Part (a) Discuss, with supporting calculations where relevant - ○ **any potential errors in the draft consolidated statement of cash flows of the Firstgro Group for FY2020; and** ○ **the cumulative effect on the loan covenant requirements to the DBSA loan, after correcting these potential errors.** • **You may rely on the IFRS expert consulted by the financial accountant.** • **Do not discuss transactions that were accounted for correctly.** • **Assume, for Part I only, that all potential errors are material.** • **Round all calculated amounts to the nearest ZWL.** • **Round ratios to two decimal places.** • **Ignore the presentation of comparative information**			**Marks**
The following potential errors occurred in the consolidated statement of cash flows of the Firstgro group for the financial year ended 31 December 2020:			
1.	**Executive directors share-based payment scheme**		
1.1	Since **Firstgro has the choice of settlement**, it should have been determined on grant date whether Firstgro had a present obligation to settle in cash (IFRS2.41). On 1 April 2020, Firstgro had a **history and past practice to always settle in cash** when similar transactions are settled. Firstgro therefore had a **present obligation to settle the transaction in cash** on the grant date and should therefore have **accounted for the grant as a cash-settled share-based payment transaction** and not as an equity-settled share based-payment (IFRS2.41 & .42).		1 1 1 1
1.2	The incorrect classification of the grant resulted in an **incorrect share-based payment expense** of ZWL40,5 million (refer point 1.3) being **included in profit before tax**. Furthermore, the share-based payment expense of ZWL40,5 million was **not added back as a non-cash item** in arriving at cash generated from operations.		1 1
1.3	The **incorrect share-based payment expense** that should be removed from profit before tax can be calculated as follows:		
	3 $^{\text{directors}}$ (½) x 1,2 million $^{\text{shares}}$ (1) x ZWL45 $^{\text{FV}}$ (1) x 9/36 $^{\text{vesting period}}$ (½)	40 500 000	3
1.4	The **correct share-based payment expense** that should be included in profit before tax and then added back as a non-cash item in the statement of cash flows can be calculated as follows:		
	3 $^{\text{directors}}$ (½) x 1 million $^{\text{shares}}$ (1) x ZWL58 $^{\text{FV}}$ (1) x 9/36 $^{\text{vesting period}}$ (½)	43 500 000	3
2.	**New production line**		
2.1	Capitalised borrowing costs was **incorrectly presented as an investing activity as part of additions to property, plant and equipment instead of interest paid.** This is because the **total amount of interest paid** during a period **should be presented as part of interest paid** in the statement of cash flows, **irrespective of whether** the interest has been **capitalised or expensed** (IAS7.32). Furthermore, since it is the **accounting policy** of Firstgro to present interest paid as part of **operating activities** in the statement of cash flows, the capitalised borrowing costs should have been presented as part of interest paid under operating activities.		1 1 1
2.2	The **effective interest not capitalised** was **incorrectly included as part of cash interest paid** in the statement of cash flows. When interest is calculated using the effective interest method, the effective interest does not represent cash interest.		1
2.3	**Capitalised borrowing costs** that should be removed from additions to property, plant and equipment in the statement of cash flows:		

	FV = ZWL87 600 000 (120 000 x ZWL730) pmt = ZWL3 360 000 (120 000 x ZWL700 x 8% x 6/12) n = 6 (3 x 2) i = 4.5% (9% / 2) ***or*** 9% and P/YR = 2 PV = ZWL84 598 118		1 1 ½ ½
	Interest capitalised during 2020	5 109 708	
	30 June 2020: 6 months (Amort 2 Interest) 31 August 2020: 2 months (Amort 3 Interest x 2/6)	3 827 027 1 282 681	½C 1C
2.4	The **effective interest not capitalised** that should be removed from interest paid in the statement of cash flows:		
	Amort 3 Interest x 4/6	2 565 362	1C
2.5	The **coupon payments** that should be **included as part of interest paid** in the statement of cash flows:		
	Interest on debentures (ZWL3 360 000 x 2)	6 720 000	1C
3.	**Senior management incentive scheme**		
