(W1) **Control to control adjustment – Sprite**

	$000	
Cash paid	(26)	Cr
Decrease in NCI (8/20 × $80 (W2))	32	Dr
	–––	
Increase to other components of equity	6	Cr
	–––	

(W2) **Non-controlling interest – Sprite**

	$000
NCI at acquisition	65
NCI% × post acquisition reserves (20% × ($100 – $25))	15
	–––
NCI before control to control adjustment	80
	–––

Sale of 10% of Tango

The sale has decreased Pepsi's holding in Tango from 75% to 65%. Tango was a subsidiary before and after the sale so there has been no change in control status. This means that no gain or loss arises on the transaction in the group financial statements and goodwill is not remeasured.

The transaction is accounted for in equity as an increase in the non-controlling interest. The increase in the NCI will be the 10% share of the net assets and goodwill of Tango at the date of the sale which Pepsi has effectively sold to the NCI.

The difference between the proceeds received of $35,000 and the increase in the non-controlling interest of $39,000 (W3) amounts to $4,000. This will be recorded as a decrease to other components of equity.

(W3) **Control to control adjustment – Tango**

	$000	
Cash received	35	Dr
Increase in NCI (10% × ($300 (W4) + $90 (W5))	(39)	Cr
	–––	
Decrease to other components of equity	(4)	Dr
	–––	

(W4) **Net assets – Tango**

	Acquisition date	Reporting date
	$000	$000
Share capital	100	100
Retained earnings	60	200
	160	300

(W5) **Goodwill – Tango**

	$000
Consideration	200
FV of NCI at acquisition	50
Fair value of net assets at acquisition (W4)	(160)
	90

Test your understanding 8 – Raven

The sale of the shares reduces Raven's holding from 25% to 5%. Raven has lost significant influence over Sword and so Sword is no longer an associate. The investment in the associate must be derecognised.

The associate would have been initially recognised at $1 million. Raven would have accounted for its share of the associate's profits since this date. As such, by the date of disposal, the carrying amount of the associate in the consolidated financial statements would have been $1.2 million ($1m + (25% × ($3.8m – $3m))).

A profit on disposal must be recorded in the statement of profit or loss.

	$m
Disposal proceeds	2.0
Fair value of shares retained	0.5
Carrying amount of associate	(1.2)
Profit on disposal	1.3

In respect of the remaining 5% shareholding, a financial asset will be recognised at $0.5 million in accordance with IFRS 9 *Financial Instruments*. By the reporting date the financial asset will be revalued to $0.6 million with a gain of $0.1 million recorded in profit or loss. Alternatively the gain could be recorded in other comprehensive income if the shares are not held for trading and an irrevocable designation was made on 30 June to measure the shares at fair value through other comprehensive income.

Test your understanding 9 – Liesel

Rosa

Liesel controlled Rosa both before and after the sale of shares. As such, it is incorrect to recognise a profit (or loss) on the sale. The transaction should be accounted for in equity as an increase in the non-controlling interest. This increase amounts to \$6.4 million (5% × (\$8m + \$120m)).

The difference between the cash proceeds and the increase in the non-controlling interest of \$2.6 million (\$9m – \$6.4m) should be recognised as an increase to shareholders' equity.

The correcting entry is:

Dr Profit or loss	\$9.0m
Cr Non-controlling interest	\$6.4m
Cr Other components of equity	\$2.6m

Hans

Liesel controlled Hans for the first 9 months of the year. Therefore the Liesel Group should have consolidated the incomes and expenses of Hans that arose during these 9 months. This will have a total impact on consolidated profit of \$15 million (\$20m × 9/12). Of this, \$10.5 million (\$15m × 70%) is attributable to the equity owners of the parent and the remaining \$4.5 million is attributable to the non-controlling interest.

The sale of shares caused Liesel to lose control of Hans. At this point, Hans ceases to be a subsidiary. The Liesel group should derecognise the goodwill, net assets and non-controlling interest of Hans and recognise a loss on disposal of \$19.1 million. This is calculated as follows:

	\$m	\$m
Sales proceeds		72
Fair value of shares retained		51
Carrying amount of subsidiary at disposal:		
Goodwill at disposal date (W1)	31	
Net assets at disposal date (W2)	163	
Less: NCI at disposal date (W3)	(51.9)	
	–––––	(142.1)
		–––––
Loss on disposal		(19.1)
		–––––

After the share sale Liesel retained significant influence over Hans. As such, Liesel should have recognised its remaining investment in Hans as an associate with an initial carrying amount of $51 million. The investment would be accounted for using the equity method. In consolidated profit or loss, Liesel should report a share of profits from associate entities of $1.5 million ($20m × 3/12 × 30%). This will increase the carrying amount of the investment in the associate to $52.5 million ($51 m + $1.5m) in the consolidated statement of financial position.

(W1) **Goodwill**

	$m
Consideration	105
NCI at acquisition	36
FV of net assets at acquisition ($100m + ($15m – $5m))	(110)
Goodwill	31

(W2) **Net assets at disposal date**

	$m
Share capital	8
Retained earnings bfd	130
Fair value adjustment ($15m – $5m)	10
Profit to disposal ($20m × 9/12)	15
	163

(W3) **NCI at disposal date**

	$m
NCI at acquisition	36.0
NCI % of post-acq'n net assets movement (30% × ($163m – $110m))	15.9
	51.9

Chapter

20

Group accounting – foreign currency

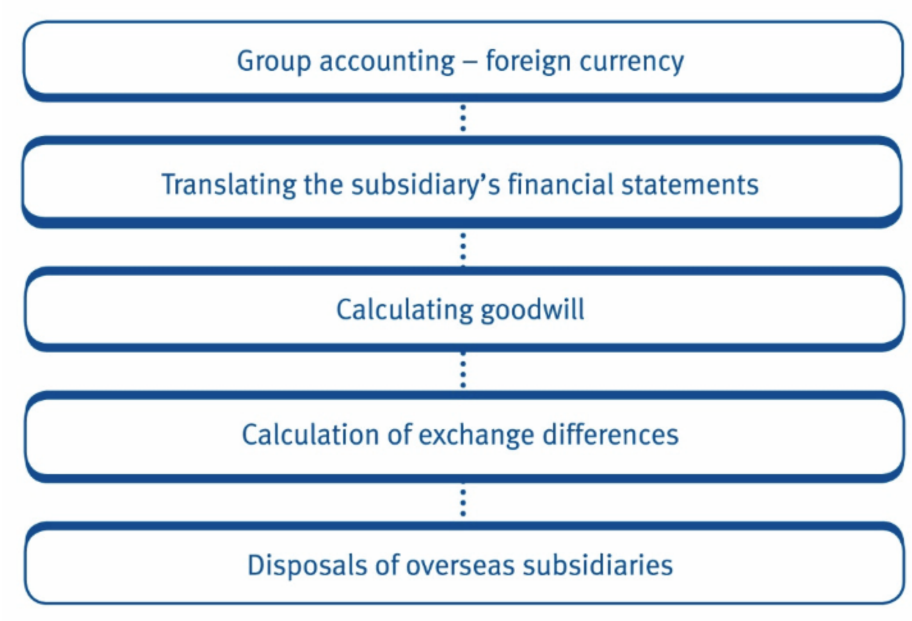
Chapter learning objectives

Upon completion of this chapter you will be able to:

- Outline and apply the translation of foreign currency amounts and transactions into the functional currency and the presentational currency
- Account for the consolidation of foreign operations, including subsidiaries, associates and joint arrangements, and their disposal.

PER

One of the PER performance objectives (PO7) is to prepare external financial reports. You take part in preparing and reviewing financial statements – and all accompanying information – and you do it in accordance with legal and regulatory requirements. Working through this chapter should help you understand how to demonstrate that objective.



1 Key definitions

Foreign currency transactions in the individual financial statements of a company were covered earlier in this text.

Below is a reminder of some key definitions:

The **functional currency** is the currency of the **'primary economic environment where the entity operates'** (IAS 21, para 8). In most cases this will be the local currency.

The **presentation currency** is the **'currency in which the entity presents its financial statements'** (IAS 21, para 8).

2 Consolidation of a foreign operation

The functional currency used by a subsidiary to prepare its own individual accounting records and financial statements may differ from the presentation currency used for the group financial statements. Therefore, prior to adding together the assets, liabilities, incomes and expenses of the parent and subsidiary, the financial statements of an overseas subsidiary must be translated.

Progression

In previous exams you did not have to consolidate a subsidiary that uses a different currency from the rest of the group.

Translating the subsidiary's financial statements

The rules for translating an overseas subsidiary into the presentation currency of the group are as follows:

- **Income, expenses and other comprehensive income** are translated at the exchange rate in place at the date of each transaction. The average rate for the year may be used as an approximation.
- **Assets and liabilities** are translated at the closing rate of exchange.

Illustration 1 – Dragon

This example runs through the chapter and is used to illustrate the basic steps involved in consolidating an overseas subsidiary.

Dragon bought 90% of the ordinary shares of Tattoo for DN180 million on 31 December 20X0. The retained earnings of Tattoo at this date were DN65 million. The fair value of the non-controlling interest at the acquisition date was DN14 million.

The financial statements of Dragon and Tattoo for the year ended 31 December 20X1 are presented below:

Statements of profit or loss for year ended 31 December 20X1

	Dragon	Tattoo
	$m	DNm
Revenue	1,200	600
Costs	(1,000)	(450)
Profit	200	150

Statements of financial position as at 31 December 20X1

	Dragon	Tattoo
	$m	DNm
Property, plant and equipment	290	270
Investments	60	–
Current assets	150	130
	500	400
Share capital	10	5
Retained earnings	290	215
Liabilities	200	180
	500	400

There has been no intra-group trading. Goodwill arising on the acquisition of Tattoo is not impaired. The presentation currency of the consolidated financial statements is the dollar ($).

Exchange rates are as follows:

	DN to $
31 December 20X0	3.0
31 December 20X1	2.0
Average for year to 31 December 20X1	2.6

Required:

For inclusion in the consolidated statement of profit or loss and other comprehensive income for the year ended 31 December 20X1, calculate:

- **Revenue**
- **Costs**

For inclusion in the consolidated statement of financial position as at 31 December 20X1, calculate:

- **Property, plant and equipment**
- **Investments**
- **Current assets**
- **Share capital**
- **Liabilities**

Solution

	$m
Revenue ($1,200 + (DN600/2.6))	1,430.8
Costs ($1,000 + (DN450/2.6))	(1,173.1)
PPE ($290 + (DN270/2))	425.0
Investments (eliminated on consolidation)	–
Current assets ($150 + (DN130/2))	215.0
Share capital (Dragon only)	10.0
Liabilities ($200 + (DN180/2))	290.0

Remember, the income and expenses of an overseas subsidiary are translated at the average rate. The assets and liabilities are translated at the closing rate.

Translating goodwill

Goodwill should be calculated in the functional currency of the subsidiary.

According to IAS 21, goodwill should be treated like other assets of the subsidiary and translated at the reporting date using the closing rate.

Illustration 2 – Goodwill

Required:

Using the information in illustration 1, calculate goodwill for inclusion in the consolidated statement of financial position for the Dragon group as at 31 December 20X1.

Solution

Goodwill calculation

	DNm
Consideration	180
NCI at acquisition	14
Net assets at acquisition (W)	(70)
	124
Goodwill impairments	–
	124

Goodwill is translated at the closing rate to give a value of $62m (DN 124/2).

(W) **Net assets of Tattoo**

	Acquisition date	**Reporting date**	**Post-acquisition**
	DNm	DNm	DNm
Share capital	5	5	
Retained earnings	65	215	150
	70	220	150

Exchange differences

The process of translating an overseas subsidiary gives rise to exchange gains and losses. These gains and losses arise for the following reasons:

- **Goodwill:** Goodwill is retranslated each year-end at the closing rate. It will therefore increase or decrease in value simply because of exchange rate movements.
- **Opening net assets:** At the end of the prior year, the net assets of the subsidiary were translated at the prior year closing rate. This year, those same net assets are translated at this year's closing rate. Therefore, opening net assets will have increased or decreased simply because of exchange rate movements.
- **Profit:** The income and expenses (and, therefore, the profit) of the overseas subsidiary are translated at the average rate. However, making a profit increases the subsidiary's assets which are translated at the closing rate. This disparity creates an exchange gain or loss.

Current year exchange gains or losses on the translation of an overseas subsidiary and its goodwill are recorded in other comprehensive income.

Goodwill translation

The proforma for calculating the current year gain or loss on the retranslation of goodwill is as follows:

	DN	Exchange Rate	$
Opening goodwill	X	Opening rate	X
Impairment loss in year	(X)	Average rate	(X)
Exchange gain/(loss)	–	**Bal fig.**	X/(X)
	____		____
Closing goodwill	X	Closing rate	X
	____		____

If the subsidiary was purchased part-way through the current year, then substitute 'opening goodwill' for 'goodwill at acquisition'. This would then be translated at the rate of exchange on the acquisition date.

It is important to pay attention to the method of goodwill calculation:

- If the full goodwill method has been used, gain and losses will need to be apportioned between the group and the non-controlling interest.
- If the proportionate goodwill method has been used, then all of the exchange gain or loss on goodwill is attributable to the group.

Illustration 3 – Translating goodwill

Required:

Using the information in illustration 1, calculate the exchange gain or loss arising on the translation of the goodwill that will be credited/charged through other comprehensive income in the year ended 31 December 20X1.

Who is this gain or loss attributable to?

Solution

	DNm	Exchange Rate	$m
Opening goodwill	124.0	3.0	41.3
Impairment loss in year	–	2.6	–
Exchange gain	–	**Bal fig.**	**20.7**
Closing goodwill	124.0	2.0	62.0

The total translation gain of $20.7m will be credited to other comprehensive income.

This is then allocated to the group and NCI based on their respective shareholdings:

Group: $20.7m × 90% = $18.6m

NCI: $20.7m × 10% = $2.1 m

Opening net assets and profit

The exchange gains or losses arising on the translation of opening net assets and profit for the year are generally calculated together.

The proforma for calculating the current year exchange gain or loss on the translation of the opening net assets and profit is as follows:

	DN	Exchange Rate	$
Opening net assets	X	Opening rate	X
Profit/(loss) for the year	X/(X)	Average rate	X/(X)
Exchange gain/(loss)	–	**Bal fig.**	X/(X)
Closing net assets	X	Closing rate	X

If the subsidiary was purchased part-way through the current year, then substitute 'opening net assets' and 'opening rate' for 'acquisition net assets' and 'acquisition rate'.

The gain or loss on translation of the opening net assets and profit is apportioned between the group and non-controlling interest based on their respective shareholdings.

Illustration 4 – Opening net assets and profit

Required:

Using the information in illustration 1, calculate the exchange gain or loss arising on the translation of the opening net assets and profit of Tattoo that will be credited/charged through other comprehensive income in the year ended 31 December 20X1.

Who are these gains or losses attributable to?

