**Provisions, contingent liabilities and contingent assets (IAS 37)**

**Objective**

IAS 37 sets appropriate recognition and measurement criteria for provisions, contingent liabilities and assets.

* It prevents entities from manipulating profits (**profit smoothing**) using provisions. For example, an entity may create a provision in years where profits are high (thereby artificially reducing profits) and subsequently reverse the provision in years where profits are low (thereby artificially increasing profits), see example.

Target Actual Profit smoothing

2022 70m 100m 30m Dr P/L 30m Cr Provision 30m

2023 90m 80m + 10m Dr Provision 10m Cr P/L 10m

**Definition of a provision**

A provision is a liability of **uncertain** timing or amount.

* Provisions differ from other liabilities like trade payables as there is **uncertainty** about their timing & amount.

**Recognition of a provision**

* A provision isrecognizedwhen**:**
* An entity has a **present** **obligation** (legal or constructive**)** as a result of a past event.
* It is **probable** (probability exceeds 50%)that a transfer of economic benefitswill be required to settle it.
* A **reliable estimate** of the obligation can be made.

If just one of them is not met, then you should either:

* Disclose a **contingent liability** (covered later), or
* **Do nothing** if the outflow of economic benefits is remote.
* A **legal obligation** arises from legislation, contracts or a court case.
* A **constructive obligation** arises from an entity’s actions where:
* From past practice, published policies or statement, that it will accept certain responsibilities and
* As a result, it has created a valid expectation on those parties that it will discharge those responsibilities.
* The obligation arises from a past event that creates a legal or constructive obligation.
* If an obligation can be avoided by some future actions, then no provision should be made.

MK Co has a published environmental policy of always replanting trees to address damage created by their operations. MK Co has a history of honouring this policy. During 2022, MK Co opened a new factory, leading to some environmental damage. MK Co estimates that the damage will cost Shs 40 million to restore. Even if the country has no legal regulations forcing MK Co to replant trees, the company has a constructive obligation because it has created an expectation from its publications, practice and history.

**Measurement of provisions**

* The amount recognized as a provision is the **best estimate** of the expenditure required to settle the present obligation at the reporting date.
* Such estimates are determined by judgement of management using their experience of similar transactions and, if necessary, reports from independent experts.
* For a single obligation like a case in court, it is the **most likely outcome.**
* For a large population such as a warranty provision for goods, it is the **expected value** calculated using the probability of all events happening.
* To record a provision: Dr Expense (P/L)/Asset\*

Cr Provision (Liability in SOFP)

\*In the cost of another asset when there it a provision for decommissioning costs for the asset in IAS 16.

The provision gives access to future economic benefits.

When it is uncertain when the amount will be paid, the provision is classified as a non-current liability.

To record an increase in a provision: Dr Expense

Cr Provision *with the amount of the increase*

To record a decrease in a provision: Dr Provision

Cr Profit or loss *with the amount of the decrease*

To record the settlement of an obligation by payment: Dr Provision

Cr Cash

**Example 1**

How would you account for the following events in the financial statements of MK Co?

1. MK Co has received legal advice that the most likely outcome of the court case by an employee is that they will lose the case and have to pay Shs10m. The legal team thinks there is an 80% chance of this. They believe there is a 10% chance of having to pay Shs 12m and a 10% chance of paying nothing.

As it is probable that MK would lose the case, a provision should be made.

As this is a single item, the most likely outcome should be used**.**

MK Co should provide Shs 10m, being the most likely outcome.

Dr Legal costs (P/L) 10m

Cr Provision for legal costs 10m (*Current liability in SOFP*)

1. MK Co gives a year’s warranty with all goods sold during the year. Past experience shows the following:

No need to do repairs on 85% of the goods

10% of the goods need minor repairs

5% of the goods need major repairs.

MK Co’s production manager has estimated the following repair costs:

Minor repairs on all goods would cost Shs 100m

Major repairs on all goods would cost Shs 400m

* There is a present obligation as a result of a past event arising from a legal contract as a result of the warranty given to customers.
* It is probable that a transfer of economic benefits will be required to settle the obligation of repairing goods.
* A reliable estimate of the obligation can be made using the expected value as it is a large population.

The provision = (10% x Shs 100m) + (5% x Shs 400m) = Shs 30m.