3.1	The settlement of the senior management incentive scheme amounting to ZWL50 million was **incorrectly classified as a financing activity** (repayment of liability). It should have been included in **operating activities, as this is a payment to employees / working capital**.		1
4.	**Dividends received**		
4.1	Dividends received of ZWL12,5 million were **incorrectly classified as an operating activity**, as it is the **accounting policy** of the Firstgro group to report dividends received as an **investing activity**.		1
5.	**Share of profit from equity accounted associates**		
5.1	The "share of profit from equity accounted associates" was **incorrectly excluded from profit before tax**. Instead, this **should have been included in profit before tax and then shown as a non-cash adjustment** to arrive at cash generated from operations.		1
6.	**Additional interest in subsidiary**		
6.1	The additional 10% interest purchased in the existing subsidiary was **incorrectly classified as an investing activity** and should rather have been classified as a **financing activity**. This is because **cash flows resulting from changes in ownership interests in a subsidiary that do not result in a loss of control, should be classified in the same way as other transactions with owners** (i.e. as financing activities) (IAS7.42B).		1 1
6.2	Furthermore, as the cash and cash equivalent balances of the subsidiary remain within the group, the **cash and cash equivalent balance of ZWL5,7 million should not have been deducted** from the ZWL24,5 million paid for the 10% interest.		1
7.	**Rental of leased premises**		
7.1	Firstgro incorrectly treated the lease as a short term lease / lease of a low value asset, since the **lease is for period of 10 years which is not short term** and/or the **leased asset is a building which cannot be regarded as a low value asset**.		1
7.2	The **monthly lease payments** were therefore **incorrectly included in profit before tax**. In terms of IFRS 16, a lease liability and right of use asset should have been recognised, with interest on the lease liability and depreciation on the right-of-use asset being included in profit before tax instead.		1
7.3	The lease payments should have been split into a capital and interest portion, with the **capital portion presented as a financing activity** and the **interest portion presented as an operating activity** (IAS7.12 / IFRS16.50).		1 1

7.4	Since the interest rate implicit in the lease is not known to Firstgro, the lease liability should initially have been recognised at the following amount, **using the incremental borrowing rate** as discount rate (IFRS16.26):		1
	pmt = ZWL2 500 000 n = 120 (10 x 12) i = 0.79% (9.48% / 12) ***or*** 9.48% and P/YR = 12 PV = ZWL193 366 625		½ ½ ½
7.5	Interest from 1 June 2020 to 31 December 2020 that should be presented as part of **interest paid** in the statement of cash flows:		
	Amrt 1 – amrt 7 (interest)	10 529 712	1C
7.6	**Capital repayments** from 1 June 2020 to 31 December 2020 that should be presented under **financing activities** in the statement of cash flows:		
	Amrt 1 – amrt 7 (principal)	6 970 288	1C
7.7	**Lease payments** that were incorrectly included as part of profit before tax / cash generated from operations that should be **removed**:		
	ZWL2 500 000 x 7 months	17 500 000	1
7.8	Furthermore, **depreciation** on the right-of-use asset **should have been included in profit before tax** and then **shown as part of the non-cash depreciation adjustment** to arrive at cash generated from operations.		1
7.9	The **depreciation** on the right-of-use asset can be **calculated** as follows:		
	ZWL193 366 625 $^{\text{PV of lease liability}}$ / 10 years $^{\text{lease term}}$ x 7/12	11 279 720	1C
8.	**General**		
	The fact that the **effective interest was reported as a cash flow** instead of the coupon interest (refer point 2) and/or the fact that the **cash balance of ZWL5,7 million was incorrectly deducted** from the amount paid for the additional 10% interest in the subsidiary (refer point 6) imply that **corresponding errors** were made **elsewhere in the statement of cash flows**. The information in the scenario is however insufficient to determine exactly where the errors are.		1
9.	**Recalculation of loan covenant ratios**		
		ZWL	
9.1	**Cash inflows from operating activities**		
	As previously reported	132 069 090	
	Corrections:		
	Executive directors share-based payment expense (added back as non-cash)	40 500 000	1C
