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FINANCIAL REPORTING

THE CONCEPTUAL AND REGULATORY FRAMEWORK

CONCEPTUAL FRAMEWORK

The IFRS Framework describes the basic concepts that underlie the preparation and presentation of financial statements for external users. A conceptual framework can be seen as a statement of Generally Accepted Accounting Principles (GAAP) that form a frame of reference for the evaluation of existing practices and the development of new ones.

Purpose of framework

It is true to say that the Framework:

- Seeks to ensure that accounting standards have a consistent approach to problem solving and do not represent a series of ad hoc responses that address accounting problems on a piece meal basis
- Assists the IASB in the development of coherent and consistent accounting standards
- Is not a standard, but rather acts as a guide to the preparers of financial statements to enable them to resolve accounting issues that are not addressed directly in a standard
- Is an incredibly important and influential document that helps users understand the purpose of, and limitations of, financial reporting
- Used to be called the Framework for the Preparation and Presentation of Financial Statements
- Is a current issue as it is being revised as a joint project with the IASB's American counterparts the Financial Accounting Standards Board.

Advantages of a conceptual framework

- Financial statements are more consistent with each other
- Avoids firefighting approach and a has a proactive approach in determining best policy
- Less open to criticism of political/external pressure

- Has a principles based approach
- Some standards may concentrate on effect on statement of financial position; others on statement of profit or loss

Disadvantages of a conceptual framework

- A single conceptual framework cannot be devised which will suit all users
- Need for a variety of standards for different purposes
- Preparing and implementing standards may still be difficult with a framework
- The purpose of financial reporting is to provide useful information as a basis for economic decision making.

OVERVIEW OF THE CONTENTS OF THE FRAMEWORK

The starting point of the Framework is to address the fundamental question of why financial statements are actually prepared. The basic answer to that is they are prepared to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.

In turn this means the Framework has to consider what is meant by useful information. In essence for information to be useful it must be considered both relevant, i.e. capable of making a difference in the decisions made by users and be faithful in its presentation, i.e. be complete, neutral and free from error.

The usefulness of information is enhanced if it is also comparable, verifiable, timely, and understandable. The Framework also considers the nature of the reporting entity and the basic elements from which financial statements are constructed. The Framework identifies three elements relating to the statement of financial position, being assets, liabilities and equity, and two relating to the statement of profit or loss, being income and expenses. The definitions and recognition criteria of these elements are very important and these are considered in detail below.

THE FIVE ELEMENTS

An asset is defined as a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Assets are presented on the statement of financial position as being non-current or current. They can be intangible, that is, without physical presence – for example, goodwill. Examples of tangible assets include property plant and equipment and inventory.

While most assets will be both controlled and legally owned by the entity it should be noted that legal ownership is not a prerequisite for recognition, rather it is control that is the key issue. For example IFRS16, Leases, with regard to a lessee, is consistent with the Framework's definition of an asset. IFRS 16requires that the lessee should recognise a leased asset on the statement of financial position in respect of the benefits that it controls, even though the asset subject to the lease is not the legally owned by the lessee. So this reflects that from lessee‘s perspective the economic reality of a lease is a loan to buy an asset, and so the accounting is a faithful presentation.

A liability is defined as a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Liabilities are also presented on the statement of financial position as being non-current or current. Examples of liabilities include trade payables, tax payable and loans.
It should be noted that in order to recognise a liability there does not have to be an obligation that is due on demand but rather there has to be a present obligation. Thus for example IAS 37, Provisions, Contingent Liabilities and Contingent Assets is consistent with the Framework's approach when considering whether there is a liability for the future costs to decommission oil rigs. As soon as a company has erected an oil rig that it is required to dismantle at the end of the oil rig's life, it will have a present obligation in respect of the decommissioning costs. This liability will be recognised in full, as a noncurrent liability and measured at present value to reflect the time value of money. The past event that creates the present obligation is the original erection of the oil rig as once it is erected the company is responsible to incur the costs of decommissioning.

Equity is defined as the residual interest in the assets of the entity after deducting all its liabilities.

The effect of this definition is to acknowledge the supreme conceptual importance of identifying, recognising and measuring assets and liabilities, as equity is conceptually regarded as a function of assets and liabilities, i.e. a balancing figure.