Dr Repair costs (P/L) 30m

Cr Provision for product warranty 30m (*Current liability in SOFP*)

* Provision should be **used only** for expenditures for which they were originally recognised.
* Provisions should be **reviewed** at each reporting date and adjusted if necessary. If they are no longer appropriate, they should be reversed.

**Reimbursements from third parties**

A provision should be made even where reimbursement is expected from a third party as the entity’s liability and right to reimbursement are two separate items.

For example, a company vehicle caused a damage amounting to Shs 20 million but it has an insurance policy covering third party liability and a reimbursement for damages is expected from the insurance company. At the end of the reporting period, no reimbursement has been made.

As there is a present obligation the company should make a provision for Shs 20m.

Dr Accident compensation expense (P/L) 20m

Cr Provision for motor vehicle accident 20m

* As it’s not virtually certain the compensation will be received, you should disclose the existence of a contingent asset in the notes to the financial statements if it is probable.

When the victim is paid: Dr Provision for motor vehicle accident 20m

Cr Bank 20m

When compensation is received: Dr Bank 20m

Cr Accident compensation expense (P/L) 20m

F**uture operating losses/costs**

* No provision is madeas there is no past event and can be avoided by selling the business.
* They may suggest that assets are impaired and they should be tested for impairment under IAS 36.
* Gains from the **expected disposal of assets** should not be taken into account in measuring a provision.
* Material provisions to be settled after a year are **discounted** (using an appropriate discount rate) because of the time value of money.

**Onerous contract**

This is a contract where unavoidable costs of fulfilling the contract exceed the benefits from the contract e.g. a leased property where a tenant would compensate the landlord for terminating the lease.

Asit is a loss contract that cannot be avoided, a provision is the lower of:

* Unavoidable net costs of fulfilling the contract and
* Penalty for not meeting the contract

Costs of fulfilling a contract include both the incremental costs of fulfilling the contract like direct labour and materials and allocation of other costs directly related to fulfilling contracts like depreciation of assets used in fulfilling the contract (*Amendment effective January 2022*).

**Restructuring**

Restructuring is a plan of management tochange scope of business or a manner of conducting a business.

A provision for restructuring is made when an entity has a constructive obligation to restructure i.e. it:

* Has a **detailed formal plan** for the restructuring\*:
* Has created a **valid expectation** that the restructuring will be carried out i.e. has communicated the plan to those affected.

\*

* Part of the business being restructured
* Locations affected by the restructuring
* Location, function and number of employees who will be compensated for terminating their employment
* When the plan will be implemented
* The expenditure that will be undertaken.

Where the restructuring involves the **sale of an operation,** no obligation arises until the entity has entered into a **binding sale agreement** as management may change its mind and withdraw from the sale.

A restructuring provision includes only **direct expenditures** arising from the restructuring which are:

* **Necessarily entailed** by the restructuring.
* Not associated with the **ongoing activities** of the entity.

The following costs should **not** be included in a restructuring provision:

* **Retraining** or relocating continuing staff
* **Marketing**
* **Investment in new systems** and distribution networks

**Example 2**

At a board meeting on 1 July 2022, the directors of Pakalast made a decision to close down one of its factories on 31 October 2022. The factory and its related plant would then be sold. A formal plan was formulated and the 250 employees at the factory were given three months’ notice of redundancy on 1 August 2022. Customers and suppliers were also informed of the closure at this date.

Fifty employees would be retrained and deployed to other subsidiaries within the group at a cost of Shs 12.5 million, the remainder will accept redundancy and be paid an average of Shs 500,000 each. Penalty payments due to the non-completion of supply contracts are estimated at Shs 20 million, 50% of which is expected to be recovered from the company’s insurers. Account for the closure of the factory in the financial statements of Pakalast for the year ended 31 December 2022.

Solution

By formulating a plan and informing interested parties (employees, customers and suppliers), a restructuring provision should be made under IAS 37. The provision includes the following:

Shs 000

Redundancy (200 employees x 500,000) 100,000

Penalty payments 20,000

120,000

The Shs 12.5m retraining costs cannot be included in the provision as they are part of future activities.

The possible insurance receipt should be ignored as there is no certainty that it would be received and should not be netted off against the provision.