Solution

	DNm	Exchange Rate	$m
Opening net assets*	70	3.0	23.3
Profit/(loss) for the year*	150	2.6	57.7
Exchange gain/(loss)	–	**Bal fig.**	29.0
	–––––		––––––
Closing net assets*	220	2.0	110.0
	–––––		––––––

*These figures are taken from the net assets working, which can be found in the solution to illustration 2.

The total translation gain of $29.0m will be credited to other comprehensive income.

This is then allocated to the group and NCI based on their respective shareholdings:

Group: 29.0m × 90% = $26.1 m

NCI: 29.0m × 10% = $2.9m

Exchange differences on the statement of financial position

Exchange gains and losses arising from the translation of goodwill and the subsidiary's opening net assets and profit which are attributable to the group are normally held in a translation reserve, a separate component within equity.

Illustration 5 – Reserves

Required:

Using the information in illustration 1, calculate the non-controlling interest, retained earnings and the translation reserve for inclusion in the consolidated statement of financial position as at 31 December 20X1.

Solution

Non-controlling interest

	$m
NCI at acquisition (DN14/3 opening rate)	4.7
NCI % of Tattoo's post-acquisition profits (10% × (DN150/2.6 average rate))	5.7
NCI % of goodwill translation (illustration 3)	2.1
NCI % of net assets and profit translation (illustration 4)	2.9
	15.4

Retained earnings

	$m
100% of Dragon	290.0
90% of Tattoo's post-acquisition profits (90% × (DN150/2.6))	51.9
	341.9

Translation reserve

	$m
Group share of goodwill forex (illustration 3)	18.6
Group share of net assets and profit forex (illustration 4)	26.1
	44.7

Illustration 6 – Completing the financial statements

Required:

Using the information in illustration 1, complete the consolidated statement of financial position and the statement of profit or loss and other comprehensive income for the Tattoo group for the year ended 31 December 20X1.

Solution

Statement of profit or loss and other comprehensive income for year ended 31 December 20X1

	$m
Revenue (illustration 1)	1,430.8
Costs (illustration 1)	(1,173.1)
	–––––––
Profit for the year	257.7
Other comprehensive income – items that may be classified to profit or loss in future periods	
Exchange differences on translation of foreign subsidiary ($20.7 (illustration 3) + $29.0 (illustration 4))	49.7
	–––––––
Total comprehensive income for the year	307.4
	–––––––
Profit attributable to:	
Owners of Dragon (bal. fig.)	251.9
Non-controlling interest (10% × (DN150/2.6 avg. rate))	5.8
	–––––––
Profit for the year	257.7
	–––––––
Total comprehensive income attributable to:	
Owners of Dragon (bal. fig.)	296.6
Non-controlling interest ($5.8 (profit) + $2.1 (illustration 3) + $2.9 (illustration 4))	10.8
	–––––––
Total comprehensive income for the year	307.4
	–––––––

Statement of financial position as at 31 December 20X1

	$m
Property, plant and equipment (illustration 1)	425.0
Goodwill (illustration 2)	62.0
Current assets (illustration 1)	215.0
	702.0
Share capital (illustration 1)	10.0
Retained earnings (illustration 5)	341.9
Translation reserve (illustration 5)	44.7
	396.6
Non-controlling interest (illustration 5)	15.4
	412.0
Liabilities (illustration 1)	290.0
	702.0

Test your understanding 1 – Parent and Overseas

Parent is an entity that owns 80% of the equity shares of Overseas, a foreign entity that has the Shilling as its functional currency. The subsidiary was acquired on 1 January 20X7 when its retained earnings were 6,000 Shillings. The reporting date is 31 December 20X7.

At the acquisition date the fair value of the net assets of Overseas was equal to the carrying amount with the exception of freehold land. The fair value of this land exceeded its carrying amount by 4,000 Shillings.

At the date of acquisition, the non-controlling interest in Overseas should be measured at its fair value of 5,000 Shillings. Goodwill at the reporting date is not impaired.

Statements of financial position as at 31 December 20X7

	Parent	**Overseas**
	$	Shillings
Investment in Overseas at cost	3,818	–
Assets	9,500	40,000
	13,318	40,000
Equity and liabilities		
Equity capital	5,000	10,000
Retained earnings	6,000	8,200
Liabilities	2,318	21,800
	13,318	40,000

Relevant exchange rates are:

Date	Shillings: $1
1 January 20X7	5.5
31 December 20X7	5.0
Average for year to 31 December 20X7	5.2

Required:

Discuss how the goodwill arising on the acquisition of Overseas should be dealt with in the consolidated financial statements of the Parent group for the year ended 31 December 20X7.

Test your understanding 2 – Saint and Albans

On the 1 July 20X1 Saint acquired 60% of Albans, whose functional currency is Ds. The presentation currency of the Saint group is the dollar ($). The financial statements of both entities are as follows.

Statements of financial position as at 30 June 20X2

	Saint	**Albans**
Assets	$	D
Investment in Albans	5,000	–
Loan to Albans	1,400	–
Property, plant and equipment	10,000	15,400
Inventories	5,000	4,000
Receivables	4,000	500
Cash and cash equivalents	1,600	560
	27,000	20,460

Equity and liabilities	$	D
Equity capital ($1/D1)	10,000	1,000
Share premium	3,000	500
Retained earnings	4,000	12,500
Non-current liabilities	5,000	5,460
Current liabilities	5,000	1,000
	27,000	20,460

The following information is applicable.

(i) Saint purchased the shares in Albans for D10,000 on the first day of the accounting period. At the date of acquisition the retained earnings of Albans were D500. The fair value of Albans' net assets exceeded the carrying amount by D1,000. This fair value adjustment was attributable to plant with a remaining five-year life as at the date of acquisition.

(ii) Just before the year-end Saint acquired some goods from a third party at a cost of $800, which it sold to Albans for cash at a mark-up of 50%. At the reporting date all these goods remain in the inventories of Albans.

(iii) On 1 June 20X2 Saint lent Albans $1,400. The liability is recorded at the historic rate within the non-current liabilities of Albans.

(iv) Saint measures non-controlling interests at acquisition at fair value. The fair value of the non-controlling interest in Albans at the date of acquisition was D5,000. An impairment review was performed and goodwill had reduced in value by 10% at 30 June 20X2.

(v) On 1 July 20X1, Saint received a government grant for $4,000. This grant was provided as a contribution towards the costs of training employees over the next two years. Saint has reduced its administrative expenses by the full $4,000.

(vi) Exchange rates are as follows:

	D: $1
1 July 20X1	2.0
Average rate	3.0
1 June 20X2	3.9
30 June 20X2	4.0

Required:

Prepare the equity section of the consolidated statement of financial position as at 30 June 20X2. With respect to Albans, your answer should explain why foreign exchange differences arise in the consolidated financial statements.

3 Other foreign operations

The rules covered in this chapter do not only apply to subsidiaries – they also apply to associates and joint arrangements.

Remember that:

- **Income, expenses and other comprehensive income** are translated at the exchange rate in place at the date of each transaction. The average rate for the year may be used as an approximation.
- **Assets and liabilities** are translated at the closing rate of exchange.
- **Exchange gains and losses** are recognised in other comprehensive income.

Test your understanding 3 – Parrot

Parrot purchases 30% of Anaconda on 1 January 20X1 for 100 million dinar.

The profit of Anaconda for the year ended 31 December 20X1 is 20 million dinar. The other comprehensive income of Anaconda for the year ended 31 December 20X1 is 5 million dinar.

Relevant exchange rates are:

Date	dinars: $1
1 January 20X1	4.0
31 December 20X1	3.0
Average for year to 31 December 20X1	3.6

Required:

Discuss the accounting treatment of Anaconda in the consolidated financial statements of the Parrot group for the year ended 31 December 20X1.

4 Disposals

On the disposal of a foreign operation, the cumulative exchange differences recognised as other comprehensive income and accumulated in a separate component of equity become realised.

IAS 21 requires that the group's share of these exchanges differences are reclassified to profit or loss on disposal of the foreign operation.

Test your understanding 4 – LUMS Group

The LUMS group has sold its entire 100% holding in an overseas subsidiary for proceeds of $50,000. The net assets at the date of disposal were $20,000 and the carrying amount of goodwill at that date was $10,000. The cumulative balance on the group foreign currency reserve is a gain of $5,000.

Required:

Discuss how the disposal should be accounted for in the consolidated financial statements.

5 Chapter summary

Group accounting – foreign currency

Translating the subsidiary's financial statements

- Assets and liabilities at the closing rate
- Incomes, expenses and OCI at the average rate

Calculating goodwill

- Calculate in the subsidiary's currency
- Translate at the closing rate

Calculation of exchange differences on:

- Goodwill
- Opening net assets and profit

Current year gains and losses are recorded in OCI and held within equity.

Disposals of overseas subsidiaries

- Recycle cumulative foreign exchange gains and losses held in equity to profit or loss

Test your understanding answers

Test your understanding 1 – Parent and Overseas

Goodwill arising on the acquisition of Overseas is calculated initially in foreign currency as follows:

		Shillings
Consideration ($3,818 × 5.5)		20,999
FV of NCI at acquisition		5,000
		25,999
FV of net assets at acquisition:		
Share capital	10,000	
Retained earnings	6,000	
Fair value adjustment	4,000	
		(20,000)
Goodwill at acquisition		5,999

According to IAS 21 *The Effects of Changes in Foreign Exchange Rates*, goodwill arising on the acquisition of a foreign operation is treated as the foreign operation's asset. This means that, at each reporting date, goodwill is translated using the closing rate of exchange. The goodwill of Overseas as at the reporting date is therefore $1,200 (Sh5999/5).

The foreign exchange gain arising on the translation of the goodwill of Overseas is calculated as follows:

	Shillings	Exchange rate	$
Goodwill at acquisition	5,999	5.5	1,091
Impairment	–		–
Exchange gain		bal. fig	109
Closing goodwill	5,999	5.0	1,200

The exchange gain of $109 is recorded in other comprehensive income and presented as an item that might be reclassified to profit or loss in the future. The exchange gain is allocated between the group and NCI because the NCI at acquisition was measured at fair value. The allocation is based on respective shareholdings:

Group: 80% × $109 = $87

NCI: 20% × $109 = $22

Test your understanding 2 – Saint and Albans

Extract from group statement of financial position at 30 June 20X2

	$
Equity capital	10,000
Share premium	3,000
Retained earnings (W1)	3,692
Translation reserve (W2)	(2,773)
	13,919
Non-controlling interest (W3)	2,046
Total equity	15,965

Discussion of exchange differences

Goodwill is translated at each reporting date at the closing rate of exchange. An exchange difference arises because goodwill at acquisition was translated at the acquisition rate but goodwill at the reporting date was translated at the closing rate.

Similarly, the net assets of Albans are retranslated each year at the closing rate of exchange and so an exchange difference arises by comparing the acquisition net assets at the rate of exchange on the acquisition date with the acquisition net assets at the closing rate of exchange.

An additional exchange difference arises because the profit of Albans is translated at the average rate of exchange for inclusion in the consolidated statement of comprehensive income. However, this profit increases the net assets of Albans which, as is indicated above, are translated at the closing rate of exchange for inclusion in the consolidated statement of financial position.

Workings

(W1) **Retained earnings**

	$
Parent retained earnings	4,000
Group share of sub's post-acq'n profit 60% × (D11,660/3 avg. rate) (W4)	2,332
Group share of goodwill impairment (W5)	(240)
PURP (W7)	(400)
Government grant (W8)	(2,000)
	3,692

(W2) **Translation reserve**

	$
Group share of forex on goodwill (W5)	(1,740)
Group share of forex on net assets and profit (W6)	(1,033)
	(2,773)

(W3) **Non-controlling interest**

	$
FV at acquisition (D5,000/2)	2,500
NCI % of post-acquisition profit 40% × (D11,660/3 avg rate) (W4)	1,555
NCI share of goodwill impairment (W5)	(160)
NCI share of forex on goodwill (W5)	(1,160)
NCI share of forex on net assets and profit (W6)	(689)
	2,046

(W4) **Net assets of subsidiary in functional currency**

	At acquisition	**Rep date**	**Post-acq'n**
	D	**D**	**D**
Equity capital	1,000	1,000	
Share premium	500	500	
Retained earnings	500	12,500	12,000
Fair value adjustment	1,000	1,000	
Depreciation (1,000/5 years)		(200)	(200)
Exchange loss on loan*		(140)	(140)
	3,000	14,660	11,660

***Exchange loss on loan received by Albans**

The loan was initially recorded at D5,460 ($1,400 × 3.9)

The loan needs to be retranslated using the closing rate to D5,600 ($1,400 × 4.0)

There is therefore an exchange loss of D140 (D5,600 – D5,460).

Dr Profit or loss/retained earnings	D140
Cr Non-current liabilities	D140

(W5) **Goodwill**

Goodwill calculation

	D
Cost to parent ($5,000 × 2.0)	10,000
FV of NCI at acquisition	5,000
FV of NA at acquisition (W4)	(3,000)
Goodwill at acquisition	12,000
Impairment – 10%	(1,200)
Goodwill at reporting date	10,800

Exchange gain (loss) on retranslation of goodwill

	D	Rate	$
Goodwill at acquisition	12,000	2.0	6,000
Impairment	(1,200)	3.0	(400)
Exchange loss		**bal fig**	**(2,900)**
Goodwill at reporting date	10,800	4.0	2,700

The impairment loss on the goodwill is allocated between the group and NCI based on respective shareholdings:

Group: 60% × $400 = $240 (W1)
NCI: 40% × $400 = $160 (W3)

The exchange loss on retranslation of goodwill is allocated between the group and NCI based on their respective shareholdings:

Group: 60% × $2,900 = $1,740 (W2)
NCI: 40% × $2,900 = $1,160 (W3)

(W6) **Exchange differences on retranslation of net assets**

	D	Rate	$
Acquisition net assets	3,000	2.0	1,500
Profit for year	11,660	3.0	3,887
Exchange loss		**bal fig**	**(1,722)**
Closing net assets	14,660	4.0	3,665

The exchange loss is allocated between the group and NCI based on respective shareholdings:

Group: 60% × $1,722 = $1,033 (W2)
NCI: 40% × $1,722 = $689 (W3)

(W7) **PURP**

The profit on the intra-group sale is \$400 ((50/100) × \$800).

All of these items remain in group inventory. Therefore the adjustment required is:

Dr Cost of sales/retained earnings (W1)	\$400
Cr Inventories	\$400

(W8) **Government grant**

This is a revenue grant. It should be recognised in profit or loss on a systematic basis. The grant is intended to cover training costs over a two year period and so it should be recognised in profit or loss over two years.

Saint should increase its expenses by \$2,000 (1/2 × \$4,000) and record the balance as deferred income on the SFP.

Dr Admin expenses/retained earnings (W1)	\$2,000
Cr Current liabilities	\$2,000

Test your understanding 3 – Parrot

A 30% investment would normally indicate that the investor has significant influence over the investee. This means that Anaconda is an associate and should be accounted for using the equity method.