Equity includes the original capital introduced by the owners, i.e. share capital and share premium, the accumulated retained profits of the entity, i.e. retained earnings, unrealised asset gains in the form of revaluation reserves and, in group accounts, the equity interest in the subsidiaries not enjoyed by the parent company, i.e. the non-controlling interest (NCI). Slightly more exotically, equity can also include the equity element of convertible loan stock equity settled share based payments, differences arising when there are increases or decreases in the NCI, group foreign exchange differences and contingently issuable shares. These would probably all be included in equity under the umbrella term of Other Components of Equity. Income is defined as the increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

Most income is revenue generated from the normal activities of the business in selling goods and services, and as such is recognised in the Income section of the statement of profit or loss and other comprehensive income, however certain types of income are required by specific standards to be recognised directly to equity, i.e. reserves, for example certain revaluation gains on assets. In these circumstances the income (gain) is then also reported in the Other Comprehensive Income section of the statement of profit or loss and other comprehensive income.

The reference to 'other than those relating to contributions from equity participants' means that when the entity issues shares to equity shareholders, while this clearly increases the asset of cash, it is a transaction with equity participants and so does not represent income for the entity.

Again note how the definition of income is linked into assets and liabilities. This is often referred to as 'the balance sheet approach' (the former name for the statement of financial position).

Expenses are defined as decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

The reference to 'other than those relating to distributions to equity participants' refers to the payment of dividends to equity shareholders. Such dividends are not an expense and so are not recognised any wherein the statement of profit or loss and other comprehensive income. Rather they represent an appropriation of profit that is as reported as a deduction from Retained Earnings in the Statement of Changes in Equity.

Examples of expenses include depreciation, impairment of assets and purchases. As with income most expenses are recognised in the profit or loss section of the statement of profit or loss and other comprehensive income, but in certain circumstances expenses (losses) are required by specific standards to be recognised directly in equity and reported in the Other Comprehensive Income section of the statement of profit or loss and other comprehensive income. An example of this is an impairment loss, on a previously revalued asset, that does not exceed the balance of its revaluation reserve.

The recognition criteria of elements of financial statements

The Framework also lays out the formal recognition criteria that have to be met to enable elements to be recognised in the financial statements. Recognition is the process of incorporating in the statement of financial position or statement of profit or loss an item that satisfies the following criteria for recognition:

- An item that meets the definition of an element
- It is probable that any future economic benefit associated with the item will flow to or from the entity and
- The item's cost or value can be measured with reliability.

Recap: Application of recognition criteria

- An asset is recognised in the statement of financial position when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.

- A liability is recognised in the statement of financial position when it is probable that an out flow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.
- Income is recognised in the statement of profit or loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably.
- Expenses are recognised when decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably.

Measurement issues for elements

Finally the issue of whether assets and liabilities should be measured at cost or value is considered by the Framework. To use cost should be reliable as the cost is generally known, though cost is not necessary very relevant for the users as it is past orientated. To use a valuation method is generally regarded as relevant to the users as it up to date, but value does have the drawback of not always being reliable. This conflict creates a dilemma that is not satisfactorily resolved as the Framework is indecisive and acknowledges that there are various measurement methods that can be used. The failure to be prescriptive at this basic level results in many accounting standards sitting on the fence how they wish to measure assets. For example, IAS 40, Investment Properties and IAS 16, Property, Plant and Equipment both allow the preparer the choice to formulate their own accounting policy on measurement.

Measurements of elements in financial statements

The IFRS Framework acknowledges that a variety of measurement bases can be used. Examples are as follows:

- Historical cost
- Current cost (Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently)
- Net realizable value (The amount of cash or cash equivalents that could currently be obtained by selling an asset in an orderly disposal)
- Present value (A current estimate of the present discounted value of the future net cash flows in the normal course of business)
- Fair value (As per IFRS 13)

HISTORICAL COST ACCOUNTING

The application of historical cost accounting means that assets are recorded at the amount they originally cost, and liabilities are recorded at the proceeds received in exchange for the obligation.

Advantages

- Simple to understand
- Figures are objective, reliable and verifiable
- Results in comparable financial statements
- There is less possibility for manipulation by using 'creative accounting' in asset valuation.

Disadvantages

- The carrying value of assets is often substantially different to market value
- No account is taken of inflation meaning that profits are overstated and assets understated
- Financial capital is maintained but not physical capital
- Ratios like Return on capital employed are distorted
- It does not measure any gain/loss of inflation on monetary items arising from the impact
- Comparability of figures is not accurate as past figures are not restated for the effects of inflation

FINACIAL AND PHYSICAL CAPITAL MAINTENANCE

The IASB Conceptual Framework identifies two concepts of capital:

1. A financial concept of capital
2. A physical concept of capital

Financial capital maintenance

A financial concept of capital is whereby the capital of the entity is linked to the net assets, which is the equity of the entity.

