjustment	(20 000)		
	11 440	2 288	9 152
Dividend from sale of L&B	(17 000)	(3 400)	(13 600)
Dividend from profits	(3 000)	(600)	(2 400)
	147 440	29 488	

Solution 31.3 continued ...

Analysis of property	Seal	Group
Selling price	142 000	142 000
Cost	(125 000)	(145 000)
Profit / loss	17 000	(3 000)

	Penguin		Seal		Adjustments		Group	
	<i>Debit</i>	<i>Credit</i>	<i>Debit</i>	<i>Credit</i>	<i>Debit</i>	<i>Credit</i>	<i>Debit</i>	<i>Credit</i>
Share capital		300 000		100 000	100 000			300 000
Retained earnings		50 000		42 000	30 000			59 600
					2 400			
Land & buildings	220 000				20 000	20 000	220 000	
Deferred tax					6 000	6 000		
Goodwill					4 800		4 800	
Investment in Seal	117 600				2 400	120 000		-
Current assets	96 400		177 500			2 400	271 500	
Current liabilities		32 000		27 060				59 060
Shareholders for dividend		9 000		3 000	3 000	600		9 600
Dividend income		16 000			16 000			-
Rental income		62 400		26 000				88 400
Profit on sale of land & buildings				17 000	20 000		3 000	
Operating expenses	7 600		10 300				17 900	
Impairment of investment	2 400					2 400		
Taxation expense	16 400		7 260			6 000	17 660	
Dividends paid & proposed	9 000		20 000			17 000	9 000	
						3 000		
Non-controlling interest (CI)					2 288		2 288	
Non-controlling interest (FP)					3 400	28 800		29 488
					600	2 400		
						2 288		
	469 400	469 400	215 060	215 060			546 148	546 148

Solution 31.4

**PORTUGAL LIMITED AND SPAIN LIMITED
CONSOLIDATED STATEMENT OF FINANCIAL POSITION
AS AT 30 JUNE 20X9**

		C
ASSETS		
Non-current assets		
Goodwill		12 555
Land	(130 + 80 + 30)	240 000
Plant		54 600
- Cost	(35 + 60 – 9.6 – 12)	73 400
- Accumulated depreciation	(14 + 18 – 12 – 1.2)	(18 800)
Furniture		5 500
- Cost	(5 + 4 – 0.8)	8 200
- Accumulated depreciation	(2.5 + 1 – 0.8)	(2 700)
Current assets		
Inventories		31 000
Accounts receivable		24 000
Cash and cash equivalents		19 000
		<u>386 655</u>
EQUITY AND LIABILITIES		
Equity		
Share capital		200 000
General reserve		67 500
Retained earnings		53 085
Equity attributable to equity holders of parent		320 585
Non-controlling interest		34 510
Non-current liabilities		
Deferred tax	(10 500 – 3 360 + 420)	7 560
Current liabilities		
Accounts payable		24 000
		<u>386 655</u>

**PORTUGAL LIMITED AND SPAIN LIMITED
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 JUNE 20X9**

		C
Profit for the period	(67.5 – 7.5 + 24 + 1.2 – 0.42)	84 780
Other comprehensive income		0
Total comprehensive profit		<u>84 780</u>
<i>Attributable to</i>		
Equity holders of parent		78 585
Non-controlling interest		6 195
		<u>84 780</u>

Solution 31.4 continued ...

**PORTUGAL LIMITED AND SPAIN LIMITED
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 30 JUNE 20X9**

	Share capital C	General reserve C	Retained earnings C	Attributable to equity holders of parent C	Non- controlling interest	Total
Balance at 30 June 20X8	200 000	50 000	12 000	262 000	-	262 000
Acquisition of subsidiary					30 815	30 815
Total comprehensive income	-	-	78 585	78 585	6 195	84 780
Dividend	-	-	(20 000)	(20 000)	(2 500)	(22 500)
Transfer to/from reserves	-	17 500	(17 500)	-		
Balance at 30 June 20X9	200 000	67 500	53 085	320 585	34 510	355 095

Workings

Plant	Years	Spain Limited	Decrease	Group
Cost 1/7/20X6	10	60 000		
Accumulated depreciation 30/6/20X8	(2)	12 000		
Carrying amount 1/7/20X8	8	48 000	(9 600)	38 400
Depreciation 30/6/20X9		(6 000)	1 200	(4 800)
Carrying amount 30/6/20X9		42 000	(8 400)	33 600

	CA	TB	TD	DT	
	48 000	48 000	-	-	
At acq	(9 600)	-	(9 600)	(3 360)	Dr
	38 400	48 000	(9 600)	(3 360)	Dr
30/6/X9	(4 800)	(6 000)	1 200	420	Cr
	33 600	42 000	(8 400)	(2 940)	Dr

Solution 31.4 continued ...

Analysis of equity of Spain Ltd		Total	25%	75%
At acquisition				
Share capital		100 000		
Retained earnings		10 000		
Land	(80 000 – 50 000)	30 000		
Deferred tax	(30 000 X 0.35)	(10 500)		
Plant		(9 600)		
Deferred tax		3 360		
	A	123 260	30 815	92 445
Fair value of consideration transferred		105 000		
NCI (128 510 X 0,25)		30 815		
		135 815		
Fair value of identifiable net assets		(123 260)		
Goodwill		12 555		
.Retained earnings at beginning of year				
At 1/7/20X8		10 000		
At acquisition		10 000		
		-	-	
Current year				
Profit for the period	B	24 000		
Depreciation adjustment		1 200		
Deferred tax		(420)		
		24 780	6 195	18 585
Dividend		(10 000)	(2 500)	(7 500)
Non-controlling interest		143 290	34 510	103 530

Solution 31.4 continued ...

Pro forma consolidating journal entries

		<i>Debit</i>	<i>Credit</i>
(1)	Share capital	100 000	
	Retained earnings	10 000	
	Land	30 000	
	Deferred tax (on plant)	3 360	
	Goodwill	12 555	
	Deferred tax (on land)		10 500
	Plant		9 600
	Non-controlling interest		30 815
	Investment in Spain Ltd		105 000
(2)	Accumulated depreciation - plant	12 000	
	Plant		12 000
(3)	Accumulated depreciation - furniture	800	
	Furniture		800
(4)	Accumulated depreciation - plant	1 200	
	Profit (Depreciation expense)		1 200
(5)	Profit (Tax expense)	420	
	Deferred tax		420
(6)	Non-controlling interest (CI)	6 195	
	Non-controlling interest (FP)		6 195
(7)	Profit for the period	7 500	
	Non-controlling interest	2 500	
	Dividend paid		10 000
(8)	Loan from Portugal Limited	30 000	
	Loan to Spain Limited		30 000
(9)*	General reserve	2 500	
	Transfer to general reserve		2 500

* This pro-forma journal entry is required following the two entries in the parent and subsidiary's accounting records respectively:

	<i>Debit</i>	<i>Credit</i>
Transfer to general reserve	10 000	
General reserve		10 000
(Parent's records)		
Transfer to general reserve	10 000	
General reserve		10 000
(Subsidiary's records)		

Solution 31.4 continued ...

