EFR summary

Corporate Reporting, FEM11115

2025-2026

Weeks 1 to 6

Deloitte.

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EUROSYSTEEM

Details

Subject: Corporate Reporting 2025-2026

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Corporate reporting

Lecture 1

Before making a journal entry, ask yourself if it is a business combination or an acquisition of stand-alone assets and liabilities.

Carrying amount is in the books, fair value is what it is worth and you would sell it for.

Business combination: a transaction or other event in which an acquirer obtains control over one or more businesses. A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities.

• If it's a business we have to apply IFRS 3, if it is not you apply other standards

Control: an investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee (IFRS 10.A) So, key words:

1. Power over the investee (existing rights that give the current ability to direct the relevant activities)
2. Exposure to variable returns
3. Ability to use power to affect those returns

Exercise 14.1

ACCOUNTING BY THE ACQUIRER

★ On 1 July 2016, New Ltd acquired the following assets and liabilities from Day Ltd:

	Carrying amount	Fair value
Land	$300 000	$350 000
Plant (cost $400 000)	280 000	290 000
Inventory	80 000	85 000
Cash	15 000	15 000
Accounts payable	(20 000)	(20 000)
Loans	(80 000)	(80 000)

In exchange for these assets and liabilities, New Ltd issued 100 000 shares that had been issued for $1.20 per share but at 1 July 2016 had a fair value of $6.50 per share.

Required

1. Prepare the journal entries in the records of New Ltd to account for the acquisition of the assets and liabilities of Day Ltd.
2. Prepare the journal entries assuming that the fair value of New Ltd shares was $6 per share.

Exercise 14.1 ⟶

Transaction? → They transfer assets and liabilities, so yes.

Business? → Not clear in this case, let's assume it is an integrated set of activities. Let's test if it has control:

1. Power

• Does New obtain existing rights? → Yes, legal ownership of assets and liabilities
• Does New get the *legal* ability to excessive the right to direct at the time decisions are made? → Yes.
• Does New get the *practical* ability to exc0essive the rights? → Yes.

Can New use the rights to direct the relevant activities?
• Relevant activities: activities of the investee that significantly affect the investee's returns (IFRS 10.A)
• Yes, given the full ownership rights New can direct the activities performed with the acquired assets and liabilities. So, New obtains power over the business of day.

→ Yes, all yes to questions so there is power.

2. Exposure to variable returns

Land	350	
Plant	290	
Inventory	85	
Cash	15	
Accounts payable		20
Loan		80
Share capital (100 * 1.20)		120
Share premium (100 * (6.50-1.20))		530
Goodwill	10	

Purchase consideration		650 (100*$6.50)
Land	350	
Plant	290	
Inventory	85	
Cash	15	
Accounts payable	(20)	
Loans	(80)	
Net assets acquired		640
Goodwill		10

→ Yes, New gets exposed to variable returns from its investment, returns from these assets and liabilities are variable.

3. Ability to use power to affect those returns

→ Yes, New will become able to use power to affect those returns, New will obtain control over the business.

So, assume it is an business combination (transaction, control, business)

Does one of the IFRS 3 exemptions apply?
• Joint arrangement (an arrangement in which two or more parties have joint control)? → No.
• Entities or business under common control (the same ultimate parent)? → Not clear, let's assume no.

So, we can apply **IFRS 3 Business Combinations**

How does it work?
1. Identify acquirer: New ltd.
2. Determine acquisition date: 1 July 2016
3. Recognize and measure assets acquired, liabilities assumed and any non-controlling interest
   • Assets acquired and liabilities assumed:
     – land, plant inventory, cash, accounts payable, loans.
     – Also possible to identify assets/liabilities that were not on the balance sheet, e.g. customer
       relationships, brands

Recognize and measure goodwill or gain from bargain purchase:

Journal entry:

Land	350	
Plant	290	
Inventory	85	
Cash	15	
Accounts payable		20
Loan		80
Share capital (100 * 1.20)		120
Share premium (100 * (6.50-1.20))		530
Goodwill	10	

Question 2: purchase consideration < fair value net assets

Assuming fair value per share of $6.00

Bargain purchase: consideration < fair value net assets recorded as gain in P/L

Journal entry:

Purchase consideration		600 (100*$6.00)
Land	350	
Plant	290	
Inventory	85	
Cash	15	
Accounts payable	(20)	
Loans	(80)	
Net assets acquired		640
Gain on bargain purchase		40

Land	350	
Plant	290	
Inventory	85	
Cash	15	
Accounts payable		20
Loan		80
Share capital (100 * 1.20)		120
Share premium (100 * (6.00-1.20))		480
Gain on bargain purchase (Recorded in P/L)		40

Exercise 14.2

Is this a business combination?

Transaction? → Yes.

Business? → Yes, complete entity activities

Exercise 14.2

ACQUISITION OF SHARES IN ACQUIREE

★ On 1 January 2016, Desert Ltd acquired all the issued shares of Island Ltd. At this date the equity of Island Ltd consisted of:

Share capital — 100 000 shares issued at $5 per share	$500 000
General reserve	200 000
Asset revaluation surplus	100 000
Retained earnings	50 000

In exchange for these shares, Desert Ltd agreed to pay the former shareholders of Island Ltd two shares in Desert Ltd, these having a fair value of $4 per share, plus $1.50 cash for each share held in Island Ltd. The costs of issuing the shares were $800.

Required

Prepare the journal entries in the records of Desert Ltd to record these events.

Let's test if it has control:

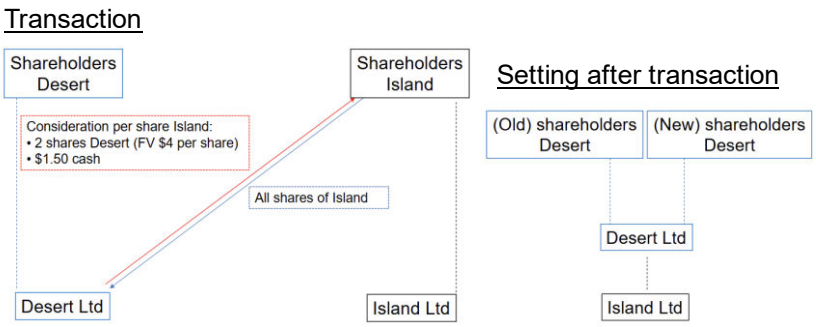
1. Power

• Does Desert obtain existing rights? → Yes, Desert obtains 100% of shares of Island

• Does Desert get the *legal* ability to excessive the right to direct at time decisions are made? → Yes.

• Does Desert get the *practical* ability to excessive the rights? → Yes.

Can New use the rights to direct the relevant activities? → Yes, because Dessert acquires 100% of the shares, Desert can direct the activities performed by Island.



→ Yes, all yes to questions so there is power.

2. Exposure to variable returns

→ Yes, dividends.

3. Ability to use power to affect those returns

→ Yes.

So, it has control. So, assume it is an business combination (transaction, control, business)

Does one of the IFRS 3 exemptions apply?
• Joint arrangement (an arrangement in which two or more parties have joint control)? → No.
• Entities or business under common control (the same ultimate parent)? → Not clear, let's assume no.

So, we can apply **IFRS 3 Business Combinations**

Notes:

Will transaction affect the financial statements of Island? → No, they do not get shares, money etc. No transaction. There is only a transaction between Desert and the shareholders of Island.

Will Desert record the assets acquired and liabilities assumed in its separate financial statements?
→ No, Desert does not become legal owner, they only get the shares. The land and the plant are still in Island Ltd. Desert acquired the shares and will record the shares in its separate financial statements. Desert does not become legal owner of land, liabilities etc. They only get the shares. However, Desert will record the asserts acquired and liabilities assumed in the consolidated financial statements. Hence, in case of a share deal, IFRS 3 is applied in in the consolidated financial statements only.

Is island classified as a subsidiary (an entity that is controlled by another entity)?
→ Yes.

If the investment is classified as a subsidiary, an associate or an interest in a joint arrangement, then the investment is at initial recognition measured at the fair value of the consideration transferred.

Accounting in separate financial statements:

Fair value of the consideration transferred:

Fair value Desert shares transferred:	$100 * 2 * \$4.00$	800
Cash payment:	$100 * \$1.50$	150
Total consideration	950	

Journal entry made by Desert regarding investment:

Investment in subsidiary	950	
Share capital		800
Cash		150

The transaction costs of an equity transaction are accounted for as a deduction from equity to the extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided

Journal entry made by Desert regarding costs of issuing shares

Share capital	0.8	
Cash		0.8

Exercise 14.3

Exercise 14.3

DETERMINING THE FAIR VALUE OF EQUITY ISSUED BY THE ACQUIRER

★ On 1 December 2016, Trout Ltd acquired all the assets and liabilities of Dory Ltd, with Trout Ltd issuing 100 000 shares to acquire them. The fair values of Dory Ltd's assets and liabilities at this date were:

Cash	$ 50 000
Furniture and fittings	20 000
Accounts receivable	5 000
Plant	125 000
Accounts payable	15 000
Current tax liability	8 000
Annual leave payable	2 000

The financial year for Trout Ltd is January to December.

Required

1. Prepare the journal entries for Trout Ltd to record the business combination at 1 December 2016, assuming the fair value of each Trout Ltd share at acquisition date is $1.90. Prepare any note disclosures for Trout Ltd at 31 December 2016 in relation to the business combination.
2. Assume the fair value of each Trout Ltd share at acquisition date is $1.90. At acquisition date, the acquirer could only determine a provisional fair value for the plant. On 1 March 2017, Trout Ltd received the final value from the independent appraisal, the fair value at acquisition date being $131 000. Assuming the plant had a further 5-year life from the acquisition date, explain how Trout Ltd will account for the business combination both at acquisition date and in the financial statements for 2017.
3. Prepare the journal entries for Trout Ltd to record the business combination at 1 December 2016, assuming the fair value of each Trout Ltd share at acquisition date is $1.70.

Is this a business combination? (transaction, business, control)
Transaction? → Yes.
Business? → Yes, assets/liabilities acquired
Let's test if it has control:

1. Power

• Does Trout obtain existing rights? → Yes, legal ownership of assets and liabilities
• Does Trout get the *legal* ability to excessive the right to direct at the time decisions are made? → Yes.
• Does Trout get the *practical* ability to excessive the rights? → Yes.

Can Trout use the rights to direct the relevant activities? → Yes, given the full ownership rights Trout can direct the activities performed with the acquired assets and liabilities.

→ Yes, all yes to questions so there is power.

2. Exposure to variable returns

→ Yes, returns from these assets and liabilities are variable.

3. Ability to use power to affect those returns

→ Yes.

So, it has control. So, assume it is an business combination (transaction, control, business)

Does one of the IFRS 3 exemptions apply?
• Joint arrangement (an arrangement in which two or more parties have joint control)? → No.
• Entities or business under common control (the same ultimate parent)? → Not clear, let's assume no.

So, we can apply **IFRS 3 Business Combinations**

Cash	50	
Furniture	20	
Accounts receivable	5	
Plant	125	
Accounts payable		15
Current tax payable		8
Annual leave payable		2
Share capital		190
Goodwill	15	

Goodwill calculation

Purchase consideration		190 (100*$1.90)
Cash	50	
Furniture	20	
Accounts receivable	5	
Plant	125	
Accounts payable	(15)	
Current tax liability	(8)	
Annual leave payable	(2)	
Net assets acquired		175
Goodwill		15

Purchase accounting
1. Identify acquirer: Trout ltd.
2. Determine acquisition date: 1 December 2016
3. Recognize and measure assets acquired, liabilities assumed and any non-controlling interest
4. Recognize and measure goodwill or gain from bargain purchase:

Journal entry

Assume Trout could only determine a provisional fair value for the plant as at acquisition date of $125. On 1 March 2017, Trout received the final assessment of the fair value as at acquisition date, amounting to $131. Economic life plant as of acquisition date is 5 years.
How to account for the plant on 1 March 2017?

Goodwill calculation based on final fair value

Purchase consideration		170 (100*$1.70)
Cash	50	
Furniture	20	
Accounts receivable	5	
Plant	125	
Accounts payable	(15)	
Current tax liability	(8)	
Annual leave payable	(2)	
Net assets acquired		175
Gain on bargain purchase		5

Journal entry to adjust fair value

Cash	50	
Furniture	20	
Accounts receivable	5	
Plant	125	
Accounts payable		15
Current tax payable		8
Annual leave payable		2
Share capital		170
Gain on bargain purchase (recognized in P/L)		5

Journal entry 2017 of additional depreciation expenses 2016 (acquisition date: 1 December 2016)

- Depreciation expenses booked in 2016 based on provisional value: 1/12 * (125/5) = 2.1
- Depreciation expense based on final fair value: 1/12 * (131/5) = 2.2

Retained earnings	0.1	
Accumulated depreciation plant		0.1

Journal entry additional depreciation expenses Jan-Feb 2017

Booked $2/12 * 125/5$	4.2	
Should have been $2/12 * 131/5$		4.4
Adjustment	0.2	

Depreciation expenses	0.2	
Accumulated depreciation plant		0.2

Now, what if fair value of shares is $1.70 instead of $1.90?

Goodwill calculation

Purchase consideration		190
Cash	50	
Furniture	20	
Accounts receivable	5	
Plant	131	
Accounts payable	(15)	
Current tax liability	(8)	
Annual leave payable	(2)	
Net assets acquired		181
Goodwill		9

Was 125 → increase with 6

Was 15 → decrease with 6

Journal entry

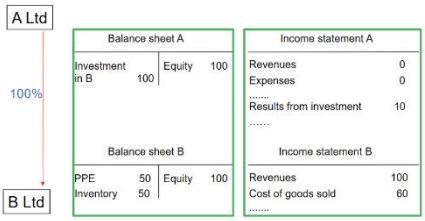
Plant (cost) (131-125)	6	
Goodwill		6

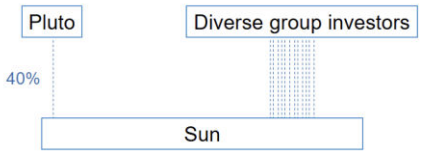
Consolidated financial statements

Example: If you want to invest in A, how do you determine how A is doing?
→ Most important here is how B is doing, because A is holding B.

Consolidation: we take all those entities together and prepare one set of financial statements for all them combined together (full picture).

Example Heineken 2024: "The consolidated financial statements are prepared as a consolidation of the financial statements of the Company and its subsidiaries. Subsidiaries are entities controlled by HEINEKEN. HEINEKEN controls an entity when it has power over the investee, is exposed or has the right to variable returns from its involvement with that entity and has the ability to affect those returns through its power over the entity."





Exercise 20.3 (1)

Diverse group of investors:
- Few attend general shareholder meetings
- Pluto nominated 3 new directors and expects that they will be appointed during the next annual meeting
- Current board has 5 members

Does Pluto control Sun? (power, exposure, ability)

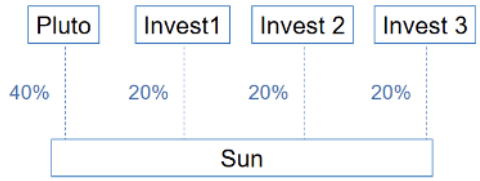
1. Power

- Does Pluto obtain existing rights? → Yes, they have 40% voting rights of ordinary shares
- Does Pluto get the *legal* ability to excessive the right to direct at the time decisions are made? → Yes.
- Does Pluto get the *practical* ability to excessive the rights? → Yes.

Can Pluto use the rights to direct the relevant activities? → Yes, given that other rights are widely dispersed, Pluto has the ability to direct the activities the directors should perform. They have 40%, but if nobody of the other investors show up you can make decisions yourself.

→ Yes, all yes to questions so there is power.

2. Exposure to variable returns



→ Yes, returns from these assets and liabilities are variable.

3. Ability to use power to affect those returns

→ Yes.

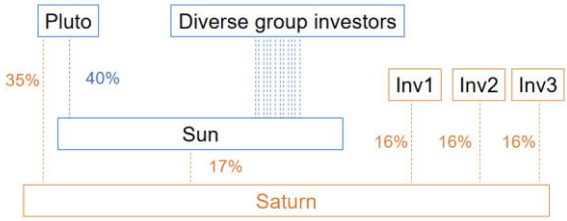
So, Pluto has control over Sun. Hence, Pluto should consolidate Sun.

Exercise 20.3 (2)

Does Pluto control Sun in this setting? (power, exposure, ability)

1. Power

- Does Pluto obtain existing rights? → Yes, they have 40% voting rights of ordinary shares
- Does Pluto get the *legal* ability to excessive the right to direct at the time decisions are made? → Yes.
- Does Pluto get the *practical* ability to excessive the rights? → Yes.



Inv 1, 2, 3:
- Keen interest in running the company
- Attend general shareholder meetings
- One has representative on board of directors

Can Pluto use the rights to direct the relevant activities? → No, investors will not provide Pluto the ability to direct the activities in Pluto's own interest. They have 40%, but there are 3 other shareholders with all 20%, big shareholders are likely to show up. So no power.

→ No power

So, Pluto has no control over Sun. Hence, Pluto should not consolidate Sun

Exercise 20.3 (1) – part 2 ⟶

Does Pluto control Sun in this setting? (power, exposure, ability)

1. Power

• Does Pluto obtain existing rights? → Yes, they have 35% voting rights of ordinary shares, but also 17% indirect voting rights because Pluto can 'dictate' how Sun should vote.
• Does Pluto get the *legal* ability to excessive the right to direct at the time decisions are made? → Yes.
• Does Pluto get the *practical* ability to excessive the rights? → Yes.

