CPA

FINANCIAL REPORTING

PART 2

CPA SECTION 3

KASNEB JULY 2018 SYLLABUS

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PAPER NO.9 FINANCIAL REPORTING

GENERAL OBJECTIVE

This paper is intended to equip the candidate with knowledge, skills and attitudes that will enable him/her to prepare financial statements for various entities and account for specialised transactions in both the public and private sectors.

9.0 LEARNING OUTCOMES

A candidate who passes this paper should be able to:

- Account for various assets and liabilities
- Prepare financial statements including published financial statements for various types of organisations
- Account for specialised transactions
- Prepare group financial statements
- Analyze and interpret financial statements
- Apply International Financial Reporting Standards (IFRSs) and International Public Sector Accounting Standards (IPSASs) in preparing non-complex financial statements.

CONTENT

9.1 Assets of financial statements

- Assets and liabilities covered in Paper No. 1: Financial Accounting still examinable (in the context of published financial statements)
- Inventories
- Borrowing costs
- Investment property
- Financial Instruments (presentation, recognition, classes, measurement, de-recognition and disclosures) (excluding impairment, hedging and embedded derivatives)
- Leases (all aspects including dealers and sale and leaseback)

9.2 Liabilities of financial statements

- Employee benefits
- Provisions, contingent liabilities and contingent assets
- Income tax (current and deferred tax but not deferred tax in the case of groups)

- events after reporting date

9.3 Further aspects of partnerships

- Dissolutions (including piece-meal)
- Amalgamation Conversion and sale of partnership firms 9.4 Special transactions
- Revenue recognition
- Contracts with customers

- Hire purchase and installment sales transactions (split of hire purchase profit into interest and gross profit and using actuarial method and sum of digits to account for interest); sale of goods, construction contracts and real estate, provision of services
- Government grants

9.5 Financial statements for various types of businesses

- Inventory and biological assets in agriculture
- Insurance
- Banks
- Professional firms (lawyers and accountants)
- Accounting for branches including foreign branches
- Co-operative societies

9.6 Published financial statements

- Presentation of financial statements (income statement, statement of comprehensive incomes, statement of changes in equity, statement of financial position and the notes to financial statements)
- Accounting policies, changes in accounting estimates and errors (prior period errors)
- Fair value measurement

9.7 Consolidated financial statements

- Accounting for one subsidiary (consolidated income statement, consolidated statement of financial position and a statement of cash flows – group financial statements); consolidated statement of cash flows also covers associate companies and jointly controlled entities but excludes acquisition and disposal of subsidiaries during the year
- Investments in associates and joint ventures

9.8 Financial statements under IPSASs

[Provisions of the following IPSASs (emphasis on distinctions with equivalent IASs/IFRSs)]

- Presentation of financial statements
- Accounting policies, changes in accounting estimates and errors
- Borrowing costs
- Consolidated and separate financial statements
- Investments in associates
- Interests in joint ventures
- Events after the reporting date
- Construction contracts, leases and inventories
- Provisions, contingent liabilities and contingent assets

9.9 Emerging issues and trends

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TOPIC 1

ACCOUNTING FOR ASSETS AND LIABILITIES

PROPERTY, PLANT AND EQUIPMENT (PPE) IAS 1 6

- IAS 1 6 PPE outlines the accounting treatment of most types of PPE items. It further stipulated the principles for recognizing property, plant and equipment as assets, measuring their carrying amount and the depreciation and impairment losses to be recognized in relation to them.
- PPE are initially measured at its cost, subsequently measured either at cost or revaluation model.

Disclosure requirements for PPE

The following information should be presented in respect of item of PPE:

1. Basis of measuring carrying amount.
2. Depreciation method used and its rates.
3. Useful life of the asset.
4. The gross carrying amount, accumulated depreciation and impairment losses at the beginning and end of period.
5. A reconciliation of the carrying amount at the beginning and end of the period showing:
   - Additions
   - Disposal
   - Asset classified as held for sale.
   - Impairment losses and reserves of impairment.

NB: De- recognition of an item of PPE is done on disposal or when no further benefits are expected from the use or disposal.

Disclosure requirement for PPE stated at revalued amount.

- The carrying amount of the PPE.
- Changes in revaluation surplus/ loss for PPE recognizes under other comprehensive income.
- Disclosure of specific accounting policies and effective date of revaluation and whether an independent valuer was involved.
- A reconciliation between the carrying amount of revaluation surplus at the beginning and at the end of the period i.e. indicating the movement balances.

INVENTORIES [IAS 2]

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

The objective of IAS 2 is to prescribe the accounting treatment for inventories ie the amount of cost to be recognized as an asset and carried forward unit the related revenues are recognized.