**Contingent liabilities**

* **A contingent liability**is:
* A possible obligation from past events confirmed by future events not within the control of the entity, or
* A present obligation from past events that is not recognised because:
* It is not probable that an outflow of economic benefits will be required to settle the obligation; or
* The amount of the obligation cannot be measured reliability.
* A contingent liability should be **disclosed** in the notes to the financial statements unless the possibility of an outflow of economic benefits is remote.
* The table below shows the treatment of various items based on their likelihood of happening.

|  |  |  |
| --- | --- | --- |
| **Likelihood** | **Outflow of resources** | **Inflow of resources** |
| Remote | Do nothing | Do nothing |
| Possible | Contingent liability | Do nothing |
| Probable | Provision | Contingent asset |
| Virtually certain | Provision | Asset |

**Contingent assets**

* A **contingent asset**is a possible asset arising from past events that will be confirmed by some uncertain future events not wholly within the control of the entity.
* A contingent asset is disclosed in the notes to the financial statements when it is **probable** that the economic benefits associated with the asset will flow to the entity.

**Example 3**

The former chief financial officer of Danze Ltd has sued the company claiming substantial damages for wrongful dismissal. The company's lawyers have advised that there is a possibility of the company losing the case in court. The lawyers’ estimates of the company's potential liabilities as follows:

Shs 000

Legal costs (to be incurred whether the claim is successful or not) 5,000

Settlement of claim if successful 50,000

55,000

Account for the claim in the financial statements.

Solution

As there is a possibility of the company not succeeding, Shs 50m should be disclosed in a contingent liability note. However, a provision for legal expenses of Shs 5m must be made as the amount has to be paid whether the claim is successful or not.

**Disclosure**

For provisions:

* Disclosure of details of the change in carrying amount of a provision from the beginning to the year end.
* Disclosure of the background to the making of the provision and the uncertainties affecting its outcome.

For each contingent liability (*unless it is likely to be remote*):

* A brief description of the nature of the contingent liability
* An estimate of its financial effect
* An indication of the uncertainties that exist
* The possibility of any reimbursement

For each contingent asset (*if they are probable*):

* A brief description of the nature of the contingent asset
* Where practicable, an estimate of its likely financial effect

A reporting entity may avoid disclosure requirements relating to provisions, contingent liabilities and contingent assets if that is expected to **seriously prejudice** itsposition in dispute with other parties. However, details of the general nature of the provision/contingencies must still be provided, together with an explanation of why it has not been disclosed.

**Discussion questions**

1. IAS 37 *Provisions, contingent liabilities and contingent assets* sets out the principles for accounting for provisions and contingences. Define a provision and explain the three conditions for recognizing a provision in accordance with IAS 37.
2. BMK Ltd sells goods under a six-month warranty. Any defect arising during that period is repaired free of charge. The company has calculated that if all the goods in the last six months of the year required repairs the cost would be Shs 200 million. If all of these goods had more serious faults and had to be replaced the cost would be Shs 600 million. The normal pattern is that 80% of goods sold will be fault-free, 15% will require repairs and 5% will have to be replaced. What is the amount of the provision required?
3. The directors of Nile Ltd decided in October 2022 to restructure the production division to reduce costs and improve efficiency. This plan was initiated in November 2020 with full staff consultation. At 31 December 2022 the anticipated costs are:

Shs 000

Redundancy costs 400,000

Lease cancellations 75,000

Retraining 60,000

Investment in new systems 25,000

Account for the above matter in the financial statements of Nile Ltd for the year ended 31 December 2022 in accordance with IAS 37 *Provisions, Contingent liabilities and Contingent assets*. Assume the items are material and ignore taxation.

Solutions

**b)** The provision is the expected value = (200m x 15%) + (600m x 5%) = 30m + 30m = Shs 60m.

**c)** The provision for restructuring costs = (400m + 75m) = Shs 475 m.

The cost of retraining and investment in a new system can be avoided and should not be included.

**Events after the reporting period (IAS 10)**

**Objective**

IAS 10 sets out the criteria for recognising events occurring after the reporting date.

**Definition**

Events after the reporting period are favourable and unfavourable events that occur between the end of the reporting period and the date when the financial statements are authorised for issue. There are two types:

* **Adjusting events** are events after the reporting period that provide evidence of conditions that existed at the reporting period.

Examples include:

* Evidence of a permanent decline in property value prior to the year end.
* Sale of inventory after the year end for less than its carrying value at the year end.
* Bankruptcy of a customer with a balance owing at the year end.
* Amounts received or paid in respect of claims which were in negotiation at the year end.
* Determination after the year end of the price of assets sold or purchased before the year end.
* Evidence of a permanent decline in the value of a long-term investment prior to the year end.
* Discovery of fraud or errors that show that the financial statements are incorrect.
* Financial statements are adjusted to reflect the adjusting events at the reporting date.
* **Non-adjusting events** are events after the reporting period that are indicative of conditions that arose after the reporting period.