Can Pluto use the rights to direct the relevant activities? → Yes, given that Pluto holds (directly 35% and indirectly 17%) more than 50% of the voting rights. Pluto has power over Sun.

Lecture 2: Data Modeling, Relational Databases and Enterprise Systems

Question 1
At 1 June 2018, Company A acquired from Company C 51% of the issued shares of Company B for a total consideration of $100 mln. Company A did not possess any shares in Company B before that date. After this transaction Company A holds 51% and Company C holds 49% of the shares of Company B. Company B is a manufacturing company active in the automobile industry.

As part of the transaction, Company A, Company B and Company C made the following agreements:

- Company C has the right to appoint, reassign or remove key management personnel of Company B;
- Company B needs approval of its business plan and budget from Company C only;
- Company A will receive 51% of the yearly dividend and Company C will receive 49%;
- Company B needs approval from both Company A and Company C for capital expenditures greater than required in the ordinary course of business and for the issue of equity instruments.

Before the transaction, Company A and Company B were not controlled by the same party.

Exercise 4.1

Q: Should Company A apply IFRS 3 "Business Combinations" to account for this event?

Transaction? Yes
Business? Yes, share in an operating manufacturing company. Let's test if it has control:

1. Power

• Does Company A obtain existing rights? → Yes, 51% of the shares.
• Does Company A get the *legal* ability to excessive the right to direct at the time decisions are made? → Yes.
• Does Company A get the *practical* ability to excessive the rights? → Yes.

Can Company A use the rights to direct the relevant activities?
• No, Company A only has protective rights, but they do not have enough to control the relevant activities. Company C has the rights to appoint key management personnel and approve the business plan and budgets. Hence, 51% is not sufficient to direct the relevant activities.

→ So no, company A does not have power

2. Exposure to variable returns

→ Yes, dividends.

3. Ability to use power to affect those returns

→ No, they do not have power.

So, no control, so, no business combination (transaction, control, business)

Does one of the IFRS 3 exemptions apply?
• Joint arrangement (an arrangement in which two or more parties have joint control)? → No.
• Entities or business under common control (the same ultimate parent)? → No.

So, Company A should not apply **IFRS 3 Business Combinations**

Exercise 2.1

Q: Prepare the journal entries regarding this transaction

Journal entry transaction (see next page for goodwill calc)

Cash	50		(cash acquired)
Cash		1500	(purchase consideration)
Land	600		
Accounts receivable	100		
Plant	600		
Customer relationship	200		
Goodwill	510		
Accounts payable		30	
Debt		500	
Contingent liability		30	

Question 1

On 1 November 2016, Prt acquired all assets and liabilities of Sbs for a cash payment of $1,500. In addition, all employees were transferred from Sbs to Prt. The carrying amount and estimated fair value of the assets and liabilities on Sbs's balance sheet were at this date:

	Carrying amount	Fair value
Cash	$50	$50
Land	$400	$600
Accounts receivable	$100	$100
Plant	$300	$600
Accounts payable	$30	$30
Debt	$500	$500

In addition, Sbs has contractual customer relationships with an estimated fair value of $200 and Sbs has a contingent liability relating to a present obligation that arises from past events but that is not recognized in the financial statements of Sbs because it is not probable that an outflow of resources embodying economics benefits will be required to settle the obligation. The fair value of this contingent liability is $30.

The financial year for Prt is January to December. Sbs and Prt did not have the same ultimate parent before the acquisition. The tax rate is 0%. Prt applies straight line depreciation and books its depreciation expenses monthly.

Goodwill calculation

Purchase consideration		1500
Cash	50	
Land	600	
Accounts receivable	100	
Plant	600	
Customer relationship	200	
Accounts payable	(30)	
Debt	(500)	
Contingent liability	(30)	
Net assets acquired		990
Goodwill		510

Notes:

• Regular intangible assets are amortized, for goodwill we do not amortize it under IFRS.

• Recognize contingent liability, if the cash outflow is less than 50%, if it is higher than it's a provision. If you do not include it, than the goodwill will be too low.

• You do not add 'employees' on the balance sheet because you do not control them. Different e.g. for a soccer club.

Provisional fair value

Assume that PRT could only determine a provisional fair value for the plant as at acquisition date of $600. On 1 July 2017, PRT received the final assessment of the fair value as at acquisition date, amounting to $660. Economic life plant as of acquisition date is 10 years. Expected residual value $0.

How to account for the plant on 1 July 2017?

→ Calculate goodwill again. Difference in 'plant', increase with 60 (660-600). Goodwill decreases therefore with 60.

Journal entry

Plant (cost) (660 – 600)	60	
Goodwill		60

Journal entry additional depreciation expenses 2016

• Depreciation expenses booked in 2016 based on provisional value: 2/12 * (600/10) = 10

• Depreciation expenses based on final fair value: 2/12 * (660/10) = 11

Retained earnings	1	
Accumulated depreciation plant		1

(retained earnings is part of equity)

Journal entry additional depreciation expenses Jan- June 2017

Booked

Should have been ~~6/12~~

Adjustment

Depreciation expenses	
Accumulated depreciation plant	3

Exercise 21.4

Exercise 21.4

BUSINESS COMBINATION VALUATION AND PRE-ACQUISITION ENTRIES

★ On 1 July 2013, Pyxis Ltd acquired all the share capital of Gemini Ltd for £218 500. At this date, Gemini Ltd's equity comprised:

Share capital — 100 000 shares	£100 000
General reserve	50 000
Retained earnings	36 000

All identifiable assets and liabilities of Gemini Ltd were recorded at fair value as at 1 July 2013 except for the following:

	Carrying amount	Fair value
Inventory	£27 000	£35 000
Land	75 000	90 000
Equipment (cost £100 000)	50 000	60 000

The equipment is expected to have a further 10-year life. All the inventory was sold by June 2014. The tax rate is 30%.

On 30 June 2014, the directors of Gemini Ltd decided to transfer £25 000 from the general reserve to retained earnings.

Required

Prepare the consolidation worksheet entries for the preparation of consolidated financial statements for Pyxis Ltd and its subsidiary Gemini Ltd as at:

1. 1 July 2013
2. 30 June 2014.

Fair value assets acquired		
Inventory	35	
Land	90	
Equipment	60	
Cash	48	
Total fair value assets acquired		233
Fair value liabilities assumed		
Debt	14	
Total fair value liabilities assumed		14-
Fair value net assets acquired		219

Step 1: Fair value net assets acquired adjustment

Yearly revenue	200
Expenses other than depreciation expenses	0
Carrying amount equipment just before transaction	100
Fair value equipment at acquisition date	200
Remaining useful life	2 years
Expected residual value	0

Depreciation expenses in consolidated financial statements after acquisition (based on fair value) (200 – 0) / 2 = 100

In most countries tax authorities do not accept fair value adjustments recognized in acquisitions in which shares are acquired

Depreciation expenses tax authorities use to calculate the required tax payments (based on carrying amount) (100 – 0) / 2 = 50

Step 2: Tax impact fair value

Note: Tax authorities do not accept fair value as a basis for depreciation because fair value is higher than the carrying amount, so therefore depreciation expenses would be higher, so lower profit before tax, so lower tax payable. Tax payment you continue with the old carrying amount.

Required tax payment year 1 and 2

Revenues	200
Depreciation expenses according to tax authorities (based on carrying amount before acquisition)	50-
Profit before tax	150
Required tax payment (30%)	45

How does P/L look like if required tax payment is used as tax expenses?

Revenues	200
Depreciation expenses in consolidated FS (based on fair value)	100-
Profit before tax	100
Tax expenses (assume equal to tax payment)	45-
Net income	55

45%

Taxes as % of profit before tax: 45 / 100 = 45%
However, tax rate is 30%
In accounting we prefer to show tax expenses based on tax rate (30%)

value adjustment

In accounting we prefer to show tax expenses based on tax rate
Solution: make adjustment to tax amount presented

Revenues		200
Depreciation expenses (based on fair value)		100-
Profit before tax		100
Tax payment	45-	
Deferred tax adjustment	15	
Tax expenses		30-
Net income		70

30%

Journal entry year 1 & 2

Deferred tax liability (BS)	15	
Deferred tax adjustment (IS)		15

This journal entry can only be made if a deferred tax liability is booked at time of acquisition

Continuation step 2: Tax impact fair

BS before acquisition

Equipment	100	....	
....			

BS after acquisition for consolidation

Equipment	200	....	
....		DTL	30

BS year 1 for consolidation

Equipment	200	....	
Acc deprec	-100	DTL	15
	100		

Deferred tax liability (BS)	15	
Deferred tax adjustment (IS)		15

P/L year 1 for consolidation purposes

Revenues	200
Depreciation expenses (based on FV)	100-
Profit before tax	100
Tax payment	45-
Deferred tax adjustment	15
Tax expenses	30-
Net income	70

30%

BS year 2 for consolidation

Equipment	200	....	
Acc deprec	-200	DTL	0
	0		

Deferred tax liability (BS)	15	
Deferred tax adjustment (IS)		15

P/L year 2 for consolidation purposes

Revenues	200
Depreciation expenses (based on FV)	100-
Profit before tax	100
Tax payment	45-
Deferred tax adjustment	15
Tax expenses	30-
Net income	70

30%

Amount of the deferred tax liabilities at time of acquisition: Summarized:

Approach 1
Year 1: 15 = Δ depreciation expenses (100-50) * 30% = 15
Year 2: 15 = Δ depreciation expenses (100-50) * 30% = 15
Total: 30

Approach 2
Fair value adjustment * tax rate: (200-100) * 30% = 30

Continuation exercise 21.4

Step 2: Tax impact fair value adjustment

Tax impact fair value adjustments (tax rate 30%)		
Inventory (FA adjustment: 35-27=8)		2.4
Land (FA adjustment: 90-75=15)	4.5	
Equipment (FA adjustment: 60-50=10)		4
Total tax impact (deferred tax liability to be created):		9.9

Step 3: Fair value net assets acquired including tax impact

Fair value net assets acquired		219
Tax impact fair value adjustments (liability)		9.9-
Fair value net assets acquired including tax impact		209.1

Step 4: Value investment

Consideration transferred to acquire shares		218.5
Fair value of previous held equity interests	0	
Value non-controlling interest		0
Total value investment		218.5

Step 5: Goodwill

Total value investment		218.5
Fair value net assets acquired (including tax impact)		209.1-
Goodwill	9.4	

Step 6: Prepare consolidated balance sheet

	BS Pyxis		BS Gemini		Adjustments		Consolidated BS	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
Assets								
Inventory			27.0		8.0		35.0	
Land			75.0		15.0		90.0	
Equipment			100.0			40.0	60.0	
Accum depr.				50.0	50.0			0.0
Cash	181.5		48.0				229.5	
Goodwill					9.4		9.4	
Investment	218.5					218.5		
Liabilities								
Debt		200.0		14.0				214.0
Def tax liab						2.4		9.9
						4.5		
						3.0		
						9.9		
Equity								
Share capital		200.0		100.0	100.0			200.0
General res.				50.0	50.0			
Retained earn.				36.0	36.0			
BC valuation reserve					32.5	5.6		
						10.5		
						7.0		
						9.4		
						32.5		

In journal entry format

XXXXX Business combination valuation entries

X Pre-acquisition entries

These are the net amounts of the FA adjustment – the deferred tax liability (see step 2)

Business combination valuation entries

Inventory (35-27)	Dr	8	
Deferred tax liability (35-27)*30%	Cr		2.4
Business combination valuation reserve (8-2.4)	Cr		5.6
Land (90-75)	Dr	15	
Deferred tax liability (90-75)*30%	Cr		4.5
Business combination valuation reserve (15-4.5)	Cr		10.5
Accumulated depreciation – equipment *(remove amount)*	Dr	50	
Equipment (100 cost – 40 adjustment = 60 fair value)	Cr		40
Deferred tax liability (60-50)*30%	Cr		3
Business combination valuation reserve (50-40-3)	Cr		7
Goodwill	Dr	9.4	
Business combination valuation reserve	Cr		9.4

Pre-acquisition entries

Share capital	Dr	100	
General reserve	Dr	50	
Retained earnings	Dr	36	
Business combination valuation reserve	Dr	32.5	
Investment	Cr		218.5

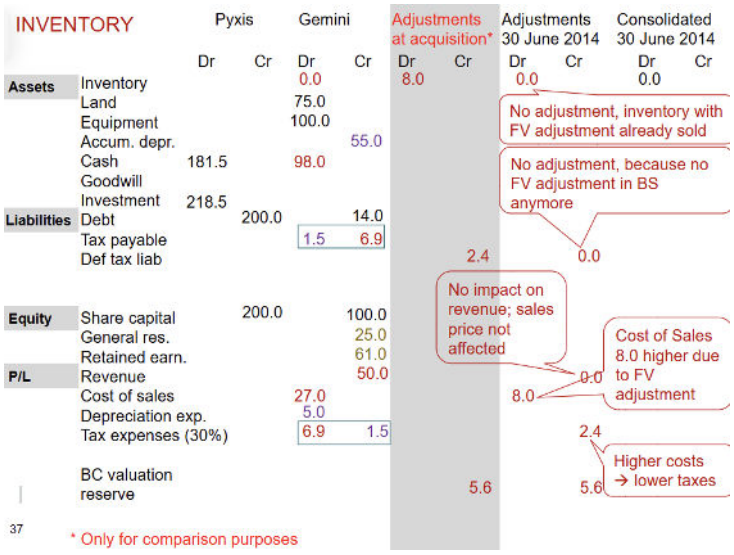
Exercise 21.4 (2): Balance sheet one year after acquisition

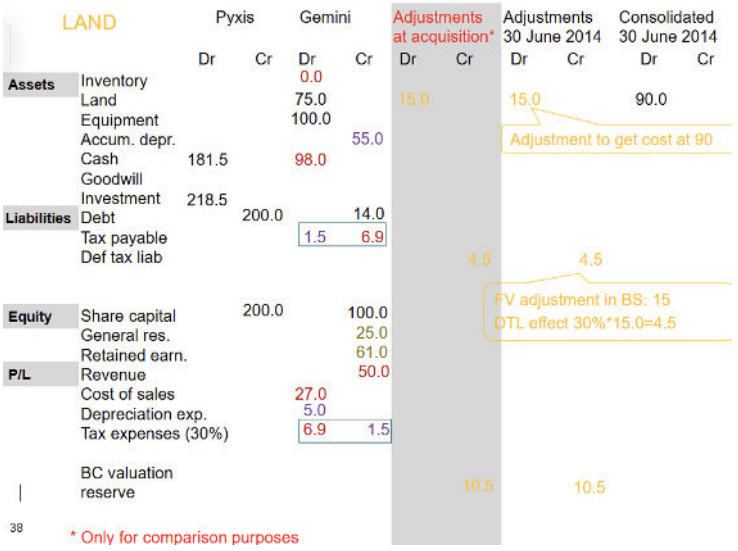
All inventory is sold. Additional assumptions:

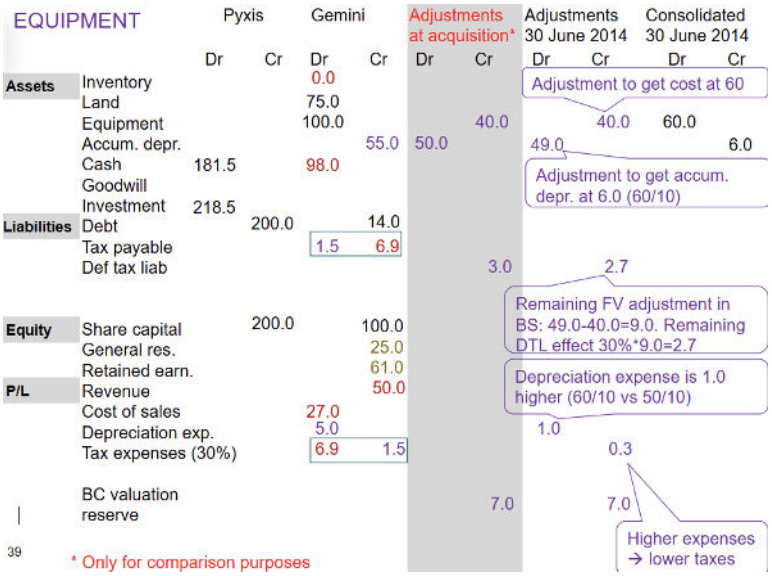
- Revenue: 50.0
- Amount received in cash
- No new inventory purchased

Equipment is depreciated based on remaining useful life of 10 years

Directors of Gemini transferred 25.0 from general reserve to retained earnings





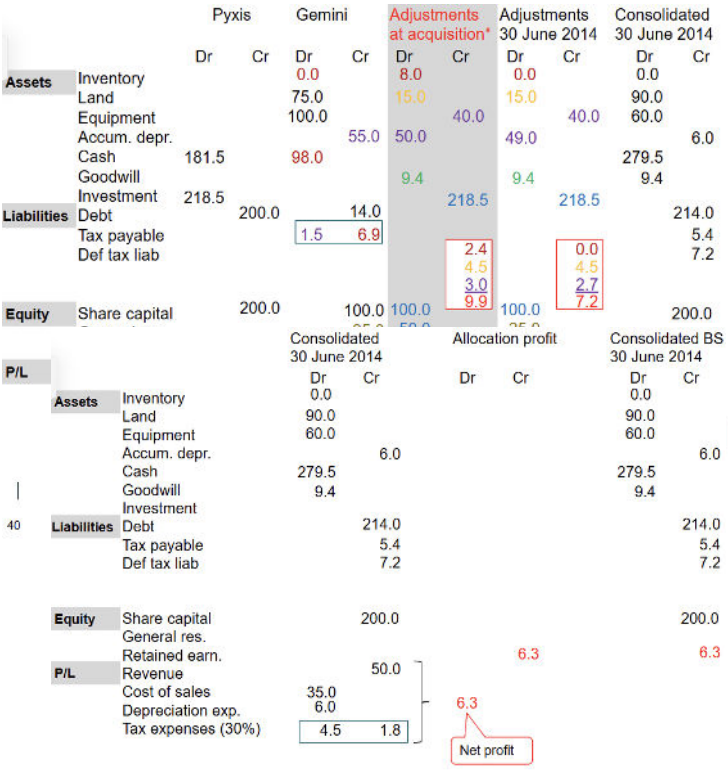


Additional assumption: no other transactions took place

Increase cash Gemini: 50.0 due to sale inventory and no cash outflows

Inventory + land + equipment:

The amount of the P&L (profit loss) should be transferred to equity, than we have stand alone balance sheet.:



Journal entries:

Business combination valuation entries				
Cost of sales	Dr	8		
Income tax expense	Cr		2.4	
Business combination valuation reserve (8-2.4)	Cr		5.6	
Land (90-75)	Dr	15		
Deferred tax liability (90-75)*30%	Cr		4.5	
Business combination valuation reserve (15-4.5)	Cr		10.5	
Accumulated depreciation – equipment	Dr	49		
Equipment	Cr		40	
Deferred tax liability	Cr		2.7	
Depreciation expense	Dr	1		
Income tax expense	Cr		0.3	
Business combination valuation reserve	Cr		7	
Goodwill	Dr	9.4		
Business combination valuation reserve	Cr		9.4	

Pre-acquisition entries				
Share capital	Dr	100		
General reserve	Dr	50		
Retained earnings	Dr	32.5		
Business combination valuation reserve	Cr		182.5	
Investment	Dr	218.5		
Retained earnings	Cr		193.5	
General reserve	Cr		25	

Trial exam 3.4 (a):

Question 4

At 1 January 2016, company PXV acquired all the shares of company SXV. At that date the carrying amount of the inventory of SXV was $100 while the fair value of the inventory amounted to $200. Half of the inventory of SXV was sold in 2016 for a total amount of $300. The remaining items were sold during 2017 for $400. The tax rate is 30%.

a. With respect to the inventory, which adjustments should PXV make to the amounts in the separate financial statements of SXV to prepare the consolidated financial statements as at 31 December 2016? The answer should include the amount of each account affected and whether it is an increase or decline of the amount. You are not required to show your calculations.