MEASUREMENT OF INVENTORIES

Inventory should be valued at the lower of cost and net realizable value. The cost shall comprise:

1. **Cost of purchase -** this comprises purchase price, import duties and others non-refundable taxes, transport and handling and other costs.
2. **Cost of conversion -** this comprises the direct labour cost, variable production overheads and fixed production overhead.
3. Administrative cost, selling cost, abnormal loses and shortage cost unless they relate to the goods in production process.

NET REALIZABLE VALUE - is the estimated selling price less estimated cost to sell.

Disclosure requirements

1. Method adopted in determining the cost i.e. FIFO or weighted average method.
2. The carrying amount of inventories suitably classified into raw material, WIP and finished goods.
3. Inventories that was valued at net realizable value.
4. Circumstances leading write down of inventories to net realizable value
5. Inventories pledged as securities.

BORROWING COST (IAS 23/IPSAS 5)

These are cost associated with borrowing e.g. interests and floatation cost that an entity incurs in connection with borrowing. Borrowing cost is directly attributable to the acquisition, construction or production of a qualifying asset. They should be capitalized. Other borrowing costs are recognized as an expense e.g. legal expense.

Examples of borrowing costs

a) Interest on loan/borrowing.
b) Floatation cost e.g. legal costs.
c) Principle amount.
d) Amortization of discount or premium relating to borrowing.
e) Exchange difference in- case of foreign currency transaction.

A qualifying asset- is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Example of qualifying asset

- Inventory that are manufactured or produced over a long period of time.
- Manufacturing plant.
- Power generation facilities.
- Intangible assets.
- Investment properties

Accounting treatment and recognition of borrowing costs

- An entity shall capitalize borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asst.
- An entity shall recognize other borrowing cost as an expense in the period in which it incurs them.

How accounting treatment under IPSAS 5 differs from IAS 23.
IPAS 5 requires borrowing costs to be expensed immediately in the period in which they are incurred regardless of how the borrowing is applied. This is the benchmark treatment. Under IAS 23 the revised version requires that all borrowing costs that are eligible for capitalization should be capitalized and included as part of qualifying asset.

INVESTMENT PROPERTY (IAS 40)

These are assets held to earn rentals or for capital appreciation or both rather than for use in the production, supply, administration or for sale in the ordinary course of business.eg Land and building.

Examples of investment property include:

(a) Land held for long term capital appreciation rather than short term sale in the ordinary course of business.
(b) Land held for predetermined future use.
(c) A building owned by the entity or held under a finance lease by the entity ad leased out.
(d) A building which is vacant but is held to be leased out under one or more operating lease.
(e) Property that is being constructed for future use as an investment property.

Property which are not considered as investment property

a) Land held for ordinary use by the entity.
b) Building held for use rather than capital appreciation or to earn rentals.
c) Asset held for normal use of production of goods or services.

Measurement of investment property

1. Initial measurement - investment property shall be measured at cost. Cost shall include the purchase price and any other direct attributable cost incurred on acquisition of investment property.

2. Subsequent measurement - an entity shall choose either the use of:

- **Cost model.-** this requires asset to be measured at cost less accumulated depreciation in accordance with IAS 1 6.
- **Fair value model.-** under fair value model, investment property is re- measured at the end of each reporting period. Any fair value gain or loss shall be disclosed and reported to profit and loss account during the period they arose.

Recognition criteria for investment property

Investment property should be recognized as an asset when:

1. It's probable that future economic benefit will flow from that asset to the entity.
2. The cost/fair value of the investment property can be measured reliably.
3. The entity controls the investment property.

- They are measured at cost or fair value.

FINANCIAL INSTRUMENTS- IFRS 9/ IAS 39

RECOGNITION AND MEASUREMENT

A financial instrument is a contract that gives rise to a financial asset to one party and a financial liability to another party e.g. cash, bank balance, commercial papers, loan, bond, debt, equity.

Classes of Financial assets

IAS 39 classifies financial asset into 4 categories which include:

1. Financial asset at fair value.
2. Available for sale financial asset.
3. Loan and receivable.
4. Held to maturity.

Financial asset at fair value

They are short term financial investment and therefore they are classified under the current assets. They are measured and valued at fair value.

Available for sale /financial asset at amortized cost

They are long term financial investment and therefore they are classified under non-current assets.

They are measured and valued at either fair value or amortized cost.

Measurement

Financial instrument are measured either:

- On amortized cost.
- At fair value
- Provisions governing initial measurement and subsequent measurement of financial asset.
- All financial instruments are initially measured at fair value plus or minus, in the case of a financial asset or liability not at fair value through profit or loss.
- Subsequently, all financial instruments are measured at either cost or fair value.