	Portugal Limited	Spain Limited		Consolidated adjustments		Consolidated Balances
				<i>Debit</i>	<i>Credit</i>	
Share capital	200 000	100 000	1)	100 000		200 000
General reserve	50 000	-			9) 17 500	67 500
Retained earnings 1/7/20X8	12 000	10 000	1)	10 000		12 000
Profit for the period	67 500	24 000	7)	7 500	4) 1 200	84 780
			5)	420		
Accumulated depreciation - plant	14 000	18 000	2)	12 000		
			4)	1 200		18 800
Accumulated depreciation - furniture	2 500	1 000	3)	800		2 700
Loan - Portugal Ltd	-	30 000	8)	30 000		-
Accounts payable	15 000	9 000				24 000
Deferred tax			1)	3 360	1) 10 500	7 560
					5) 420	
NCI (FP)			7)	2 500	1) 30 815	
					6) 6 195	34 510
	<u>361 000</u>	<u>192 000</u>				<u>451 850</u>
Land and buildings	130 000	80 000	1)	30 000		240 000
Plant	35 000	60 000			1) 9 600	
					2) 12 000	73 400
Furniture	5 000	4 000			3) 800	8 200
Inv in Spain Ltd	105 000	-				-
Loan - Spain Ltd	30 000	-			8) 30 000	-
Inventories	18 000	13 000				31 000
Accounts receivable	13 000	11 000				24 000
Cash	5 000	14 000				19 000
Dividends paid	20 000	10 000			7) 10 000	20 000
Goodwill			1)	12 555		12 555
NCI (CI)			6)	6 195		6 195
Transfer to G.R.			9)	17 500		17 500
	<u>361 000</u>	<u>192 000</u>				<u>451 850</u>

Solution 31.5

MAX LIMITED AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENT OF FINANCIAL POSITION
AS AT 31 OCTOBER 20X7

		C
ASSETS		
Non-current assets		
Land and buildings	(130 + 125 + 130)	385 000
Plant and equipment	(180 + 130 - 50 - 33)	227 000
Goodwill		1 480
Current assets		
Inventories		18 000
Accounts receivable		32 100
Cash and cash equivalents		5 000
		<u>668 580</u>
EQUITY AND LIABILITIES		
Equity		
		456 840
Share capital		300 000
Non-distributable reserve		20 620
General reserve		3 600
Retained earnings		55 500
Equity attributable to equity holders of parent		379 720
Non-controlling interest	(19,6 + 58,36)	77 960
Non-current liabilities		
Long term liabilities	(60 + 80 - 20 + 30)	150 000
Deferred tax	(M 2,8 + L 2,1)	4 900
Current liabilities		
Accounts payable		33 000
Shareholders for dividends		15 000
Bank overdraft		8 000
		<u>668 580</u>

MAX LIMITED AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 OCTOBER 20X7

		C
Profit before finance cost	(52,2 + 50 + 5 - 6 - 2 - 4)	95 200
Finance cost	(7 + 11 - 2)	(16 000)
Profit before tax		79 200
Income tax expense	(18 + 12)	(30 000)
Profit for the period		49 200
Other comprehensive income		0
Total comprehensive income		<u>49 200</u>
<i>Attributable to:</i>		
Equity holders of the parent		37 400
Non-controlling interest	(1 + 10,8)	11 800
		<u>49 200</u>
Earnings per share	(37 400 / 300 000 shares)	0,1247

Solution 31.5 continued ...

MAX LIMITED AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 OCTOBER 20X7

	Share capital C	Non- distributable reserve C	General reserve C	Retained earnings C	Attributable to equity holders of parent C	Minoritie s C	Total C
Balance at 31/10/20X6	300 000	~20 620		#36 700	356 480	^70 160	426 640
Total comprehensive income				37 400	37 400	11 800	49 200
Dividends				(15 000)	(15 000)	(4 000)	(19 000)
Transfer to general reserve			3 600	(3 600)			
Balance at 31/10/20X7	300 000	20 620	3 600	55 500	378 880	77 960	456 840

~ [M 17,2 + L (12,9 – 7,2 – 2,28)]

[(M 30 + 6,8) + L (16 – 5 – 4,4 + 0,1) + A (- 7 – 1,5 + 1,7)]

^ [A (20,3 – 1,7) + L (44,88 + 2,28 + 4,4)]

Workings

Analysis of equity of Ape Limited	Total	NCI (20%)	P (80%)
At acquisition			
Share capital	100 000		
Retained earnings	1 500		
	101 500	20 300	81 200
Fair value of consideration transferred	81 100		
NCI (101 500 X 0,20)	20 300		
	101 400		
Fair value of identifiable net assets	101 500		
Gain on acquisition	100		
Beginning of year			
Retained earnings at 01/10/X7	(7 000)		
At acquisition	(1 500)		
	(8 500)	(1 700)	(6 800)
Current year			
Profit after tax	5 000	1 000	4 000
Non-controlling interest		19 600	

Solution 31.5 continued ...

Analysis of equity of Lisa Limited	Total	NCI (40%)	P(60%)
At acquisition			
Share capital	100 000		
Retained earnings	5 000		
Land	10 000		
Deferred tax	(2 800)		
	<u>112 200</u>	44 880	67 320
Fair value of consideration transferred	68 800		
NCI (113 600 X 0,40)	<u>44 880</u>		
	113 680		
Fair value of identifiable net assets	<u>112 200</u>		
Goodwill	1 480		
Beginning of year			
NDR at 01/10/X7 (17 917 X 0.72)	12 900		
(Effectively) At acquisition	<u>(7 200)</u>		
	5 700	2 280	3 420
Retained earnings at 01/10/X7	16 000		
At acquisition	<u>(5 000)</u>		
	11 000	4 400	6 600
Current year			
Profit before interest and tax	50 000		
Interest	(11 000)		
Tax	<u>(12 000)</u>		
	27 000	10 800	16 200
Dividends	(10 000)	<u>(4 000)</u>	(6 000)
Non-controlling interest		<u>58 360</u>	

Solution 31.5 continued ...

