CHAPTER 6
REPORTING PERFORMANCE

Quick test

Question 1

On 1 September 20X2 for each of (a) (b) and (c), an impairment loss of £5,000 (20,000 – 15,000) is recognised, and the asset is written down to its fair value less costs to sell of £15,000.

	(a)	(b)	(c)
	£	£	£
20X2			
1 September impairment (loss)	(5,000)	(5,000)	(5,000)
31 December impairment (loss) / gain	(1,000)	2,000[1]	5,000[2]
(Loss)/gain recognised in 20X2	(6,000)	(3,000)	-
Asset remeasured at	14,000	17,000	20,000
20X3			
At June 20X3			
Profit / (loss) on disposal	16,000 – 14,000	16,000 – 17,000	16,000 – 20,000
	Profit £2,000	Loss £(1,000)	Loss £(4,000)

[1] This gain can be recognised because there was a previously recognised loss of greater amount.
[2] The gain is restricted to £5,000, and cannot be £7,000, since this would exceed the previously recognised impairment loss.

Comments
(i) The total charge (loss) to the statements of profit or loss over the 2 years is £4,000 in (a), (b) and (c) (an asset with carrying value of £20,000 has been sold for £16,000).
(ii) The impact of the revaluing to fair value in each of (a), (b) and (c) alters in which accounting period the gains / losses are recognised – quite substantial differences in each case.

Question 2

An operating segment is a reportable segment if one of its revenues, profit/loss and assets exceed 10% of the company’s total revenues, total profit/loss and total assets respectively.

As Dewey has both profit making and loss making segments, the results of those in profit and those in loss must be totalled to see which is the greater:

		£m
Profits	(310 + 130 + 80 + 30)	550
Losses	(50 + 100)	(150)
		400

So the '10% of profit or loss' threshold is 10% x £550 million = £55 million
Other thresholds are:
10% x total revenue = £240 million
10% x total assets = £100 million

Operating segment	***Reportable?***
Sparrow	Reportable, because it generates more than 10% of total revenue (and profits)
Hawk	Not reportable, because it generates less than 10% total revenue, its losses are less than 10% of £550m and its assets less than 10% of total assets
Eagle	Reportable, because it meets one (in fact all the) criteria
Owl	Reportable, because it meets one (in fact all the) criteria
Robin	Reportable, but only because its losses are more than 10% of £550m
Thrush	Not reportable, because it fails all criteria

Check that the reportable segments identified above satisfy the 75% of total external revenue test:
(940 + 400 + 220 + 160) / 2,000 = 86%

Sparrow, Eagle, Owl and Robin are reportable segments.

Question 3

(a) Beta is not a related party. A junior manager is unlikely to be a member of key management personnel in Alpha and with only a 10% holding in Beta is unlikely to have significant influence over it.

(b) The daughter is a related party. The director is a related party as a member of key management personnel, and his or her daughter falls within the definition of close family members.

(c) Gamma Ltd. is a related party as it is under the control of a member of key management personnel.

(d) Miss Delta is probably a related party since a 25% shareholding is likely to provide her with the ability to exert significant influence. This will depend, however, on who holds the remaining 75%.

(e) If the director is one amongst many on the board of Epsilon and there are no other directors on both the boards of Alpha and Epsilon, then it is unlikely that there is common control or influence. The act of merely being a director on both boards does not mean that the second entity is automatically a related party of the first entity. There is probably no related party relationship.

(f) The niece is not a sufficiently close relative of Alpha's finance director for Zeta Ltd. to constitute a related party.

Question 4

(a) The ownership of White makes it a related party of Black. Disclosure needs to be made of the nature of the relationship, any transaction during the period and the fact that the £100,000 balance was considered to be non-recoverable and therefore charged to the statement of profit or loss. There is no requirement to disclose the debt collection costs of £4,000, or the names of White, the director or his or her son.

(b) Blue is almost certainly a related party of Black as a result of Black's significant influence through the 40% shareholding. Despite being at an arm's length price, the value of the transaction should be disclosed (aggregated with similar transactions during the year if appropriate). If Black discloses that the related party transactions were made on terms equivalent to market price transactions, this should be substantiated. The nature of the relationship, but no names, is required to be disclosed.

(c) A distributor is not a related party, so no disclosure is required.

(d) The nature of the relationship, details of the amount and nature of the transaction should be disclosed, along with the fact that Black is guaranteeing the loan of a related party. If payment is outstanding at the year-end then the amount should be disclosed, although the director does not need to be named.