The associate would be recognised initially at its cost of 100m dinars. This would be translated using the exchange rate on the purchase date to give \$25 million.

Parrot would recognise 30% of Anaconda's profit and translate it at the average rate. Parrot's share of Anaconda's profit in the statement of profit or loss is therefore \$1.7 million.

Parrot would recognise 30% of Anaconda's other comprehensive income and translate it at the average rate. Parrot's share of Anaconda's other comprehensive income is therefore \$0.4 million.

At the reporting date, the investment in the associate is 107.5m dinars. This will be translated at the closing rate of exchange. The statement of financial position will show a carrying amount of \$35.8 million.

An exchange gain of \$8.7 million arises on translation of the associate. This is reported in other comprehensive income and will be held in a translation reserve in equity.

Working

	dinars m	Exchange rate	$m
Purchase of associate	100.0	4.0	25.0
Share of profit (30% × 20m dinars)	6.0	3.6	1.7
Share of OCI (30% × 5m dinars)	1.5	3.6	0.4
Exchange gain		bal. fig	8.7
	–––––		–––––
Closing associate	107.5	3.0	35.8
	–––––		–––––

Test your understanding 4 – LUMS Group

The LUMS group has lost control over its overseas subsidiary. The income and expenses of the overseas subsidiary should be consolidated up to the date of disposal. On the disposal date, the goodwill and net assets of the overseas subsidiary are derecognised from the consolidated financial statements. Additionally, the foreign exchange gains previously recognised in other comprehensive income should be reclassified to profit or loss.

A gain of $25,000 should be presented in consolidated statement of profit or loss, calculated as follows:

	$	$
Proceeds		50,000
Net assets recorded prior to disposal:		
Net assets	20,000	
Goodwill	10,000	
	––––––	
		(30,000)
Reclassification of forex gains to P/L		5,000
		––––––
		25,000
		––––––

Chapter

21

Group statement of cash flows

Chapter learning objectives

Upon completion of this chapter you will be able to:

- prepare and discuss group statements of cash flows.

PER

One of the PER performance objectives (PO7) is to prepare external financial reports. You take part in preparing and reviewing financial statements – and all accompanying information – and you do it in accordance with legal and regulatory requirements. Working through this chapter should help you understand how to demonstrate that objective.

OBJECTIVE OF STATEMENTS OF CASH FLOWS

CLASSIFICATION OF CASH FLOWS

PREPARATION OF GROUP STATEMENTS OF CASH FLOWS

FOREIGN CURRENCY TRANSACTIONS

EVALUATION OF STATEMENTS OF CASH FLOWS

1 Statements of cash flows

Exam focus

Question 1 in the SBR exam will always test consolidated financial statements. This might include consolidated statements of cash flows.

The exam will not ask for the production of a full consolidated statement. Instead, candidates will be required to produce extracts from these statements and to explain the accounting numbers that they have produced.

Some questions in this chapter do require the production of full consolidated statements of cash flows. This is to enable SBR candidates to revise, practice and develop a deeper understanding of cash flow techniques. Without this, you will find it difficult to tackle exam-style questions that focus on extracts and discussion.

Progression

You learned about statements of cash flows when studying for your earlier exams. For SBR, you need to be able to discuss, and prepare extracts from, group statements of cash flows.

Objectives of statements of cash flows

IAS 7 *Statement of Cash Flows* provides guidance on the preparation of a statement of cash flows. The objective of a statement of cash flows is to provide information on an entity's changes in cash and cash equivalents during the period.

The statement of financial position and statement of profit or loss are prepared on an accruals basis and do not show how the business has generated and used cash in the reporting period. The statement of profit or loss may show profits even though the company is suffering severe cash flow problems.

A statement of cash flows is therefore important because it enables users of the financial statements to assess the liquidity, solvency and financial adaptability of the business.

e.g

The *Conceptual Framework*

According to the *Conceptual Framework*, investors, lenders and other creditors can only make informed decisions if provided with information that will help them to predict an entity's future cash flows. Historical cash flow information, as presented in the statement of cash flows, will help these users to assess the amount, likelihood and certainty of an entity's future cash flows.

Analysis of cash outflows may also help users to assess management's stewardship of the entity's assets.

2 Proforma

Statement of cash flows for the year ended 31 December 20X1

	$	$
Cash flows from operating activities		
Profit before tax	X	
Add: finance costs	X	
Less: investment income	(X)	
Less: income from associate	(X)	
Adjust for non-cash items dealt with in arriving at operating profit:		
Add: depreciation	X	
Less: gain on disposal of subsidiary	(X)	
Add: loss on disposal of subsidiary	X	
Add: loss on impairment charged to P/L	X	
Add: loss on disposal of non-current assets	X	
Add: increase in provisions	X	
	X/(X)	

Changes in working capital:		
Increase in inventory	(X)	
Increase in receivables	(X)	
Decrease in payables	(X)	
Cash generated/used from operations	X/(X)	
Interest paid	(X)	
Taxation paid	(X)	
Net cash Inflow/(outflow) from operating activities		X/(X)
Cash flows from investing activities		
Payments to purchase non-current assets	(X)	
Receipts from non-current asset disposals	X	
Net cash paid to acquire subsidiary	(X)	
Net cash proceeds from subsidiary disposal	X	
Cash paid to acquire associates	(X)	
Dividend received from associate	X	
Interest received	X	
Net cash inflow/(outflow) from investing activities		X/(X)
Cash flows from financing activities		
Proceeds from share issue	X	
Proceeds from loan or debenture issue	X	
Cash repayment of loans or debentures	(X)	
Lease liability repayments	(X)	
Equity dividend paid by parent	(X)	
Dividend paid to NCI	(X)	
Net cash inflow/(outflow) from financing activities		X/(X)
Increase/(decrease) in cash and equivalents		X/(X)
Cash and equivalents brought forward		X/(X)
Cash and equivalents carried forward		X/(X)

3 Classification of cash flows

IAS 7 does not prescribe a specific format for the statement of cash flows, although it requires that cash flows are classified under one of three headings:

- **cash flows from operating activities,** defined as the entity's principal revenue earning activities and other activities that do not fall under the next two headings
- **cash flows from investing activities,** defined as the acquisition and disposal of long-term assets and other investments (excluding cash equivalents)
- **cash flows from financing activities,** defined as activities that change the size and composition of the entity's equity and borrowings.

Cash flows from operating activities

The key figure within cash flows from operating activities is 'cash generated from operations'. There are two methods of calculating cash generated from operations:

- The **direct method** shows operating cash receipts and payments, such as cash receipts from customers, cash payments to suppliers and cash payments to and on behalf of employees.
- The **indirect method** (used in the proforma statement of cash flows presented earlier in the chapter) starts with profit before tax and adjusts it for non-cash charges and credits, deferrals or accruals of past or future operating cash receipts and payments, as well as for items that relate to investing and financing activities. The most frequently occurring adjustments required are:
  - finance costs and investment incomes
  - depreciation or amortisation charges in the year
  - impairment charged to profit or loss in the year
  - profit or loss on disposal of non-current assets
  - change in inventories
  - change in trade receivables
  - change in trade payables.

IAS 7 permits either method, although encourages the use of the direct method. A comparison between the direct and indirect method to arrive at cash generated from operations is shown below:

Direct method:	$m	**Indirect method:**	$m
Cash receipts from customers	15,424	Profit before tax	6,022
Cash payments to suppliers	(5,824)	Depreciation charges	899
Cash payments to and on behalf of employees	(2,200)	Increase in inventories	(194)
Other cash payments	(511)	Increase in receivables	(72)
		Increase in payables	234
	–––––		–––––
Cash generated from operations	6,889	Cash generated from operations	6,889
	–––––		–––––

e.g

Investor perspective

Entities can choose whether to present 'cash generated from operations' using the direct or indirect method. This is a problem for users of the financial statements because it limits comparability.

The majority of companies use the indirect method for the preparation of statements of cash flow. They justify this on the grounds that the information required for the direct method is too costly and time-consuming to obtain.

The adjustments required by the indirect method are difficult to understand and can be confusing to financial statement users. In many cases these adjustments cannot be reconciled to observed changes in the statement of financial position.

Financial statement users often prefer the direct method because it reports operating cash flows in understandable categories, such as cash collected from customers, cash paid to suppliers, cash paid to employees and cash paid for other operating expenses. When presented in this way, users can assess the major trends in cash flows and can compare these to the entity's competitors. This is relevant information because it aids investment decisions.

Cash flows from investing activities

Cash flows to appear under this heading include:

- cash paid for property, plant and equipment and other non-current assets
- cash received on the sale of property, plant and equipment and other non-current assets
- cash paid for investments in, or loans to, other entities (excluding movements on loans from financial institutions, which are shown under financing)
- cash received for the sale of investments or the repayment of loans to other entities (again excluding loans from financial institutions).

Cash flows from financing activities

Financing cash flows mainly comprise receipts or repayments of principal from or to external providers of finance.

Financing cash inflows include:

- receipts from issuing shares or other equity instruments
- receipts from issuing debentures, loans, notes and bonds and from other long-term and short-term borrowings (other than overdrafts, which are normally included in cash and cash equivalents).

IAS 7 says that financing cash outflows include:

- repayments of amounts borrowed (other than overdrafts)
- the capital element of lease payments
- payments to reacquire or redeem the entity's shares.

Interest and dividends

IAS 7 allows interest and dividends, whether received or paid, to be classified under any of the three headings, provided the classification is consistent from period to period.

The practice adopted in this text is to classify:

- interest received as a cash flow from investing activities
- interest paid as a cash flow from operating activities
- dividends received as a cash flow from investing activities
- dividends paid as a cash flow from financing activities.

Test your understanding 1 – Plaster

Plaster, a public limited entity, raised considerable amounts of cash during the period by selling items of property, plant and equipment (PPE). Plaster's directors believe that presenting the proceeds received from the disposals within 'cash flows from investing activities' will jeopardise attempts to raise finance in the future. They have therefore decided to increase 'cash generated from operations' by the proceeds from the PPE disposals.

Required:

Explain the likely impact of the directors' decision on users' perception of the statement of cash flows and discuss the ethical and professional issues that it raises.

4 Cash and cash equivalents

The statement of cash flows reconciles cash and cash equivalents at the start of the reporting period to the end of the reporting period.

Cash equivalents are **'short-term, highly liquid investments that are readily convertible to known amounts of cash and are subject to an insignificant risk of changes in value**' (IAS 7, para 6).

IAS 7 does not define 'readily convertible' but notes that an investment would qualify as a cash equivalent if it had a short maturity of '**three months or less from the date of acquisition**' (IAS 7, para 7).

Equity investments are generally excluded from being included in cash equivalents because there is a significant risk of a change in value. IAS 7 makes an exception for preference shares with a short period to maturity and a specified redemption date.

Test your understanding 2 – Cash and cash equivalents

The accountant for Minted, a company, is preparing a statement of cash flows. She would like advice about whether the following items can be included within 'cash and cash equivalents'.

- An overdraft of $100,000.
- A balance of $500,000 held in a high-interest account. Minted must give 28 days' notice in order to access this money, which is held with the intention of meeting working capital shortages.
- An investment in the ordinary shares of Moolah. The shares are listed and therefore could be sold immediately. The shares have a fair value of $1m.

Required:

Advise the accountant of Minted whether the above items qualify as 'cash and cash equivalents'.

5 Individual statements of cash flows

During your prior studies you will have learned how to prepare statements of cash flows for individual companies. It may be worthwhile taking some time to revise this knowledge using the following exercises.

Test your understanding 3 – Extracts

Calculate the required cash flows in each of the following scenarios:

1

	20X1	20X0
	$	$
Property, plant and equipment (PPE)	250	100

During the year depreciation charged was $20, a revaluation surplus of $60 was recorded, and PPE with a carrying amount of $15 was disposed of. The carrying amount of assets recognised through lease agreements and classified as PPE was $30.

Required:

How much cash was spent on property, plant and equipment in the period?

2

	20X1	20X0
	$	$
Deferred tax liability	100	50
Income tax liability	120	100

The income tax charge in the statement of profit or loss was $180.

Required:

How much tax was paid in the period?

3

	20X1	20X0
	$	$
Retained earnings	300	200

The statement of profit or loss showed a profit for the period of $150.

Required:

How much was the cash dividend paid during the period?

Illustration 1 – Single entities

Below are the financial statements of Single for the year ended 30 September 20X2:

Statement of financial position as at 30 September 20X2 (including comparatives)

	20X2	**20X1**
	$m	$m
Non-current assets		
Property, plant and equipment	90	60
Current assets		
Inventories	32	20
Trade receivables	20	27
Cash and cash equivalents	8	12
	150	119
Equity and liabilities		
Share capital ($1 shares)	30	5
Retained earnings	60	35
	90	40
Non-current liabilities:		
Loans	10	29
Deferred tax	15	14
Current liabilities:		
Trade payables	23	25
Tax payable	12	11
	150	119

Statement of profit or loss for the year ended 30 September 20X2

	$m
Revenue	450
Operating expenses	(401)
Profit from operations	49
Finance cost	(3)
Profit before tax	46
Tax	(12)
Profit for the period	34

Notes

1. Property, plant and equipment with a carrying amount of $9 million was disposed of for cash proceeds of $13 million. Depreciation for the year was $17 million.
2. Trade payables as at 30 September 20X2 includes accruals for interest payable of $4 million (20X1: $5 million).

Required:

Prepare the statement of cash flows for Single for the year ended 30 September 20X2.

Solution

Statement of cash flows

	$m	$m
Cash flows from operating activities		
Profit before tax	46	
Finance cost	3	
Depreciation	17	
Profit on disposal of PPE ($13 – $9)	(4)	
Increase in inventories ($32 – $20)	(12)	
Decrease in receivables ($20 – $27)	7	
Decrease in payables (($23 – $4) – ($25 – $5))	(1)	
	56	
Interest paid (W1)	(4)	
Tax paid (W2)	(10)	
		42
Cash flows from investing activities		
Proceeds from sale of PPE	13	
Purchases of PPE (W3)	(56)	
		(43)
Cash flows from financing activities		
Proceeds from shares ($30 – $5)	25	
Repayment of loans ($10 – $29)	(19)	
Dividends paid (W4)	(9)	
		(3)
Decrease in cash and cash equivalents		(4)
Opening cash and cash equivalents		12
Closing cash and cash equivalents		8

Workings

(W1) **Interest**

	$m
Balance b/fwd	5
Profit or loss	3
Cash paid (bal. fig.)	(4)
Balance c/fwd	4

(W2) **Tax**

	$m
Balance b/fwd ($14 + $11)	25
Profit or loss	12
Cash paid (bal. fig.)	(10)
Balance c/fwd ($15 + $12)	27

(W3) **PPE**

	$m
Balance b/fwd	60
Depreciation	(17)
Disposal	(9)
Cash paid (bal. fig.)	56
Balance c/fwd	90

(W4) **Retained earnings**

	$m
Balance b/fwd	35
Profit or loss	34
Cash dividends paid (bal. fig.)	(9)
Balance c/fwd	60

6 Preparation of a consolidated statement of cash flows

A consolidated statement of cash flows shows the cash flows between a group and third parties. It is prepared using the consolidated statement of financial position and the consolidated statement of profit or loss. This means that intra-group transactions have already been eliminated.