Consolidating journal entries		Debit	Credit
	(Ape Limited)		
1.	Share capital	100 000	
	Retained earnings	1 500	
	Non-controlling interest (FP)		20 300
	Retained earnings (Gain on acquisition)		100
	Investment in subsidiary (Ape)		81 100
2.	Non-controlling interest (FP)	1 700	
	Retained earnings		1 700
3.	Non-controlling interest (CI)	1 000	
	Non-controlling interest (FP)		1 000
4.	Investment in subsidiary (Ape)	6 800	
	Retained earnings		6 800
	Profit before tax and interest	4 000	
	Investment in subsidiary (Ape)		4 000
	(Lisa Limited)		
5.	Share capital	100 000	
	Retained earnings	5 000	
	Land	10 000	
	Goodwill	1 480	
	Deferred tax		2 800
	Non-controlling interest (FP)		44 880
	Investment in subsidiary (Lisa)		68 800
	Deferred tax	2 800	
	Non-distributable reserve	7 200	
	Land		10 000
6.	N.D.R	2 280	
	Non-controlling interest (FP)		2 280
7.	Retained income	4 400	
	Non-controlling interest (FP)		4 400
8.	Non-controlling interest (CI)	10 800	
	Non-controlling interest (FP)		10 800
9.	Net operating profit (dividends received)	6 000	
	Non-controlling interest (FP)	4 000	
	Dividends declared		10 000
10.	Shareholders for dividends	10 000	
	Dividends receivable		6 000
	Accounts payable		4 000
11.	Net operating profit (interest received)	2 000	
	Interest paid		2 000
12.	General reserve	2 400	
	Transfer to general reserve		2 400
	<i>or</i>		
	General reserve	2 400	
	Non-controlling interest (FP)		2 400
	Non-controlling interest (FP)	2 400	
	Transfer to general reserve		2 400
13.	Long term liabilities	20 000	
	Investment in subsidiaries (loan)		20 000

Solution 31.5 continued ...

	Max	Lisa	Ape	Consolidation adjustments				Consolidated trial balance	
				Debit		Credit		Debit	Credit
Share capital	300	100	100	1) 100					
				5) 100					300
N.D.R.	17.2	12.9	-	5) 7.2					
				6) 2.28					20.62
General reserve	-	6	-	12) 2.4					3,6
Retained earnings	30	16	(7)	1) 1.5	2) 1.7				
				5) 5	4) 6.8				36.7
				7) 4.4	5) 0.1				
Accumulated depreciation	50	33	-						83
Profit before tax and interest	52.2	50	5	4) 4					
				9) 6					95.2
				11) 2					
Long term liability	60	80	30	13) 20					150
Bank overdraft	5	-	3						8
Accounts payable	15	10	4		10) 4				33
Shareholders for dividends	15	10	-	10) 10					15
NCI (FP)				2) 1.7	1) 20.3				
				9) 4	3) 1				
					5) 44.88				
					6) 2.28				
					7) 4.4				
					8) 10.8				77.96
Deferred tax	2,8	2,1		5) 2,8	5) 2,8				4,9
	<u>547.2</u>	<u>320</u>	<u>135</u>						<u>827.98</u>
Land	130	125	130	1) 10	5) 10			385	
Plant & equipment	180	130	-					310	
Investment in subs – Lisa	68.8	-	-		5) 68.8			-	
Investment in subs – Ape	78.3			4) 6.8	1) 81.1				
					4) 4				
10% loan (Lisa)	20	-	-		13) 20			-	
Inventory	9	9	-					18	
Accounts receivable	15.1	12	5					32.1	
Dividends receivable	6	-	-		10) 6			-	
Cash	-	5	-					5	
Interest paid	7	11	-		11) 2			16	
Transfer to general reserve	-	6	-		12) 2.4			3.6	
Dividends proposed	15	10	-		9) 10			15	
Tax	18	12						30	
NCI (CI)				3) 1				11.8	
				8) 10.8					
Goodwill				5)				1,48	
	<u>547.2</u>	<u>300</u>	<u>135</u>					<u>827.98</u>	

Solution 31.6

a)

GENERAL JOURNAL OF HURRY LTD			
		<i>Debit</i>	<i>Credit</i>
01/01/X1	Investment in Scurry Ltd Bank	995 000	995 000
30/06/X1	Cash Dividend income	(25 000 x 0.8) 20 000	20 000
01/09/X1	Cash Dividend income	(120 000 x 0.8) 96 000	96 000
31/12/X1	Accounts receivable / Dividends accrued Dividend income	(10 000 x 0.8) 8 000	8 000

Workings

	Scurry (Pty) Ltd	Group
Selling price	800 000	800 000
CA	(585 000)	(675 000)
Profit	215 000	125 000

b)

**HURRY LTD AND ITS SUBSIDIARY
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X5**

		C
Operating profit	(120 000 + 60 000 + 5 000 – 10 000 – 20 000 – 96 000 – 8 000)	51 000
Profit on sale of land & buildings	(800 000 - 675 000)	125 000
Profit before tax		176 000
Taxation	(36 000 + 18 000 + 1 500)	(55 500)
Profit for the period		120 500
<i>Other comprehensive income</i>		0
Total comprehensive income		120 500
<i>Attributable to</i>		
Equity holders of parent.		88 400
Non-controlling interest		32 100
		120 500

Solution 31.6 continued ...

c)

**HURRY (PTY) LTD AND ITS SUBSIDIARY
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X1**

	Share capital C	Retained earnings C	General reserve C	Attributable to equity holders of parent C	Non- controlling interest	Total
Balance at 31/12/X0	2 500 000	100 000	15 000	2 615 000		2 615 000
Acquisition of subsidiary					211 200	211 200
Total comprehensive income		88 400		88 400	32 100	120 500
Dividends		(50 000)		(50 000)	(31 000)	(81 000)
Transfer to general reserve		(13 000)	[^] 13 000			
Balance at 31/12/X1	2 500 000	125 400	28 000	2 653 400	212 300	2 865 700

[^] (5 000 + 8 000)

d)

**HURRY LTD AND ITS SUBSIDIARY
EXTRACT FROM CONSOLIDATED STATEMENT OF FINANCIAL POSITION
AT 31 DECEMBER 20X5**

	C
ASSETS	
Goodwill	150 200
Equipment	285 000
- At cost	380 000
- Accumulated depreciation	(95 000)
EQUITY AND LIABILITIES	
Non-controlling interest	212 300

e) Pro-forma consolidating entries for interim and final dividends (20X1)

	Debit	Credit
Profit before tax / dividend income	20 000	
Non-controlling interest (FP)	5 000	
Dividends (Interim dividend paid)		25 000
Profit before tax- dividend income	8 000	
Non-controlling interest (FP)	2 000	
Dividends		10 000
Shareholders for dividend	10 000	
Accounts receivable / dividend receivable		8 000
Accounts payable (Final dividend declared)		2 000
Profit before tax / dividend income	96 000	
Non-controlling interest (FP)	24 000	
Dividends (Dividend from profit on property)		120 000

Solution 31.6 continued ...