Impact fair value adjustment inventory one year after acquisition date

- PXV acquired all shares of SXV at 1 January 2016
- Value inventory at acquisition date:
  - Carrying amount: 100
  - Fair value: 200
- Half inventory sold in 2016 for 300
- Tax rate 30%

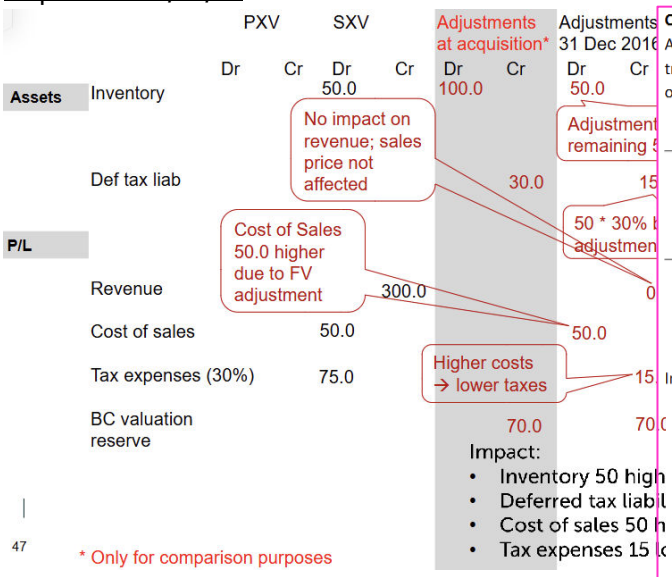
Question: impact fair value adjustment on consolidated financial statements at 31 December 2016?

	BS PXV		BS SXV		Adjustments		Consolidated BS	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
Assets								
Inventory			100.0		100.0		200.0	
Liabilities								
Def tax liab						30.0		30.0
BC valuation reserve						70.0		

<u>Impact at acquisition date</u>: Inventory carrying amount was 100, the fair value is 200, so at the consolidated we want to see 200. So we need to make 100 debit adjustment.

There is an fair value adjustment, so we need an deferred tax effect of 30%. The remaining goes to the reserve.

Impact at 31/12/16:



Question 2

At 1 October 2017, Company P acquired 100% of the shares of Company S for $500,000. Before the transaction, Company P and Company S were not controlled by the same party. The balance sheets of Company P and Company S as at 1 October 2017 (just before the acquisition) were:

Assets	**Balance Sheet Company P - 1 October 2017**	Equity & Liabilities	
Cash	600,000	Share capital	500,000
		Retained earnings	100,000
Total	*600,000*	*Total*	*600,000*

Assets	**Balance Sheet Company S - 1 October 2017**	Equity & Liabilities	
Cash	50,000	Share capital	100,000
Inventory	50,000	Retained earnings	100,000
Plant	200,000	Debt	100,000
Total	*300,000*	*Total*	*300,000*

In addition, the following is known about Company S as at 1 October 2017:

- The fair value of the customer contracts amounts to $50,000.
- There is an unrecorded internally generated brand. The costs to develop the brand are estimated at $10,000. The fair value of the brand is estimated at $20,000.
- The fair value of the inventory is $60,000.
- The fair value of the plant is $300,000. The plant was originally acquired for $400,000.
- The fair value of the debt is $90,000.
- There is a contingent liability, but Company S did not recognize this contingent liability because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation. The fair value of the contingent liability is $20,000.

The tax rate is 30%. Company P applies straight line depreciation and books its depreciation expenses monthly.

At the end of the year half of the inventory is there, it was 100, so 50. Half of the inventory was sold, they got 300. The cost of sales was 50% of 100, so 50. Tax expense is 300-50 x 30%.

At the consolidated:
Fair value inventory is 200, 50% is left, so that's 100. So need adjustment of 50. Inventory 200, 50% is sold, so COS is 100, so we need an adjustment of 50. We have adjustment in tax, 2 x 15 = 30.

Fair value adjustment does not affect the sales
Inventory is sold, we include the fair value impact, sold 200 * 50% = 100, so adjustment of 50
Tax expenses adjustment of 15, because higher costs corresponds to lower taxes

Lecture 3

Trial Exam 4.2

The transaction is between P and the shareholders of S, S itself is not involved so it stays the same.

Question: Prepare consolidated balance sheet right after transaction

Step 1: Fair value net assets acquired

Cash	50
Inventory	60
Plant	300

Brand	20	
Customer contacts	50	
Total fair value assets acquired:		480
Debt	90 -	
Contingent liability	20 -	
Fair value net assets acquired		370

Step 2 Tax impact fair value adjustments

Fair value adjustment → higher carrying amount → higher expenses in consolidated financial statements (FS) → lower profit before tax

Tax authorities often do not accept fair value adjustment for calculation tax payment → profit before tax for consolidated FS is lower than for tax purposes → tax payment is higher than 'profit before tax in FS x tax rate'

Solution in future FS: journal entry:

Deferred tax liability (BS)	XXX	
Deferred tax adjustment (P/L)		XXX

At acquisition date: create deferred tax liability: 'fair value adjustment x tax rate'

Tax impact fair value adjustments (tax rate 30%)

• Inventory (FA adjustment: 10 (increase asset))	3
• Plant (FA adjustment: 100 (increase asset))	30
• Brand (FA adjustment: 20 (increase asset))	6
• Customer contracts (FA adjustment: 50 (increase asset))	15
• Contingent liability (FA adjustment: 20 (increase liability))	- 6
• Debt (FA adjustment:10 (decrease liability))	3
• Total tax impact (deferred tax liability to be created)	51

Note: Because consolidated uses fair value, you get a lower profit than the profit used for tax. It means that you get a mismatch. Because you pay a lot of taxes compared to profit, using fair value. You solve it by creating a DTL at the moment of acquisition, and then later on you release the DTL in the P&L. That means that we have a benefit in the P&L, that compensate for the relatively high payment.

Due to contigent liability, next year commercial purposes you have lower expenses than for tax purposes. An increase in an asset leads to a DTL, increase in liability results in a DTA

Step 3 Fair value net assets acquired including tax impact

Fair value net assets acquired	370
Tax impact fair value adjustments (liability)	51-
Fair value net assets acquired including tax impact	319

Step 4 Value investment

Consideration transferred to acquire shares		500
Fair value of previous held equity interests	0	
Value non-controlling interest		0
Total value investment		500

Step 5 Goodwill

Value investment	500	
Fair value net assets acquired (including tax impact)		319-
Goodwill	181	

Step 6 Prepare consolidated balance sheet

	BS P Dr	BS P Cr	BS S Dr	BS S Cr	Adjustments Dr	Adjustments Cr	Consolidated BS Dr	Consolidated BS Cr
Assets								
Cash	100		50				150	
Inventory			50		10		60	
Plant			400			100	300	
Accum depr.				200	200			0
Brand					20		20	
Customer contract					50		50	
Goodwill					181		181	
Investment	500					500		
Liabilities								
Debt				100	10			90
Contingent liability						20		20
Def tax liab					6	3		51
						30		
						6		
Equity						15		
Share capital		500		100	100	3		500
Retained earn.		100		100	100			100
BC valuation reserve					300	7		
					14	70		
						14		
						35		
						181		
						7		

XXXXXX Business combination valuation entries

X Pre-acquisition entries

These are the net amounts of the FA adjustment – the deferred tax liability (see step 2)

Q4.2(d): Assume now that the plant value of $300 is a provisional fair value. On 29 June 2018, Company P received the final value from the independent appraisal. The final fair value at acquisition date was $250. The plant had a further 5-year economic useful life from the acquisition date onwards. The residual value after 5 years is expected to be $100. What is the carrying amount of the plant in the consolidated interim financial statements as at 30 June 2018?

Provisional fair value: It takes a while to determine all the fair values, so then you are allowed to make an estimate (provisional) fair values.

- Provisional fair value 300
- Final fair value 250

If final value is known within one year after acquisition date, numbers are adjusted as if final fair value was known at acquisition date → goodwill also changes.

Carrying amount 30/6 based on fair value 250:

Fair value	250	
Depreciation 9/12 * ((250-100)/5)	22.5 -	(9 months of depreciation expenses, oct-jun)
Carrying amount	227.5	

These 9 months of depreciation expenses adjusted in:

- Previous year -> retained earnings
- This year P/L0

Exercise 21.6 (1)

Assumption: tax effects regarding change in value of initial investment of 20% can be ignored

Exercise 21.6

PARENT HOLDS PREVIOUSLY ACQUIRED INVESTMENT, CONSOLIDATION WORKSHEET

★★ On 1 December 2009, Reticulum Ltd acquired 20% of the shares of Dorado Ltd for £10 000. These were classified as a financial investment by Reticulum Ltd with changes in fair value being recognised in other comprehensive income. At 30 June 2013, these were recorded at a fair value of £20 400. Reticulum Ltd acquired the remaining 80% of the share capital of Dorado Ltd for £81 600 on 1 July 2013 when the equity of Dorado Ltd consisted of:

Share capital — 50 000 shares	£50 000
Retained earnings	30 000

All identifiable assets and liabilities of Dorado Ltd were recorded at amounts equal to fair value, except as follows:

	Carrying amount	Fair value
Inventory	£20 000	£25 000
Plant (cost £80 000)	60 000	70 000

The plant is expected to have a further useful life of 5 years. All the inventory on hand at 1 July 2013 was sold by 31 December 2013.

The income tax rate is 30%.

At 30 June 2015, the information below was obtained from both entities.

Required

1. Prepare the consolidation worksheet entries for the preparation of consolidated financial statements for Reticulum Ltd and its subsidiary, Dorado Ltd, as at 1 July 2013.

Transaction related journal entries

1. Recognize previously held equity interest at fair value & gain/loss in P/L if applicable
Investment already recognized at FV, however gain/loss not yet recorded in P/L

Financial asset reserve	10.4	
Finance income		10.4

2. Purchase additional shares Dorado

Investment	81.6	
Cash		81.6

1. Before transaction
(Separate) balance sheet Reticulum

Cash	179.6	Share cap.	50
Investment	20.4	Retained earnings	50
		Financial asset reserve	10.4
		Debt	89.6
Total	*200*	*Total*	*200*

3. After transaction
(Separate) balance sheet Reticulum

Cash	98	Share cap.	50
Investment	102	Retained earnings	50
		Earnings of the year	10.4
		Debt	89.6
Total	*200*	*Total*	*200*

(Separate) balance sheet Dorado

Inventory	20	Share capital	50
Plant	80	Retained earnings	30
Accum. depr	-20	Debt*	20
Cash*	20		
Total	*100*	*Total*	*100*

Step 1 Fair value net assets acquired

Fair value assets acquired		
Inventory	25	
Plant	70	
Cash	20	
Brands		5
Total fair value assets acquired:		120
Fair value liabilities assumed		
Debt	20	
Total fair value liabilities assumed:		20 -
Fair value net assets acquired:		100

Step 2 Tax impact fair value adjustments

Tax impact fair value adjustments (tax rate 30%)	
Inventory (FA adjustment 5):	1.5
Plant (FA adjustment 10):	3.0
Brands (FA adjustment 5):	1.5
	6.0

Step 3 Fair value net assets acquired including tax impact

Fair value net assets acquired: 100

Tax impact fair value adjustments: ~~6~~

Fair value net assets acquired including tax impact: 94

Step 4 Value investment

	BS Reticulum		BS Dorado		Adjustments		Consolidated BS	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
Assets								
Inventory			20.0		5.0		25.0	
Brand					5.0		5.0	
Plant			80.0			10.0	70.0	
Accum depr.				20.0	20.0			0.0
Cash	98.0		20.0				118.0	
Goodwill					8.0		8.0	
Investment	102.0					102.0		
Liabilities								
Debt		89.6		20.0				109.6
Def tax liab						1.5		6.0
						1.5		
						3.0		
						6.0		
Equity								
Share capital		50.0		50.0	50.0			50.0
Retained earn.		60.4		30.0	30.0			60.4
BC valuation reserve					22.0	3.5		
						3.5		
						7.0		
						8.0		
						22.0		
		102.0						

Including 10.4 earnings of the year

XXXXX Business combination valuation entries

X Pre-acquisition entries

Consideration transferred to acquire shares:

81.6

Fair value of previous held equity interests:

20.4

Value non-controlling interest:

0.0

Total fair value investment:

102.0

Step 5 Goodwill

Total value investment:

102.0

Fair value net assets acquired (including tax impact): 94.0 -

Goodwill: 8.0

Step 6 Consolidated balance sheet

In journal entry format

Exercise 21.6 (2)

Q2. Prepare the consolidation worksheet entries and the consolidation worksheet for the preparation of consolidatedfinancial statements for Reticulum Ltd and its subsidiary, Dorado Ltd, as at 30 June 2015.