Requirement for de- recognition of financial instruments

- De- recognition is the removal of a previously recognized financial instrument from an entity balance sheet. A financial instrument should be derecognized if either the entity's contractual rights or the asset's cash flows have expired, or the asset has been transferred to a third party along with the risks of ownership.
- If the risks and reward of ownership have not passed to the buyer, then the selling entity must still recognize the entire financial instrument and treat any consideration received as a liability.

Impact of IFRS 9 on the tax expenses of commercial banks (May 201 8 Question 5b)

- IFRS 9 encompasses the accounting for financial instruments and their impairment.
- The objective of IFRS 9 is to recognize a whole year and lifetime expected credit losses for all financial instruments for which there has been a significant increase in credit risk.
- There is a high likelihood that the only incurred credit losses recognized on non-performing loans and advances under IFRS 9 will be allowed as tax- deductible.
- The major issue with the adoption of IFRS 9 for banks is the effect of bigger and more volatile impairment losses on capital ratios. From tax perspective, it may also mean significantly lower profits but higher scrutiny of specific impairment loses, a apart of which may be disallowed for tax purposes. Furthermore, there will be an increase in the number of fair vale movement through the income statement which will need to be properly tracked and adjusted for tax purposes.

Impact of IFRS 9 on the provision of bad and doubtful debts by banks

- The highest effect of IFRS is the increases in loss provisions from new expected loss impairment model, as compared to IAS 39 incurred loss model. The increase in the provision is large and quite variable.
- Reported credit losses are expected to increase and become more volatile under the new credit loss model. The number and complexity of judgment is also expected to increase.

- It is based on internal credit risk management practices and/or policies and is usually considered to be consistent with the definition of default used for measuring probability of default. Forward looking factor macro- economic variables and their forecasts used in the calculation of impairment under IFRS

IMPAIRMENT OF ASSET

An asset is said to be impaired if the carrying amount is greater than the recoverable amount.

Indicators of impairment of asset

EXTERNAL INDICATORS

- There is significance decrease in the market value of the asset.
- There are significance changes with the adverse effect on the entity technology, economy or legal environment.
- There is an increase in market interest rate likely to affect the discounting rate used in calculating assets value in use.

INTERNAL INDICATORS

- Evidence is available of obsolesce or physical damage of an asset.
- Evidence is available that indicates that the economic performance of an asset will be worse than expected.

LEASES (IAS 17)

This is a contract between two parties where one party known as lessor (owner) gives another party known as lessee the right to use the asset and enjoy the benefits and risk associated with the utilization of the asset.

Types of leases

a) Operating lease.
b) Finance lease.
c) Sell and leaseback lease.
d) Leverage lease

Operating lease/off balance sheet lease

This is a short term lease. It has the following characteristics:

- The lease period is very short relative to the economic life of the asset.
- The lease contract can be cancelled by either party any time before end of lease period.
- The owner (lessor) incurs maintenance, operating and insurance expenses of the asset.
- The lessee is not given an option to buy the asset at the end of lease period.

Finance lease/capital lease

This is long- term in nature and the lease period is almost equal to the economic life of the asset.

Characteristics

- The lease period should be at least equal to 75% of the asset economic life.
- The lease contract cannot be cancelled by either party before lease period matures.
- The lessee incurs all maintenance cost.
- The lessee is given an option to buy the asset at the end of lease period.

Advantages of a lease

1. Lease does not involve strict terms and conditions associated with long term debts.
2. Leasing has lower effective cost compared to long term debts.
3. It does not require a significant initial capital investment compared with cost of buying new asset.
4. It reduces the risk of obsolescence.
5. It provides off- balance sheet financing i.e. operating lease are shown as foot notes to the financial statements.

Differences between finance and operating lease.

Finance lease	**Operating lease**
It is a long term lease taking more than 75% of economic life of the asset.	It is a short term lease.
The lessee has an option to purchase the asset at the end of the lease period.	The lessee has no such option.
The contract cannot be cancelled before maturity.	The lease contract can be canceled any time before maturity.
The lessee incurs all incidental operating expenses and account for the items in its financial statement	The lessor incurs the operating expenses and accounts for the asset in his books of account.

Sell and leaseback lease.

This is a type of lease or a financial transaction in which one sells the asset and leases it back therefore, one continue to be able to use the asset but no longer owns its. It has the following features/characteristics:

1. **Long initial terms -** when one buys a sale- leaseback asset, one knows that he could end up with a lease option.
2. **Triple net lease** - most sale leasebacks are structured with a triple net lease. This means the tenant takes full responsibility for the property e.g. building.