When producing a consolidated statement of cash flows, there are three extra elements that need to be considered:

- acquisitions and disposals of subsidiaries
- cash paid to non-controlling interests
- associates.

Acquisitions and disposals of subsidiaries

Acquisitions

In the statement of cash flows we must record the actual cash flow for the purchase of the subsidiary net of any cash held by the subsidiary that is now controlled by the group.

e.g

Acquisition of a subsidiary

Sparkling buys 70% of the equity shares of Still for $500,000 in cash. At the acquisition date, Still had cash and cash equivalents of $25,000.

Although Sparkling paid $500,000 for the shares, it also gained control of Still's cash of $25,000. In the consolidated statement of cash flows, this would be presented as follows:

Cash flows from investing activities

	$000
Acquisition of subsidiary, net of cash acquired ($500,000 – $25,000)	(475)

The assets and liabilities of the acquired subsidiary must be dealt with in your workings when calculating the cash movement for an item during the year.

Acquisition of a subsidiary

The carrying amount of Mirror's property, plant and equipment (PPE) in its consolidated financial statements is as follows:

	20X2	20X1
	$m	$m
PPE	69	45

The depreciation charge in the consolidated statement of profit or loss for the year ended 31 December 20X2 was $3 million. PPE with a carrying amount of $2 million was disposed during the reporting period.

On 30 June 20X2, Mirror purchased 90% of the ordinary shares of Glass. At this date, the carrying amount of Glass' PPE was $7 million and the fair value was $8 million.

The easiest way to calculate the cash spent by the Mirror Group on the purchase of PPE during the year ended 31 December 20X2 is to set up a working:

	$m
PPE b/fwd	45
Depreciation	(3)
Disposal	(2)
Acquisition of sub	8
Cash (bal. fig.)	21
	———
PPE c/fwd	69
	———

Remember that Glass' identifiable net assets are measured at fair value at the acquisition date.

As can be seen from the working above, $21 million was spent on PPE during the period. This outflow would be presented under cash flows from investing activities.

Disposals

The statement of cash flows will show the cash received from the sale of the subsidiary, net of any cash held by the subsidiary that the group has lost control over.

The assets and liabilities of the disposed subsidiary must be dealt with in your workings when calculating the cash movement for an item during the year.

Disposal of a subsidiary

Sparkling owned 80% of the equity shares of Fizzy. During the period, these shares were sold for $800,000 in cash. At the disposal date, Fizzy had cash and cash equivalents of $70,000.

Although Sparkling received $800,000 for the shares, it lost control of Fizzy's cash of $70,000. In the consolidated statement of cash flows, this would be presented as follows:

Cash flows from investing activities

	$000
Disposal of subsidiary, net of cash disposed of ($800,000 – $70,000)	730

Illustration 2 – Acquisitions and disposals

Extracts from a group statement of financial position are presented below:

	20X8	**20X7**
	$000	$000
Inventories	74,666	53,019
Trade receivables	58,246	62,043
Trade payables	93,678	86,247

During 20X8, Subsidiary A was acquired and all shares in Subsidiary B were disposed of.

Details of the working capital balances of these two subsidiaries are provided below:

	Working capital of Subsidiary A at acquisition	**Working capital of Subsidiary B at disposal**
	$000	$000
Inventories	4,500	6,800
Trade receivables	7,900	6,700
Trade payables	8,250	5,740

Required:

Calculate the movement in inventories, trade receivables and trade payables for inclusion in the group statement of cash flows.

Solution

The net assets of Subsidiary A are being consolidated at the end of the year, but they were not consolidated at the start of the year. Conversely, the net assets of Subsidiary B are not consolidated at the end of the year, but they were consolidated at the start of the year. The working capital balances brought forward and carried forward are therefore not directly comparable.

Comparability can be achieved by calculating the movement between the closing and opening figures and then:

- Deducing the subsidiary's balances at the acquisition date for a subsidiary acquired during the year.
- Adding the subsidiary's balances at the disposal date for a subsidiary disposed of during the year.

	Inventories	**Trade receivables**	**Trade payables**
	$000	$000	$000
Bal c/fwd	74,666	58,246	93,678
Bal b/fwd	(53,019)	(62,043)	(86,247)
	21,647	(3,797)	7,431
Less: Sub acquired in year	(4,500)	(7,900)	(8,250)
Add: Sub disposed in year	6,800	6,700	5,740
Movement in the year	inc 23,947	dec (4,997)	inc 4,921
Impact on cash flow	Outflow	Inflow	Inflow

Cash paid to non-controlling interests

When a subsidiary that is not wholly owned pays a dividend, some of that dividend is paid outside of the group to the non-controlling interest. Dividends paid to non-controlling interests should be disclosed separately in the statement of cash flows.

To calculate the dividend paid, reconcile the non-controlling interest in the statement of financial position from the opening to the closing balance. You can use a T-account or a schedule to do this.

Illustration 3 – Cash paid to NCI

The following information has been extracted from the consolidated financial statements of WG, which has a year end of the 31 December:

	20X7	**20X6**
	$000	$000
Statement of financial position		
Equity:		
Non-controlling interest	780	690
Statement of profit or loss		
Profit for the period attributable to the non-controlling interest	120	230

During the year, WG bought a 70% shareholding in CC. WG uses the full goodwill method for all subsidiaries. The fair value of the non-controlling interest in CC at the acquisition date was $60,000.

During the year, WG disposed of its 60% holding in TT. At the acquisition date, the fair value of the NCI and the fair value of TT's net assets were $35,000 and $70,000 respectively. The net assets of TT at the disposal date were $100,000.

Required:

What is the dividend paid to non-controlling interest in the year ended 31 December 20X7?

Solution

	$000
NCI b/fwd	690
NCI re sub acquired in year	60
NCI share of profit for the year	120
NCI derecognised due to subsidiary disposal (W1)	(47)
Cash dividend paid in year (bal. fig.)	(43)
NCI c/fwd	780

(W1) **NCI at date of TT disposal**

	$000
FV of NCI at acquisition	35
NCI% of post-acquisition net assets 40% × ($100,000 – $70,000)	12
	47

Alternatively, a T account can be used:

Non-controlling interests

	$000		$000
NCI derecognised re sub disposal (W1)	47	NCI Balance b/fwd	690
Dividends paid (bal fig.)	43	NCI recognised re acq'n of sub	60
NCI Balance c/fwd	780	Share of profits in year	120
	870		870

Associates

An associate is a company over which an investor has significant influence. Associates are not part of the group and therefore cash flows between the group and the associate must be reported in the statement of cash flows.

Cash flows relating to associates that need to be separately reported within the statement of cash flows are as follows:

- dividends received from an associate
- loans made to associates
- cash payments to acquire associates
- cash receipts from the sale of associates.

These cash flows should be presented as cash flows from investing activities.

Remember, associates are accounted for using the equity method. This means that, in the consolidated statement of profit or loss, the group records its share of the associate's profit for the year. This is a non-cash income and so must be deducted in the reconciliation between profit before tax and cash generated from operations.

e.g

Illustration 4 – Associates

The following information is from the consolidated financial statements of H:

Extract from consolidated statement of profit or loss for year ended 31 December 20X1

	$000
Profit from operations	734
Share of profit of associate	48
Profit before tax	782
Tax	(304)
Profit for the year	478

Extracts from consolidated statement of financial position as at 31 December 20X1 (with comparatives)

	20X1	20X0
	$000	$000
Non-current assets		
Investment in associate	466	456
Loan to associate	380	300

Required:

Calculate the relevant figures to be included in the group statement of cash flows for the year ended 31 December 20X1.

Solution

Extracts from statement of cash flows

	$000
Cash flows from operating activities	
Profit before tax	782
Share of profit of associate	(48)
Investing activities	
Dividend received from associate (W1)	38
Loan to associate (380 – 300)	(80)

(W1) **Dividend received from associate**

When dealing with the dividend from the associate, the process is the same as we have already seen with the non-controlling interest.

Set up a schedule or T account and include all the balances that relate to the associate. The balancing figure will be the cash dividend received from the associate.

	$000
Balance b/fwd	456
Share of profit of associate	48
Cash dividend received **(bal. fig.)**	(38)
Balance c/fwd	466

Instead of a schedule, a T-account could be used:

Associate

	$000		$000
Balance b/fwd	456	Dividend received (bal. fig.)	38
Share of profit of associate	48	Balance c/fwd	466
	–––––		–––––
	504		504
	–––––		–––––

Test your understanding 4 – The Z group

The following information is from the consolidated financial statements of Z:

Extract from consolidated statement of profit or loss for year ended 31 December 20X1

	$000
Profit from operations	900
Share of profit of associate	15
	–––––
Profit before tax	915
Tax	(200)
	–––––
Profit for the year	715
	–––––

Extracts from consolidated statement of financial position as at 31 December 20X1 (with comparatives)

	20X1	**20X0**
	$000	$000
Non-current assets		
Investment in associate	600	580

During the year, Z received dividends from associates of $5,000.

Required:

Based on the above information, prepare extracts showing relevant figures to be included in the group statement of cash flows for the year ended 31 December 20X1.

7 Question practice

Test your understanding 5 – Consolidated extracts

Calculate the required cash flows in each of the following scenarios:

1

	20X1	20X0
	$	$
Non-controlling interest	840	440

The group statement of profit or loss and other comprehensive income reported total comprehensive income attributable to the non-controlling interest of $500.

Required:

How much was the cash dividend paid to the non-controlling interest?

2

	20X1	20X0
	$	$
Non-controlling interest	850	500

The group statement of profit or loss and other comprehensive income reported total comprehensive income attributable to the non-controlling interest of $600.

Required:

How much was the cash dividend paid to the non-controlling interest?

3

	20X1	20X0
	$	$
Investment in associate	500	200

The group statement of profit or loss reported 'share of profit of associates' of $750.

Required:

How much was the cash dividend received by the group?

4

	20X1	20X0
	$	$
Investment in associate	3,200	600

The group statement of profit or loss reported 'share of profit of associates' of $4,000.

In addition, the associate revalued its non-current assets during the period. The group share of this gain is $500.

Required:

How much was the cash dividend received by the group?

5

	20X1	20X0
	$	$
Property, plant and equipment (PPE)	500	150

During the year depreciation charged was $50, and the group acquired a subsidiary which held PPE of $200 at the acquisition date.

Required:

How much cash was spent on property, plant and equipment in the period?

Test your understanding 6 – AH Group

Extracts from the consolidated financial statements of the AH Group for the year ended 30 June 20X5 are given below:

Consolidated statement of profit or loss for the year ended 30 June 20X5

	$000
Profit from operations	19,850
Finance cost	(1,400)
	–––––––
Profit before tax	18,450
Tax	(6,250)
	–––––––
Profit for the period	12,200
	–––––––

Extract from statement of financial position, with comparatives, at 30 June 20X5

	20X5	20X4
	$000	$000
Non-current assets		
Goodwill	5,910	4,160
Current assets		
Inventories	33,500	28,750
Trade receivables	27,130	26,300
Current liabilities		
Trade payables	33,340	32,810

Notes:

1 On 1 January 20X5, AH acquired 75% of the issued equity shares of CJ for $6 million. The net assets of CJ at the date of acquisition had the following fair values:

	$000
Property, plant and equipment	4,200
Inventories	1,650
Trade receivables	1,300
Cash and cash equivalents	50
Trade payables	(1,950)
Tax	(250)
	5,000

Goodwill relating to the acquisition of entity CJ during the year was calculated on the full goodwill basis. On 1 January 20X5 when CJ was acquired, the fair value of the non-controlling interest was $1,750,000.

Any impairments of goodwill during the year have been accounted for within operating expenses.

2 During the year, AH disposed of property, plant and equipment for proceeds of $2,250,000. The carrying amount of the asset at the date of disposal was $1,000,000. Depreciation of $7,950,000 was charged to profit or loss during the year.

Required:

(a) Prepare 'cash generated from operations' using the indirect method as it would appear in the consolidated statement of cash flows for the year ended 30 June 20X5.

(b) Explain the reasons behind the adjustments made to profit before tax in part (a).

Test your understanding 7 – Pearl

Below are the consolidated financial statements of the Pearl Group for the year ended 30 September 20X2:

Consolidated statements of financial position

	20X2	**20X1**
	$000	$000
Non-current assets		
Goodwill	1,930	1,850
Property, plant and equipment	2,545	1,625
Investment in associate	620	540
	5,095	4,015
Current assets		
Inventories	470	435
Trade receivables	390	330
Cash and cash equivalents	210	140
	6,165	4,920
Equity and liabilities		
Share capital ($1 shares)	1,500	1,500
Retained earnings	1,755	1,085
Other reserves	750	525
	4,005	3,110
Non-controlling interest	310	320
	4,315	3,430
Non-current liabilities:		
Loans	500	300
Deferred tax	150	105
Current liabilities:		
Trade payables	800	725
Tax payable	400	360
	6,165	4,920

Consolidated statement of profit or loss and other comprehensive income for the year ended 30 September 20X2

	$000
Revenue	2,090
Operating expenses	(1,155)
Profit from operations	935
Gain on disposal of subsidiary	100
Finance cost	(35)
Share of profit of associate	115
Profit before tax	1,115
Tax	(225)
Profit for the period	890
Other comprehensive income	200
Other comprehensive income from associate	50
Total comprehensive income	1,140
Profit for the year attributable to:	
Owners of the parent	795
Non-controlling interests	95
	890
Total comprehensive income for the year attributable to:	
Owners of the parent	1,020
Non-controlling interests	120
	1,140

Consolidated statement of changes in equity

	Attributable to owners of the parent	Attributable to the NCI
	$000	$000
Equity brought forward	3,110	320
Total comprehensive income	1,020	120
Acquisition of subsidiary	–	340
Disposal of subsidiary	–	(420)
Dividends	(125)	(50)
Equity carried forward	4,005	310

1 Depreciation of $385,000 was charged during the year. Plant with a carrying amount of $250,000 was sold for $275,000. The gain on disposal was recognised in operating costs. Certain properties were revalued during the year resulting in a revaluation gain of $200,000 being recognised.

2 During the year, Pearl acquired 80% of the equity share capital of Gem paying cash consideration of $1.5 million. The NCI holding was measured at its fair value of $340,000 at the date of acquisition. The fair value of Gem's net assets at acquisition was made up as follows:

	$000
Property, plant and equipment	1,280
Inventories	150
Trade receivables	240
Cash and cash equivalents	80
Trade payables	(220)
Tax payable	(40)
	1,490

3 During the year, Pearl disposed of its 60% equity shareholding in Stone for cash proceeds of $850,000. The subsidiary had been acquired several years ago for cash consideration of $600,000. The NCI holding was measured at its fair value of $320,000 at acquisition and the fair value of Stone's net assets were $730,000. Goodwill had not suffered any impairment. At the date of disposal, the net assets of Stone were carried in the consolidated statement of financial position as follows:

	$000
Property, plant and equipment	725
Inventories	165
Trade receivables	120
Cash and cash equivalents	50
Trade payables	(80)
	980

Required:

Prepare the consolidated statement of cash flows for the Pearl group for the year ended 30 September 20X2.