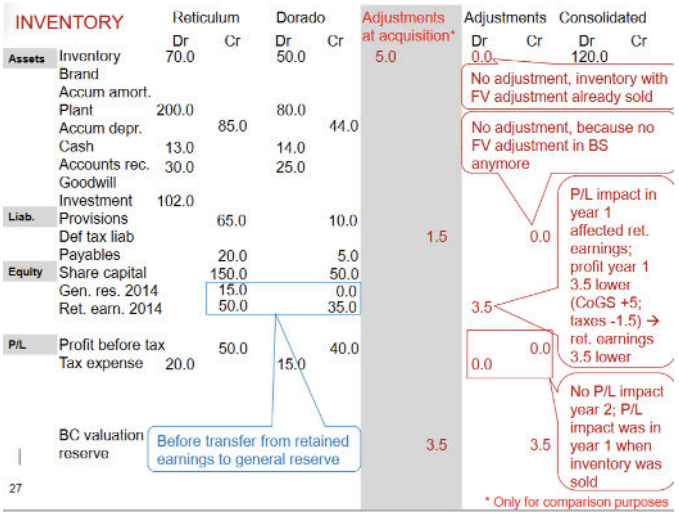
Business combination valuation entries			
Inventory(25-20)	Dr	5	
Deferred tax liability (25-20)*30%	Cr		1.5
Business combination valuation reserve (5-1.5)	Cr		3.5
Brand (5-0)	Dr	5	
Deferred tax liability (5-0)*30%	Cr		1.5
Business combination valuation reserve (5-1.5)	Cr		3.5
Accumulated depreciation – plant *(remove amount)*	Dr	20	
Plant (80-70)	Cr		10
Deferred tax liability (70-60)*30%	Cr		3
Business combination valuation reserve (20-10-3)	Cr		7
Goodwill	Dr	8.0	
Business combination valuation reserve	Cr		8.0
Pre-acquisition entries			
Share capital	Dr	50	
Retained earnings	Dr	30	
Business combination valuation reserve	Dr	22	
Investment	Cr		102

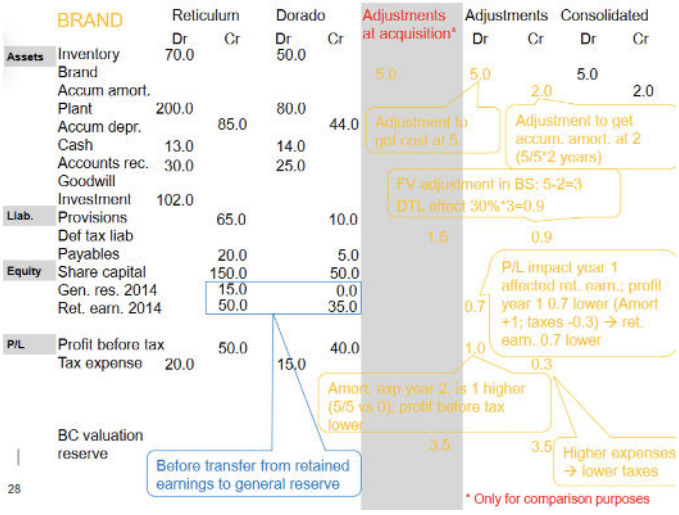
For the year ending 30 June 2015	Reticulum Ltd	Dorado Ltd
Profit before tax	£ 50 000	£ 40 000
Income tax expense	(20 000)	(15 000)
Profit	30 000	25 000
Retained earnings (1/7/14)	50 000	35 000
	80 000	60 000
Transfer to general reserve (approved by parent)	(20 000)	(5 000)
Retained earnings (30/6/15)	£ 60 000	£ 55 000

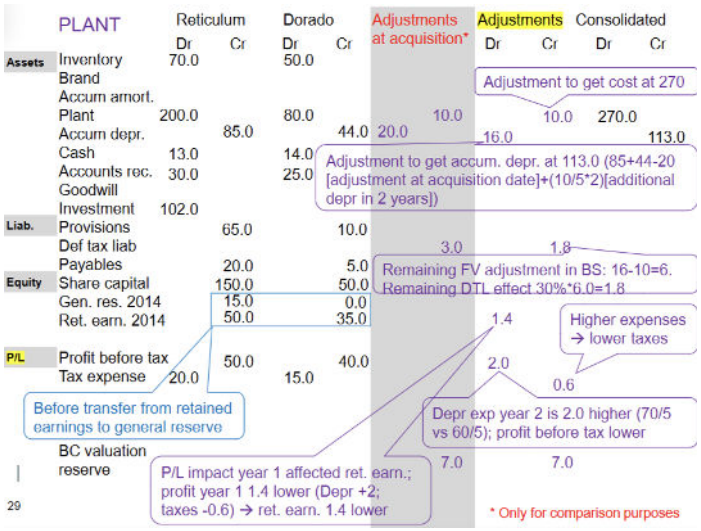
Statement of Financial Position 30 June 2015		
Cash	£ 13 000	£ 14 000
Accounts receivable	30 000	25 000
Inventory	70 000	50 000
Investment in Dorado Ltd	102 000	—
Plant	200 000	80 000
Accumulated depreciation	(85 000)	(44 000)
Total assets	£330 000	£125 000
Provisions	65 000	10 000
Payables	20 000	5 000
Total liabilities	£ 85 000	£ 15 000
Share capital	150 000	50 000
General reserve	35 000	5 000
Retained earnings	60 000	55 000
Total equity	245 000	110 000
Total liabilities and equity	£330 000	£125 000

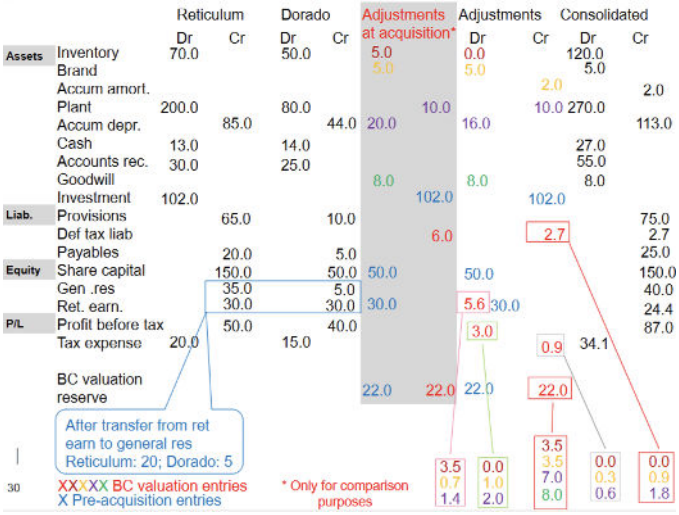
Balance sheet two years after acquisition

- All inventory is sold in 2013
- Brand is amortized in 5 years
- Plant is depreciated based on remaining useful life of 5 years

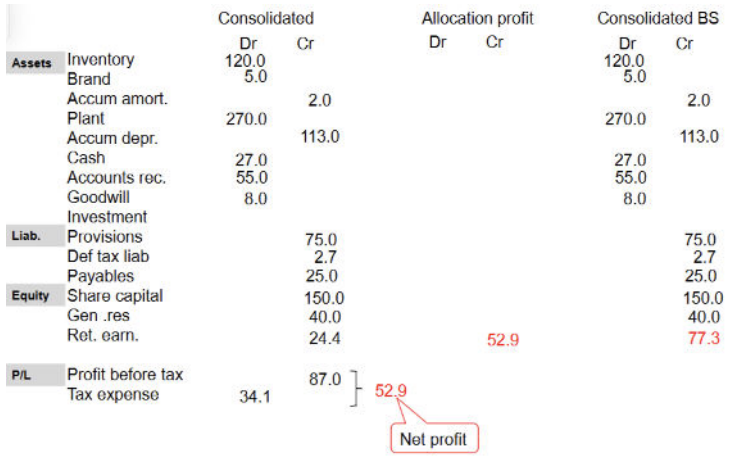








Balance sheet



Consolidation table (full)

Consolidated BS (summary + allocation profit)

In journal entry format

Business combination valuation entries			
Retained earnings (5 x 0.70)	Dr	3.5	
Business combination valuation reserve	Cr		3.5
Brand	Dr	5.0	
Accumulated amortization - brand	Cr		2.0
Deferred tax liability	Cr		0.9
Profit before tax	Dr	1.0	
Tax expenses	Cr		0.3
Retained earnings	Dr	0.7	
Business combination valuation reserve	Cr		3.5
Plant	Cr		10
Accumulated depreciation – plant	Dr	16	
Deferred tax liability	Cr		1.8
Depreciation expense	Dr	2	
Income tax expense	Cr		0.6
Retained earnings	Dr	1.4	
Business combination valuation reserve	Cr		7
Goodwill	Dr	8.0	
Business combination valuation reserve	Cr		8.0

Pre-acquisition entries			
Share capital	Dr	50	
Retained earnings	Dr	30	
Business combination valuation reserve	Dr	22	
Investment	Cr		102

Exercise 22.2

Description (Mia & Molly)
Note: For (a)–(e) assume that period is 1 January 2016 to 31 December 2016 instead of 1 January 2015 to 31 December 2016 as mentioned in exercise.

Exercise 22.2

ELIMINATION OF INVESTMENT IN SUBSIDIARY AND INTRAGROUP TRANSACTIONS, NO FAIR VALUE — CARRYING AMOUNT DIFFERENCES AT ACQUISITION DATE

★★ On 1 January 2013, Molly Ltd acquired all the share capital of Mia Ltd for $300 000. The equity of Mia Ltd at 1 January 2013 was:

Share capital	$200 000
Retained earnings	50 000
General reserve	20 000
	$270 000

At this date, all identifiable assets and liabilities of Mia Ltd were recorded at fair value. Goodwill is tested annually for impairment. By 31 December 2016, no impairment has occurred. At 1 January 2013, no goodwill had been recorded by Mia Ltd.

On 1 May 2016, Mia Ltd transferred $15 000 from the general reserve (pre-acquisition) to retained earnings. The current tax rate is 30%. Assuming consolidated financial statements are required for the period 1 January 2015 to 31 December 2016, provide journal entries (including the elimination of investment in subsidiary) to show the adjustments that would be made in the consolidation worksheets. Use the following information:

a. At 31 December 2016, Mia Ltd holds $100 000 of 7% debentures issued by Molly Ltd on 1 January 2015. All necessary interest payments have been made.

b. At the end of the reporting period, Mia Ltd owes Molly Ltd $1000 for items sold on credit.

c. Mia Ltd undertook an advertising campaign for Molly Ltd during the year. Molly Ltd paid $8000 to Mia Ltd for this service.

d. The beginning and ending inventories of Molly Ltd and Mia Ltd in relation to the current period included the following unsold intragroup inventory:

	Molly		Mia		Adjustments		Consolidated	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
Assets								
Debentures			100			100	0	
Deferred tax asset	2.1						2.1	
.....								
Liabilities								
Debentures		100			100			0
Deferred tax liability								
Tax payable				2.1				2.1
.....								
Equity								
P&L								
Interest expenses	7.0					7.0	0.0	
Interest income				7.0	7.0			0.0
Tax expense		2.1	2.1				0.0	
							Net income: 0.0	

Assumption: in future there will be sufficient taxable profits to apply a tax loss carry forward and book "positive" tax expenses and a deferred tax asset.

	Molly		Mia		Adjustments		Consolidated	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
Assets								
Accounts receivable	1					1	0	
.....								
Liabilities								
Accounts payable				1	1			0
.....								
Equity								
P&L								
Interest expenses								
Interest income								
Tax expense								

a. Intragroup borrowing

b. Accounts receivable / payable

Assumption: in future there will be sufficient taxable profits to apply a tax loss carry forward and book "positive" tax expenses and a deferred tax asset.

c. Advertising campaign

	Molly		Mia		Adjustments		Consolidated	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
Assets								
Deferred tax asset	2.4						2.4	
.....								
Liabilities								
Deferred tax liability								
Tax payable				2.4				2.4
.....								
Equity								
P&L								
Revenue				8.0	8.0			0.0
Advertising expenses	8.0					8.0	0.0	
Tax expense		2.4	2.4				0.0	
							Net income: 0.0	

d. Intragroup inventory (overview)

1. Molly sold to Mia in current period (transfer price 3; original cost 2.5); Mia has part of the items in inventory

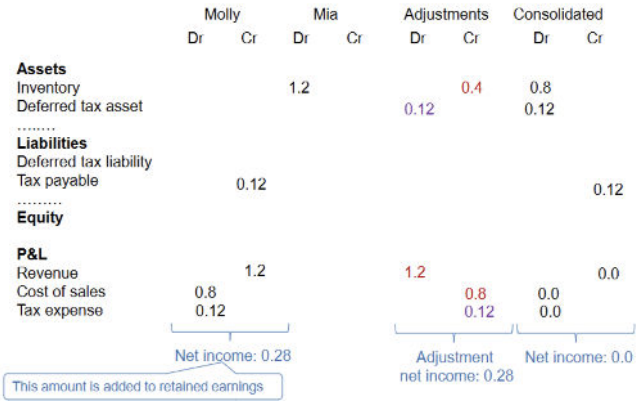
	Molly		Mia		Adjustments		Consolidated	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
Assets								
Inventory			0.9			0.2	0.7	
Deferred tax asset					0.06		0.06	
.....								
Liabilities								
Deferred tax liability								
Tax payable		0.15		0.57				0.72
.....								
Equity								
P&L								
Revenue		3.0		4.0	3.0			4.0
Cost of sales	2.5		2.1			2.8	1.8	
Tax expense	0.15		0.57			0.06	0.66	
	Net income: 0.35		Net income: 1.33		Adjustment net income: 0.14		Net income: 1.54	

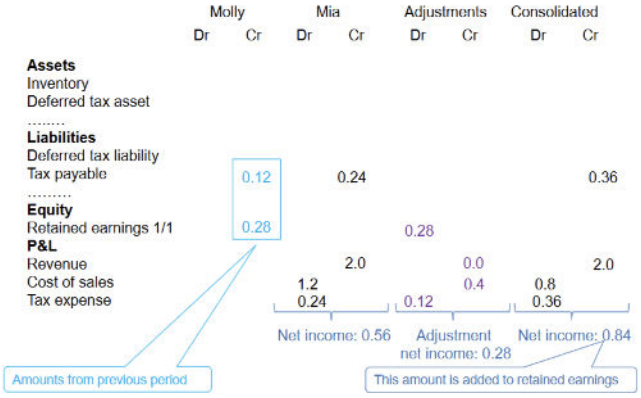
at end (transfer price 0.9; original cost 0.7);
Hence, Mia sold part of the items to a third party which Mia bought for 2.1 (3.0-0.9)
Molly bought these originally from a third party for 1.8 (2.5-0.7)
Assume: Mia sold items for 4.0 (this assumption does not affect outcome)

2. Mia sold to Molly in current period (transfer price 2.5; original cost 1.7);
Molly has part of the items in inventory at end (transfer price 0.5; original cost 0.3);
Hence, Molly sold part of the items to a third party which Molly bought for 2.0 (2.5-0.5)
Mia bought these originally from a third party for 1.4 (1.7-0.3)

	Molly		Mia		Adjustments		Consolidated	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
Assets								
Inventory	0.5					0.2	0.3	
Deferred tax asset					0.06		0.06	
.....								
Liabilities								
Deferred tax liability								
Tax payable		0.9		0.24				1.14
.....								
Equity								
P&L								
Revenue		5.0		2.5	2.5			5.0
Cost of sales	2.0		1.7			2.3	1.4	
Tax expense	0.9		0.24			0.06	1.08	
	Net income: 2.1		Net income: 0.56		Adjustment net income: 0.14		Net income: 2.52	

Assume: Molly sold items for 5.0 (this assumption does not affect outcome)





3. Molly sold to Mia in previous period (transfer price 1.2; original cost 0.8);
Mia sold all items in current period.
Assume: Mia sold items for 2.0 (this assumption does not affect outcome)

Financial statements previous year Financial statements current year

4. Mia sold to Molly in previous period (transfer price 2.0; original cost 1.4);
Molly sold all items in current period.
Assume: Molly sold items for 3.0 (this assumption does not affect outcome)

Financial statements previous year

Additional: intragroup sale of equipment previously regarded as inventory:

On 1 July 2016, Molly Ltd sold an item of machinery to Mia Ltd for $6000. This item had cost Molly Ltd $4000. Molly Ltd regarded this item as inventory whereas Mia Ltd intends to use it as a non-current asset. Mia Ltd charges depreciation at the rate of 10% p.a. on cost.

	Molly		Mia		Adjustments		Consolidated	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
Assets								
Machinery			6.0			2.0	4.0	
Accumulated depreciation				0.3	0.1			0.2
Deferred tax asset			0.09		0.57		0.66	
Liabilities								
Deferred tax liability								
Tax payable		0.6						0.6
.....								
Equity								
P&L								
Revenue		6.0			6.0			0.0
Cost of sales	4.0					4.0	0.0	
Depreciation expenses			0.3			0.1	0.2	
Tax expense	0.6			0.09		0.57		0.06

½ year x 6.0 x 10%

½ year x 4.0 x 10%

Cost to Molly: $4000 (treated as inventory at Molly)

Mia intends to use as non-current asset (PPE), depreciation at 10% p.a. on cost

Depreciation ½ year × 6000 × 10% = 0.3

Depreciation ½ year × 4000 × 10% = 0.2

	Molly		Mia		Adjustments		Consolidated	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
Assets								
Machinery			6.0			2.0	4.0	
Accumulated depreciation				0.67		0.13		0.8
Deferred tax asset			0.2		0.64		0.84	
Liabilities								
Deferred tax liability								
Tax payable		0.6						0.6
.....								
Equity								
P&L								
Gain on sale of machinery		2.4			2.4			0.0
Depreciation expenses	0.4		0.67			0.27	0.8	
Tax expense	0.6			0.2		0.64		0.24

4.0/5 x ½ year

Sale price - Carrying amount
6.0 - (4.0-0.4) =2.4

6.0/4.5 x ½ year

4.0/5 x 1 year

Additional: intragroup sale of equipment previously regarded as non-current asset:

On 1 July 2016, Molly Ltd sold a depreciable asset to Mia Ltd for $6000. Molly Ltd had acquired the machinery on 1 January 2016 for $4000. Molly Ltd had charged 6 months of depreciation expenses before the sale. The useful life of the asset ends on 31 December 2020 and the residual value is $0. Both companies apply straight-line depreciation.