Workings

Analysis of equity of Scurry Ltd		Minorities (20%)	Hurry Ltd (80%)
At acquisition			
Share capital	700 000		
General reserve	40 000		
Retained earnings	160 000		
Equipment	80 000		
Deferred tax	(24 000)		
Land & buildings (Property)	100 000		
	<u>1 056 000</u>	211 200	844 800
Investment in Scurry Ltd			995 000
Goodwill			150 200
Beginning of the year			
Retained earnings at 01/01/20X1	160 000		
Retained earnings at acquisition	<u>(160 000)</u>		
	-	-	-
Current year			
Profit for the period	257 000		
Group profit on sale of property	(90 000)		
Depreciation adjustment - equipment	5 000		
Deferred tax	(1 500)		
Depreciation adjustment – property	(10 000)		
	160 500	32 100	128 400
Dividends - interim	(25 000)	(5 000)	(20 000)
- property	(120 000)	(24 000)	(96 000)
- final	(10 000)	(2 000)	(8 000)
	<u>996 500</u>	<u>212 300</u>	<u>797 200</u>

Equipment

Cost to Scurry Ltd = 500 000

Depreciation expense per year = 100 000 (500 000 x 0.20)

Accumulated depreciation at 01/01/20X1 = 200 000

Equipment thus two years old, three years remaining life

Hurry estimates the remaining life at four years.

	Scurry Ltd	Adjustment	Group
Cost	500 000		
Accumulated depreciation	<u>(200 000)</u>		
01/01/x1 Carrying amount	300 000	80 000	380 000
31/12/x1 Depreciation	<u>(100 000)</u>	5 000	(95 000)
	200 000	85 000	285 000
31/12/x2 Depreciation	<u>(100 000)</u>	5 000	(95 000)
31/12/x3 Depreciation	<u>(100 000)</u>	5 000	(95 000)
31/12/x4 Depreciation	<u>-</u>	(95 000)	(95 000)
	-	-	-

Deferred tax

	Group	Tax	TD	DT	
01/01/X1	380 000	300 000	80 000	24 000	
31/12/X1	<u>(95 000)</u>	<u>(100 000)</u>	5 000	1 500	Dr TE Cr DT
	285 000	200 000	85 000	25 500	
31/12/X2	<u>(95 000)</u>	<u>(100 000)</u>	5 000	1 500	
31/12/X3	<u>(95 000)</u>	<u>(100 000)</u>	5 000	1 500	
	95 000	-	95 000	28 500	
31/12/X4	<u>(95 000)</u>		<u>(95 000)</u>	<u>(28 500)</u>	Dr DT Cr TE

Solution 31.7

a)

THE RUGBY GROUP		
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME		
FOR YEAR ENDED 31 DECEMBER 20X5		
		C
Profit before tax	(360 000 + 200 000 + 240 000 – 150 000 – 32 000)	618 000
Income tax expense	(108 000 + 60 000 – 22 500)	(123 000)
Profit for the period		495 000
<i>Other comprehensive income</i>		0
Total comprehensive income		495 000
<i>Attributable to:</i>		
Equity holders of parent		440 000
Non-controlling interest		55 000
		495 000

b)

THE RUGBY GROUP						
STATEMENT OF CHANGES IN EQUITY						
FOR THE YEAR ENDED 31 DECEMBER 20X5						
	Share capital	NDR	Retained Earnings	Attributable to equity holders of parent	Minorities	Total
	C	C	C	C	C	C
Balance at 01/01/X5	2 000 000		[^] 1 188 000	3 206 000	*367 000	3 555 000
Total comprehensive income			440 000	440 000	55 000	495 000
Transfer to NDR		~79 200	(79 200)			
Dividends			(200 000)	(200 000)	(8 000)	(208 000)
Balance at 31/12/X5	2 000 000	79 200	1 348 800	3 428 000	414 000	3 842 000

[^] (920 000 + 730 000 – 420 000 – 62 000 + 20 000)

* (305 000 + 62 000)

~ [(204 000 – 105 000) – 19 800]

	Dr	Cr
Scrum		
RE	204 000	
NDR		204 000
<i>(Transfer of after tax profit of R110 000 X 0,86)</i>		
Group adjustments		
NDR	105 000	
RE		105 000
<i>(50 000 – 7 000)</i>		
NDR	19 800	
RE		19 800

Solution 31.7 continued ...

c)

	<i>Debit</i>	<i>Credit</i>
Retained earnings	82 000	
Non-controlling interest (FP)		82 000
NDR	150 000	
Property		150 000
Deferred tax	45 000	
Retained earnings		45 000
NDR	19 800	
Non-controlling interest (FP)		19 800

d)

		<i>Debit</i>	<i>Credit</i>
Journal of Scrum Limited			
Dividends		600 000	
Shareholders for dividend			600 000
Journal of Prop Limited			
Dividends receivable	(600 000 X 0.80)	480 000	
Dividend income			480 000
Pro-forma consolidating journal entries			
Dividend income		480 000	
Non-controlling interest (FP)	(600 000 X 0.20)	120 000	
Dividends			600 000
Shareholders for dividend		480 000	
Dividends receivable			480 000

Workings

	Scrum Ltd	Group
Selling price	890 000	890 000
Cost	650 000	800 000
Profit	240 000	90 000

Solution 31.7 continued ...

Workings continued ...

Analysis of equity of Scrum Limited

		20X5	P		20X6	P
	Total	Minorities (20%)	(80%)		Total	Minorities (20%)
At acquisition						
Share capital	1 000				1 000	
Retained earnings	420				420	
Property	150				150	
Deferred tax	(45)				(45)	
	<u>1 525</u>	305	1 220		<u>1 525</u>	305
						1 220
Fair value of consideration transferred	1 200				1 200	
NCI (1 547,5 X 0,20)	<u>305</u>				<u>305</u>	
	1 505				1 505	
Fair value of identifiable net assets	(1 525)				(1 525)	
Gain on acquisition	<u>(20)</u>				<u>(20)</u>	
Beginning of year						
<i>Retained earnings</i>						
- At 01/01/X5 / X6	730				866	
- At acquisition	<u>(420)</u>				<u>(420)</u>	
	310	62	248		446	89.2
						356.8
<i>NDR</i>						
- At 01/01/X6					204	
- At acquisition					<u>0</u>	
					204	
Group adjustment					<u>(105)</u>	
					99	19.8
					<u>414</u>	79.2
Current year						
Profit before tax	200				100	
Taxation	(60)				<u>(30)</u>	
Profit on property	240					
Group adjustment	(150)					
Deferred tax	<u>45</u>					
	275	55	220		<u>70</u>	14
						56
Dividend	(40)	(8)	(32)		(600)	(120)
	<u>2 070</u>	<u>414</u>			<u>308</u>	
						(480)