Test your understanding 8 – Book

During the reporting period, Book acquired 90% of the equity shares of Journal. The consideration comprised two forms: cash and 1 million of Book’s own shares. Book’s shares had a fair value of $5 each at the acquisition date. Goodwill arising on the acquisition was correctly measured and recognised at $50 million.

The Book Group values non-controlling interests at acquisition at fair value. This was $7 million.

The carrying amount of Journal’s net assets at acquisition was $20 million. This included inventories with a carrying amount of $4 million and a fair value of $6 million. The tax base of the inventories is $4 million. All group companies pay tax at 20%.

At the acquisition date, Journal had cash and cash equivalents of $1 million.

Required:

Explain the impact of the subsidiary acquisition on the statement of cash flows.

8 Foreign exchange and cash flow statements

Exchange gains and losses

The values of assets and liabilities denominated in an overseas currency will increase or decrease partly due to movements in exchange rates. These movements must be factored into your workings in order to determine the actual cash payments and receipts during the year.

e.g

Dealing with foreign exchange issues

The loan balances of the Grey group as at 31 December 20X1 and 31 December 20X0 are presented below:

	20X1	**20X0**
	$m	$m
Loans	60	20

One of the subsidiaries of the Grey group prepares its financial statements in sterling (£). The exchange loss on the translation of the loans of this subsidiary was $10 million.

Remember that an exchange loss increases the carrying amount of a liability. This is not a cash flow. Therefore, the exchange loss must be factored into the cash flow workings as follows:

	$m
Bal b/fwd	20
Exchange loss	10
Cash received (bal. fig.)	30
	–––
Bal c/fwd	60
	–––

The cash received from issuing new loans during the year was $30 million. This will be shown as an inflow within cash flows from financing activities.

Overseas cash balances

If cash balances are partly denominated in a foreign currency, the effect of exchange rate movements must be reported in the statement of cash flows in order to reconcile the cash balances at the beginning and end of the period.

According to IAS 7, this reconciling item is presented separately from cash flows from operating, investing and financing activities.

Test your understanding 9 – Boardres

Set out below is a summary of the accounts of Boardres, a public limited company, for the year ended 31 December 20X7.

Consolidated statement of profit or loss and other comprehensive income for the year ended 31 December 20X7

	$000
Profit from operations	5,141
Income from associates	30
Finance cost	(305)
	–––––
Profit before tax	4,866
Tax	(2,038)
	–––––
Profit for the period	2,828
	–––––

Extracts from consolidated statements of financial position at 31 December

	20X7	**20X6**
	$000	$000
Non-current assets		
Property, plant and equipment	11,157	8,985
Investment in associate	300	280

Additional information

1 **Property, plant and equipment**

Property, plant and equipment movements include the following:

	$000
Carrying amount of disposals	305
Proceeds from disposals	854
Depreciation charge for the year	907
Exchange gain on translation of overseas subsidiary	138

2 **Liberated**

During the year, the company acquired 82% of the issued equity capital of Liberated for cash consideration. Goodwill arising on the acquisition was $585,000. The non-controlling interest was valued using the proportion of net assets method. The fair values of the assets of Liberated at acquisition were as follows:

	$000
Property, plant and equipment	208
Inventories	612
Trade receivables	500
Cash and cash equivalents	232
Trade payables	(407)
Debenture loans	(312)
	833

Required:

Prepare 'cash flows from investing activities' as it would appear in the consolidated statement of cash flows for the year ended 31 December 20X7. Explain your treatment of the acquisition of Liberated.

9 Other issues

The following criticisms have been made of IAS 7 *Statement of Cash Flows*.

Direct and indirect method

Allowing entities to choose between using the direct or indirect method of presenting cash generated from operations limits comparability.

Many users of the financial statements will not understand the adjustments made to profit when cash generated from operations is presented using the indirect method.

Lack of guidance and disagreements

There is insufficient guidance in IAS 7 as to how to classify cash flows. This can create the following problems:

- IAS 7 allows dividends and interest paid to be presented as cash flows from either operating or financing activities. This limits comparability between companies.
- Entities may classify cash flows related to the same transaction in different ways (a loan repayment might be split between interest paid within operating activities and the repayment of the principal in financing activities). This could hinder user understanding.
- There are disagreements about the presentation of payments related to leases. Some argue that they should be classified as a financing activity, whereas others argue that they are a form of investment activity.
- Expenditure on research is classified as an operating activity. Some argue that this should be included within investing activities, because it relates to items that are intended to generate future income and cash flows.

Disclosures

Current cash flow disclosures are deemed to be inadequate. In particular, there is a lack of disclosure about restrictions on an entity's ability to use its cash and cash equivalents (particularly if located overseas) and whether other sources of finance would be more economical.

10 Chapter summary

Objective of statements of cash flows

- To provide information on changes in cash and cash equivalents
- To enable users to assess the liquidity, solvency and financial adaptability of a business

Classifications of cash flows

- IAS 7 only requires 3 headings:
  - Operating activities
  - Investing activities
  - Financing activities

Preparation of group statements of cash flows

- Three additional elements:
  - Cash paid to non-controlling interest
  - Associates
  - Acquisition and disposal of subsidiaries/ associates

Foreign currency transactions

- Exchange gains must be taken out of the statement of financial position movements as they are not cash

Evaluation of statements of cash flows

- Proivdes information not available in the statement of financial position and the statement of profit or loss
- Shows relationship between profitability and cash generating ability

Test your understanding answers

Test your understanding 1 – Plaster

The cash flow relates to the sale of property, plant and equipment (PPE) and so, per IAS 7 *Statement of Cash Flows*, should be presented as a cash flow from investing activities.

Classifying the proceeds from PPE disposals as an operating cash flow will make Plaster look more liquid, sustainable and financially secure than it really is. Plaster cannot keep selling its property, plant and equipment indefinitely. Therefore, proceeds from these disposals are unlikely to recur and cannot be relied on. It is vital that entities generate sufficient cash flows from their trading activities to meet mandatory repayments as they fall due (such as interest, tax, and borrowings).

Financial statements are used by an array of different groups, such as lenders, when making decisions about whether to advance economic resources to the reporting entity. The information presented must be reliable, truthful and neutral. Accountants are professionals, who are bestowed with status and are trusted by the public. To ensure that this trust is not broken, accountants are bound by a *Code of Ethics and Conduct*.

Integrity is defined as being honest and straight-forward. Manipulating cash flow classification shows a lack of integrity.

If the decision to misclassify cash flows has been motivated by a desire to alter user perception of the company, perhaps to facilitate the raising of finance, then this demonstrates a lack of objectivity.

The directors have a responsibility, as members of the accountancy profession, to prepare financial statements that offer a faithful representation of the Plaster's cash flows. This can be achieved through compliance with IAS 7 *Statement of Cash Flows.* False classification of cash flows will mislead key user groups and is therefore always unethical.

Test your understanding 2 – Cash and cash equivalents

To qualify as a cash equivalent, an item must be readily convertible to cash and have an insignificant risk of a change in value. Furthermore, it should be held for the purpose of meeting short-term cash commitments.

Bank overdrafts are an integral part of most company's cash management. They are therefore generally treated as a component of cash.

The balance of $500,000 in a high interest account is readily available (only 28 days' notice is required to access it). This money is also held to meet short-term needs. Assuming that there is not a significant penalty for accessing this money, it should be included within cash equivalents.

The shares are not a cash equivalent. Shares are investments rather than a way of meeting short-term cash requirements. Moreover, there is a significant risk that the value of the shares will change. Any cash spent on shares in the period should be shown within cash flows from investing activities.

Test your understanding 3 – Extracts

1 **Property, plant and equipment**

	$
Bal b/fwd	100
Revaluation	60
Leases	30
Depreciation	(20)
Disposals	(15)
Additions (bal. fig.)	95
Bal c/fwd	250

2 **Tax**

	$
Bal b/fwd (50 + 100)	150
Profit or loss charge	180
Tax paid (bal. fig.)	(110)
Bal c/fwd (100 + 120)	220

3 **Retained earnings**

	$
Bal b/fwd	200
Profit or loss	150
Dividend paid (bal. fig.)	(50)
	–––––
Bal c/fwd	300
	–––––

Test your understanding 4 – The Z group

Extracts from statement of cash flows

	$000
Cash flows from operating activities	
Profit before tax	915
Share of profit of associate	(15)
Cash flows from investing activities	
Dividend received from associate	5
Cash paid to acquire associates (W1)	(10)

(W1) **Associate**

	$000
Balance b/fwd	580
Share of profit of associate	15
Cash dividend received	(5)
Cash spent on investments in associates (bal. fig.)	10
	–––––
Balance c/fwd	600
	–––––

Test your understanding 5 – Consolidated extracts

1 **Non-controlling interest**

	$
Bal b/fwd	440
Total comprehensive income	500
Dividend paid (bal. fig.)	(100)
Bal c/fwd	840

2 **Non-controlling interest**

	$
Bal b/fwd	500
Total comprehensive income	600
Dividend paid (bal. fig.)	(250)
Bal c/fwd	850

3 **Associate**

	$
Bal b/fwd	200
Profit or loss	750
Dividend received (bal. fig.)	(450)
Bal c/fwd	500

4 **Associate**

	$
Bal b/fwd	600
Profit or loss	4,000
Revaluation	500
Dividend received (bal. fig.)	(1,900)
Bal c/fwd	3,200

5 **Property, plant and equipment**

	$
Bal b/fwd	150
New subsidiary	200
Depreciation	(50)
Additions (bal. fig.)	200
Bal c/fwd	500

Test your understanding 6 – AH Group

(a) **Cash generated from operations**

	$000
Profit before tax	18,450
Finance cost	1,400
Profit on disposal of property (2,250 – 1,000)	(1,250)
Depreciation	7,950
Goodwill impairment (W1)	1,000
Decrease in trade receivables (27,130 – 26,300 – 1,300)	470
Increase in inventories (33,500 – 28,750 – 1,650)	(3,100)
Decrease in trade payables (33,340 – 32,810 – 1,950)	(1,420)
Cash generated from operations	23,500

(W1) **Goodwill**

	$000
Bal b/fwd	4,160
Goodwill on sub acquired (W2)	2,750
Impairment in year (bal. fig.)	(1,000)
Bal c/fwd	5,910

(W2) **Goodwill arising on acquisition of subsidiary**

	$000
Consideration	6,000
Fair value of NCI at acquisition	1,750
Fair value of net assets at acquisition	(5,000)
Goodwill at acquisition	2,750

(b) **Profit adjustments**

IAS 7 *Statement of Cash Flows* states that the indirect method of calculating cash generated from operations involves adjusting the profit (or loss) for the period for the effects of changes in working capital, non-cash items, and items which relate to investing or financing.

Finance costs in the statement of profit or loss are not a cash flow because they are accounted for on an accruals basis. Finance costs are therefore added back to profit to eliminate them. Any cash interest paid is separately presented in the statement of cash flows (normally below 'cash generated from operations').

A profit recorded on the disposal of PPE is not a cash item. The proceeds received should be reported in the statement of cash flows as an investing activity. The profit on disposal of PPE must be deducted from profit before tax to eliminate it from operating activities.

Depreciation and impairment losses are non-cash expenses. These are eliminated by adding them back to profit.

Businesses buy and sell goods on credit, but only cash receipts and cash payments should be reported in the statement of cash flows. Adjusting for the movement in working capital items eliminates the impact of accruals accounting. Some of the year-on-year movement in working capital relates to the acquisition of a subsidiary, rather than resulting from cash flows with customers and suppliers, and so the effect of this acquisition has been eliminated.

Test your understanding 7 – Pearl

Consolidated statement of cash flows

	$000	$000
Cash flows from operating activities		
Profit before tax	1,115	
Finance cost	35	
Profit on sale of subsidiary	(100)	
Income from associates	(115)	
Depreciation	385	
Impairment (W1)	80	
Gain on disposal of PPE ($275 – $250)	(25)	
Increase in inventories ($470 – $435 – $150 + $165)	(50)	
Decrease in receivables ($390 – $330 – $240 + $120)	60	
Decrease in payables ($800 – $725 – $220 + $80)	(65)	
	1,320	
Interest paid	(35)	
Tax paid (W4)	(180)	
		1,105
Cash flows from investing activities		
Proceeds from sale of PPE	275	
Purchases of PPE (W5)	(800)	
Dividends received from associate (W6)	85	
Acquisition of subsidiary ($1,500 – $80)	(1,420)	
Disposal of subsidiary ($850 – $50)	800	
		(1,060)
Cash flows from financing activities		
Proceeds from loans ($500 – $300)	200	
Dividends paid to shareholders of the parent (per CSOCIE)	(125)	
Dividends paid to NCI (per CSOCIE)	(50)	
		25
Increase in cash and cash equivalents		70
Opening cash and cash equivalents		140
Closing cash and cash equivalents		210

Workings

(W1) **Goodwill**

	$000
Balance b/f	1,850
Acquisition of subsidiary (W2)	350
Disposal of subsidiary (W3)	(190)
Impairment (bal. fig.)	(80)
Balance c/f	1,930

(W2) **Goodwill on acquisition of subsidiary**

	$000
Cost of investment	1,500
Fair value of NCI at acquisition	340
Fair value of net assets at acquisition	(1,490)
	350

(W3) **Goodwill at disposal date**

	$000
Cost of investment	600
Fair value of NCI at acquisition	320
Fair value of net assets at acquisition	(730)
	190

(W4) **Tax**

	$000
Balance b/f ($360 + $105)	465
Acquisition of subsidiary	40
Disposal of subsidiary	–
Profit or loss	225
Cash paid (bal. fig.)	(180)
Balance c/f ($400 + $150)	550

(W5) **PPE**

	$000
Balance b/f	1,625
Depreciation	(385)
Revaluation gain	200
Disposal of plant	(250)
Acquisition of subsidiary	1,280
Disposal of subsidiary	(725)
Cash paid (bal. fig.)	800
Balance c/f	2,545

(W6) **Dividend from associate**

	$000
Balance b/f	540
Share of profit of associate	115
OCI from associate	50
Dividend received (bal. fig.)	(85)
Balance c/f	620

Test your understanding 8 – Book

The cash consideration net of Journal's cash and cash equivalents at acquisition will be presented as a cash outflow from investing activities. The share consideration is not a cash flow and so is not presented in the statement of cash flows.