Develop your understanding

Question 5

The key question is – are these discontinued operations as defined by IFRS 5, and if so how should they be accounted for? The IFRS provides details of the definition of a discontinued operation:

A component of an entity that either has been disposed of or is classified as held for sale and:
(a) represents a separate major line of business or geographical area of operations,
(b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations, or
(c) is a subsidiary acquired exclusively with a view to resale.

A component of an entity is further defined as one whose operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

Applying these definitions to the scenarios:

(a) The closure of the only remaining manufacturing division amounts to the withdrawal from a particular line of business, and would therefore be classed as a discontinued operation.

(b) The sale of the only division that operated in Europe amounts to the withdrawal from a geographical area of operation, and would also be a discontinued operation. The fact the sale has not occurred by the end of the year means the division would be classed as a disposal group held for sale. The actual date of sale is irrelevant.

(c) The activities carried on by the research division would not meet the definition of a component of an entity since its operations do not appear to be clearly distinguishable from the other smaller ones which are operated from the same location in the main headquarters of the company. Therefore this division's closure would not be a discontinued operation.

For (a) and (b) a single separate line item would be included in the statement of comprehensive income, called profit/loss from discontinued operations, and the amount would comprise:
- the post-tax profit or loss of these two divisions, plus
- the post-tax profit or loss from the sale of the net assets of the manufacturing division, plus
- the post-tax gain or loss recognised on the remeasurement of the European division's net assets to fair value less costs to sell.

Question 6

(a) One of the main difficulties with interpreting the performance of a large international company like Bullfinch plc is that the figures on the face of the main financial statements are aggregated. The company is operating hotels in several different geographical regions which have their own economic environment and which are subject to:

- different rates of profitability and growth;
- different future prospects and opportunities; and
- different risks.

To fully understand the performance of Bullfinch as a whole, the information needs to be disaggregated into these different economic environments, so that the effect of them on the performance and financial position can be determined. This will enable users to identify and take appropriate actions if there are regions in which Bullfinch is operating which are performing poorly.

The core principle of IFRS 8 is to:

> "disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates."

(b) Management determines what an operating segment is for their company, but based on guidance set out in IFRS 8. This specifies that an operating segment is a component of a business:

- that engages in business activities from which it may earn revenues and incur expenses,
- whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and
- for which discrete financial information is available.

The "chief operating decision maker" is a description of the role of someone who is essentially in charge of the segment; a company does not have to have an individual employee with that title. It may be Bullfinch's chief executive officer (CEO), but it may be the whole board of directors.

The business activity for Bullfinch, which provides the same service world-wide, would be a geographical region where its hotels are located.

To determine for which regions disaggregated information is required to be disclosed, IFRS 8 specifies certain size thresholds that should be reached by a region. Only one of the following thresholds has to be reached:

1. Reported revenue, including both sales to external customers and intersegment sales or transfers, is 10% or more of the combined revenue, internal and external, of all operating segments.

2. The absolute amount of its reported profit or loss is 10% or more of the greater, in absolute amount, of (i) the combined reported profit of all operating segments that did not report a loss and (ii) the combined reported loss of all operating segments that reported a loss.
3. The assets are 10% or more of the combined assets of all operating segments.

Geographical regions that do not meet any of these thresholds should be combined with other regions, provided they have similar economic characteristics, and the aggregated figures tested for reportability. The management of Bullfinch may also classify a geographical region as reportable even if the thresholds are not reached, if it believes this information would be useful to users.

To ensure that sufficient detailed information is disclosed about the Bullfinch's activities, IFRS 8 requires that if the total external revenue of the reportable regions identified from the 10% tests constitutes less than 75% of the Bullfinch's revenue, additional regions have to be identified as reportable, even if they do not meet the 10% criteria.

For Bullfinch plc the 10% thresholds are:

Revenue	10% x (200 + 3 + 300 + 2 + 500 + 5) = £101 million
Profit / (loss)	10% x (60 + 105) = £16.5 million*
Assets	10% x (300 + 800 + 2,000) = £310 million

* Note – the higher of the absolute profits or losses is taken

All regions provided have total revenues in excess of £101 million, so all regions are reportable segments. Given that these regions constitute the whole of Bullfinch's business, the 75% criteria is also satisfied.