Solution 31.8

**POLAND LIMITED AND SLOVENIA LIMITED GROUP
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 AUGUST 20X1**

		C
Profit before finance costs	(57,3 + 31 - 2)	86 300
Finance cost	(6,3 – 4,2)	(2 100)
Profit before tax		84 200
Income tax expense	(16,38 + 9,48)	(25 860)
Profit for the period		58 340
<i>Other comprehensive income</i>		0
Total comprehensive income		58 340
<i>Attributable to :</i>		
Equity holders of parent		51 210
Non-controlling interest	(Ord 3,53 + Pref 3,6)	7 130
		58 340

**POLAND LIMITED AND SLOVENIA LIMITED GROUP
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 AUGUST 20X1**

	Share capital C	General reserve C	Retained earnings C	Attributable to equity holders of parent C	Non- controlling interest	Total
Balance at 31 August 20X0	150 000	~ 39 500	* 37 000	226 500	^65 500	292 000
Total comprehensive income	-	-	51 210	51 210	7 130	58 340
Dividends	-	-	(15 000)	(15 000)	(5 100)	(20 100)
Balance at 31 August 20X1	150 000	39 500	73 210	262 710	67 530	330 240

~ [35 000 + (10 000 – 4 000 – 1 500)]

* [40 000 + (24 000 – 16 000 – 12 000 + 1 000)]

^ [(35 000 + 1 500 – 1 000) + 30 000]

Solution 31.8 continued. . .

**POLAND LIMITED AND SLOVENIA LIMITED GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION
AT 31 AUGUST 20X1**

		C
ASSETS		
Non-current assets		
Land and buildings	(130 + 200 + 20 – 12 - 2)	196 000
Cost	(325 + 400 – 200 + 20)	545 000
Accumulated depreciation	(195 + 340 – 200 + 14)	(349 000)
Current assets		
Cash and cash equivalents	(23,32 + 156,92)	180 240
		<u>376 240</u>
EQUITY AND LIABILITIES		
Equity		
Share capital		330 240
General reserve	(35 + 4.5)	150 000
Retained earnings		39 500
Attributable to equity holders of the parent		73 210
Non-controlling interest	(37.530 + 30)	262 710
		<u>67 530</u>
Non-current liabilities		
Long term liability – debentures	(45 – 30)	15 000
Current liabilities		
Accounts payable	(8.9 + 3.8)	12 700
Shareholders for dividends	(15 + 1.5 + 1.8)	18 300
		<u>376 240</u>

Solution 31.8 continued ...

Workings

Analysis of equity of Slovenia Limited – Ordinary shares	Total	25%	75%
At acquisition			
Share capital	100 000		
General reserve	4 000		
Retained earnings	16 000		
Land and buildings	20 000		
	<u>140 000</u>	35 000	105 000
FV of consideration transferred	105 000		
NCI (140 000 X 0,25)	<u>35 000</u>		
	140 000		
FV of identifiable net assets	<u>140 000</u>		
	-		
Beginning of year			
General reserve			
Balance 1/9/20X0	10 000		
At acquisition	(4 000)		
	6 000	1 500	4 500
Retained earnings			
Balance 1/9/20X0	24 000		
At acquisition	<u>(16 000)</u>		
	8 000		
Group depreciation (2 000 X 6 yrs)	<u>(12 000)</u>		
	(4 000)	(1 000)	(3 000)
Current year			
Profit before interest and tax	31 000		
Interest received	4 200		
Interest paid	(3 600)		
Taxation	(9 480)		
Group depreciation	<u>(2 000)</u>		
	20 120		
Preference dividend	<u>(6 000)</u>		
	14 120	3 530	10 590
Ordinary dividend	(6 000)	<u>(1 500)</u>	(4 500)
Ordinary Non-controlling interest		37 530	
Analysis of Slovenia Limited - Preference shares	Total	60%	40%
At acquisition			
Share capital	50 000	30 000	20 000
Investment			<u>20 000</u>
			-
Current year			
Preference income for the year	6 000	3 600	2 400
Dividend paid	(3 000)	(1 800)	(1 200)
Dividend declared	(3 000)	<u>(1 800)</u>	(1 200)
Preference Non-controlling interest		<u>30 000</u>	

Solution 31.8 continued ...

Workings continued ...

		Slovenia Ltd	Adjustment	Group
	Cost	400 000		
	Accumulated depreciation	(200 000)		
01/09/W4	Carrying amount	200 000	20 000	220 000
31/08/W5	Depreciation	(20 000)	(2 000)	(22 000)
31/08/W6	Depreciation	(20 000)	(2 000)	(22 000)
31/08/W7	Depreciation	(20 000)	(2 000)	(22 000)
31/08/W8	Depreciation	(20 000)	(2 000)	(22 000)
31/08/W9	Depreciation	(20 000)	(2 000)	(22 000)
31/08/X0	Depreciation	(20 000)	(2 000)	(22 000)
	Balance at boy	80 000		88 000
31/08/X1	Depreciation	(20 000)	(2 000)	(22 000)
		60 000		66 000

Solution 31.8 continued ...

Journals

Proforma consolidating journal entries		<i>Debit</i>	<i>Credit</i>
1)	Ordinary share capital	100 000	
	General reserve	4 000	
	Retained earnings	16 000	
	Land and buildings	20 000	
	Non-controlling interest (FP)		35 000
	Shares in Slovenia Ltd - ordinary		105 000
2)	Accumulated depreciation	200 000	
	Land and buildings		200 000
3)	General reserve	1 500	
	Non-controlling interest (FP)		1 500
4)	Non-controlling interest (FP)	1 000	
	Retained earnings		1 000
5)	Non-controlling interest (CI)	3 530	
	Non-controlling interest (FP)		3 530
6)	Dividend income	4 500	
	Non-controlling interest (FP)	1 500	
	Ordinary dividend		6 000
7)	Shareholders for dividend – ordinary	4 500	
	Dividend receivable		4 500
8)	Preference share capital	50 000	
	Non-controlling interest		30 000
	Shares in Slovenia Ltd - preference		20 000
9)	Non-controlling interest (CI)	3 600	
	Non-controlling interest (FP)		3 600
10)	Dividend income	2 400	
	Non-controlling interest (FP)	3 600	
	Preference dividend paid		3 000
	Preference dividend declared		3 000
11)	Shareholders for dividends - preference	1 200	
	Dividend receivable		1 200
12)	Retained earnings	12 000	
	Land and buildings		12 000
13)	Profit before tax, interest and dividends (Depreciation)	2 000	
	Land and buildings		2 000
14)	Loan from Poland Ltd	40 000	
	Loan to Slovenia Ltd		40 000
15)	Interest received	3 600	
	Interest paid - loan		3 600
16)	Debentures	30 000	
	Debentures in Poland Ltd		30 000
17)	Interest received	4 200	
	Interest paid - debentures		4 200