The cash consideration is calculated as follows:

	$m	$m
Cash consideration (bal. fig.)		59.6
Share consideration (1m × $5)		5
NCI at acquisition		7
FV of net assets at acquisition		
Carrying amount	20	
Inventories uplift	2	
Deferred tax liability ($2m × 20%)	(0.4)	
		(21.6)
Goodwill at acquisition		50

Note that the subsidiary's identifiable net assets are measured at fair value at acquisition and so the inventories must be measured at acquisition at $6 million. This is an uplift of $2 million ($6m – $4m). A taxable temporary difference arises because the tax base of the inventories remains at $4 million. A deferred tax liability must therefore be recognised for $0.4 million ($2m × 20%) and is treated as part of the subsidiary's acquisition net assets.

Per the above calculation, the cash consideration transferred for the acquisition of Journal was $59.6 million. The net cash outflow presented in the statement of cash flow will be $58.6 million ($59.6m – $1m).

Test your understanding 9– Boardres

Cash flows from investing activities	$000
Purchase of PPE (W1)	(3,038)
Proceeds from disposal of PPE	854
Dividend received from associate (W2)	10
Cash consideration paid on acquisition of subsidiary, net of cash acquired (1,268 (W3) – 232)	(1,036)
	(3,210)

Liberated was acquired during the year for cash consideration of $1,268,000 (see W3 below). This is a cash outflow that must be presented under investing activities. However, Liberated's cash and cash equivalents of $232,000 are also now controlled by the group and this represents a cash inflow. Therefore, in the consolidated statement of cash flows, Boardres must show the net cash impact of the subsidiary acquisition: a net cash outflow of $1,036,000.

Workings

(W1) **Property, plant and equipment**

	$000
Bal b/fwd	8,985
Exchange gain	138
Acquisition of subsidiary	208
Depreciation	(907)
Disposal	(305)
Additions (bal. fig.)	3,038
Bal c/fwd	11,157

(W2) **Dividends from associates**

	$000
Bal b/fwd	280
Profit or loss	30
Dividend received (bal. fig.)	(10)
Bal c/fwd	300

(W3) **Purchase consideration**

	$000
Cash consideration (bal. fig.)	1,268
NCI at acquisition (18% × 833)	150
FV of net assets at acquisition	(833)
Goodwill at acquisition	585

Chapter

22

Analysis and interpretation

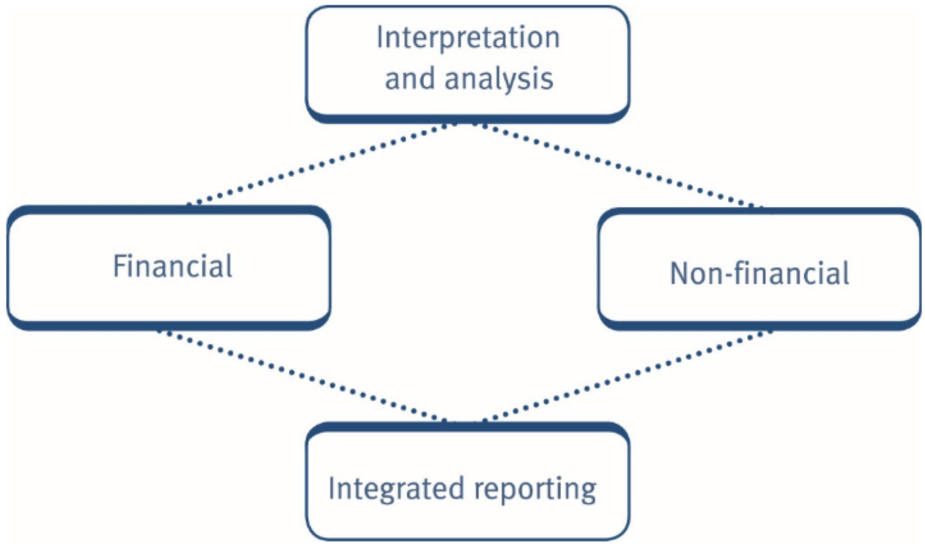
Chapter learning objectives

Upon completion of this chapter you will be able to:

- Discuss and apply relevant indicators of financial and non-financial performance including earnings per share and additional performance measure
- Discuss group statements of cash flows
- Discuss the increased demand for transparency in corporate reports, and the emergence of non-financial reporting standards
- Appraise the impact of environmental, social, and ethical factors on performance measurement
- Discuss the importance of effective sustainability reporting
- Discuss developments in corporate reporting related to sustainability reporting and sustainability standards.
- Discuss how integrated reporting improves the understanding of the relationship between financial and non-financial performance and of how a company creates sustainable value.

PER

One of the PER performance objectives (PO8) is to analyse and interpret financial reports. You analyse financial statements to evaluate and assess the financial performance and position of an entity. Working through this chapter should help you understand how to demonstrate that objective.



1 Analysis and interpretation

The SBR syllabus requires students to reflect on the usefulness of corporate reports to stakeholders and to discuss the nature of the information that would help stakeholders assess the future prospects of the entity.

Remember that, according to the *Conceptual Framework*, the purpose of financial reporting is to provide information to current and potential investors, lenders and other creditors that will enable them to make decisions about providing economic resources to an entity.

If investors, lenders and creditors are going to make these decisions then they require information that will help them to assess:

- an entity's potential future cash flows, and
- management's stewardship of the entity's economic resources.

Some of this information is found in financial statements. However, more and more companies are producing other types of reports, such as integrated reports. These shift the focus of reporting away from short-term financial measures and instead provide a more holistic and long-term representation of the entity's societal impact.

This chapter examines the different sources of information available, and a range of analysis techniques, that can enable key user groups to make informed investment decisions.

Progression

Analysis was a key area of the Financial Reporting syllabus. SBR places less emphasis on the calculation of ratios.

2 Assessing financial performance and position

In your previous studies, you will have learned a number of ratios that can be used to interpret an entity's financial statements.

A selection of the key ratios are provided below:

Profitability

Gross profit margin:

$$\frac{\text{Gross profit}}{\text{Revenue}} \times 100\%$$

An increase in gross profit margin may be a result of:

- higher selling prices
- lower purchase prices (perhaps resulting from bulk-buy discounts)
- a change in the sales mix.

Operating profit margin:

$$\frac{\text{Operating profit}}{\text{Revenue}} \times 100\%$$

Operating profit margin is affected by more factors than gross profit margin. Many operating costs are fixed and therefore do not necessarily increase or decrease with revenue. This means that operating profit margin may be more volatile year-on-year than gross profit margin.

Be aware that many operating costs, such as depreciation and impairment losses, are heavily reliant on management judgement. This may hinder the ability to compare the operating profit margin of one company with another company.

Return on capital employed (ROCE):

$$\frac{\text{Operating profit}}{\text{Capital employed}} \times 100\%$$

Capital employed is equity plus interest bearing finance.

ROCE is a measure of how efficiently an entity is using its resources. It should be compared to:

- previous years' figures
- the target ROCE
- the ROCE of competitors
- the cost of borrowing.

Liquidity and working capital

Current ratio:

$$\frac{\text{Current assets}}{\text{Current liabilities}} : 1$$

The current ratio measures whether an entity has sufficient current assets to meet its short-term obligations. The higher the ratio, the more financially secure the entity is. However, if the ratio is too high then it may suggest inefficiencies in working capital management.

Inventory turnover period:

$$\frac{\text{Inventories}}{\text{Cost of sales}} \times 365 \text{ days}$$

A high inventory turnover period may suggest:

- lack of demand for the entity's goods
- poor inventory control.

Receivables collection period:

$$\frac{\text{Trade receivables}}{\text{Credit sales}} \times 365 \text{ days}$$

An increase in the receivables collection period may suggest a lack of credit control, which could lead to irrecoverable debts.

Payables payment period:

$$\frac{\text{Trade payables}}{\text{Credit purchases}} \times 365 \text{ days}$$

This represents the credit period taken by the company from its suppliers. A long credit period can be a good sign because it is a free source of finance. However, if an entity is taking too long to pay its suppliers then there is a risk that credit facilities could be reduced or withdrawn.

Long-term financial stability

Gearing:

$$\frac{\text{Debt}}{\text{Equity}} \text{ or } \frac{\text{Debt}}{\text{Debt + equity}}$$

Gearing indicates the risk attached to the entity's finance. Highly geared entities have a greater risk of insolvency.

Interest cover:

$$\frac{\text{Operating profit}}{\text{Finance costs}}$$

Interest cover indicates the ability of an entity to pay interest out of the profits generated. A low interest cover suggests that an entity may have difficulty financing its debts if profits fall.

Investor ratios

P/E ratio:

$$\frac{\text{Current share price}}{\text{EPS}}$$

The P/E ratio represents the market's view of the future prospects of an entity's shares. A high P/E ratio suggests that growth is expected.

The calculation of EPS (earnings per share) is revised in the next section of this chapter.

Test your understanding 1 – Starling

Starling has issued B class shares and has recorded them as equity instruments in the statement of financial position. Under the terms of the shareholder agreement, Starling is obliged to redeem the shares in cash in three years' time.

Required:

Discuss the impact on the financial statements of the above error. Your answer should make reference to financial statement ratios.

3 IAS 33 *Earnings per Share*

Scope

IAS 33 *Earnings per Share* applies to listed entities. If private entities choose to disclose earnings per share, it must be calculated in accordance with IAS 33.

Investor perspective – EPS

Cottage Group is a listed entity. It has a reporting period of 31 December 20X1. An extract from the 'earnings per share' disclosure note is provided below:

	20X1 cents per share	20X0 cents per share
Basic earnings	17.4	23.8
Diluted earnings	16.3	22.4

Basic earnings per share must be calculated in accordance with IAS 33 *Earnings per Share*. This means that the EPS of one company can be easily compared to another company. A company with a higher EPS figure is likely to pay higher dividends per share (although not necessarily in the short-term). This helps investors to decide whether to buy, sell or hold the company's equities.

Many investors look to invest in companies with a steadily increasing 'earnings per share' figure. Cottage Group's year-on-year decline may cause concern. Further analysis of the financial statements is required to ascertain the reasons for this.

Of course, investors are often interested in future returns. For this reason, they may use earnings per share to calculate other ratios, such as the price/earnings ratio. A high price/earnings ratio suggests that the market is confident about the entity's future prospects. It is important to remember that the market can be wrong – as was the case with the dotcom collapse at the beginning of the twenty-first century.

The basic calculation

The actual earnings per share (EPS) for the period is called the **basic EPS** and is calculated as:

$$\frac{\text{Profit or loss for the period attributable to equity shareholders}}{\text{Weighted average number of ordinary shares outstanding in the period}}$$

Profit for the period must be reduced (or a loss for the period must be increased) for any irredeemable preference dividends paid during the period.

If an entity prepares consolidated financial statements, then EPS will be based on the consolidated profit for the period attributable to the equity shareholders of the parent company (i.e. total consolidated profit less the profit attributable to the non-controlling interest).

The weighted average number of shares takes into account the timing of share issues during the year.

Illustration 1 – Basic earnings per share

An entity issued 200,000 shares at full market price on 1 July 20X8.

Relevant information is provided below:

	20X8	**20X7**
Profit attributable to the ordinary shareholders for the year ending 31 Dec	$550,000	$460,000
Number of ordinary shares in issue at 31 Dec	1,000,000	800,000

Required:

Calculate basic EPS for the years ended 31 December 20X7 and 20X8.

Solution

Calculation of earnings per share

20X7 = $460,000/800,000 = 57.5c

20X8 = $550,000/900,000 (W1) = 61.1c

(W1) **Weighted average number of shares in 20X8**

800,000 × 6/12 =	400,000
1,000,000 × 6/12 =	500,000
	900,000

Since the additional 200,000 shares were issued at full market price but have only contributed finance for half a year, a weighted average number of shares must be calculated. The earnings figure is not adjusted.

Bonus issues

If an entity makes a bonus issue of shares then share capital increases. However, no cash has been received and therefore there is no impact on earnings. This means that a bonus issue reduces EPS.

For the purpose of calculating basic EPS, the bonus issue shares are treated as if they have always been in issue. The easiest way to do this is multiply the number of shares outstanding before the bonus issue by the bonus fraction.

The bonus fraction is calculated as follows:

$$\frac{\text{Number of shares after bonus issue}}{\text{Number of shares before bonus issue}}$$

EPS for the comparative period must be restated. The easiest way to achieve this is to multiply the EPS figure from the prior year's financial statements by the inverse of the bonus fraction.

Illustration 2 – Bonus issues

An entity made a bonus issue of one new share for every five existing shares held on 1 July 20X8.

Relevant information

	20X8	20X7
Profit attributable to the ordinary shareholders for the year ending 31 Dec	$550,000	$460,000
Number of ordinary shares in issue at 31 Dec	1,200,000	1,000,000

Required:

(a) Calculate basic EPS for the year ended 31 December 20X8.

(b) Calculate the prior year comparative EPS figure as it would appear in the financial statements for the year ended 31 December 20X8.

Solution

(a) EPS = $550,000/1,200,000 (W1) = 45.8c

(W1) **Weighted average number of shares**

1,000,000 × 6/12 × 6/5 (W2)	600,000
1,200,000 × 6/12	600,000
Weighted average number of shares	1,200,000

(W2) **Bonus fraction**

It was a one for five bonus issue.

A shareholder who had five shares before the bonus issue would have six shares after the bonus issue.

The bonus fraction is therefore 6/5.

(b) EPS in the financial statements for the year ended 31 December 20X7 would have been 46.0c ($460,000/1,000,000).

This is re-stated in the financial statements for the year ended 31 December 20X8 by multiplying it by the inverse of the bonus fraction.

The restated comparative is therefore 38.3c (46.0c × 5/6).

Rights issues

A rights issue of shares is normally made at less than the full market price. A rights issue therefore combines the characteristics of an issue at full market price with those of a bonus issue.

As already seen, the easiest way to deal with the bonus element is to calculate the bonus fraction and to apply this to all shares outstanding before the rights issue.

The bonus fraction for a rights issue is calculated as follows:

$$\frac{\text{Market price per share before rights issue}}{\text{Theoretical market price per share after the rights issue}}$$

EPS for the comparative period must be restated. The easiest way to achieve this is to multiply the EPS figure from the prior year's financial statements by the inverse of the bonus fraction.

Illustration 3 – Rights issues

An entity issued one new share for every two existing shares at $1.50 per share on 1 July 20X8. The pre-issue market price was $3.00 per share.

Relevant information

	20X8	**20X7**
Profit attributable to the ordinary shareholders for the year ending 31 Dec	$550,000	$460,000
Number of ordinary shares in issue at 31 Dec	1,200,000	800,000

Required:

(a) **Calculate basic EPS for the year ended 31 December 20X8.**

(b) **Calculate the prior year comparative EPS figure as it would appear in the financial statements for the year ended 31 December 20X8.**

Solution

(a) EPS = $550,000/1,080,000 (W1) = 50.9c

(W1) **Weighted average number of shares**

800,000 × 6/12 × 3.00/2.50 (W2)	480,000
1,200,000 × 6/12	600,000
Weighted average number of shares	1,080,000

(W2) **Bonus fraction**

The bonus fraction is calculated as:

$$\frac{\text{Market price per share before rights issue}}{\text{Theoretical market price per share after the rights issue}}$$

The bonus fraction is $3.00/$2.50 (W3).