When a financial concept of capital is used, a profit is earned only if the financial amount of the net assets at the end of the period is greater than the net assets at the beginning of the period, adjusted of course for any distributions paid to the owners during the period, or any equity capital raised.

The main concern of the users of the financial statements is with the maintenance of the financial capital of the entity.

Assets – Liabilities = Equity

Opening equity (net assets) + Profit – Distributions = Closing equity (net assets)

Physical capital maintenance

A physical concept of capital is one where the capital of an entity is regarded as its production capacity, which could be based on its units of output.

When a physical concept of capital is used, a profit is earned only if the physical production capacity (or operating capability) of the entity at the end of the period is greater than the production capacity at the beginning of the period, adjusted for any distributions paid to the owners during the period, or any equity capital raised.

QUALITATIVE CHARACTERISTICS OF USEFUL FINANCIAL INFORMATION

They identify the types of information likely to be most useful to users in making decisions about the reporting entity on the basis of information in its financial report.

Fundamental qualitative characteristics

- Relevance

Relevant financial information is capable of making a difference in the decisions made by users if it has predictive value, confirmatory value, or both.

Materiality is an entity-specific aspect of relevance based on the nature or magnitude (or both) of the items to which the information relates in the context of an individual entity's financial report.

- Faithful representation

Information must be complete, neutral and free from material error

Enhancing qualitative characteristics

- Comparability

Comparison with similar information about other entities and with similar information about the same entity for another period or another date

- Verifiability

It helps to assure users that information represents faithfully the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement

- Timeliness

It means that information is available to decision-makers in time to be capable of influencing their decisions.

- Understandability

Classifying, characterising and presenting information clearly and concisely. Information should not be excluded on the grounds that it may be too complex/ difficult for some users to understand

The IFRS framework states that going concern assumption is the basic underlying assumption.

RESTRUCTURING OF CONCEPTUAL FRAMEWORK BY IASB

The International Accounting Standards Board (IASB) is coming towards the end of its own renovation process on the Conceptual Framework for Financial Reporting 2010.

Chapter 1, the objective of general purpose financial reporting

The only major change to =Chapter 1, The-objective of general purpose financial reporting is that the IASB proposes the reintroduction of the term = stewardship into the objective of general purpose financial reporting. This is a relatively minor change and a nice gentle ease-in to the process.

As many respondents to the consultation highlighted, stewardship is not a new concept. The importance of stewardship by management is inherent within the existing framework and within financial reporting, so this statement may largely be reinforcing what already exists.

Chapter 2, The-reporting entity

The 2010 framework has had ‘Chapter 2, The-reporting entity’ classified as ‘to be added’ since inception.

The major additions here relate to the description and boundary of a reporting entity. The IASB has proposed the description of a reporting entity as an entity that chooses or is required to prepare general purpose financial statements.

The proposed boundaries outline that the financial statements of a reporting entity whose boundary is based on direct control only are called unconsolidated financial statements, whereas one with direct and indirect control are called consolidated financial statements.

Whilst these have been tentatively confirmed by the IASB, the terms 'direct' and 'indirect' control are likely to be changed and clarified, meaning that there may still be some time before the extension is ready to be inhabited.

Chapter 3, Qualitative characteristics of useful financial information

Originally, the IASB had not planned on making any changes to 'Chapter 3, Qualitative characteristics of useful financial information', but following many responses to the discussion paper, there have been some changes that have tentatively been accepted by the IASB.

Primarily, the qualitative characteristics are unchanged. Relevance and faithful representation will remain as the two fundamentals. The four enhancing qualitative characteristics will continue to be timeliness, understandability, verifiability and comparability.

However, while the qualitative characteristics remain unchanged, the IASB has tentatively decided to reinstate explicit references to prudence and substance over form.

In the Conceptual Framework for Financial Reporting 2010, these were removed. The conclusion reached was that substance over form was not considered to be a separate component of faithful representation, because it would be redundant. It was decided that representing a legal form that differed from the economic substance could not result in a faithful representation.

Whilst that statement is true, the IASB felt that the importance of the concept needed to be reinforced and so a statement has now been included outlining that faithful representation provides information about the substance of an economic phenomenon rather than its legal form.