Molly bought it on 1 Jan 2016 for $4000 (PPE)

	Molly		Mia		Adjustments		Consolidated	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
Assets								
Inventory	2.0					0.6	1.4	
Deferred tax asset					0.18		0.18	
.....								
Liabilities								
Deferred tax liability								
Tax payable				0.18				0.18
.....								
Equity								
P&L								
Revenue			2.0		2.0			0.0
Cost of sales			1.4			1.4	0.0	
Tax expense			0.18			0.18	0.0	

Net income: 0.42

Adjustment net income: 0.42

Net income: 0.0

This amount is added to retained earnings

	Molly		Mia		Adjustments		Consolidated	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
Assets								
Inventory								
Deferred tax asset								
.....								
Liabilities								
Deferred tax liability								
Tax payable		0.3		0.18				0.48
.....								
Equity								
Retained earnings 1/1				0.42	0.42			
P&L								
Revenue		3.0				0.0		3.0
Cost of sales	2.0					0.6	1.4	
Tax expense	0.3				0.18		0.48	

Net income: 0.7

Adjustment net income: 0.42

Net income: 1.12

Amounts from previous period

This amount is added to retained earnings

Depreciated 6 months before sale

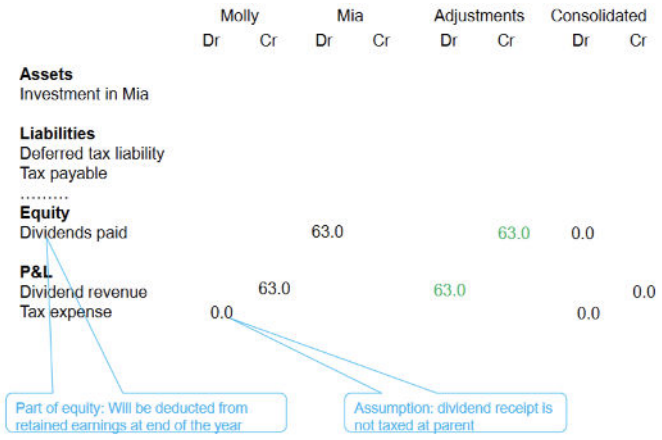
Sale price – Carrying amount = 6.0 – (4.0 – 0.4) = 2.4

Depreciation at Mia: 6000 / 4.5 × ½ year = 0.67

Depreciation at Molly (pre-sale): 4000 / 5 × ½ year = 0.4

e. Dividends

Assumptions: Investment is recorded at cost



Lecture 4: Integrated Reporting

Refresher trial exam 3.4(b), Impact fair value adjustment inventory two years after acquisition date

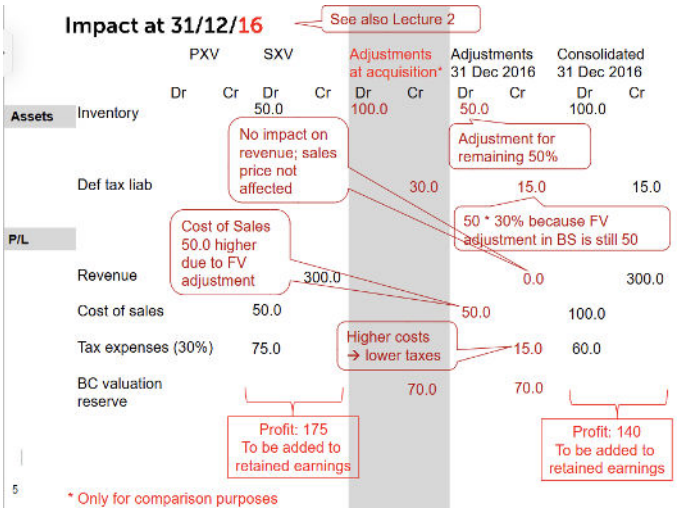
Question 4

At 1 January 2016, company PXV acquired all the shares of company SXV. At that date the carrying amount of the inventory of SXV was $100 while the fair value of the inventory amounted to $200. Half of the inventory of SXV was sold in 2016 for a total amount of $300. The remaining items were sold during 2017 for $400. The tax rate is 30%.

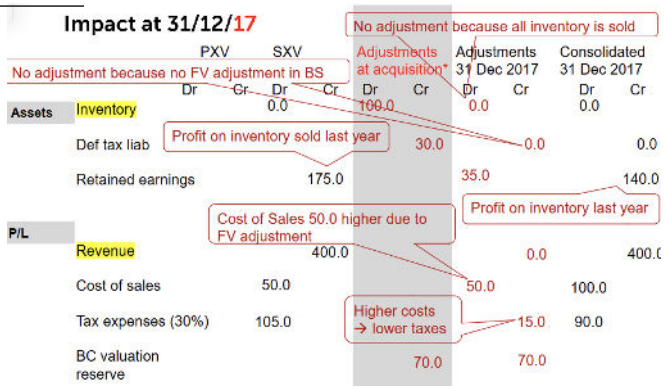
b. With respect to the inventory, which adjustments should PXV make to the amounts in the separate financial statements of SXV to prepare the consolidated financial statements as at 31 December 2017? The answer should include the amount of each account affected and whether it is an increase or decline of the amount. You are not required to show your calculations.

Summarized:
PXV acquired all shares of SXV at 1 January 2016. Value inventory at acquisition date:
• Carrying amount: 100

• Fair value: 200
Half inventory sold in 2016 for 300
Remaining items were sold in 2017 for 400
Tax rate 30%



Question: impact fair value adjustment on consolidated financial statements



at 31 December 2017?

Notes on separate statement
• At the end of 2016, there is still inventory of 50, because half of it is not sold.
• There is revenue of 300, cost of sales is 50 (because half of it), tax expense is $250 * 0.3$

Notes on consolidated statement
• Fair value inventory is 200, half of it (100) is in inventory and the other 100 is in 'cost of sales'.

Notes on separate statement
• Everything is sold on the end of 2017, so no inventory

Impact:
• Retained earnings 35 lower
• Cost of sales 50 higher
• Tax expenses 15 lower
→ BC valuation reserve 70

Last year there was a difference in retained earning

Question 2

At 1 July 2016, company P acquired 90% of the shares of S for $900,000 cash. P had acquired 10% of the shares of S two years earlier for $60,000. This investment, classified as a financial asset, was recorded at a fair value of $90,000 on 1 July 2016. The changes in fair value had all been taken to other comprehensive income. The balance sheets of P and S as at 1 July 2016 (just before the acquisition) were:

Assets	**Balance Sheet P - 1 July 2016**	Liabilities & Equity	
Cash	900,000	Share capital	500,000
Investment	90,000	Retained earnings	460,000
		Financial asset reserve	30,000
Total	*990,000*	*Total*	*990,000*

Assets	**Balance Sheet S - 1 July 2016**	Liabilities & Equity	
Cash	50,000	Share capital	100,000
Inventory	50,000	Retained earnings	200,000
Plant	400,000	Debt	200,000
Total	*500,000*	*Total*	*500,000*

In addition, the following is known about company S as at 1 July 2016:

- There is an unrecorded internally generated brand. The costs to develop the brand are estimated at $10,000. The fair value of the brand is estimated at $50,000. The remaining useful life is 10 years and the expected residual value is $0.
- The fair value of the inventory is $80,000.
- The fair value of the plant is $500,000. The plant was originally acquired for $500,000. The remaining useful life is 8 years and the expected residual value is $0.
- The fair value of the debt is $200,000.

The tax rate is 30%. However, P does not have to pay taxes on changes in the fair value of investments in other entities. Straight line depreciation is applied.

Fair value adjustments
Dr Investment 30
Cr Financial asset reserve 30

Refresher trial exam 2.2 →

Notes:

P acquires 90% share capital S (consideration 900). They already had 10%, so after transaction: P owns 100% of S.

At fair value through OCI: change in FV is booked through Other Comprehensive Income instead of P/L and recorded as financial asset reserve

1. Before transaction
(Separate) balance sheet P

Cash	900	Share cap.	500
Investment	90	Retained earnings	460
		Financial asset reserve	30
Total	*990*	*Total*	*990*

3. After transaction
(Separate) balance sheet P

Cash	0	Share cap.	500
Investment	990	Retained earnings	460
		Earnings of the year	30
Total	*990*	*Total*	*990*

Journal entry prior years:

Purchase
Dr Investment 60
Cr Cash 60

Transaction related journal entries

1. Recognize previously held equity interest at fair value & gain/loss in P/L Investment already recognized at FV, however gain/loss not yet recorded in P/L

Financial asset reserve 30
Finance income 30

2. Purchase additional shares S

Investment 900
Cash 900

Step 1 Fair value net assets acquired

Inventory 80
Plant 500

	BS P		BS S		Adjustments		Consolidated BS	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
Assets								
Inventory			50		30		80	
Brand					50		50	
Plant			500			0	500	
Accum depr.				100	100			0
Cash	0		50				50	
Goodwill					564		564	
Investment	990					990		
Liabilities								
Debt				200				200
Def tax liab						9 15 30 54		54
Equity								
Share capital		500		100	100			500
Retained earn.		490		200	200			490
BC valuation reserve					690	21 35 70 564 690		

Including 30 earnings of the year

XXXXX Business combination valuation entries
X Pre-acquisition entries

15

54

Cash 50
Brands 50
Total assets: 680

Liabilities (Debt) 200 -

Net assets acquired: 480

Step 2 Tax impact fair value adjustments (30%)

Inventory (FA adjustment 30):
9
Plant (FA adjustment 100):
30
Brands (FA adjustment 50):

Step 3 Net assets including tax impact

480 (fair value net assets) – 54 (tax impact) = 426

Step 4 Value investment

Consideration transferred to acquire shares: 900
Fair value previous interest: 90
Non-controlling interest: 0
Total FV investment: 990

Step 5 Goodwill

Value investment: 990
Net assets (incl. tax impact): 426
Goodwill: 564

Step 6 Consolidated balance sheet

Part 2 of trial exam 2.2

Financial statements end fiscal year
- All inventory sold in 2016
- Brand amortized in 10 years
- Plant depreciated over remaining life of 8y

Company S

	Debit	*Credit*
Cash	315,000	
Inventory	20,000	
Plant	375,000	
Debt		200,000
Share capital		100,000
Retained earnings		200,000
Revenue		600,000
Cost of sales	225.000	
Tax expenses	90,000	

In 2016, the separate financial statements of P were only affected by the acquisition of S. S prepared the following separate trial balance regarding the period 1 July – 31 December 2016.

All inventory on hand at 1 July 2016 is sold by 31 December 2016.

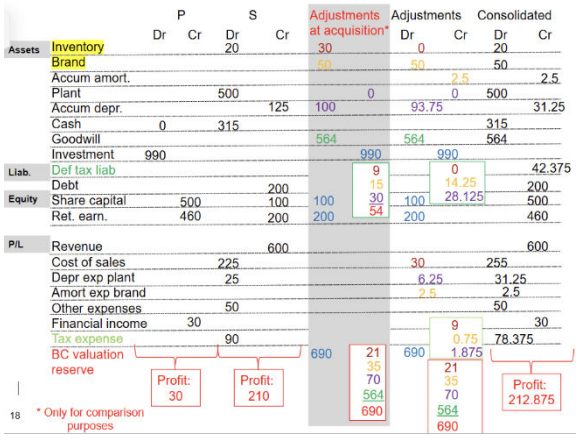
Consolidated P/L P-group 2016

Revenue:		600,000
Cost of sales:	255,000	
Depreciation:	31,250	
Amortization:	2,500	
Other expenses:	50,000	
Total expenses:		337,750
Financial income:		30,000
Profit before tax:		291,250
Tax:		78,375
Profit after tax:		212,875

460,000 + 212,875

Consolidated BS P-group 31 December 2016

Cash	315,000	Share capital	500,000
Inventory	20,000	Retained earnings	672,875
Plant	468,750	Debt	200,000
Goodwill	564,000		
Brand	47,500	DTL	42,375
Total	1,415,250	Total	1,415,250



Heineken 2017

• Business combinations: are accounted for using the acquisition method at the acquisition date (date control is transferred).
• Goodwill measured as: FV consideration transferred + FV previously-held equity interest + NCI value – net FV of identifiable assets & liabilities assumed.
• Negative excess → bargain purchase gain in profit or loss.

Non-controlling interest (NCI)

NCI = share of net assets not belonging to parent.
→ If you e.g. have 90% shares, you will take the full assets into account, because you have control you have a say over all the assets. On the balance sheet, you record the assets (Debit) at 100%, but record share capital (credit) of the parent at 90%, and then 10% NCI.

Example 23.3 Non-controlling interest (NCI) – Partial goodwill

Notes:

• Norilsk Ltd (Parent), Rudny Ltd (Subsidiary).
• Consideration: $290,160 for 90% share capital.
• Norilsk acquires 90%, shareholders Rudny have 10%.

Balance sheets after transaction for Norilsk results in adding 'Investment' for 290,160 and subtracting that amount from 'cash'.

CONSOLIDATION WORKSHEET ENTRIES INCLUDING NCI

★ On 1 July 2016, Norilsk Ltd acquired 90% of the capital of Rudny Ltd for $290 160. The equity of Rudny Ltd at this date consisted of:

Share capital	$ 200 000
Retained earnings	80 000

The carrying amounts and fair values of the assets and liabilities recorded by Rudny Ltd at 1 July 2016 were as follows:

	Carrying amount	Fair value
Fittings	$ 20 000	$ 20 000
Land	90 000	100 000
Inventory	10 000	12 000
Machinery (net)	200 000	220 000
Liabilities	40 000	40 000

The machinery and fittings have a further 10-year life, benefits to be received evenly over this period. Differences between carrying amounts and fair values are recognised on consolidation. Norilsk Ltd uses the partial goodwill method.

The tax rate is 30%. All inventory on hand at 1 July 2016 is sold by 30 June 2017.

Required

1. What are the entries for the consolidation worksheet if prepared immediately after 1 July 2016?
2. What are the entries for the consolidation worksheet if prepared at 30 June 2017? Assume a profit for Rudny Ltd for the 2016–17 period of $20 000.
3. If the non-controlling interest had a fair value of $31 800 on 1 July 2016, and the full goodwill method had been used, what entries in parts 1 and 2 above would change? Prepare the changed entries.

Step 1 Fair value net assets Rudny

Fittings		20,000
Land	100,000	
Inventory	12,000	
Machinery	220,000	
Total assets	352,000	
Liabilities (Debt)	40,000 -	
FV net assets:	312,000	

Step 2 Tax impact fair value adjustments (30%)

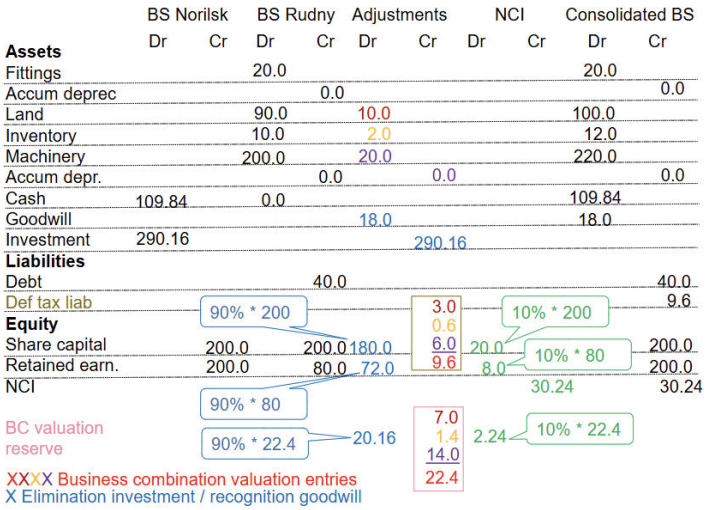
Land (FA adjustment 10,000): 3,000
Inventory (FA adjustment 2,000): 600
Machinery (FA adjustment 20,000): 6,000
Total tax impact FV adjustment: 9,600

Step 3 Net assets incl. tax impact

312,000 – 9,600 = 302,400

Step 4 Value investment (partial goodwill)

Consideration: 290,160
FV previous interest: 0



Business combination valuation entries

Land	Dr	10	
Deferred tax liability	Cr		3
Business combination valuation reserve	Cr		7
Machinery	Dr	20	
Deferred tax liability	Cr		6
Business combination valuation reserve	Cr		14
Inventory	Dr	2	
Deferred Tax Liability	Cr		0.6
Business combination valuation reserve	Cr		1.4

Elimination investment / recognition goodwill

Share capital	Dr	180	
Retained earnings (1/7/16)	Dr	72	
Business combination valuation reserve	Dr	20.16	
Goodwill	Dr	18	
Investment in Rudny Ltd	Cr		290.16

NCI share of equity at 1 July 2016

Share capital	Dr	20	
Retained earnings (1/7/16)	Dr	8	
Business combination valuation reserve	Dr	2.24	
NCI	Cr		30.24

Value NCI (10% of 302,400)
30,240

Total value investment: 320,400

Step 5 Goodwill (partial)

Total value investment: 320,400
FV net assets (incl. tax): 302,400
Goodwill: 18,000

Goodwill related to investment parent:
Consideration paid for 90% 290,160
90% fair value net assets acquired 272,160 (90% of 320,400)
Goodwill 18,000

Goodwill related to non-controlling interest:
Value NCI (10% fair value net assets) 30,240
10% fair value net assets acquired 30,240
Goodwill 0

Step 6 Consolidated balance sheet

Partial goodwill method: The value of the NCI is based on the fair value of the assets acquired and liabilities

Journal entry format

Journal entry format

Business combination valuation entries			
Land	Dr	10	
Deferred tax liability	Cr		3
Business combination valuation reserve	Cr		7
Machinery	Dr	20	
Deferred tax liability	Cr		6
Business combination valuation reserve	Cr		14
Depreciation expense (1/10 x 20)	Dr	2	
Accumulated depreciation	Cr		2
Deferred tax liability	Dr	0.6	
Income tax expense	Cr		0.6
Cost of sales	Dr	2	
Income tax expenses	Cr		0.6
Business combination valuation reserve	Cr		1.4

Elimination investment / recognition goodwill			
Share capital	Dr	180	
Retained earnings (1/7/16)	Dr	72	
Business combination valuation reserve	Dr	20.16	
Goodwill	Dr	18	
Investment in Rudny Ltd	Cr		290.16
NCI share of equity at 1 July 2016			
Share capital	Dr	20	
Retained earnings (1/7/16)	Dr	8	
Business combination valuation reserve	Dr	2.24	
NCI	Cr		30.24
NCI share of equity: 1/7/16 - 30/6/17			
NCI share of profit	Dr	1.72	
NCI (10% ($20 000 – ($2 000 - $600) – ($2 000 – $600)))	Cr		1.72

Exercise 23.3 (2) NCI – Partial goodwill after one year

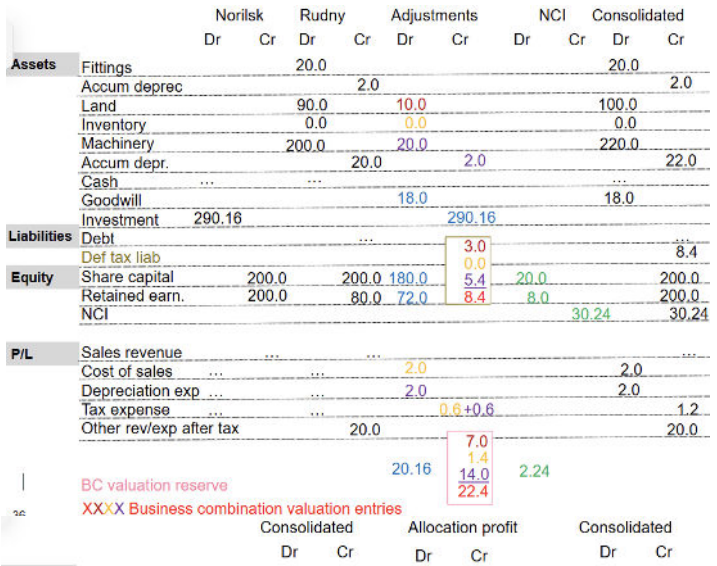
Q2: What are the entries for the consolidation worksheet if prepared at 30 June 2017? Assume a profit for Rudny Ltd for the 2016–17 period of $20 000.