	Settlement of senior management incentive scheme (previously financing activities)	(50 000 000)	1C
	Lease payments (incorrectly expensed)	17 500 000	1C
	Dividends received (should be investing activities)	(12 500 000)	1
	Correction of interest paid	(14 684 350)	
	Effective interest on debentures (not cash interest)	2 565 362	1C
	Coupon interest on debentures (cash interest paid)	(6 720 000)	1C
	Interest on lease	(10 529 712)	1C
		112 884 740	
9.2	**Cash generated from operations**		
	Correct cash inflows from operating activities (as above)	112 884 740	
	Add back interest paid	54 088 780	1C
	As previously reported	39 404 430	
	Corrections (refer 9.1 above)	14 684 350	
	Add back income tax paid (unchanged)	38 823 520	1C
		205 797 040	

9.3	**Cash outflows from investing activities**		
	As previously reported	(97 502 000)	
	Corrections:		
	Capitalised borrowing cost (should be interest paid)	5 109 708	1C
	Dividends received (previously operating activities)	12 500 000	1C
	Additional interest purchased in subsidiary (should be financing activities)	18 800 000	1C
		(61 092 292)	
9.4	**Cash inflows from financing activities**		
	As previously reported	85 002 500	
	Corrections:		
	Settlement of senior management incentive scheme (should be operating activities)	50 000 000	1C
	Additional interest purchased in subsidiary (previously investing activities)	(24 500 000)	1C
	Capital repayments on lease	(6 970 288)	1C
		103 532 212	
9.5	**Total non-current liabilities as at 31 December 2020**		
	Given (as per statement of financial position)	416 000 100	
	Install-Ment Bank (should be a current liability)	(110 000 000)	1C
	Share-based payment liability (executive directors)	43 500 000	1C
	Lease liability (Amrt 19 (balance))	173 516 626	1C
		523 016 726	
	Install-Ment Bank: The loan from Install-Ment bank is a current liability at 31 December 2020 since, according to the original payment terms, the full capital amount of the loan was repayable at 31 December 2021. The **restructuring of debt after year end** (15 January 2021) is a **non-adjusting event** after reporting date (IAS1.76(a) and IAS10.3 & .10). Therefore, the loan from Install-Ment Bank should still be **classified as a current liability** at 31 December 2020 (and not as a non-current liability as suggested by the CFO).		1 1
	Share-based payment liability: The incorrect classification of the executive director incentive scheme (refer point 1), resulted in the **recognition of a share based payment reserve instead of a liability**. The share based payment liability should therefore be included in the total non-current liabilities.		1
	Lease liability: The incorrect treatment of the leased premises (refer point 7), resulted in **no lease liability being recognised**. The non-current portion of the lease liability should therefore be included in the total non-current liabilities.		1
10.	**Non-current liability coverage ratio**		
	$\frac{112\,884\,740 + 0 \text{ dividends paid}}{523\,016\,726} = 0{,}22$		1C
	The non-current liability coverage ratio is below the required minimum of 0.3.		½C
11.	**Cash interest coverage ratio**		
	$\frac{205\,797\,040}{54\,088\,780} = 3{,}80$		1C
	The cash interest coverage ratio is below the required minimum of 5.		½C
12.	**Financing cash flow to investing cash flow ratio**		
	$\frac{103\,532\,212}{61\,092\,292} = 1{,}69$		1C

	The financing cash flow to investing cash flow ratio is above the required maximum of 1.	½C
13.	**Current ratio**	
13.1	The following factors will negatively affect the current ratio:	
	The **current portion of the lease liability** will **increase the current liabilities** by ZWL12 879 711.	1
	The **current portion of the DBZ loan** payable will increase the **current liabilities**.	1
	The **loan from Install-Ment Bank** should be classified as a current liability and therefore **increase the current liabilities** by ZWL110 million.	1
14.	**Conclusion**	
14.1	Firstgro **breached three of the loan covenant ratios** and therefore DBZ has the right to demand repayment of its loan within 12 months after 31 December 2020.	1C
14.2	The **DBZ loan** should therefore now be **presented as a current liability** in terms of IAS 1, due to loan covenant requirements being breached.	1
	Available	**72½**
	Maximum	**47**
	Communication skills – presentation; logical argument	*2*
	Total for part (a)	**49**