In the 2010 framework, faithful representation was defined as information that was complete, neutral and free from error. The basis for conclusions in the 2010 framework stated that prudence was not

included, as including it would be inconsistent with neutrality. However, the removal of the term led to confusion and many respondents to the IASB's discussion paper urged the Board to reinstate prudence.

Therefore, an explicit reference to prudence has now been included, stating that 'prudence is the exercise of caution when making judgments under conditions of uncertainty'.

As is often the case with a building project, making one minor change may lead to others, and everyone wants a building that is on the level. The problem with adjusting the building blocks here, even slightly, was that by adding in the reference to prudence, the IASB encountered the further issue of asymmetry.

Many standards, such as IAS 37, Provisions, Contingent Liabilities and Contingent Assets, apply a system of asymmetric prudence. In IAS 37, a probable outflow of economic benefits would be recognised as a provision, whereas a probable inflow would only be shown as a contingent asset, disclosed in the financial statements. Therefore, two sides in the same court case could have differing accounting treatments despite the likelihood of the payout being identical for either party. Many respondents highlighted this asymmetric prudence as necessary under some accounting standards and felt that a discussion of the term was required. Whilst this is true, the IASB believes that the framework should not identify asymmetric prudence as a necessary characteristic of useful financial reporting.

The IASB has tentatively decided to state that the concept of prudence does not imply a need for asymmetry, such as the need for more persuasive evidence to support the recognition of assets than liabilities. It has included a statement that such asymmetry may sometimes arise in financial reporting standards as a consequence of requiring the most useful information.

Chapter 5, Recognition and derecognition

In terms of recognition, the current framework specifies three recognition criteria that apply to all assets and liabilities:

- The item meets the definition of an asset or liability;
- It is probable that any future economic benefit associated with the asset or liability will flow to or from the entity; and

- The asset or liability has a cost or value that can be measured reliably.

The IASB has confirmed the new approach to recognition, which requires decisions to be made by reference to the qualitative characteristics of financial information. The IASB has tentatively confirmed that an entity recognises an asset or a liability (and any related income, expense or changes in equity) if such recognition provides users of financial statements with:

- Relevant information about the asset or the liability and about any income, expenses or changes in equity;
- A faithful representation of the asset or liability and of any income, expenses or changes in equity; and
- Information that results in benefits exceeding the cost of providing that information.

A key change to this is the removal of a 'probability criterion'. This has been removed, as different financial reporting standards apply a different criterion, with some applying 'probable', some 'virtually certain', some 'reasonable possible'. This also means that it will not prohibit the recognition of assets or liabilities with a low probability of an inflow or outflow of economic resources.

The final major change in Chapter 5 relates to derecognition. This is an area not previously covered by the framework. The IASB tentatively accepted the principles in the exposure draft relating to derecognition, namely that accounting requirements for derecognition should aim to represent faithfully both:

- The assets and liabilities retained after the transaction or other event that led to the derecognition (including any asset or liability acquired, incurred or created as part of the transaction or other event); and
- The change in the entity's assets and liabilities as a result of that transaction or other event.

These are some of the changes with significant work being done to-many aspects of the framework.

NOTE: The revised Conceptual Framework for Financial Reporting (Conceptual Framework) issued in March 2018 is effective immediately for the International Accounting Standards Board (Board)

and the IFRS Interpretations Committee. The details are included in exposure drafts at the end of these notes.