(c) The following information can be calculated:

Relative sizes of each of the regions:

Region	***External revenue***	***Profit / (loss)***	***Net assets (Assets – liabilities)***
Europe	20%	(6.5%)	8.3%
South East Asia	30%	38.7%	41.7%
Americas	50%	67.7%	50.0%
	100%	100%	100%

Financial ratios for each of the regions:

Region	***ROCE (Profit/Net assets)***	***Net profit margin (Profit/Revenue)***	***Asset turnover (Revenue/ Net assets)***
Europe	(10%)	(5%)	2.0
South East Asia	12%	20%	0.6

Americas	17.5%	21%	0.83
Total	12.9%	15.5%	0.83

This reveals the following:

- The Americas region is the largest by all measures – although it generates half of total external revenues and has half of Bullfinch's net assets, it brings in 67.7% of the total net profit. Its influence on the overall results of the company will be the largest.
- Europe generates one fifth of the company's revenues, but has made a loss. It has relatively low net assets because it has proportionately larger liabilities than the other two regions.
- Europe has therefore got negative returns, but is generating higher revenues from its net assets than the other two regions. This is due to the proportionately higher liabilities.
- The Americas region has outperformed Europe and South East Asia by all measures, which has pulled up the overall company performance. The losses of Europe are less significant, although they still need to be investigated.

(d) Bullfinch is operating its hotels globally, and economic conditions are very different in different international regions. Without the segmental information, it would be difficult for an external user of the financial statements to ascertain where Bullfinch is generating its returns, or how the different economic conditions have affected the company's performance and financial position in these regions. It would not be known, for example, that the hotels in Europe were making an overall loss, given that overall the company has made a profit. Investors will probably wish to question the management about this, and the answers may influence their investment actions.

What is not known about the segmental information presented, and which is a criticism of the approach to the disclosures taken by IFRS 8, is the following:

- The basis on which this information has been drawn up and whether it is in accordance with IFRS (although note that IFRS 8 does require a reconciliation of this segmental data to the IFRS-based financial statements)
- Whether there are common costs or other financial items which have not been allocated to the segments – note this is particularly common for liabilities which are often on a total company basis
- Whether this information ties in with the narrative information included in Bullfinch's annual report

In particular for Bullfinch, the presented segments are fairly large and aggregate financial information from different economic environments themselves – e.g. does the Americas include both the USA and Sothern America countries, and what countries are included in South East Asia? A further break-down of this information would be useful, although IFRS 8 does suggest that the information should not become too detailed and unwieldy with ten suggested as the maximum number of segments.

Question 7

	Hotels and restaurants	***Costa***	***Total***
Revenue % of total Underlying operating profit % of total Net assets % of total allocated	64% 75% 91%	36% 25% 9%	
RONA Underlying operating profit Net assets	401.4 2,984.3 = 13.5%	132.5 286.1 = 46.3%	504.4 1,977.9 = 25.5%
Net profit margin Underlying operating profit Revenue	401.4 1,659.2 = 24.2%	132.5 948.9 = 14.0%	504.4 2,608.1 = 19.3%
Net asset turnover Revenue Net assets	1,659.2 2,984.3 = 0.56	948.9 286.1 = 3.3	2,608.1 1,977.9 = 1.3

Previous years' financial information is not available, so it is not possible to ascertain how the relative sizes of the two segments has changed. However in 2015 the hotels and restaurants segment is clearly the largest in terms of all three financial measures – revenues, operating profit and net assets. The differences in the proportions of the measures should be noted. It should not be surprising that the hotels and restaurants segment has a large majority (91%) of the company's net assets given the nature of this business segment. The operation of a coffee shop franchise will require far fewer assets. However, hotels and restaurants bring in only 64% of total revenues and contribute 75% of operating profit – both much lower proportions.

This then influences an analysis of the relative financial ratios which have been calculated. Costa's return on net assets is an impressive 46.3% and far larger than the hotels and restaurants return of 13.5%. Of course with a much higher proportion of net assets and lower proportion of profit, this latter segment will have a lower return, but the difference between the two segments is significant. The net asset turnover, which measures the revenues generated from the use of the net assets, follows this. Costa generates £3.30 of revenues for every £1 of net assets, whilst the hotels and restaurants segment only generates £0.56 per £1. Based on these two ratios, the statement relating to the growth of Costa being a key strategy is understandable.