Differences compared to the first question:

Profit and loss (P/L) of Rudny is included:
• The 2.0 cost of sales arises because of the inventory revaluation to fair value at acquisition, and since that inventory was sold during the year, the adjustment flows through P&L as extra cost of sales.

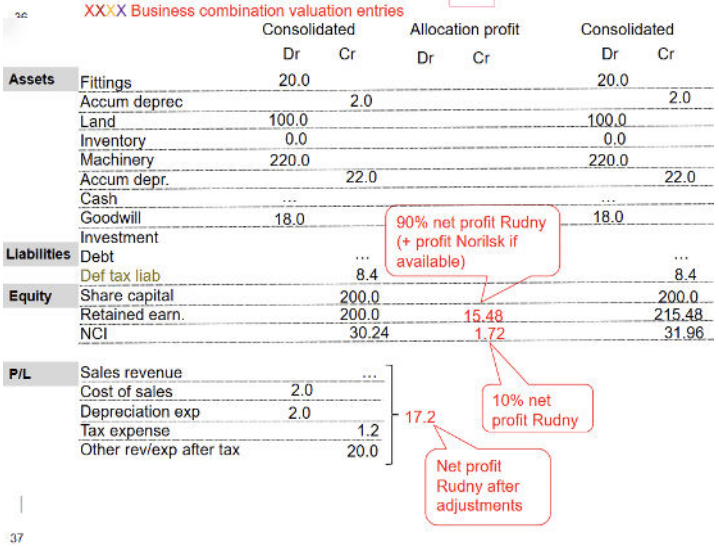
Depreciation on fair value adjustments:
• Since machinery was adjusted upward, extra depreciation must be recorded: 20 / 10 years = 2.

Rudny earned 20.0. But consolidation adjustments:
– 2.0 (extra cost of sales from inventory revaluation)
– 2.0 (extra depreciation from machinery revaluation)
Apply 30% tax on these differences (4.0) = +1.2 tax reduction (because expenses reduce taxable income).
So: 20.0 – 2.0 – 2.0 + 1.2 = 17.2 net profit



Exercise 23.3 (3) NCI – Full goodwill

Q3: If the non-controlling interest had a fair value of $31,800 on 1 July 2016, and the full goodwill method had been used, what entries in parts 1 and 2 above would change? Prepare the changed entries.



Step 1 Fair value net assets Rudny (same as question 1: 312,000)

Step 2 Tax impact fair value adj. (30%) (same as question 1: 9,600)

Step 3 Net assets incl. tax impact (same as question 1: 302,400)

Step 4 Value investment (full goodwill)

Consideration:	290,160
FV previous interest:	0
Value NCI (given in question)	31,800
Total value investment:	321,960

Step 5 Goodwill (full goodwill)

Total FV investment	321,960
FV net assets acquired	302,400 -
Goodwill	19,560

FV Rudny excluding control premium (31800/10%)	318,000
FV net assets acquired	302,400 -
Goodwill of Rudny – excluding control premium	15,600
NCI's share of goodwill (10% of 15,600)	= 1,560
Goodwill excl CP related to parent (90% * 15600)	= 14,040
FV total investment	321,960
FV Rudny excluding control premium (31800/10%)	318,000 -
Goodwill parent only – control premium	3,960

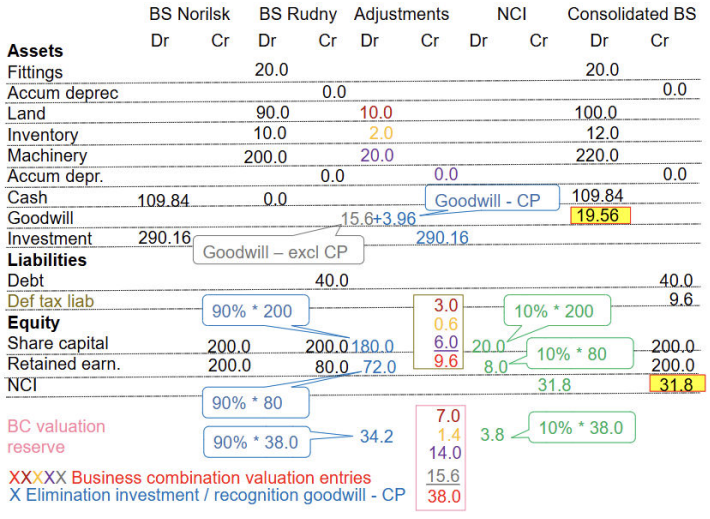
Parent's share of goodwill (14,040 + 3,960) = 18,000 (same as partial method)

Full goodwill method:
The value of the NCI is based on the fair value of the NCI (instead of the fair value of the assets acquired and liabilities assumed) assumed

Step 6 Consolidated balance sheet (full goodwill)

Notes:
- Goodwill is higher because now part of goodwill is attributed to NCI (1.56).
- NCI is higher, this reflects that NCI has its own share of goodwill (1.56 extra).

Exercise 23.3 (2) NCI – Full goodwill after one year



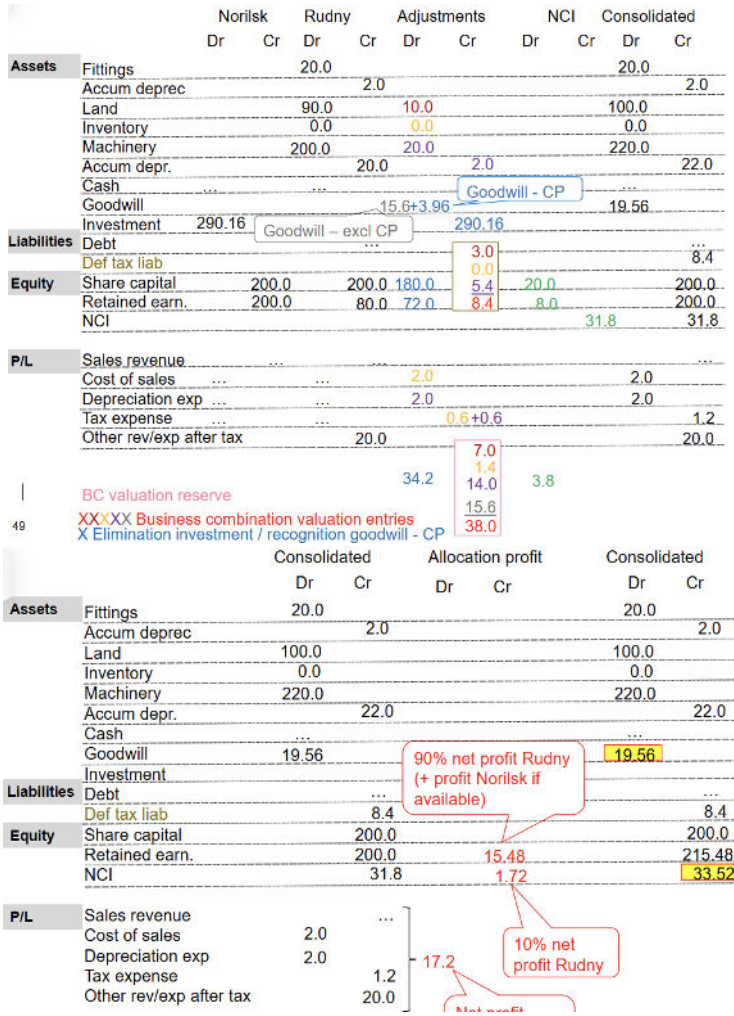
Q2: What are the entries for the consolidation worksheet if prepared at 30 June 2017? Assume a profit for Rudny Ltd for the 2016–17 period of $20 000.

Similar to partial, but with NCI goodwill difference.

Assets & Liabilities (no changes partial-full)
• Land uplift +10
• Inventory uplift +2 (sold within the year → COS)
• Machinery uplift +20 (→ depreciated 2.0 per year)
• Deferred tax liability adjusted to 8.4

Goodwill recognized at 19.56, it consists of: Parent's goodwill 18.0, NCI's goodwill 1.56

Equity: Retained earnings are increased by the parent's share of Rudny's profit (90% of adjusted net profit 17.2 = 15.48). Allocation of net profit
• 90% to Norilsk = 15.48 → added to parent's retained earnings.
• 10% to NCI = 1.72 → added to NCI = 33.52.



Investment Decisions

• Before investing: You'd want information on the business model, risks, expected returns, financial statements, competitive environment, and strategy.
• After investing: You'd want updates on performance vs. forecasts, dividend policy, reinvestment needs, and strategic developments.

Key point: Investors require both pre-investment due diligence and post-investment monitoring.

Integrated reporting

IR framework consists of information you need and use to evaluate investments. The model states the why and what of the projects, the capitals that are available, funding, performance, future etc.

Six capitals: Financial, Manufactured, Intellectual, Human, Social & Relationship, Natural.

Value creation model: input, business model, output, desired outcome, impact

Example: Value creation model – Ahold Delhaize

Inputs: 16 brands, 7,765 stores, 388k associates, €500m bond issued.

Outputs: 52.4% healthy own-brand sales, 3.5% online growth, 78% engagement, 2.6 Mt food donated.

Outcomes: customers make healthier choices, engaged workforce, reduced food waste, strong returns to shareholders.

Question 3

Company PT owns all of the share capital of Company SB. On 1 March 2016, PT sold a depreciable asset to SB for $42,000 cash. PT had acquired the asset on 1 July 2014 for $60,000. PT had charged 20 months of depreciation expenses before the sale. The useful life of the asset ends on 30 June 2019 and the residual value is $ 0. Both companies apply straight-line depreciation.

a. Prepare the consolidation worksheet adjusting entries, in journal entry format, for the preparation of the consolidated financial statements as at 31 December 2016. Assume an income tax rate of 25% and that all income on sale of assets is taxable and expenses are tax deductible. You are not required to show your calculations.

Lecture 5: Foreign currency & Sustainability reporting

Refresher Trial exam 2-3

Depreciation PT until sale

Purchase price: 60,000
Remaining useful life (in months): 60
Residual value: 0
Depreciation per month: (60-0)/60 = 1,000

Depreciation 2016 (2 months): 2,000
Accumulated depreciation before sale (20 months): 20,000
Accumulated depreciation end of 2016: 0

Depreciation SB as of sale

Purchase price: 42,000
Remaining useful life (in months): 40
Residual value: 0
Depreciation per month: (42-0)/40 = 1,050

Depreciation 2016 (10 months): 10,500
Accumulated depreciation end 2016 (10 months): 10,500

Journal entries related to transaction

	PT		SB		Adjustments		Consolidated	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
							60.0/60 x 30 months	
Assets								
Machinery			42.0		18.0		60.0	
Accumulated depreciation				10.5		19.5		30.0
Deferred tax asset			2.625		0.375		3.0	
Liabilities								
Deferred tax liability								
Tax payable								
.....								
Equity								
P&L								
Gain on sale of machinery		2.0			2.0			0.0
Depreciation expenses	2.0		10.5			0.5	12.0	
Tax expense	0.0			2.625		0.375		3.0
						60.0/60 x 12 months		

PT

Cash	42,000	
Accumulated depreciation	20,000	
Machinery		60,000
Gain on sale machinery		2,000

SB

Machinery	42,000	
Cash		42,000

Adjustments

Consolidation worksheet adjusting entries (journal format):

Equipment	18,000		
Deferred tax asset	375		
Gain on sale equipment	2,000		
Accumulated depreciation		19,500	
Depreciation expense			500
Tax expenses		375	

Refresher Trial exam 3-3

Question 3

Company PRT owns all of the share capital of company SUB. In January 2015, PRT sold inventory to SUB for $10,000. The inventory had previously cost PRT $8,000. Half of this inventory is sold by SUB to external parties for $12,000 during 2015. The remainder is sold to an external party for $14,000 in 2016. Assume an income tax rate of 25% and that all income on the sale of assets is taxable and that expenses are tax deductible.

a. Prepare the consolidation worksheet adjusting entries, in journal entry format, for the preparation of the consolidated financial statements as at 31 December 2015. You are not required to show your calculations.

Adjustments 31 December 2015

Notes:

• 0.25 (Deferred tax asset): This comes from the unrealized profit on inventory (1,000). At 25% tax → 0.25.

• 2.25 (Deferred tax liability): Includes 0.5 $(2 * 25\%)$ tax payable + 1.75 $((12000 - 5000 * 25\%)$ deferred tax adjustment = 2.25.

• 2.0 (Tax expense): Originally 2.5 (0.5 + 2.0), but we eliminate 0.25 tax linked to intra-group profit → 2.0.

	PRT		SUB		Adjustments		Consolidated	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
Assets								
Inventory			5.0			1.0	4.0	
Deferred tax asset					0.25		0.25	
.....								
Liabilities								
Deferred tax liability								
Tax payable		0.5		1.75				2.25
.....								
Equity								
P&L								
Revenue		10.0		12.0	10.0			12.0
Cost of sales	8.0		5.0			9.0	4.0	
Tax expense	0.5		1.75			0.25	2.0	
		Net income: 1.5		Net income: 5.25		Adjustment net income: -0.75		Net income: 6.0

This amount is added to retained earnings

Journal entries:

Inventory	1,000	
Cost of sales	9,000	
Tax expenses	250	
Deferred tax asset		250
Revenue		10,000

Question 3(b): Prepare the consolidation worksheet adjusting entries, journal entry format, as at 31 December 2016.

Adjustments 31 December 2016

	PRT		SUB		Adjustments		Consolidated	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
Assets								
Inventory								
Deferred tax asset								
.....								
Liabilities								
Deferred tax liability								
Tax payable		0.5		1.75 + 2.25				4.5
.....								
Equity								
Retained earnings 1/1		1.5		5.25	0.75			6.0
P&L								
Revenue				14.0		0.0		14.0
Cost of sales			5.0			1.0	4.0	
Tax expense			2.25		0.25		2.5	
				Net income: 6.75		Adjustment net income: 0.75		Net income: 7.5

Amounts from previous period

Journal entries:

Retained earnings	750	
Tax expenses	250	
Cost of sales		1,000

Foreign Currency

Heineken 2024

• The consolidated financial statements are presented in Euro

• Assets & liabilities of foreign operations translated to euro at exchange rates at reporting date.

• Income & expenses translated at rates at transaction dates.

• Differences go to Other Comprehensive Income, presented in translation reserve.
• Cumulative translation reserve reclassified upon disposal or liquidation.

Financial Statements:
• Consolidated Income Statement: has an impact but you can not see it directly
• Net finance income/expense: 'Net foreign exchange gain/(loss)'
• Consolidated Statement of Other Comprehensive Income: 'Currency translation differences'

Exercise 24.2 TRANSLATION OF FINANCIAL STATEMENTS INTO FUNCTIONAL CURRENCY

** Faber Ltd, a company incorporated in Singapore, acquired all the issued shares of Lantau Ltd, a Hong Kong company, on 1 July 2015. The trial balance of Lantau Ltd at 30 June 2016 was:

	HK$ Dr	HK$ Cr
Share capital		800 000
Retained earnings (1/7/15)		240 000
General reserve		100 000
Payables		160 000
Deferred tax liability		120 000
Current tax liability		20 000
Provisions		80 000
Sales		610 000
Proceeds on sale of land		250 000
Accumulated depreciation — plant		340 000
Plant	920 000	
Land	400 000	
Cash	240 000	
Accounts receivable	300 000	
Inventory at 1 July 2015	60 000	
Purchases	260 000	
Depreciation — plant	156 000	
Carrying amount of land sold	200 000	
Income tax expense	50 000	
Other expenses	134 000	
	2 720 000	2 720 000

Additional information

1. Exchange rates based on equivalence to HK$1 were:

	S$
1 July 2015	0.2
8 October 2015	0.25
1 December 2015	0.28
1 January 2016	0.3
2 April 2016	0.27
30 June 2016	0.22
Average during last quarter 2015–16	0.24
Average 2015–16	0.26

2. Inventory was acquired evenly throughout the year. The closing inventory of HK$60 000 was acquired during the last quarter of the year.
3. Sales and other expenses occurred evenly throughout the year.
4. The Hong Kong tax rate is 20%.
5. The land on hand at the beginning of the year was sold on 8 October 2015. The land on hand at the end of the year was acquired on 1 December 2015.
6. Movements in plant over 2015–16 were:

Plant at 1 July 2012	HK$600 000
Acquisitions — 8 October 2015	200 000
— 2 April 2016	120 000
Plant at 30 June 2016	920 000

Depreciation on plant is measured at 20% per annum on cost. Where assets are acquired during a month, a full month's depreciation is charged.