STANDARD SETTING PROCESS

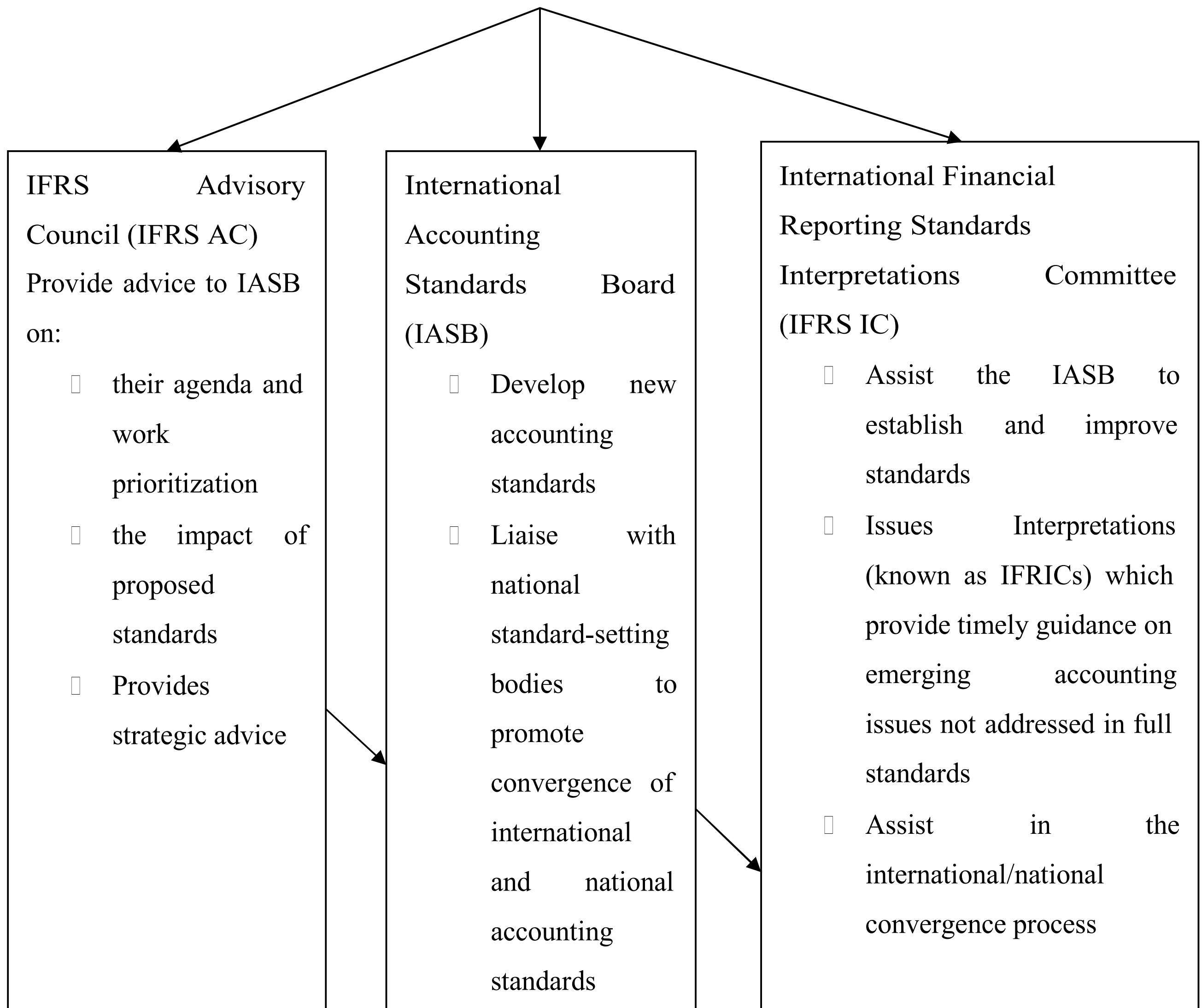
The due process for developing an IFRS comprises of six stages:

1. Setting the agenda
2. Planning the project
3. Development and publication of Discussion Paper
4. Development and publication of Exposure Draft
5. Development and publication of an IFRS Standard
6. Procedures after a Standard is issued

REGULATORY FRAMEWORK

International Financial Reporting Standards Foundation (IFRS Foundation)

Responsible for governance of standard setting process, It oversees, funds, appoints and monitors the operational effectiveness of:



PRINCIPLES VS RULES-BASED APPROACH

Rules-based accounting system

- Likely to be very descriptive
- Relies on a series of detailed rules or accounting requirements that prescribe how financial statements should be prepared
- Considered less flexible, but often more comparable and consistent, than a principlesbased system
- Can lead to looking for 'loopholes'

Principles-based accounting system

- It relies on generally accepted accounting principles that are conceptually based and are normally underpinned by a set of key objectives
- More flexible than a rules-based system
- Require judgment and interpretation which could lead to inconsistencies between reporting entities and can sometimes lead to the manipulation of financial statements

Because IFRSs are based on The Conceptual Framework for Financial Reporting, they are often regarded as being a principles-based system.

IAS 1 PRESENTATION OF FINANCIAL STATEMENTS

A complete set of financial statements comprises:

- A statement of financial position
- A statement of profit or loss and other comprehensive income
- A statement of changes in equity
- A statement of cash flows
- Accounting policies and explanatory notes

Recommended basic formats (no complex treatments included) for financial statements are as follows:

THE STATEMENT OF FINANCIAL POSITION

XYZ Co.