Solution 31.9

a)

THE COLOUR GROUP LIMITED		
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME		
FOR THE YEAR ENDED 30 JUNE 20X8		
		R
Revenue	[P 1 500 000 + Sc 820 000 + (Si 1 000 000 – 125 000)]	3 195 000
Profit before tax	[(P 365 000 – 24 000 – 3 200) + (Sc 168 000 + 110 000 – 50 000) + (Si 208 000 – 2 000)]	771 800
Income tax expense	[P 94 584 + (Sc 62 440 – 14 000) + (Si 58 240 – 560)]	(290 704)
Profit for the period		481 096
<i>Other comprehensive income</i>		0
Total comprehensive income		481 096
<i>Attributable to:</i>		
Equity holders of the parent		375 280
Non-controlling interest	[Sc 44 890 + (Si 56 126 + 4 800)]	105 816
		481 096

b)

THE COLOUR GROUP LIMITED						
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY						
FOR THE YEAR ENDED 30 JUNE 20X8						
	Share capital R	NDR R	Retained earnings R	Attributable to equity holders of parent R	NCI R	Total R
Balance 30/06/X7	500 000	-	^470 454	970 454	*131 370	1 101 824
TCI			375 280	375 280	105 816	481 096
Transfer to NDR		32 400	(32 400)			
Dividend			(70 000)	(70 000)	~(20 800)	(90 800)
Balance 30/06/X8	500 000	32 400	743 334	1 275 734	216 386	1 492 120

^ [P 382 000 + (Sc 73 000 – 12 000 – 15 250 + 11 000) + (Si 87 000 – 32 000 – 3 000 + 840 – 21 136)]

* [(Sc 37 000 + 15 250) + (Si 57 984 + 21 136)]

(79 200 – 36 000 – 10 800)

~ (Si Ord 16 000 + Pref 4 800)

Solution 31.9 continued . . .

#	Dr	Cr
Scarlet		
RE	79 200	
NDR		79 200
<i>(Transfer of after tax profit of C110 000 X 0.72)</i>		
Group adjustments		
NDR	36 000	
RE		36 000
<i>(50 000 – 14 000)</i>		
NDR	10 800	
RE		10 800
<i>(79 200 – 36 000) X 0.25 or (60 000 X 0.72 X 0.25)</i>		
<i>or</i>		
NCI	12 900	
RE		12 900
NDR	10 800	
NCI		10 800

c)

THE COLOUR GROUP LIMITED
EXTRACT FROM CONSOLIDATED STATEMENT OF FINANCIAL POSITION
AT 30 JUNE 20X8

	R
ASSETS	
Non-current assets	
Goodwill, at cost	13 024
Land, at cost	600 000
Plant and equipment	391 500
- Cost	679 000
- Accumulated depreciation	(287 500)

d)

	Debit	Credit
Non-distributable reserve	36 000	
Deferred tax	14 000	
Land		50 000
Non-distributable reserve	10 800	
NCI (FP)		10 800

Solution 31.9 continued . . .

Workings

Analysis of equity of Scarlet Limited	Total	25%	75%
At acquisition			
Share capital	100 000		
Retained earnings	12 000		
Land	50 000		
Deferred tax (50 000 x 0.28)	(14 000)		
	148 000	37 000	111 000
Fair value of consideration transferred	100 000		
NCI (155 000 X 0,25)	37 000		
	137 000		
Fair value of identifiable net assets	(148 000)		
Gain on acquisition	11 000		
Beginning of year			
RE at 1/7/X7	73 000		
At acquisition	(12 000)		
	61 000	15 250	45 750
Current year			
Profit before tax	168 000		
Profit on sale of land	110 000		
Group adjustment - profit	(50 000)		
Group adjustment - tax	14 000		
Taxation	(62 440)		
	179 560	44 890	134 670
Non Controlling Interest		97 140	

Land & buildings	Subsidiary	Group
Selling price	610	610
Cost	500	550
Profit / loss	110	60

Solution 31.9 continued . . .

Workings continued ...

Analysis of equity of Silver Limited	Total	40%	60%
At acquisition			
Share capital	100 000		
Retained earnings	32 000		
Plant & equipment	18 000		
Deferred tax	(5 040)		
	<u>144 960</u>	57 984	86 976
Fair value of consideration transferred	100 000		
NCI (144 960 X 0.40)	<u>57 984</u>		
	157 984		
Fair value of identifiable net assets	<u>144 960</u>		
Goodwill	13 024		
Beginning of year			
RE at 1/7/X7	87 000		
At acquisition	<u>(32 000)</u>		
	55 000		
Additional depreciation	(3 000)		
Deferred tax	<u>840</u>		
	52 840	21 136	31 704
Current year			
Profit before tax	208 000		
Taxation	(58 240)		
Additional depreciation	(2 000)		
Deferred tax	<u>560</u>		
	148 320		
Preference dividend	<u>(8 000)</u>		
	140 320	56 126	84 192
Dividends	<u>(40 000)</u>	(16 000)	(24 000)
Non-controlling interest	<u>298 120</u>	<u>119 248</u>	
Preference share capital	Total	60%	40%
Profit	8 000	4 800	3 200
Dividends	(8 000)	(4 800)	(3 200)

Solution 31.9 continued . . .

Workings continued ...

Revaluation of plant	Years	Subsidiary	Revaluation	Group	Deferred tax
Cost 1/1/X5	10	290 000			
Depreciation 30/6/X5	(1/2)	(14 500)			
Depreciation 1/1/X6	(1/2)	(14 500)			
Carrying amount 1/1/X6	*9	261 000	18 000	279 000	5 040
Depreciation 30/6/X6	(1/2)	(14 500)	(1 000)	(15 500)	(280)
Depreciation 30/6/X7	(1)	(29 000)	(2 000)	(31 000)	(560)
Depreciation 30/6/X8	(1)	(29 000)	(2 000)	(31 000)	(560)
Carrying amount 30/6/X8		188 500	13 000	201 500	3 640

*101 500 accumulated depreciation / 29 000 = 3.5 yrs at 30/06/X8 . . . Bought 01/01/X5

Proforma consolidation entries for ordinary dividends

	Debit	Credit
Silver		
PBT (P)	24 000	
NCI (FP)	16 000	
Dividends declared		40 000
Shareholders for dividend	24 000	
Accounts receivable (P)		24 000

Proforma consolidation entries for preference dividends

	Debit	Credit
NCI (FP)	4 800	
PBT	3 200	
Preference dividends paid		8000

Solution 31.10

(a) Journal entries relating to equipment of Skype Limited and related tax consequences