7. The functional currency of the Hong Kong operation is the Singaporean dollar.

Required

1. Prepare the financial statements of Lantau Ltd in Singaporean dollars at 30 June 2016.
2. Verify the translation adjustment.

Exercise 24.2

Step 1: Reconstruct the opening balance (as at 1 July 2015)

The first step is to identify the carrying amounts of non-monetary items (e.g. plant, accumulated depreciation, land, inventory) at the beginning of the financial year.

Why?

Because under IAS 21, non-monetary items must be translated at the historical exchange rate (the rate at the date of acquisition). To apply this correctly, you need to separate:

• Items that were already on the balance sheet at 1 July 2015 (opening balances, translated at their historical rates), and

• New transactions during the year (acquisitions, disposals, depreciation), which are translated using the rate at the date of those transactions.

This reconstruction ensures that the translation into the functional currency (S$) reflects the correct exchange rates for each component.

Relevant balance sheet information per 1 July 2015

Plant = 600.000

Accumulated depreciation = (184.000)

Land = 200.000

Inventory = 60.000

Step 2: Build the income statement and balance sheet in HK$

Step 3: Translation into Singapore dollars (S$)

Once you've prepared the HK$ income statement and balance sheet, you apply the translation rules from IAS 21:

Type of item	Translation rate	Explanation
Non-monetary items (Plant, Land, Inventory, Accumulated Depreciation, Share Capital, Reserves)	Historical rate	Use the rate from when the asset was acquired or the equity was contributed.
Monetary items (Cash, Receivables, Payables, Tax liabilities)	Closing rate	Translate at the rate on the reporting date (30 June 2016).
Income & expenses	Average or transaction-date rate	Reflects the exchange rate at the time the revenue or cost was incurred.
Equity (Retained earnings 1 July 2015)	Historical rate	Because it represents accumulated results of prior years.

Balance sheet 30 June 2016 in HK$

Plant		Share capital	800,000
• At acquisition	600,000	General reserve	100,000
• 8 October	200,000	Ret earn. 1/1	240,000
• 2 April	120,000	Profit period	60,000
	920,000	Payables	160,000
Accum.depr.		Deferred tax liab.	120,000
• At acquisition	184,000	Current tax liab.	20,000
• Full year	120,000	Provisions	80,000
• 8 October	30,000		
• 2 April	6,000		
	(340,000)		
Land	400,000		
Inventory	60,000		
Cash	240,000		
Accounts rec.	300,000		
Total	*1,580,000*	*Total*	*1,580,000*

Description – Income statement

		In HK$
Sales		610,000
Cost of sales		
Beginning inventory	60,000	
Purchases	260,000	
Goods available for sale	320,000	
Ending inventory	(60,000)	
Cost of sales		(260,000)
Depreciation expenses		
Of plant at time acquisition	600,000/5 * 12/12 = 120,000	
Of purchase 8 October	200,000/5 * 9/12= 30,000	
Of purchase 2 April	120,000/5 * 3/12= 6,000	(156,000)
Other expenses		(134,000)
Sale of land		
Proceeds of land sold	250,000	
Carrying amount of land sold	200,000	
Gain on sale		50,000
Profit before tax		110,000
Tax expenses		(50,000)
Net profit		60,000

Balance sheet 30 June 2016

	In HK$	Rate	In S$		In HK$	Rate	In S$
Plant				Share capital	800,000	0.20	160,000
• At acquisition	600,000	0.20	120,000	General reserve	100,000	0.20	20,000
• 8 October	200,000	0.25	50,000	Ret earn. 1/1	240,000	0.20	48,000
• 2 April	120,000	0.27	32,400	Profit period	60,000		66,080
Accum.depr.				Payables	160,000	0.22	35,200
• At acquisition	(184,000)	0.20	(36,800)	Deferred tax liab.	120,000	0.22	26,400
• Full year	(120,000)	0.20	(24,000)	Current tax liab.	20,000	0.22	4,400
• 8 October	(30,000)	0.25	(7,500)	Provisions	80,000	0.22	17,600
• 2 April	(6,000)	0.27	(1,620)				
Land	400,000	0.28	112,000				
Inventory	60,000	0.24	14,400				
Cash	240,000	0.22	52,800				
Accounts rec.	300,000	0.22	66,000				
Total	*1,580,000*		*377,680*	*Total*	*1,580,000*		*377,680*

Calculated as residual

Income statement

Translation from local currency to functional currency. Lantau Ltd operates in Hong Kong, and its functional currency is the Singapore dollar (S$). It keeps its accounting records in HK$ (local currency), but for consolidation in the group's books, it must first convert everything into its functional currency (S$).

Non-monetary:	Historical rate
Monetary:	Closing rate
Equity:	Historical rate

"FX translation reserve" ensures total assets = total equity + liabilities after translation. It captures exchange-rate differences that arise when the group consolidates a foreign subsidiary.

The FX differences that arise during the year are treated as exchange gains or losses in profit or loss (they affect net income).

Additional: Translation from functional currency to presentation currency

Average rate as of 8 October 2015 0.23

Average rate as of 2 April 2015

0.25

Now, Lantau's figures (already in functional currency S$) are being translated again into the presentation currency of the parent company (for example, Heineken consolidating everything in €).

When we translate the functional currency statements into the presentation currency, the company hasn't actually made or lost money, it's just expressing the same results in another currency.

From local to functional

Rate at date of transaction

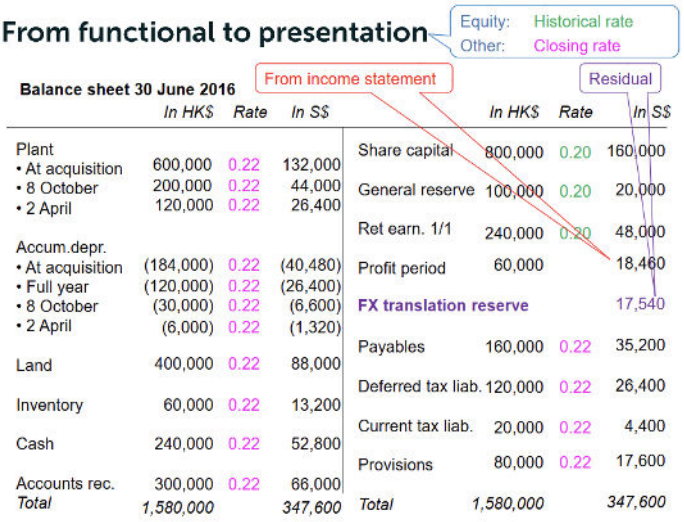
Depreciation: Rate used to translate the related non-monetary items

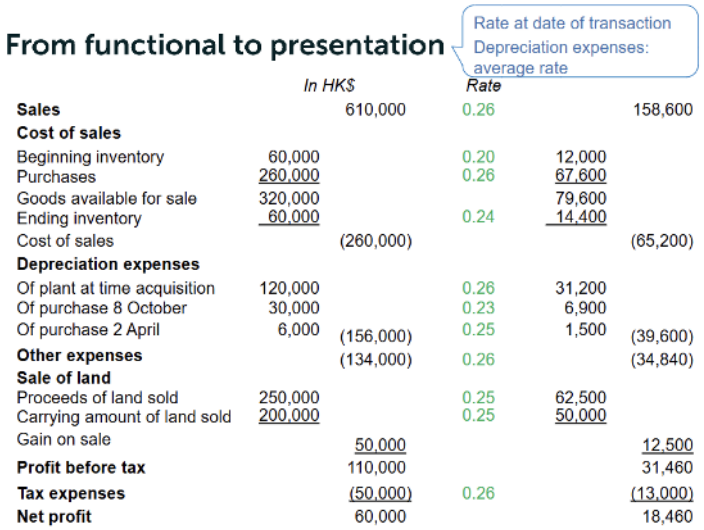
		In HK$	Rate		
Sales		610,000	0.26		158,600
Cost of sales					
Beginning inventory	60,000		0.20	12,000	
Purchases	260,000		0.26	67,600	
Goods available for sale	320,000			79,600	
Ending inventory	60,000		0.24	14,400	
Cost of sales		(260,000)			(65,200)
Depreciation expenses					
Of plant at time acquisition	120,000		0.20	24,000	
Of purchase 8 October	30,000		0.25	7,500	
Of purchase 2 April	6,000	(156,000)	0.27	1,620	(33,120)
Other expenses		(134,000)	0.26		(34,840)
Sale of land					
Proceeds of land sold	250,000		0.25	62,500	
Carrying amount of land sold	200,000		0.20	40,000	
Gain on sale		50,000			22,500
FX translation gain/(loss)				Residual	47,940 31,140
Profit before tax		110,000			79,080
Tax expenses		(50,000)	0.26		(13,000)
Net profit		60,000		From balance sheet	66,080

Therefore, these exchange rate movements go into Other Comprehensive Income (OCI) and accumulate in the Translation Reserve (FCTR).

- Sales, expenses, and profit are retranslated at average rates or transaction-date rates.
- The resulting exchange differences no longer go into the income statement.
- The outcome is that total comprehensive income changes due to the translation reserve in equity.

Summarized:





Aspect	Local → Functional currency	Functional → Presentation currency
Purpose	To measure the subsidiary's performance in its *economic environment*	To express the subsidiary's results in the *group's reporting currency*
When applied	During initial consolidation of a foreign operation that keeps books in a different currency	During preparation of consolidated financial statements
IAS 21 rule	Exchange differences **go to Profit or Loss**	Exchange differences **go to Other Comprehensive Income (OCI)**
Why	Reflects *real economic exposure*: the company earns/spends in another currency	Only for *presentation*: no real cash flow or performance impact
Effect on performance	Changes profit and loss (FX gain/loss in P&L)	Does *not* affect profit — affects equity (translation reserve)
Type of translation	"Functional currency translation"	"Presentation translation"
Example	Lantau Ltd translates HK$ transactions into S$ to reflect actual economic conditions	Group translates S$ financials into € (presentation currency) for reporting

Aspect	Local → Functional currency	Functional → Presentation currency
Resulting difference shown as…	"Exchange gain/loss" in P&L	"Foreign currency translation reserve (FCTR)" in equity (OCI)

Introduction to International Sustainability Standards Board (ISSB)

• Established by the IFRS Foundation in November 2021
• Aim: develop a global baseline of sustainability disclosures for financial markets
• In June 2023, the IFRS Foundation issued two standards:

IFRS S1 – General Requirements for Disclosure of Sustainability-related Financial Information
IFRS S2 – Climate-related Disclosures

• Effective date: 1 January 2024
• Application: depends on national endorsement, no mandatory adoption yet in Europe

IFRS S1 (General Requirements)

• Entities must disclose information about sustainability-related risks and opportunities.
• This information should be useful for primary users of general-purpose financial reports, mainly investors, lenders, and creditors.
• Focus: how sustainability matters affect enterprise value, access to finance, and cost of capital.
• Not all stakeholders are covered, only those relevant to investment decisions.

IFRS S1 sets the general principles (what to report, how to structure it, and for whom) for sustainability disclosures; topic-specific guidance appears in other standards (like S2).

IFRS S2 (Climate-related Disclosures)

• Require disclosure of information about an entity's climate-related risks and opportunities, useful for investors' decision-making.

Content pillars:
• Governance: oversight and control of climate issues
• Strategy: how the entity manages climate-related risks and opportunities
• Risk management: identification, assessment, and monitoring processes
• Metrics and targets: performance indicators and progress measurement

IFRS S2 is theme-specific: it applies the general S1 principles but only to climate information.

EU Taxonomy Regulation

Purpose: Provide investors with information about the environmental performance of companies. Encourage green finance by increasing transparency.

Environmental objectives: Climate change mitigation, Climate change adaptation, Sustainable use and protection of water and marine resources, Transition to a circular economy, Pollution prevention and control, Protection and restoration of biodiversity and ecosystems.

The EU Taxonomy defines which activities can be considered "sustainable", it's the classification system underlying the EU's sustainability reporting framework.

How the EU Taxonomy Works

Two key questions:
1. Is the company engaged in Taxonomy-eligible activities (activities defined in the regulation)?
2. If yes, are those activities Taxonomy-aligned (i.e., substantially contributing to at least one objective, doing no significant harm to others, and respecting human/labour rights)?

Disclosure requirements:
• % of revenue, OPEX, and CAPEX related to eligible and non-eligible activities.
• Within eligible activities: % of Taxonomy-aligned activities.

This is a quantitative disclosure system, companies must show how much of their business qualifies as environmentally sustainable.

Corporate Sustainability Reporting Directive (CSRD)
• Adopted by the European Parliament in 2022.
• Part of the European Green Deal, aiming EU resource-efficient and competitive low-carbon economy.
• Standard-setting delegated to EFRAG (European Financial Reporting Advisory Group).
• EFRAG develops the European Sustainability Reporting Standards (ESRS).
• Requires limited assurance (auditor review).

Applies (from 2024 reporting year) to large public-interest entities meeting ≥ 2 criteria: Assets > €25 million, Revenue > €50 million, Employees > 250

CSRD = EU's legally binding sustainability reporting directive, replacing and expanding the old NFRD.

ESRS 1 (General Requirements):
Defines mandatory concepts and principles (materiality, stakeholders, reporting boundaries).

ESRS 2 (General Disclosures):
Lists cross-cutting disclosure requirements applicable to all sustainability topics, such as: Company overview and business model; Time horizons and value-chain information; Materiality assessment process

ESRS 1 and 2 are the foundation layer, they apply to all topics (environmental, social, and governance).

Stakeholders: those who can affect or be affected by the undertaking:

1. Affected stakeholders: people or groups impacted by the company's operations (positively or negatively).

2. Users of sustainability statements:
• Primary users: investors, lenders, creditors.
• Other users: business partners, unions, NGOs, governments, analysts, academics.

CSRD / ESRS consider a broader stakeholder view than IFRS S1/S2, which focus only on investors.

Double Materiality (Impact & Financial)

Concept: CSRD introduces the idea that something is "material" if it is significant from either an impact perspective or a financial perspective.
• Impact materiality: A matter is material if it reflects the company's actual or potential positive/negative impacts on people or the environment across its value chain.
• Financial materiality: A matter is material if it has or could have a material financial effect on the company (affecting its development, performance, cash flows, or cost of capital).

Summary: → IFRS S1/S2 = single materiality (focus on investors).
→ CSRD / ESRS = double materiality (investor + societal impact).

Each specific sustainability topic under ESRS follows the same four-pillar structure (aligns with IFRS S2 and TCFD):

Pillar	Content
Governance	How the company oversees sustainability risks and opportunities
Strategy	How the business model and strategy interact with impacts, risks, and opportunities
Impact / Risk / Opportunity Management	Processes for identifying, assessing, and managing these issues
Metrics and Targets	Quantitative indicators and goals for performance measurement

How Climate Change Affects IFRS Financial Statements

• Property, Plant & Equipment: Should assets be impaired? Should useful lives be adjusted?
• Goodwill: Impairment tests – lower terminal values due to climate risks?
• Provisions: Onerous contracts, decommissioning, environmental liabilities?
• Financial Instruments: Expected credit losses, sustainability-linked loans?
• Disclosures: Key assumptions, estimates, going-concern implications?

Summary:

Topic	Standard / Directive	Focus	Who uses it	Key concept
IFRS S1/S2	Global (IFRS Foundation / ISSB)	Investor-oriented sustainability & climate disclosures	Investors, lenders, creditors	*Single materiality*
EU Taxonomy	EU Regulation	Classification of "green" economic activities	Investors, regulators	*Eligibility & alignment*
CSRD / ESRS	EU Directive & Standards	Broad sustainability reporting, legally required	All stakeholders	*Double materiality*

Lecture 6: Financial Instruments

Trial exam 1–4

- The *local currency* is where the foreign operation is based (USD).
- The *functional currency* is where the entity primarily operates (EUR or USD).
- The *presentation currency* is the one used in the financial statements (EUR).

Translation is required only when local ≠ functional currency.

No adjustment is needed for consolidation when local and functional currencies are the same.

Balance Sheet Translation

Income Statement Translation

(Rate at date of transaction)

From local to functional

Non-monetary: Historical rate
Monetary: Closing rate
Equity: Historical rate

Balance sheet 31 December 2016

	In US$	*Rate*	*In EUR*		*In US$*	*Rate*	*In EUR*
Equipment	200,000	0.90	180,000	Share capital	200,000	0.90	180,000
Accum.depr.	(25,000)	0.90	(22,500)	Ret earnings 1/1	0		0
Accounts rec.	40,000	1.10	44,000	Profit period	125,000		140,000
Inventory	50,000	1.05	52,500	Debt	50,000	1.10	55,000
Cash	120,000	1.10	132,000	Accounts pay.	10,000	1.10	11,000
Total	*385,000*		*386,000*	*Total*	*385,000*		*386,000*

Calculated as residual

Question 4

USfirm is a company located in the United States. NLfirm, a Dutch company, formed USfirm on 1 January 2016 with an investment of $200,000. The functional and presentation currency of NLfirm is EUR. Because USfirm sells all its products in Europe, the functional currency of USfirm is EUR. However, USfirm uses the US$ as its local currency.