Examples include:

* Major purchases and disposals of assets.
* Destruction of a production plant by fire after the end of the reporting period.
* A decline in the market value of investments.
* Dividends declared or proposed after the reporting period.
* Announcement or commencing implementation of a major restructuring.
* Share transactions after the end of the reporting period.
* Litigation commenced after the end of the reporting period.
* Acquisition or disposal of a subsidiary after the year end.
* Announcement of a plan to discontinue an operation.
* Financial statements are not adjusted but material events are disclosed in notes as they could influence decisions taken based on the financial statements.

Disclosures include:

* The nature of the event.
* An estimate of its financial effect or the statement that such estimate cannot be made

**Going concern** – if a non-adjusting event shows that an entity is not a going concern, the event should be treated as an adjusting event and the financial statements should not be prepared on a going concern basis.

**Dividends** – dividends declared after reporting date are **non-adjusting** events as they do not meet the criteria of a present obligation in IAS 37.

**Example**

The draft financial statements of Mapeera Ltd for year ended 31 December 2022 were expected to be approved by the board of directors on 15 March 2023 and published on 20 March 2023. No adjustment has been made for the following matters highlighted during the audit. The company's statement of profit or loss showed a profit before tax of Shs 180m. You are required to advise on how each matter should be handled in the financial statements of Mapeera Ltd for year ended 31 December 2022.

1. Closing inventory at 31 December 2022 includes 100 items carried at cost of Shs 50,000 each. These items do not comply with the new safety regulations announced on 5 January 2023 and take immediate effect. As a result, the net realisable value of each inventory item is only Shs 45,000.
2. A customer had sued Mapeera Ltd on 31 December 2022. According to the judgment given on 20 January 2023, the company was found liable for damages and costs totalling Shs 31 million. On 21 January 2023 Mapeera filed a claim with its insurers and on 28 February 2023 the company was notified that the insurer would cover Shs 26 million of the loss.

Provision 31m 31m

Award 50m 21m

Dr Court expense 19m

Cr Provision for court costs 19m

Dr Provision for court costs 10m

Cr Decrease in court provision (P/L) 10m

1. The company issued 1,000,000 ordinary shares in April 2023.
2. On 12 February 2023 a fire completely destroyed the company’s largest warehouse and the inventory it contained. The carrying amounts of the warehouse and the inventory were Shs 60 million and Shs 500 million respectively. It appears that the company had not updated the value of its insurance cover and only expects to be able to recover a maximum of Shs 300 million from its insurers. Mapeera’s trading operations have been severely disrupted since the fire and it expects large trading losses for some time to come.

Solution

1. The event causing the loss in value occurred after the reporting date and there was no condition existing at the reporting date. Had the goods been sold at the reporting date, the company would have obtained full price for them. Therefore, this is a non-adjusting event. If the loss is material, disclosure of the event should be made in the notes to the financial statements.
2. The liability existed at the reporting date but confirmation of the amount was only received on 20 January 2023. This is an adjusting event and a provision for the entire Shs 31 million should be included in the financial statements. The filing of the insurance claim was done after the reporting date and therefore no account should be taken of this at 31 December 2022. As confirmation of the successful claim was received before the financial statements were approved, the matter of the Shs 26m should be disclosed in the notes.
3. The issue of shares was made after the financial statements had been approved and this is neither an adjusting nor a non-adjusting event for the period ended 31 December 2022. Had the issue been before 15 March 2022, this would have been treated as a non-adjusting event requiring disclosure of the nature of the event and the possible financial effect on company in the notes to the financial statements.
4. This is normally classified as a non-adjusting event as the value of warehouse and the inventory was less than its carrying amount at the reporting date at 31 December 2022. The total loss suffered as a result of the fire is Shs 560 million and the company expects Shs 300 million of this loss to be recovered from insurance. Recoveries from third parties should be assessed separately from the related loss. As this event has caused serious disruption to trading, IAS 10 requires the details of this non-adjusting event to be disclosed as a note to the financial statements for the year ended 31 December 2022.