However, when it comes to net profit margin, a different picture emerges – of the hotels and restaurants segment being more profitable – a net profit margin of 24.2% compared to only 14.0% for Costa. The provision of hotel services and restaurant meals can command a much higher profit margin than the limited services of a coffee shop. This segment has a significant influence on the company's overall profit margin – a key measure of profitability. The company would not wish to concentrate on growing Costa at the expense of its more profitable hotels and restaurants business. Given the competition in the coffee shop business and the limitations of what it can offer or make different, it is likely that significant increases in profit margins from this business are restricted.

It should be noted that in the calculations using net assets, £1,337.5 million of liabilities are unallocated. It is likely that these corporate liabilities include company borrowings and other corporate obligations. It is assumed that the allocation of the liabilities to the two segments has been done in a consistent manner, so a comparison of the ratios including net assets is relevant.

Take it further

Question 8

Crompton plc
Statement of comprehensive income for the year ended 31 December 20X7

	£
Revenue (W1)	2,459,666
Cost of sales (W2)	1,913,961
Gross profit	545,705
Distribution costs (W3)	214,797
Administrative expenses (W4)	190,240
	405,037
Profit from operations	140,668
Finance costs (W5)	(20,000)
Income from investments	2,100
Loss on disposal of discontinuing operations (W6)	(16,388)
Profit before tax	106,380
Income tax (W7)	49,200
Net profit for the year	£57,180

Crompton plc
Statement of financial position at 31 December 20X7

	£
ASSETS	
Non-current assets	
Property, plant and equipment (W8)	284,940
Investments	20,000
Held for sale	25,000
	329,940
Current assets	
Inventories	340,600
Trade and other receivables (W9)	415,526
	756,126
TOTAL ASSETS	£ 1,086,066
EQUITY	
Capital and Reserves	
Share capital	200,000
Retained earnings	201,456
	401,456

LIABILITIES	
Non-current liabilities	
Financial liabilities	200,000
Current liabilities	
Trade and other payables (W10)	471,410
Tax liabilities (W11)	13,200
	484,610
TOTAL EQUITY AND LIABILITIES	£ 1,086,066

Workings

1. Revenue

	£
Per trial balance	2,640,300
Less: from discontinued operation	(180,634)
	£ 2,459,666

2. Cost of sales

	£
Inventories at 1.1.X7	318,500
Purchases	2,089,600
Inventories at 31.12.X7	(340,600)
Less: from discontinued operation	(153,539)
	£ 1,913,961

3. Distribution costs

	£
Selling and distribution costs	216,320
Accrual	21,300
Less: from discontinued operation	(22,823)
	£ 214,797

4. Administration expenses

	£
Per trial balance	220,280
Prepayments	(12,200)
Increase in provision for bad debts	2,400
Less: from discontinued operation	(20,240)
	£ 190,240

5. Interest payable

	£
Per trial balance	10,000
Accrual	10,000
	£ 20,000

6. Discontinued operations

			£	£
Results from operations of discontinued operation				
Revenue				180,634
Cost of sales				(153,539)
Admin expenses				(20,240)
Distribution costs				(22,823)
				(15,968)
Income tax				3,500
				(12,468)
Loss on sale of business operation				(8,800)
Profit on sale of premises				40,000
Revaluation of non-current assets held for sale				
	Vehicles	Fair value less costs to sell	20,000	
		Carrying amount	43,554	
		Impairment loss		(23,554)
	Office equipment	Fair value less costs to sell	5,000	
		Carrying amount	16,566	
		Impairment loss		(11,566)
				£ (16,388)

7. Tax expense

	£
Per trial balance	45,700
Tax gain on discontinued operation	3,500
	£ 49,200

8. Non-current assets

Property, plant and equipment	£
Office equipment	110,060
Less: held for sale	(16,566)
Vehicles	235,000
Less: held for sale	(43,554)
	£ 284,940

9. Trade and other receivables

	£
Trade receivables	
Per trial balance	415,800
Provision for doubtful debts (3% x 415,800)	12,474
	403,326
Prepayment	12,200
	£ 415,526

10. Trade and other payables

	£
Bank overdraft	11,860
Trade payables	428,250
Accruals (£21,300 + £10,000)	31,300
	£ 471,410

11. Tax liabilities

	£
Corporation tax charge	45,700
Tax paid in year	(32,500)
	£ 13,200

Note
Included in the notes would be analysis of the loss on disposal of discontinuing operations between loss from operations and tax effect of this, plus loss on disposal of non-current assets and revaluation of assets held for sale.

Question 9 – Next plc

See solution to Chapter 6's case study