The trial balance of USfirm in US$ as at 31 December 2016 is:

	US$ Debit	US$ Credit
Share capital		200,000
Retained earnings		0
Debt		50,000
Accounts payable		10,000
Sales		400,000
Accumulated depreciation – equipment		25,000
Equipment	200,000	
Accounts receivable	40,000	
Inventory	50,000	
Cash	120,000	
Cost of goods sold	200,000	
Depreciation expenses	25,000	
Other expenses	50,000	

Assume a tax rate of 0%. In addition, the following information is available:

- The equipment was acquired on 1 January 2016. The yearly depreciation is $25,000.
- All sales and expenses occurred evenly throughout the period.
- The inventory on hand at the beginning of the year amounted to $0.
- The inventory on hand at the end of the year was acquired during December 2016.
- Exchange rates were ($1 = EUR)

1 January 2015	0.80
Average for December 2015	0.85
31 December 2015	0.90
1 January 2016	0.90
Average for 2016	1.00
Average for December 2016	1.05
31 December 2016	1.10

Financial Instruments (IFRS 9 topics)

A financial instrument is any <u>contract</u> giving rise to a

		In US$	*Rate*		*In EUR*
Sales		400,000	1.00		400,000
Cost of sales					
Beginning inventory	0			0	
Purchases	250,000		1.00	250,000	
Goods available for sale	250,000			250,000	
Ending inventory	(50,000)		1,05	(52,500)	
Cost of goods sold	200,000	(200,000)		197,500	(197,500)
Depreciation expenses		(25,000)	0.90		(22,500)
Other expenses		(50,000)	1.00		(50,000)
Profit before FX effect		125,000			130,000
FX translation gain/(loss)				Residual	10,000
Net profit		125,000	From balance sheet		140,000

financial asset of one entity, and a financial liability or equity instrument of another. (IAS 32.11)

Examples:
• Financial assets: cash, equity of another entity, contractual rights to receive cash.
• Financial liabilities: contractual obligations to deliver cash.
• Equity: residual interest after liabilities are deducted.

Examples of a Financial Instrument**:**
• Loan provided to another entity
• Accounts receivable
• Investment in shares of another entity (equity instrument of another party, financial asset for you)
• Interest rate swap (right to receive cash for you, right to pay cash for other party)
• Debt
But, NOT tax payable (since not contractual obligation between entities)

Classification of Financial Assets

Flowchart for IFRS 9 asset classification:

1. Cash Flow Test (SPPI) – Are cash flows *solely payments of principal and interest*?
    - If yes → move to Business Model assessment.
2. Business Model Assessment
    - (1) Hold to collect → Amortized Cost
    - (2) Hold to collect and sell → FVOCI (with recycling)
    - Other → FVTPL (Fair Value Through P&L)
3. Equity instruments
    - If *held for trading* → FVTPL
    - Else, can elect FVOCI (no recycling) option.

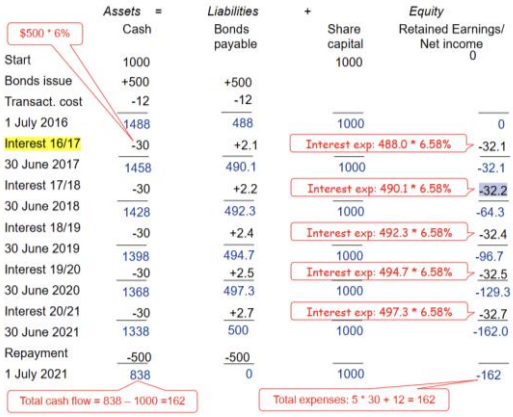
Examples:
- Amortized cost → government/corporate bonds, receivables
- FVOCI → government/corporate bonds
- FVTPL → share portfolio, derivatives

Classification of Financial Liabilities

1. Held for trading (incl. derivatives)?
    - Yes → FVTPL
    - No → check fair value option
2. If Fair Value option chosen to reduce inconsistency → FVTPL
3. Otherwise → Amortized cost

Examples:

- Amortized cost → trade creditors, issued bonds
- FVTPL → trading liabilities, derivative positions



Exercise 7.8 – Amortized Cost

Case: Company B issues a bond on 1 July 2016
- Face value: 500
- Transaction costs: 12
- Interest: 6% annually, payable June 30
- Market interest rate: 6%
- Maturity: 30 June 2021

Effective interest rate (EIR) = rate discounting expected cash flows to the amortized cost (IFRS 9A).

Initial recognition: fair value – transaction costs = *488* (500–12).

EIR is the rate that discounts future cash flows (interest + principal) to equal *488*.

Sum PV = 488 → Effective interest = 6.58%
Note: understanding is required, not actual calculation in exam.

Journal Entries (6.58%)

- Bond issued at 488 (500 – 12).
- Interest expense = 488 × 6.58% = 32.1 in first year. (add the 32.1-30=2.1 to bonds payable)
  = 490.1 * 6.58% = 32.2 in second year
- Each year's interest slightly rises as amortized cost increases.
- At maturity, debt = 500, total expenses = 162 (5×30 + 12).

Amortized Costs (Extended Example)

New scenario:
- Nominal rate 6%
- Market rate 10% (bond issued at discount)
- Transaction costs: 12
- Maturity: 30 June 2021

Key point: The *effective rate* is higher than 6%, reflecting discount and costs → will be computed next.

Fair value computation table for a 5-year bond with:
Nominal rate = 6%, Market rate = 10%, Annual interest = 30 (6% of 500), Maturity = 500

	1-Jul-16	**30-Jun-17**	**30-Jun-18**	**30-Jun-19**	**30-Jun-20**	**30-Jun-21**
Discount rate/Cash payment	10%	30	30	30	30	530

	1-Jul-16	30-Jun-17	30-Jun-18	30-Jun-19	30-Jun-20	30-Jun-21
Discount factor		0.91	0.83	0.75	0.68	0.62
Discounted cash flows		27.3	24.8	22.5	20.5	329.1

Fair value = 424.2

Subtract transaction costs (12) → Amortized cost = 412.2

To match 412.2, the effective interest rate (EIR) must be 10.72%.

Conceptually: the EIR equals the internal rate that equates discounted outflows (interest + redemption) with the initial amortized cost.

Bonds Amortized Cost (Journal Entries)

Date	Cash	Debt	Retained Earnings / Net Income	Debt
Start	1,000	–	1,000 (Equity)	
Bond issue	+424.2 cash	424.2		
Transaction cost	–12			–12
Interest 2017	–30 cash	412.2	412.2 × 10.72% = 44.2	14.2
Interest 2018	–30 cash	426.4	426.4 × 10.72% = 45.7	15.7
Interest 2019	–30 cash	442.1	47.4	17.4
Interest 2020	–30 cash	459.4	49.2	19.2
Interest 2021	–30 cash	478.7	51.3	21.3
Repayment	–500 cash	–500		

Total expense: (500 – 424.2) + (30 × 5) + 12 = 237.8
This reflects the full cost of borrowing given the discount.

Impairment of Financial Assets

Expected Credit Loss (ECL) Example

Scenario:
• Loan to another company: 100
• Maturity: 5 years

Probabilities of default (PD):
• At start: 1% within 1 year, 5% within 5 years
• End of Year 1: PD = 10% (1 yr), 30% (remaining)
• After Year 2: interest payments cancelled, debt covenants breached, PD = 60%

Question: How to treat expected credit losses under IFRS 9?

General Approach

1. Stage 1 – 12-month ECL
    - Initially recognized assets
    - Low risk
    - Interest calculated on *gross carrying amount*
2. Stage 2 – Lifetime ECL
    - Significant increase in credit risk
    - Lifetime losses recognized

- Interest still on gross carrying amount

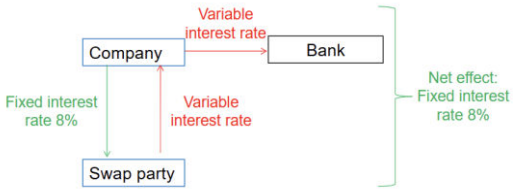
3. Stage 3 – Credit-Impaired
   - Actual evidence of loss
   - Lifetime ECL
   - Interest now based on *amortized cost (net of allowance)*

Simplified Approach

Used for trade receivables: always *lifetime ECL*; no need to track credit risk changes.

Hedge Accounting

Example: Heineken 2024 – Hedge Accounting
• Derivative financial instruments are recognized initially at fair value.
• Subsequent accounting depends on hedge designation: Cash flow hedge, Fair value hedge, Net investment hedge
• Positive fair values → assets; negative → liabilities.



Example: Cash Flow Hedge

• Changes in FV recognized in Other Comprehensive Income (OCI) if hedge is effective.
• Ineffective portion → P&L as net finance income/expense.

Example: Borrowings: borrowings at FV include adjustments for *hedged risks*.

Cash Flow Hedge Example

Scenario setup:
• Date: 1 January FY1
• Loan with bank
• Face value: 100
• Maturity: 2 years
• Variable interest rate
• Interest paid each 31 December
• No transaction costs

To hedge the interest rate risk, the company enters a swap contract:
• Company pays fixed 8% interest.
• Receives variable rate from swap counterparty.

Expected variable (market) rates:
• 1 Jan FY1: 8%
• 31 Dec FY1: 10% (expectation for FY2)

Actual rates:
• FY1: 8%
• FY2: 10%

Fair value of debt at 1 Jan FY1 (discounted at 8%):

Year	Interest	Discount factor	PV 8%
1	8	0.93	7.4
2	108	0.86	92.6

Balance Sheet at 31 Dec FY1 with hedge

Asset	Liabilities
Cash 192	Share capital 100
Swap 1.8	Retained earnings -8
	Hedging reserve 1.8
	Debt 100
Total = 193.8	Total = 193.8

Year	Interest	Discount factor	PV 8%

Total FV = 100.0

Fair value of swap at 1 Jan FY1:

- Payments: fixed 8% = −8
- Receipts: variable 8% = +8

Net = 0, so FV = 0

Balance Sheet at 1 Jan FY1

Asset	Liabilities
Cash 200	Share capital 100
Swap 0	Debt 100
Total = 200	Total = 200

Both debt and swap initially at par (no FV change).

Fair Value of Swap at 31 Dec FY1

- Payments: fixed −8
- Receipts: variable +10
- Net = +2
- Discounted by 10% (2*0.9)= 1.8

→ Fair value = +1.8

At FY2 end: no future cash flows → FV = 0.

So, swap gains €1.8 in Year 1 and loses it back in Year 2.

Without Hedge Accounting (FY1):

Interest expenses -8.0, Financial income (FV swap) 1.8
So, net income (assuming no taxes) -6.2

Explanation: The hedge *economically stabilizes* interest at 8%, but without hedge accounting, volatility remains in net income.

With Hedge Accounting (FY1):

Interest expenses -8.0, Financial income (FV swap) 0
So, net income (assuming no taxes) -8

Reason: FV change in swap (+1.8) is recorded in Hedging Reserve (OCI), not in P&L.

Balance Sheet at 31 Dec FY1 without hedge

Asset	Liabilities
Cash 192	Share capital 100
Swap 1.8	Retained earnings -6.2
	Debt 100
Total = 193.8	Total = 193.8

Without Hedge Accounting (FY2)

Interest expense	−8.0
FV swap change	−1.8
Net income	−9.8

Explanation: The hedge offsets actual interest changes economically, but accounting still shows volatility.

Balance Sheet (31 Dec FY2) without hedge:

Assets		Liabilities	
Cash	184	Share capital	100
Swap	0	Retained earnings	−16
		Debt	100
Total	184	Total	184

With Hedge Accounting (FY2)

FV swap returns to 0; the 1.8 gain from Year 1 is reversed out of the Hedging Reserve.

Journal entry: Dr Hedging reserve 1.8, Cr Swap 1.8

Interest expense	−8.0
Financial income (swap)	0.0
Net income	−8.0

Key takeaway: Hedge accounting successfully stabilizes *reported profit*, avoiding artificial P&L swings.

Balance Sheet (31 Dec FY2) with hedge:

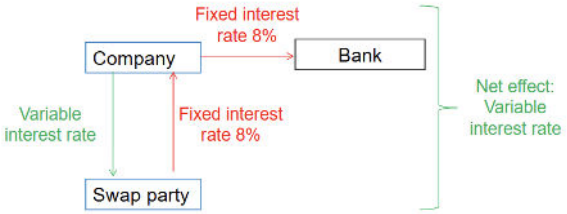
Asset		Liability & Equity	
Cash	184	Share capital	100
Swap	0	Retained earnings	−16
Debt	100	Hedging reserve	0
Total	184	Total	184

Cash Flow Hedge: Overall Impact

• Key principle: When a cash flow hedge is *fully effective*:
• Changes in fair value of the hedging instrument are recognized in Other Comprehensive Income (OCI), within equity (hedging reserve).
• The *P&L* is not affected until the hedged cash flows actually occur.

	Without Hedge Accounting		**With Hedge Accounting**	
	Interest	−8.0	Interest	−8.0
FY1	Change FV swap	+1.8	Change FV swap	0.0
	Total	**−6.2**	**Total**	**−8.0**
	Interest	−8.0	Interest	−8.0
FY2	Change FV swap	−1.8	Change FV swap	0.0
	Total	**−9.8**	**Total**	**−8.0**
Total		**−16.0**		**−16.0**

Interpretation: Hedge accounting doesn't change total profit over time, but it removes volatility per year, producing smoother income.



Fair Value Hedge Example

Scenario:

- Date: 1 January FY1
- Fixed interest rate 8%
- Loan agreement with bank:
- Interest paid 31 December each year
- Face value: 100
- Transaction costs: 0
- Maturity: 2 years

The company enters into a *swap* that converts fixed interest payments into variable ones.

Market Interest Rates

Expected variable rate (at 1 Jan FY1) for FY1 and FY2: 8%
Expected at 31 Dec FY1 (for FY2): 10%

Actual variable rate FY1: 8% and FY2: 10%

Fair Value of Debt at 1 Jan FY1

At start, the fair value equals par value (100):

Year	**Interest**	**Discount 8%**	**PV**
1	8	0.93	7.4
2	108	0.86	92.6

Total FV = 100

Fair Value of Swap at 1 Jan FY1

The swap initially has *no fair value* (because both fixed and variable rates = 8%).

Balance Sheet 1 Jan FY1

Assets		Liabilities	
Cash	200	Share capital	100
		Debt	100
Total	200	Total	200

Starting balance before any changes in rates or swaps.

Swap Fair Value at 31 Dec FY1

With rates rising to 10%:

Year	Payments (variable)	Receipts (fixed)	Net	PV (10%)	FV
1	−10	+8	−2	×0.91	−1.8

Fair value = −1.8

At 31 Dec FY2: FV = 0 (no future cash flows left).
Thus, in FY1, the swap *loses 1.8* in fair value.

Debt Fair Value at 31 Dec FY1

As market rates rise to 10%, the debt's value falls:

Year	Interest 8%	Principal 100	PV @10%	FV
1	8	100	0.91	**98.2**

So, the bond's fair value decreases by 1.8 (from 100 → 98.2).
At FY2 end: FV = 100 (final repayment).

Without Hedge Accounting (FY1)

Interest expense	−8.0
FV change (swap)	−1.8
Net income	−9.8

Key idea: Swap loss (−1.8) enters P&L immediately, but debt remains at amortized cost (not revalued).
→ Profit volatility not aligned with actual risk exposure.

Balance Sheet:

Assets	Liabilities
Cash 192	Share capital 100
	Retained earnings −9.8
	Swap 1.8
	Debt 100
Total 192	Total 192

With Hedge Accounting (FY1)

Now, the *hedged item (debt)* and *hedging instrument (swap)* are both measured at fair value.

Interest expense	−8.0
FV change swap	−1.8
FV adjustment debt	+1.8
Net income	−8.0

Journal Entries: Dr Swap 1.8, Cr Financial income (swap) 1.8
Dr Debt 1.8, Cr Financial income (debt) 1.8

Balance Sheet:

Assets	Liabilities
Cash 192	Share capital 100
	Retained earnings −8
	Swap 1.8
	Debt 98.2
Total 192	Total 192

The P&L impact now reflects the variable rate environment.

Without Hedge Accounting (FY2)

Interest expense	−10.0
FV change (swap)	+1.8
Net income	−8.2

Interpretation**:** Even though interest rises, the P&L fluctuates inconsistently with rate movements — *not aligned with real risk profile.*

Balance Sheet:

Assets	Liabilities
Cash 182	Share capital 100
	Retained earnings −18
	Swap 0
	Debt 100
Total 182	Total 182

With Hedge Accounting (FY2)

Interest expense	−10.0
FV change swap	+1.8
FV change debt	−1.8
Net income	−10.0

Journal Entries:
Dr Swap 1.8
  Cr Financial income (swap) 1.8

Dr Financial income (debt) 1.8
  Cr Debt 1.8

Balance Sheet:

Assets	Liabilities
Cash 182	Share capital 100
	Retained earnings –18
	Swap 0
	Debt 100
Total 182	Total 182

Hedge accounting results in stable net income, reflecting the economic reality of the hedge.

Impact of Hedge Accounting

	Without Hedge Accounting	**With Hedge Accounting**
FY1	Interest –8.0 Change FV swap –1.8 **Total –9.8**	Interest –8.0 Change FV debt +1.8 Change FV swap –1.8 **Total –8.0**
FY2	Interest –10.0 Change FV swap +1.8 **Total –8.2**	Interest –10.0 Change FV debt –1.8 Change FV swap +1.8 **Total –10.0**
Total	–18.0	–18.0

Interpretation: Under *fair value hedge accounting*, both hedged item and hedging instrument are measured at *fair value*, changes go directly into *P&L*. Removes mismatch, aligns accounting with economic hedge.