The severe disruption in the company’s trading operations since the fire together with the expected large trading losses for some time to come, may lead to doubt the going concern status of the company. If it is concluded that Mapeera is no longer a going concern, then the fire and its consequences are treated as an adjusting event and the financial statements for the year ended 31 December 2022 should be redrafted on a liquidation basis.

**Disclosures for adjusting and non-adjusting events**

* Date of authorisation of issue of financial statements and by whom.
* If the entity’s owners or others have the power to amend the financial statements after issue, the entity is required to disclose that fact.
* For any information received about conditions that existed at reporting date, disclosure that relate to those conditions should be updated with the new information.

**Discussion questions**

1. IAS 10 *Events after the reporting period gives* guidance for accounting for events that occur after the reporting date. Define the period to which IAS 10 relates, distinguish between adjusting and non-adjusting events and explain the accounting treatment and disclosures required in each case.
2. Justin Co prepares financial statements for the year ended 31 December 2022. The financial statements are to be authorised for issue on 15 March 2023. The following three events have occurred in January 2023:
3. A health and safety investigation of an incident which occurred in 2022 was concluded in January 2023, resulting in a Shs 15 million fine for Justin Co. A provision for Shs 1 million had been recognised in Justin Co’s financial statements for the year ended 31 December 2022.
4. Notice was received on 10 January 2023 that a customer owing Shs 120 million at 31 December 2022 had ceased trading. It is unlikely that the debt will be recovered in full.
5. The acquisition of a competitor was finalised on 10 January 2023, being the date Justin Co obtained control over the competitor. Negotiations in respect of the acquisition commenced in May 2022.
6. In addition to this, there is an outstanding court case at 31 December 2022 relating to faulty goods supplied by Justin Co. Legal advice states that there is a small chance that they will have to pay out Shs 60 million, but the most likely outcome is believed to be a payout of Shs 50 million. Either way, Justin Co will have to pay legal fees of Shs 2 million. All payments are expected to be made on 31 December 2023. Justin Co has a cost of capital of 10% (discount factor 0·909). Justin Co believes the fault lies with the supplier and is pursuing a counter-claim. Legal advice states that it is possible, but not likely, that this action will succeed.
7. In February 2023, a major fire broke out in Justin Co’s property and warehouse. Justin Co has no insurance, and now the management of the company believes it is unable to continue trading.

Required:

1. Which of the three events which occurred in January 2023 would be classified as adjusting events in accordance with IAS 10 *Events after the reporting period*?
2. What amount should be recorded as a provision in respect of the outstanding court case against Justin Co as at 31 December 2022 (to the nearest hundred thousand)?
3. How would you account for the counter-claim by Justin Co against the supplier at 31 December 2022?
4. How should the fire be reflected in Justin Co’s financial statements for the year ended 31 December 2022?

Solution

1. Health and safety fine and the customer ceased trading.
2. The provision should be recorded at the most likely outcome. This will be Shs 52 million discounted at 10% for one year = (52m x 0.909) = Shs 47,268,000.
3. Nothing is recognised or disclosed in the financial statements.
4. The financial statements can no longer be prepared on a going concern basis.

**Foreign currency transactions (IAS 21)**

**Objective and definitions**

IAS 21 *The effects of changes in foreign exchange* rates prescribes how to:

* Account for an entity’s foreign currency transactions and operations.
* Translate the financial statements of a foreign subsidiary to a presentation currency (*not covered here*).

A **functional currency** is the currency of the primary economic environment in which the entity operates (i.e. the one in which it generates and spends cash).

A **foreign currency** is a currency other than a functional currency.

A **presentation currency** isthe currency in which financial statements are presented.

**Spot exchange** rate is the exchange rate for immediate delivery.

**Closing rate** is the spot exchange rate at the end of the reporting period.

**Monetary items** are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency e.g. cash, receivables, trade payables, lease payables.

**Non-monetary items** are assets or liabilities that are not to be received or paid in a fixed or determinable amount of money e.g. PPE, investment properties, intangible assets, inventories, equity shares, government grants.

**Primary factors determining the functional currency include:**

* The currency that mainly influences the sales prices for goods and services.
* The currency of the country whose economy determines the sales prices of goods and services.
* The currency that influences labour, material and other costs.
* The currency in which funds from financing activities (e.g. loans and equity) are generated.
* The currency in which cash generated from an entity’s operating activities is usually retained.
* Where activities of a foreign operation are carried out as an extension of the reporting entity e.g. when it only sells goods imported from the reporting entity and remits the proceeds to it, the foreign operation should have the same functional currency as the parent.
* If the presentation currency is different from the functional currency, the financial statements must be translated into the presentation currency in order to prepare consolidated statements.