JOURNAL OF SKYPE LIMITED				
		Debit	Credit	
01/10/X5	Accumulated depreciation Equipment	400 000	400 000	} Not required for answer
	Equipment	150 000		
	Revaluation reserve		106 500	
	Deferred tax		43 500	
30/09/X6	Depreciation expense Accumulated depreciation	125 000	125 000	
	Deferred tax	7 250		
	Tax expense		7 250	
30/09/X7	Depreciation expense Accumulated depreciation	125 000	125 000	
	Deferred tax	7 250		
	Tax expense		7 250	
	Accumulated depreciation Equipment (125 000 + 125 000)	250 000	250 000	
	Equipment	100 000		
	Revaluation reserve		71 000	
	Deferred tax		29 000	

(b) At acquisition, pro-forma consolidation adjusting entry relating to the ordinary share capital of Skype Limited for the year ended 30 September 20X7

	Debit	Credit
Share capital	800 000	
Retained earnings	240 000	
Revaluation reserve	106 500	
Investment in Skype Limited		1 100 000
Goodwill	182 800	
Non-controlling interest (FP) (At acquisition)		229 300

Solution 31.10 continued . . .

(c) Pro-forma consolidation adjusting entries relating to the preference share capital of Skype Limited for the year ended 30 September 20X7.

	Debit	Credit
Preference share capital	100 000	
Non-controlling interest (FP) (At acquisition)		100 000
Non-controlling interest (CI)	8 000	
Non-controlling interest (FP) (Preference income for current year)		8 000
Non-controlling interest (FP)	8 000	
Dividends - preference (Preference dividend declared)		8 000

(d) Journal entry in accounting records of Phone Limited and the pro-forma consolidation adjusting entries relating to the ordinary dividends declared by Skype Limited for the year ended 30 September 20X7.

	Debit	Credit
Journal of Phone Limited		
Accounts receivable	12 800	
Profit before interest and tax / Dividend income (16 000 X 0.80)		12 800
Pro-forma consolidating adjusting entries		
Profit before interest and tax / (Reversing Phone Limited's income)	12 800	
Dividend income		
Non-controlling interest (FP) (Non-controlling share)	3 200	
Dividends (Reversing Skype Limited's dividends)		16 000
Shareholders for dividend (Reversing Skype Limited's liability)	16 000	
Dividend receivable (Reversing Phone Limited's asset)		12 800
Accounts payable (Non-controlling share)		3 200

Solution 31.10 continued . . .

(e)

TALK FOR EVER GROUP**CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 SEPTEMBER 20X7**

		C
Profit before interest and tax	P (383 600 – 12 800 – 10 800) S (289 600)	649 600
Interest expense	S (18 000 – 10 800)	(7 200)
Profit before tax		642 400
Taxation expense	(108 112 + 75 900))	(184 012)
Profit for the period		458 388
<i>Other comprehensive income</i>		
Revaluation surplus		71 000
Total comprehensive income		529 388
<i>Profit for the period attributable to</i>		
Equity holders of parent		412 848
Non-controlling interest	(37 540 + 8 000)	45 540
		458 388
<i>Total comprehensive income attributable to:</i>		
Equity holders of parent	(Proof: 412 848 + 56 800)	469 648
Non-controlling interest	(37 540 + 8 000 + 14 200)	59 740
		529 388

(f)

TALK FOR EVER GROUP**CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 30 SEPTEMBER 20X5**

	Share capital	Revaluation reserve	Retained earnings	Attributable to equity holders of parent	Non-controlling interest	Total
	C	C	C	C	C	C
Balance at 30/09/X6	1 200 000	~213 000	^1 036 000	2449 000	*393 300	2 842 300
Total comprehensive income		#56 800	412 848	469 648	59 740	529 388
Dividends			(20 000)	(20 000)	**(11 200)	(31 200)
Balance at 30/09/X7	1 200 000	269 800	1 428 848	2 898 698	441 840	3 340 488

~ (213 000 + 106 500 – 106 500)

^ (740 000 + 560 000 – 240 000 – 64 000 + 40 000)

* (229 300 + 64 000 + 100 000)

** (3 200 + 8 000)

(100 000 X 0.71 = 71 000 X 0.80 = 56 800) (Dr Revaluation reserve 14 200 Cr NCI (FP) 14 200)

Solution 31.10 continued . . .

Workings

W1. Analysis of equity of S Limited – Ordinary shares

	Total	NCI (20%)	Parent (80%)
At acquisition			
Share capital	800 000		
Retained earnings	240 000		
Revaluation reserve	106 500		
	<u>1 146 500</u>	229 300	917 200
Fair value of consideration transferred	1 100 000		
NCI (1 146 500 X 0.20)	229 300		
	<u>1 329 300</u>		
Fair value of identifiable net assets	1 146 500		
Goodwill	<u>182 800</u>		
Retained earnings at 01/10/X6	560 000		
Retained earnings at acquisition	<u>240 000</u>		
	320 000	64 000	256 000
Revaluation reserve at 01/10/X6	106 500		
Revaluation reserve at acquisition	<u>106 500</u>		
	-	-	-
Current year			
Profit before interest and tax	289 600		
Interest expense	(18 000)		
Tax expense	(75 900)		
Preference dividend paid	<u>(8 000)</u>		
	187 700	37 540	150 160
Ordinary dividend declared	(16 000)	(3 200)	(12 800)
Revaluation	71 000	14 200	
	<u>1 709 200</u>	<u>341 840</u>	

W2. Analysis of equity of S Limited – Preference shares

	Total	NCI (100%)	Parent (0%)
At acquisition			
Share capital	100 000	100 000	-
Current year			
Preference income	8 000	8 000	-
Dividend declared	<u>(8 000)</u>	<u>(8 000)</u>	-
	100 000	100 000	-

Solution 31.10 continued . . .

W3. S Limited equipment and deferred tax

		Yr	CA	TB	TD	DT X29%	RS
01/10/X5	Carrying amount	6	600 000	600 000	0	0	
	Revalue		150 000			43 500	106 500
		6	750 000	600 000	150 000	43 500	L 106 500
30/09/X6	Depreciation / tax allowance (750 000 / 6) (600 000 / 6)		(125 000)	(100 000)		(7 250)	
			625 000	500 000	125 000	36 250	L 106 500
30/09/X7	Depreciation / tax allowance		(125 000)	(100 000)		(7 250)	
			500 000	400 000	100 000	29 000	L 106 500
	Revalue		100 000			29 000	71 000
			600 000	400 000	200 000	58 000	L 177 500

Solution 31.11

a) Pro-forma consolidation adjusting entries relating to the equipment of Sky Limited for the year ended 30 September 20X5.