(W3) **Theoretical share price after rights issue**

	No. shares	**Price per share**	**Market capitalisation**
		$	$
Before rights issue	800,000	3.00	2,400,000
Rights issue	400,000	1.50	600,000
	1,200,000		3,000,000

The theoretical price per share after the rights issue is $2.50 ($3,000,000/1,200,000).

(b) EPS in the financial statements for the year ended 31 December 20X7 would have been 57.5c ($460,000/800,000).

This is restated in the financial statements for the year ended 31 December 20X8 by multiplying it by the inverse of the bonus fraction.

The restated comparative is therefore 47.9c (57.5c × 2.50/3.00).

Diluted EPS

Many companies issue convertible instruments, options and warrants that entitle their holders to purchase shares in the future at below the market price. When these shares are eventually issued, the interests of the original shareholders will be diluted. The dilution occurs because these shares will have been issued at below market price.

The Examiner has indicated that diluted earnings per share will not be examined in detail. However, students should have awareness of the topic as summarised below:

- Shares and other instruments that may dilute the interests of the existing shareholders are called potential ordinary shares.
- Examples of potential ordinary shares include:
  - debt and other instruments, including preference shares, that are convertible into ordinary shares
  - share warrants and options (instruments that give the holder the right to purchase ordinary shares)
  - employee plans that allow employees to receive ordinary shares as part of their remuneration and other share purchase plans
  - contingently issuable shares (i.e. shares issuable if certain conditions are met).
- Where there are dilutive potential ordinary shares in issue, the diluted EPS must be disclosed as well as the basic EPS. This provides relevant information to current and potential investors.
- When calculating diluted EPS, the profit used in the basic EPS calculation is adjusted for any expenses that would no longer be paid if the convertible instrument were converted into shares, e.g. preference dividends, loan interest.
- When calculating diluted EPS, the weighted average number of shares used in the basic EPS calculation is adjusted for the conversion of the potential ordinary shares.

Assessing EPS as a performance measure

The EPS figure is used to compute the major stock market indicator of performance, the Price/Earnings ratio (P/E ratio). The stock market places great emphasis on the earnings per share figure and the P/E ratio. IAS 33 sets out a standard method of calculating EPS, which enhances the comparability of the figure.

EPS also has limitations as a performance measure:

- An entity's earnings are affected by its choice of accounting policies. Therefore, it may not always be appropriate to compare the EPS of different companies.
- EPS does not take account of inflation. Apparent growth in earnings may not be true growth.
- EPS does not provide predictive value. High earnings may be achieved at the expense of investment, which would have generated increased earnings in the future.
- In theory, diluted EPS serves as a warning to equity shareholders that the return on their investment may fall in future periods. However, diluted EPS is based on current earnings rather than forecast earnings.
- EPS is a measure of profitability but profitability is only one aspect of performance. Concentration on earnings per share and 'the bottom line' arguably detracts from other important aspects of an entity's affairs, such as cash flow and stewardship of assets.

Test your understanding 2 – Coe

Coe, a public limited company, is preparing its consolidated financial statements for the year ended 31 December 20X1. Coe has owned 75% of the equity shares of Crace for a number of years. The following accounting issues have yet to be finalised:

1 On 1 January 20X1, 1,000 of Coe's managers were granted 500 share options each. These will vest on 31 December 20X3 if the managers are still employed by Coe. The fair value of one share option at the grant date was \$6. By 31 December 20X1, 50 of these managers had left the business and another 80 were expected to leave by the vesting date. The exercise price of the options is \$3. The average price of one of Coe's equity shares over the year is \$10. No entries have been posted in relation to this share option scheme.

2 Freehold land is accounted for using the revaluation model in IAS 16 *Property, Plant and Equipment*. A revaluation has taken place in the current year. However, one plot of land is still carried in Coe's financial statements at its purchase cost of \$4 million. Similar plots of land have sold for \$5 million.

3 On 31 December 20X1, Crace made an interest-free loan of $3 million to a charity and recognised this amount as a financial asset. The charity will repay the money on 31 December 20X4. Market rates of interest are 5%.

Required:

(i) Explain, with calculations, how the above events should be corrected in the consolidated financial statements for the year ended 31 December 20X1.

(ii) Discuss the impact of these corrections on basic and diluted earnings per share. No calculations are required.

4 Impact of policies and estimates

Accounting policies and estimates can significantly affect the view presented by financial statements, and the ratios computed by reference to them, without affecting an entity's cash generation.

This is a particularly important issue when:

- accounting standards permit a choice, such as between a cost model or a fair value model
- judgement is needed in making accounting estimates, such as with depreciation, allowances and provisions
- there is no relevant accounting standard (although this is rare).

e.g

Investor perspective – Accounting policy choices

Assume that two separate entities, A and B, both buy an identical building for $10m on 1 January 20X1 and classify them as investment properties. Each building is expected to have a useful life of 50 years. By 31 December 20X1, the fair value of each building is $11m.

Entity A measures investment properties using the cost model. Entity B measures investment properties at fair value.

Extracts from the financial statements of the two entities are provided below:

Statement of financial position

	Entity A	Entity B
	$m	$m
Investment properties	9.8	11.0

Statement of profit or loss

	Entity A	Entity B
	$m	$m
Depreciation	(0.2)	–
Gain on investment properties	–	1.0

Assuming no other differences between the two entities, entity B will report higher profits and therefore higher earnings per share than entity A. Entity B will also show higher equity in its statement of financial position, so its gearing will reduce.

As this example shows, the fact that IAS 40 permits a choice in accounting policy could be argued to reduce the comparability of financial information.

Test your understanding 3 – Impact of policy choices

Entities A and B are identical in all respects, except for their application of IAS 16 *Property, Plant and Equipment*.

Entity A accounts for buildings using the cost model whereas Entity B uses the revaluation model. Property prices have risen recently and so Entity B recorded a revaluation gain at the beginning of the current reporting period.

Extracts from the financial statements of both entities are provided below:

Statements of profit or loss (extracts)

	A	B
	$000	$000
Revenue	220	220
Operating costs (including depreciation)	(180)	(210)
Profit from operations	40	10

Statements of financial position (extracts)

	A	B
	$000	$000
Share capital	50	50
Retained earnings	90	60
Other components of equity	–	210
Total equity	140	320
Borrowings	100	100
Total equity and liabilities	240	420

Required:

Using ratio analysis, compare the financial statements of Entity A and Entity B and explain how the differences may impact stakeholder perception.

5 Statements of cash flows

Usefulness of the statement of cash flows

A statement of cash flows provides information that is not available from the statement of financial position or the statement of profit or loss and other comprehensive income. There are a number of reasons why it is useful for stakeholder analysis:

- Profits can be manipulated through the use of judgement or choice of a particular accounting policy whereas cash flows are objective and verifiable.
- Cash generated from operations is a useful indication of the quality of the profits generated by a business. Good quality profits will generate cash.
- Statements of cash flows provide valuable information to stakeholders on the financial adaptability of an entity.
- Cash flow information has some predictive value. It may assist stakeholders in making judgements about the amount, timing and certainty of future cash flows.

Test your understanding 4 – Tuyet

Tuyet is a public limited company that prepares its financial statements in accordance with International Financial Reporting Standards and has a year end of 31 December 20X1. It manufactures furniture that is sold to a range of retail outlets. As at the year-end Tuyet has loans outstanding, with repayments of $7 million due annually in each of the next four years.

You are a potential investor in Tuyet. You are analysing its statement of cash flows for the year ended 31 December 20X1, which is presented below:

Statement of cash flows for year ended 31 December 20X1

	$m	$m
Cash flows from operating activities		
Profit before tax	35	
Finance cost	5	
Depreciation	12	
Profit on disposal of PPE	(8)	
Reduction in provisions	(6)	
Increase in inventories	(19)	
Increase in receivables	(14)	
Increase in payables	13	
Cash generated from operations	18	
Interest paid	(5)	
Tax paid	(10)	
		3

Cash flows from investing activities		
Proceeds from sale of PPE	20	
Purchases of PPE	(30)	
		(10)
Cash flows from financing activities		
Proceeds from shares	15	
Repayment of loans	(7)	
Dividends paid	–	
		8
Increase in cash and cash equivalents		1
Opening cash and cash equivalents		(5)
Closing cash and cash equivalents		(4)

Required:

From analysis of the statement of cash flows, what conclusions would you draw about Tuyet?

6 Additional performance measures

Background

Users of financial statements are demanding more information. In response, many entities present additional performance measures (APMs) in their published many statements, such as:

- **EBIT** – earnings before interest and tax
- **EBITDA** – earnings before interest, tax, depreciation and amortisation
- **Net financial debt** – gross debt less cash and cash equivalents and other financial assets
- **Free cash flow** – cash flows from operating activities less capital expenditure.

Benefits

APMs can have many benefits, such as:

- Helping users of financial statements to evaluate an entity through the eyes of management
- Enabling comparison between entities in the same sector or industry
- Stripping out elements that are not relevant to current or future year operating performance.

Drawbacks

Presenting APMs in financial statements can create problems:

- An entity might calculate an APM in a different way year-on-year
- Two entities might calculate the same APM in a different way
- Entities often provide little information about how an APM is calculated or how it reconciles with the figures presented in the financial statements
- APMs might be selected and calculated so as to present an overly optimistic picture of an entity's performance
- Too much information can be confusing to users of the financial statements
- Giving an APM undue prominence may mislead users of the financial statements into believing it is a requirement of IFRS Standards.

e.g

Investor perspective – underlying profit

Bug in a Rug Group, a public limited entity, reports 'underlying profit before tax' in its annual financial statements. In a disclosure note, 'underlying profit before tax' is reconciled to 'profit before tax'. Below is an extract from the financial statements:

In order to provide shareholders with additional insight into the underlying performance of the business, items recognised in reported profit or loss before tax which, due to their size and or nature, do not reflect the Group's underlying performance are excluded from the Group's underlying results:

	$m	$m
Underlying profit before tax		600
Profit on property disposals	20	
Fair value movements on investment properties	(10)	
Impairment of property	(17)	
Transaction costs on subsidiary acquisition	(4)	
IT write offs	(7)	
Defined benefit expenses	(11)	
Total adjustments		(29)
Profit before tax		571

Some argue that the disclosure of additional performance measures makes it easier for stakeholders to assess the future profits and cash flows of an entity. However, as can be seen above, additional performance measures often present an entity's performance in a more favourable light than performance measures that are based solely on the application of IFRS Standards. This may mislead investors when they are assessing an entity's financial performance.

e.g

Investor perspective – free cash flow

Below is an extract from the financial statement disclosure notes of Spotty Potty Group for the year ended 31 December 20X1:

The Directors use the additional performance measure 'free cash flow' because it is critical to understanding the financial performance and financial health of the Group. As this is not defined by International Financial Reporting Standards, it may not be directly comparable with other companies who use similar measures.

Free cash flow is calculated as net cash generated from operations less cash capital expenditure excluding strategic capital expenditure. A calculation of this figure for the current period, and comparative period, is provided:

	20X1	20X0
	$m	$m
Cash generated from operations	561	612
Interest paid	(46)	(47)
Tax paid	(50)	(60)
Purchase of PPE	(243)	(230)
Strategic capital expenditure	93	–
Free cash flow	315	275

Despite lower cash generated from operations in 20X1 compared to 20X0, the entity appears to have a higher free cash flow available to repay its debts and to pay dividends to investors. However, this increase year-on-year is a result of the exclusion of 'strategic capital expenditure'. No definition is provided as to what this relates to, making it difficult to assess the appropriateness of the adjustment. While this adjustment may be a legitimate attempt to present investors with like-for-like information, it could also be a conscious attempt to present the cash performance of the entity in a more favourable light.

Exam focus

It is important that you refer to a real set of published financial statements. This will help you to appreciate the wide range of APMs that listed entities disclose. Think critically as you read through the financial statements: are the APMs useful, confusing or, even, misleading?

Test your understanding 5 – Hutton

Hutton discloses an additional performance measure (APM) called 'underlying profit' in its financial statements. The following is an extract from one of Hutton's financial statement disclosure notes for the year ended 31 December 20X1:

	$m
Loss before tax	(8)
Finance cost	4
Depreciation	10
Amortisation	8
Impairment of brand	7
Foreign exchange loss on monetary items	3
Gains on FVPL financial assets	(5)
Underlying profit	19

Hutton presents comparable information for the prior period.

Required:

Discuss why this APM may not be useful to Hutton's stakeholders.

7 Tech companies

According to the *Conceptual Framework*, the statement of financial position provides relevant information about a company's financial position and the statement of profit or loss provides relevant information about a company's financial performance.

However, there is growing concern that financial statements produced under IFRS Standards (as well as other national accounting standards) do not produce useful information with regards to tech companies (such as Amazon, Google, Facebook and Apple).

Statement of financial position

The carrying amounts of net assets in the statement of financial position for a tech company tends to be significantly lower than its market capitalisation (share price multiplied by number of shares in issue). Tech company financial statements underreport a significant amount of 'value'.

One key reason is that tech companies have powerful and valuable brands. In accordance with IAS 38 *Intangible Assets*, internally generated brands are not recognised on the statement of financial position.

Another reason is that operating assets used by many tech companies are not owned or leased by the company itself (such as the music available on Spotify, or the cars available to ride through the Uber app). Tech companies benefit from these assets but they do not meet the criteria for recognition in the statement of financial position because they are controlled by other parties (such as record labels, or taxi drivers).

A further reason is that many intangible assets developed and used by tech companies appreciate in value as they are used even though accounting standards may require them to be depreciated or amortised. For example, each new user on a social media platform increases the benefits of the platform for existing users as well as increasing the advertising fees that the platform owner can charge. Although there will be some incremental operating costs associated with new users (in relation to help, support and regulation of online behaviour), the growth is mainly driven by the assets already in place.

Statement of profit or loss

Many tech companies, such as Uber and Twitter, are valued at billions of dollars even though they have historically made losses. When assessing economic performance, it would seem that investors increasingly look beyond the statement of profit or loss.

Tech companies tend to incur high costs in the initial years after incorporation. However, once these costs are incurred, the further costs required to expand are lower in comparison (for example, companies that offer online services can expand by adding to server capacity, rather than by acquiring new premises). As such successful tech companies often report losses for many years but then high margins once established as a market-leader. Therefore, at all stages in the lifecycle of a tech company, the statement of profit or loss does not effectively match the revenues earned in the current period with the costs incurred to earn those revenues.

This is not to argue that the statement of profit or loss is worthless to the analysis of performance. Investors are certainly interested in the revenue generated by a tech company – after all, this is a good indicator or growth and market-share. Furthermore, the share price of many tech companies rises significantly in the first period when a profit is recorded, indicating that markets attach some importance to this performance measure. It may be that profit generation indicates that the business has moved into a different stage in its lifecycle – away from a high risk, capital demanding initial stage into a mature, less risky, cash generative stage.