**Reporting foreign currency transactions in the functional currency**

* The foreign currency amount is initially translated into the functional currency using:
* Either the exchange rate on the transaction date (**Spot exchange rate**) or,
* An **average rate** over a period of time e.g. a month, if the exchange rates do not fluctuate significantly.
* At each subsequent SOFP date:
* Monetary amounts are translated at the closing rate.

Exchange gains or losses are recognized in profit or loss.

* Non-monetary items at historical cost are not translated.
* **Non-monetary items** measured at fair value are translated using the exchange rate at the fair value date.

Exchange gains or losses are recognised where gains or losses on the asset are recognized (OCI or P/L).

* Monetary items are cash and assets and liabilities to be received or paid in a fixed or determinable amount of cash. They include cash, receivables, payables, loans, leases payables, provisions, deferred tax.
* Non-monetary items are items that will not be received or paid in a fixed or determinable amount of cash.

They include property, plant, and equipment, investment property, intangible assets, inventory, prepayments, equity securities, deferred income, government grant.

**Example 1**

Pearl Ltd carried out the following transactions in foreign currency during the year ended 31st December 2024.

1. Exported coffee for $40,000 on 2 January 2024, $20,000 was received on 1 April 2024 and the balance in 2025.
2. Bought a generator on 1 April 2024 at $10,000, $5,000 was paid on 1 July 2024 and the balance in 2025.

The generator is depreciated over six years.

1. Bought property in Dubai at $40,000 on 2 January 2024. The property had a 20-year useful life with no residual value. The property was revalued at $50,000 on 31 December 2024.

Account for the above transactions in the financial statements of Pearl Ltd for year ended 31 December 2024.

Show the necessary journal entries**.** Relevant exchange rates against the dollar in 2024 were as follows:

2 January $1 = Shs 3,500

1 April $1 = Shs 3,600

1 July $1 = Shs 3,700

31 December $1 = Shs 3,200

Solution (Shs million)

1. To record revenue on 2/1/2024 at the spot rate: $40,000 x 3,500 = 140m.

Dr Trade receivable 140m

Cr Revenue 140m

To record money received on 1 April 2024 at the spot rate: $20,000 x 3,600 = 72m.

The shilling has depreciated against the dollar and this favours the exporter.

Foreign exchange gain recognized in profit or loss = 72m – 70m = 2m

Dr Bank 72m

Cr Trade receivable 70m

Cr Foreign exchange gain (P/L) 2m

To translate the monetary amount receivable on 31.12.2024 using the closing rate: $20,000 x 3,200 = 64m

The shilling has appreciated against the dollar and this does not favour the exporter.

Foreign exchange loss recognized in profit or loss = 64m – 70m = (6m)

Dr Foreign exchange loss (P/L) 6m

Cr Trade receivable 6m

Trade receivable in the SOFP at 31.12.2024: 64m (140m – 70m – 6m)

1. To record the purchase of plant (generator) on 1/4/2024 at the spot rate: $10,000 x 3,600 = 36m.

Dr Plant 36m

Cr Trade payable 36m

To record payment on 1 July 2024 at the spot rate: $5,000 x 3,700 = 18.5m.

The shilling has depreciated against the dollar and this does not favour the importer.

Foreign exchange loss recognized in profit or loss = 18m – 18.5m = (0.5m)

Dr Trade payable 18m

Dr Foreign exchange loss (P/L) 0.5m

Cr Bank 18.5m

To translate the monetary amount payable on 31.12.2024 using the closing rate: $5,000 x 3,200 = 16m

The shilling has appreciated against the dollar and this favours the importer.

Foreign exchange gain recognized in profit or loss = 18m – 16m = 2m.

Dr Trade payable 2m

Cr Foreign exchange gain (P/L) 2m

Trade payable in the SOFP at 31.12.2024: 16m (36m – 18m – 2m)

The plant is a non-monetary asset that is not restated at the reporting date, it remains at historical cost of 36m.

Depreciation of plant on 31.12.2024 = (36m/6) x 9/12) = 4.5m.

Carrying amount of plant in the SOFP at 31.12.2024 = 36m – 4.5m = 31.5m.