		<i>Debit</i>	<i>Credit</i>
Ordinary share capital		800 000	
Retained earnings		420 000	
Property		200 000	
Equipment		150 000	
Deferred tax			43 500
Non-controlling interest (FP)			305 300
Investment in Sky Limited			1 800 000
Goodwill		578 800	
Retained earnings	(Group depreciation adjustment from 01/10/X3 – 30/09/X4)	25 000	
Accumulated depreciation			25 000
Deferred tax	(Group deferred tax adjustment from 01/10/X3 – 30/09/X4)	7 250	
Retained earnings			7 250
Depreciation expense	(Current year group depreciation adjustment)	25 000	
Accumulated depreciation			25 000
Deferred tax	(Current year group deferred tax adjustment) (7 250 + 29 000)	36 250	
Taxation expense			36 250
Profit before tax	(Adjusting the R40 000 profit to Sky to give a R60 000 loss to the group)	100 000	
Equipment			150 000
Accumulated depreciation		50 000	

Note from authors: There is no reversal of the accumulated depreciation at acquisition of R400 000 as the equipment has been sold.

b) Pro-forma consolidation adjusting entries relating to the dividends declared by Sky Limited for the year ended 30 September 20X5

		<i>Debit</i>	<i>Credit</i>
Dividend income		3 200	
Non-controlling interest (FP)	(Interim dividend paid)	800	
Dividends			4 000
Dividend income	(Reversing Pie's income)	6 400	
Non-controlling interest (FP)		1 600	
Dividends	(Reversing Sky's dividends)		8 000
Shareholders for dividend	(Reversing Sky's liability)	8 000	
Dividends receivable	(Reversing Pie's asset)		6 400
Accounts payable	(Non-controlling share)		1 600

Solution 31.11 continued ...

c)

PIE AND SKY GROUP
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 SEPTEMBER 20X5

		C
Profit before tax	P (320 000 + 9 600 – 9 600)	506 000
	S (280 000 + 31 000 – 25 000 – 100 000)	
Taxation expense	(94 800 + 59 500 – 36 250)	(118 050)
Profit for the period		387 950
<i>Other comprehensive income</i>		
Revaluation surplus		50 000
Total comprehensive income		437 950
<i>Attributable to:</i>		
Equity holders of parent – Form profit (355 400) for the period		395 400
Non-controlling interest – From other comprehensive income		42 550
		437 950

d)

PIE AND SKY GROUP
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 30 SEPTEMBER 20X5

	Share capital	Revaluation reserve	Retained earnings	Attributable to equity holders of parent	Non- controlling interest	Total
	C	C	C	C	C	C
Balance at 30/09/X4	1 000 000	-	[^] 1 123 400	2 123 400	*339 750	2 463 150
Total comprehensive income		~40 000	355 400	395 400	42 550	437 950
Dividends			(16 000)	(16 000)	(2 400)	(18 400)
Balance at 30/09/X5	1 000 000	40 000	1 462 800	2 502 800	379 900	2 882 700

[^] (985 600 + 610 000 – 420 000 – 25 000 + 7 250 – 34 450)

* (305 300 + 34 450)

~ [(250 000 – 200 000) X 0.80] (Dr Revaluation reserve 200 000 Cr Property 200 000)
and (Dr Revaluation reserve 10 000 Cr Non-controlling FP 10 000)

Solution 31.11 continued ...

- e) **Pro-forma consolidation journal entries affected by the property and the equipment of Sky Limited for the year ended 30 September 20X6.**

		<i>Debit</i>	<i>Credit</i>
Ordinary share capital		800 000	
Retained earnings		420 000	
Property		200 000	
Equipment		150 000	
Deferred tax			43 500
Non-controlling interest (FP)			305 300
Investment in Sky Limited			1 800 000
Goodwill		578 800	
Revaluation reserve	(50 000 x 20%)	200 000	
Property			200 000
Revaluation reserve	(50 000 x 20%)	10 000	
Non-controlling FP			10 000
Retained earnings	(50 000 - 43 500 + 100 000)	106 500	
Deferred tax		43 500	
Equipment			150 000
<i>Or</i>			
{	Retained earnings	50 000	
	Accumulated depreciation		50 000
	Deferred tax	43 500	
	Retained earnings		43 500
	Retained earnings	100 000	
	Accumulated depreciation	50 000	
	Equipment		150 000

Solution 31.11 continued ...

Workings

Analysis of equity of Sky Limited	Total	Minorities (20%)	Parent (80%)
At acquisition			
Share capital	800 000		
Retained earnings	420 000		
Property	200 000		
Equipment	150 000		
Deferred tax	(43 500)		
	<u>1 526 500</u>	305 300	1221 200
Investment in Sky			<u>1 800 000</u>
Goodwill			578 800
Beginning of year			
Retained earnings at 01/10/X4	610 000		
Retained earnings at acquisition	<u>(420 000)</u>		
	190 000		
Group depreciation adjustment	(25 000)		
Group deferred tax adjustment	<u>7 250</u>		
	172 250	34 450	137 800
Current year			
Operating profit before tax	280 000		
Dividend income	31 000		
Tax expense	(59 500)		
Group depreciation adjustment	(25 000)		
Group deferred tax adjustment (7 250 + 29 000)	36 250		
Group adjustment to profit on sale of equipment	<u>(100 000)</u>		
	162 750	32 550	130 200
Interim dividend paid	(4 000)	(800)	(3 200)
Final dividend declared	(8 000)	(1 600)	(6 400)
	<u>1 849 500</u>	<u>369 900</u>	

Equipment of Sky Limited	Cost	Group adjustment	Group
Cost	10	1 000 000	
	(4)	<u>(400 000)</u>	
01/10/X3 Carrying amount	6	600 000	150 000
30/09/X4 Depreciation		(100 000)	(25 000)
30/09/X5 Depreciation		<u>(100 000)</u>	(25 000)
		400 000	100 000
			500 000

Deferred tax	Group	Tax	Temporary difference	Deferred tax (X0,29)	
01/10/X3	750 000	600 000	150 000	43 500	Cr
30/09/X4	(125 000)	(100 000)	(25 000)	(7 250)	Dr
30/09/X5	<u>(125 000)</u>	<u>(100 000)</u>	<u>(25 000)</u>	<u>(7 250)</u>	Dr
	500 000	400 000	100 000	29 000	Cr
	<u>(500 000)</u>	<u>(400 000)</u>	<u>(100 000)</u>	<u>(29 000)</u>	Dr

0	0	0	0
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Solution 31.11 continued ...

Workings continued ...

	Sky Limited	Group
Selling price	440 000	440 000
Carrying amount	(400 000)	(500 000)
	<hr/> 40 000	<hr/> (60 000)