Remedies

Due to the weaknesses identified above, tech companies may need to report other types of information to investors and lenders. This might be done via:

- Integrated reporting (covered later in this chapter)
- Online real-time reporting of key performance indicators (such as membership numbers, monetary spend per user etc.).

8 Non-financial performance measures

Problems arise from an over-reliance on financial performance indicators:

- They are normally calculated from historical financial information and provide limited information about future performance.
- They do not provide information about key issues that impact long-term success, such as customer satisfaction
- There are concerns about whether traditional financial reporting adequately reports the financial position and performance of tech companies
- They can be manipulated through accounting estimates or policy choices.

Due to these limitations, analysis of non-financial performance measures is important. These measures are related to entity performance but are not expressed in monetary units.

Examples of non-financial performance measures include:

- Employee turnover
- Absentee rates
- Employee satisfaction
- Customer satisfaction
- Delivery times
- Brand awareness and brand loyalty.

Entities are not required to disclose non-financial performance measures. However, many choose to do so in their annual reports or as part of their integrated report.

Test your understanding 6 – Lorenzo

Lorenzo develops and manufactures desktop and laptop computers. Profit after tax for the year-ended 31 December 20X1 is 5% lower than the prior period. Lorenzo discloses the following non-financial performance measures in its Integrated Report for the year ended 31 December 20X1.

	20X1	20X0
Faults per 1,000 sales	2.1	3.2
Customer service helpline waiting time (minutes)	1.5	4.2
Staff turnover* (%)	6.5	13.2

*(leavers/average number of employees × 100)

Required:

Discuss how the above information might be interpreted by Lorenzo's current and potential investors.

9 The impact of ethical, environmental and social factors

Entity behaviour

Many investors will not financially support entities that they perceive to be unethical or harmful to the environment. Some will only invest in entities that meet the very highest ethical standards, even if this means achieving a low overall return.

Factors which may be of interest to investors include:

- **Animal welfare** – does the entity test its products on animals?
- **Arms** – does the entity, or any entities within its group, manufacture or supply weapons?
- **Emissions** – does the entity monitor and take steps to reduce harmful emissions, such as carbon dioxide?
- **Energy** – is the entity committed to using renewable energy?
- **Marketing** – does the entity use irresponsible or offensive marketing strategies?
- **Remuneration** – what is the gap between the highest and lowest paid employees?
- **Supply chain management** – are goods and services only purchased from entities that have high ethical standards?
- **Tax** – does the entity use tax avoidance schemes?
- **Transparency** – does the entity make enhanced disclosures about its social and environmental impact?
- **Treatment of workers** – are working conditions safe and humane?

Investors will prioritise these issues to different degrees.

Reporting

Entities often provide this information in additional reports, such as:

- environmental reports
- social reports
- sustainability reports
- integrated reports.

Within these reports, some entities disclose key performance indicators on their ethical behaviour.

A range of non-financial reporting standards have been published in recent years to guide preparers of such reports. Some of these are discussed later in the chapter.

Ethical behaviour and profit

Entities that pay employees higher wages, or which reject tax avoidance schemes, are likely to have higher costs. Moreover, these entities may have to raise selling prices to compensate for higher costs, making their products and services less competitive. As a result, profit levels may fall.

However, a strong ethical stance might attract 'green' investors and customers. Some entities are the subject of boycotts as a result of their perceived unethical stance. Moreover, an ethical business model may be more sustainable than one which prioritises short-term profits.

As you can see, the relationship between ethics and profit is not straight forward.

10 Developments in sustainability reporting

Background

Sustainable development consists of balancing local and global efforts to meet basic human needs without destroying or degrading the natural environment.

Sustainable Development Goals (SDGs) are a range of 17 goals agreed by UN member states that include no poverty, zero hunger, decent work, reduced inequalities, and responsible production and consumption. Some of these will only be achieved through the cooperation of industry.

There are lots of reasons why companies should set their own sustainable development goals:

- It is ethical
- Government funding will increasingly focus on sustainable businesses
- There will be a reduction in reputational and regulatory risk
- Sustainable products and services are a growth area
- Short-term, profit-based models are now less relevant for many investors.

Investors are increasingly interested in companies that make a credible contribution to some of the SDGs. Investors will see opportunities in companies that address the risks to people and the environment and those companies that develop new products and services which will have positive impacts on the achievement of SDGs. Conversely, some potential investors employ screening tactics, eliminating companies that exhibit specific characteristics, such as low pay or high levels of gender inequality.

As can be seen from the above, effective sustainability reporting provides useful information to potential and current investors. This is because it helps them to make economic decisions about whether or not to advance financial resources to the reporting entity.

Reporting standards and initiatives

It is vital for companies to carefully consider how to communicate their commitment to, and progress towards, SDGs. There are many reporting initiatives that can be used:

- **The United Nations Global Compact** (UNGC) is an initiative to support UN goals. It encourages entities to produce an annual Communication in Progress (COP) report, in which they describe the practical actions taken to implement UN principles in respect of human rights, labour, the environment, and anti-corruption.
- **The Global Reporting Initiative** (GRI) publishes the most widely used standards on sustainability reporting and disclosure. Using the GRI standards should mean that entities produce balanced reports that represent their positive and negative economic, environmental and social impacts. GRI principles encourage stakeholder engagement in order to ensure that their information needs are met.
- **The International Integrated Reporting Council** has published the International Integrated Reporting Framework. This is discussed in more detail in the next section of this chapter.

Legislation

Many countries are introducing legislation on sustainability reporting:

- The Singapore Stock Exchange has made sustainability reporting mandatory for listed companies, on a ‘comply or explain’ basis.
- The European Union requires certain large companies to disclose non-financial information on employee diversity.

Test your understanding 7 – Environmental impact

Entities are investing more time and money in implementing sustainable development practices. A key sustainable development goal set by many entities is to minimise the impact of business operations on the environment. Many entities now disclose considerable information about this in annual reports.

Required:

Discuss the potential benefits that might arise when an entity discloses its impact on the environment to its stakeholders.

The IFRS Foundation

The IFRS Foundation has publicly recognised the importance of sustainability reporting for an entity's stakeholders. For example:

- **Investors** want more information about climate risks in order to inform their decision making.
- **Banks** are focussing on climate-related risks when assessing financial stability.

As noted, many sets of sustainability standards already exist, but these often have a differing focus. For example, some centre on company impacts, others focus on environmental impacts. This causes significant diversity in how entities report sustainability issues. Moreover, some regions such as The European Union, are proposing their own approaches to sustainability reporting. These developments pose a risk of global fragmentation.

Against this backdrop, the IFRS Foundation has stressed the need for stakeholders to be presented with more consistent and comparable sustainability reporting. With its expertise in standard setting and relationships with governments and regulators around the world, the IFRS Foundation believes it can offer a solution.

Proposals

The IFRS Foundations' trustees have proposed expanding its objectives to enable the creation of a new board (separate from the International Accounting Standards Board). This would be called the International Sustainability Standards Board (ISSB).

The ISSB's aim would be to develop a global set of sustainability reporting standards with the aim of harmonising and streamlining reporting in this area.

It is believed that the primary users of the financial statements would benefit if there was a single organisation tasked with developing both financial reporting and sustainability reporting requirements.

Climate risk is of growing and immediate importance to investors and regulators. In response, the ISSB would initially focus on developing standards focussed on climate-related information, while also consulting on other environmental, social and governance priorities.

11 Integrated reporting

What is the International Integrated Reporting Council?

The International Integrated Reporting Council (IIRC) was created to respond to the need for a concise, clear, comprehensive and comparable integrated reporting framework.

The IIRC define an integrated report (IR) as 'a concise communication about how an organisation's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium and long term.'

The IIRC believe that integrated reporting will contribute towards a more stable economy and a more sustainable world.

What is the role of the IIRC?

The role of the IIRC is to:

- develop an overarching integrated reporting framework setting out the scope of integrated reporting and its key components
- identify priority areas where additional work is needed and provide a plan for development
- consider whether standards in this area should be voluntary or mandatory and facilitate collaboration between standard-setters and convergence in the standards needed to underpin integrated reporting; and
- promote the adoption of integrated reporting by relevant regulators and report preparers.

Objective of the Framework

The IR Framework establishes 'guiding principles' and 'content elements' that govern the overall content of an integrated report. This will help organisations to report their value creation in ways that are understandable and useful to the users.

The IR Framework is aimed at the private sector, although could be adapted for use by charities and the public sector.

The key users of an integrated report are deemed to be the providers of financial capital. However, the report will also benefit employees, suppliers, customers, local communities and policy makers.

The Framework is principles based and therefore does not prescribe specific KPIs that must be disclosed. Senior management need to use judgement to identify which issues are material. These decisions should be justified to the users of the report.

Those charged with governance are not required to acknowledge their responsibility for the integrated report. It was felt that such disclosures might increase legal liability in some jurisdictions and therefore deter some companies from applying the IR Framework.

Fundamental concepts in the IR framework

An integrated report explains how an entity creates value over the short-, medium- and long-term. To this extent, a number of fundamental concepts underpin the IR framework. These are:

- The capitals
- The organisation's business model
- The creation of value over time.

The **capitals** are stocks of value that are inputs to an organisation's business model. The capitals identified by the IR Framework are financial, manufactured, intellectual, human, social and relationship, and natural.

The capitals will increase, decrease or be transformed through an organisation's business activities. For example:

- The use of natural resources will decrease natural capital, making a profit will increase financial capital.
- Employment could increase human capital through training, or reduce human capital through unsafe or exploitative working practices.

Central to integrated reporting is the overall impact that a business has on the full range of capitals through its business model.

The **business model** is a business' chosen system of inputs, business activities, outputs and outcomes that aims to create value over the short, medium and long term.

- An integrated report must identify key **inputs**, such as employees, or natural resources. It is important to explain how secure the availability, quality and affordability of components of natural capital are.
- At the centre of the **business model** is the conversion of inputs into outputs through business activities, such as planning, design, manufacturing and the provision of services.
- An integrated report must identify an organisation's key **outputs**, such as products and services. There may be other outputs, such as chemical by-products or waste. These need to be discussed within the business model disclosure if they are deemed to be material.

- **Outcomes** are defined as the consequences (positive and negative) for the capitals as a result of an organisation's business activities and outputs. Outcomes can be internal (such as profits or employee morale) or external (impacts on the local environment).

Value is created over time and for a range of stakeholders. IR is based on the belief that the increasing financial capital (e.g. profit) at the expense of human capital (e.g. staff exploitation) is unlikely to maximize value in the longer term. IR thus helps users to establish whether short-term value creation can be sustained into the medium- and long-term.

Guiding principles

The following Guiding Principles underpin the preparation of an integrated report.

- **Strategic focus and future orientation** – An integrated report should provide insight into the organisation's strategy; how it enables the organisation to create value in the short, medium and long term; and its effects on the capitals.
- **Connectivity of information** – An integrated report should show a holistic picture of the factors that affect the organisation's ability to create value.
- **Stakeholder relationships** – An integrated report should provide insight into the nature and quality of the organisation's relationships with its stakeholders.
- **Materiality** – An integrated report should disclose information on matters that significantly affect the organisation's ability to create value.
- **Conciseness** – An integrated report should be concise.
- **Reliability and completeness** – An integrated report should be balanced and free from material error.
- **Consistency and comparability** – The information in an integrated report should be comparable over time, and comparable with other entities.

The content of an integrated report

An integrated report should include all of the following content elements:

- **Organisational overview and external environment** – 'What does the organisation do and what are the circumstances under which it operates?'
- **Governance** – 'How does the organisation's governance structure support its ability to create value in the short, medium and long term?'
- **Opportunities and risks** – 'What are the specific opportunities and risks that affect the organisation's ability to create value over the short, medium and long term, and how is the organisation dealing with them?'
- **Strategy and resource allocation** – 'Where does the organisation want to go and how does it intend to get there?'

- **Business model** – 'What is the organisation's business model and to what extent is it resilient?'
- **Performance** – 'To what extent has the organisation achieved its strategic objectives and what are its outcomes in terms of effects on the capitals?'
- **Future outlook** – 'What challenges and uncertainties is the organisation likely to encounter in pursuing its strategy, and what are the potential implications for its business model and future performance?'
- **Basis of presentation** – 'How does the organisation determine what matters to include in the integrated report and how are such matters quantified or evaluated?'

Including this content will help companies shift the focus of their reporting from historical financial performance to longer-term value creation.

Test your understanding 8 – AA

AA is a UK-based public limited company that purchases shoes directly from manufacturers and then sells them through its own UK-based shops. AA has been profitable for many years and has continued to expand, financing this through bank loans.

AA's shoes sell particularly well amongst lower income families and AA has therefore specifically targeted this demographic. AA offers a discount of 50% on school shoes if the child is entitled to free school meals. This discount is partly subsidised by a government grant.

AA maximises its profits by buying its inventory from overseas. In the past year there have been several press reports about poor working conditions and pay in factories where AA products are manufactured. AA is conscious that it needs to monitor its supplier's employment conditions more closely.

AA has also been criticised in the press for the quality of its products. Some customers have complained that the shoes are not well-made and that they must be regularly replaced. A major consumer magazine has strongly argued that AA products are a 'false economy' and that customers would save money in the long-term if they bought slightly more expensive but better quality shoes.

Staff who work in AA's shops are paid the national minimum wage. Training is minimal and staff turnover is extremely high.

AA does not fully engage with local or national recycling initiatives. The directors of the company believe these initiatives would increase operating costs, thus reducing the affordability of its products for its target demographic.

The success of the AA business model has led to an increased number of competitors. Although these competitors do not yet have the same high street presence as AA, some of them have invested more money into developing online stores. Although AA has a website, its products cannot be purchased online.

Required:

Why would an integrated report provide useful information about AA?

12 Not-for-profit entities

A **not-for-profit entity** is one that does not carry on its activities for the purposes of profit or gain to particular persons and does not distribute its profits or assets to particular persons.

The main types of not-for-profit entity are:

- clubs and societies
- charities
- public sector organisations (including central government, local government and National Health Service bodies).

The objectives of a not-for-profit entity

The main objective of public sector organisations is to provide services to the general public. Their long-term aim is normally to break even, rather than to generate a surplus.

Most public sector organisations aim to provide value for money, which is usually analysed into the three Es – economy, efficiency and effectiveness.

Other not-for-profit entities include charities, clubs and societies whose objective is to carry out the activities for which they were created.

Assessing performance in a not-for-profit entity

It can be difficult to monitor and evaluate the success of a not-for-profit organisation as the focus is not on a resultant profit as with a traditional business entity.

The success of the organisation should be measured against the key indicators that reflect the visions and values of the organisation. The strategic plan will identify the goals and the strategies that the organisation needs to adopt to achieve these goals.

The focus of analysis should be the measures of output, outcomes and their impact on what the charity is trying to achieve.

13 Chapter summary