1. To record the purchase of property at the spot rate on 2.1.2024: $40,000 x 3,500 = 140m

Dr Property 140m

Cr Trade payable 140m

To record depreciation on 31.12.2024 in profit or loss of 7m (140m/20 years).

Dr Depreciation expense 7m

Cr Accumulated depreciation expense 7m

Carrying amount of plant before revaluation at 31.12.2024 = 140m – 7m = 133m

Property is a non-monetary item translated at the spot rate at the fair value date.

Property at fair value in SOFP at 31.12.2024 = $50,000 x 3,200 = 160m.

Foreign exchange gain to OCI/SOCE at 31.12.2024 = 160m – 133m = 27m.

Dr Property 27m

Cr Foreign exchange gain to OCI/SOCE 27m

The trade payable is a monetary item translated at the closing rate: $40,000 x 3,200 = 128m

Foreign exchange gain = 140m – 128m = 12m

Dr Trade payable 12m

Cr Foreign exchange gain 12m

**Translation of financial statements from the functional to presentation currency**

* Assets and liabilities for each SOFP are translated at the closing rate at the date of the SOFP.
* Income and expenses for each SOPLOCI are translated at actual exchange rates at the date of the transactions or at the average rate for the period if exchange rates do not fluctuate significantly.
* All resulting exchange differences are recognized in OCI as a translation reserve as a separate component of equity.

**Discussion questions**

1. IAS 21 *The effects of changes in foreign exchange rates* deals with the recording of foreign currency transactions and the translation of foreign currency financial statements into the presentation currency.
2. Distinguish between an entity’s presentation currency and functional currency.
3. State factors that determine the functional currency of an entity.
4. Mukwano Ltd whose year-end is 31 December 2024 purchased raw materials at $10,000 on 15 November 2024. The invoice was to be paid in two equal installments on 18 December 2024 and 31 January 2025. On 31 December 2024, one quarter of these goods remained in inventory. The exchange rates were as follows:

15 November 2024 $1 = Shs 3,600

18 December 2024 $1 = Shs 3,700

31 December 2024 $1 = Shs 3,400

31 January 2025 $1 = Shs 3,650

Account for the above in the books of Mukwano Ltd.

1. Elgon Ltd whose functional currency is the shilling, exported coffee for £30,000 at 31 July 2024. The amount remained receivable at 31 December 2024. The relevant exchange rates were as follows:

31 July 2024: £1 = Shs 4,500

31 December 2024: £1 = Shs 4,700

Account for the above in the financial statements of Elgon Ltd for year ended 31.12.2024.

Solution (Million Shs)

1. To record purchases using the exchange spot rate on 15.11.2024: ($10,000 x 3,600) = 36m

Dr Purchases 36m

Cr Trade payables 36m

Payment of $5,000 at the exchange spot rate on 18.12.2024: ($5,000 x 3,700) = Shs 18.5m.

The shilling has depreciated against the dollar.

Exchange loss = 18m ($5,000 x 3,600) – 18.5m = (0.5m):

Dr Trade payables 18m

Dr Exchange loss (P/L) 0.5m

Cr Bank 18.5m

Trade payables are a monetary item translated at the closing rate on 31.12.2024:

Amount payable is $5,000 x 3,400 (Closing rate) = 17m.

The shilling has appreciated against the dollar.

Exchange gain to profit or loss = (18m – 17m) = Shs 1m.

Dr Trade payables 1m

Cr Exchange loss (P/L) 1m

Inventory is a non-monetary item that remains at the historical rate and is not restated.

Inventory in the SOFP = 36m x1/4 = Shs 9m

Payment of $5,000 at the exchange spot rate on 18.12.2024: ($5,000 x 3,650) = Shs 18.25m.

The shilling has depreciated against the dollar.

Exchange loss = 18m – 18.25m = (Shs 0.25m)

Dr Trade payables 18m

Dr Exchange loss (P/L) 0.25m

Cr Bank 18.25m

**c)** 31.7.2024: The trade receivable & revenue are recorded at the spot rate = £30,000 x 4,500 = Shs 135m

31.12.2024: The trade receivable is a monetary item reported at the closing rate.

Trade receivable in SOFP: (£30,000 x 4,700) = Shs 141m

Exchange gain to profit or loss = 141m – 135m = Shs 6m

Sales revenue in the SOPL is at the spot rate = Shs 135m.