Statement of Financial Position as at 31 December 20X8

Assets	$	$
Non-current assets:		
Property, plant and equipment	X	
Intangible assets	X	
		X
Current assets:		
Inventories X Trade receivables X		
Cash and cash equivalents	X	
		X
Total assets		X
Equity and liabilities		
Capital and reserves:		
Share capital X Retained earnings X Other components of equity X		
		X
Total equity		X
Non-current liabilities:		
Long-term borrowings	X	
Deferred tax X		
		X
Current liabilities:		
Trade and other payables	X Short-term borrowings X Current tax payable X	
Short-term provisions	X	
		X

Total equity and liabilities X

Current assets include all items which:

- Will be settled within 12 months of the reporting date, or
- Are-part of the entity's normal operating cycle.

Within the capital and reserves section of the statement of financial position, other components of equity include:

- Revaluation reserve General reserve

STATEMENT OF CHANGES IN EQUITY

The statement of changes in equity provides a summary of all changes in equity arising from transactions with owners in their capacity as owners.

This includes the effect of share issues and dividends.

XYZ Co.

Statement of changes in equity for the year ended 31 December 20X8

	Share Capital	Share Premium	Revaluation surplus	other components of equity	Retained earnings	Total equity
	$	$	$	$	$	$
Balance at 31 December 20X7	X	X	X	X	X	X
Change in accounting policy					(X)	(X)
	—	—	—	—	—	
Restated balance	X	X	X	X	X	X
Dividends					(X)	(X)

Issue of share capital	X	X					X
Total comprehensive income for the year			X			X	X
Adjustment to other component of equity				X/(X)			X/(X)
Transfer to retained earnings			(X)			X	-
		—	—	—	—	—	
Balance at 31 December 20X8		X	X	X	X	X	X

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

A recommended format for the statement of profit or loss and other comprehensive income is as follows:

XYZ Co.

Statement of profit or loss and other comprehensive income for the year ended 31 December 20X8

	$
Revenue	X
Cost of sales	(X)
Gross profit	X
Distribution costs	(X)
Administrative expenses	(X)
Profit from operations	X
Finance costs	(X)
Profit before tax	X
Income tax expense	(X)
Net Profit for the period	X

	$
Profit for the year	X
Other comprehensive income	

Gain on property revaluation	X
Gain/Loss on financial asset fair value through OCI	X/(X)
Income tax relating to components of other comprehensive income	(X)
Other comprehensive income for the year, net of tax	X
Total comprehensive income for the year	X

IAS 16 – PROPERTY, PLANT AND EQUIPMENT

OBJECTIVE

The objective of IAS 16 is to prescribe the accounting treatment for property, plant, and equipment.

DEFINITIONS:

Property plant and equipment are tangible assets that:

- Are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
- Are expected to be used during more than one period.

Carrying amount is the amount at which an asset is recognized after deducting any accumulated depreciation and accumulated impairment losses

Depreciation is systematic allocation of the depreciable amount of assets over its useful life.

Depreciable amount is the cost of an asset less its residual value.

Residual Value is the estimated amount that an entity can obtain when disposing of an asset after its useful life has ended. When doing this the estimated costs of disposing of the asset should be deducted.

There are essentially four key areas when accounting for property, plant and equipment:

- Initial recognition and measurement
- Depreciation
- Revaluation
- Derecognition (disposals)

RECOGNITION CRITERIA

PPE are recognized if

- It is probable that future economic benefits associated with the item will flow to the entity; and
- The cost of the item can be measured reliably.

Note: This criteria is applicable for both initial and subsequent recognition.

Aggregation and segmenting This IAS does not provide what constitute an item of property, plant and equipment and judgment is required in applying the recognition criteria to specific circumstances or types of enterprise.
That is:

i. It may be appropriate to aggregate individually insignificant items, such as moulds, tools dies, etc.
ii. It may be appropriate to allocate total expenditure on an asset to its component parts and
iii. Account for each component separately e.g. an aircraft and its engines, parts of a Furnace.

MEASUREMENT CRITERIA
Initial measurement:

PPE are initially recognized at the cost.

Elements of costs comprise:

- Its purchase price
- Any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating,
- The initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located. The present value of dismantling cost will be added to the cost of asset and provision will be created and the company will have to unwind this provision at every year end. The amount will be recognized in statement of profit or loss as finance cost
  and provision will be increased in statement of financial position. This treatment is as the accounting for provision as per IAS 37, Provisions, Contingent Assets and Liabilities
- Directly attributable cost of bringing the assets to the location and condition necessary for the intended performance, e.g.

- Costs of employees benefits arising directly from the construction or acquisition of property, plant and equipment the cost of site preparation
- Initial delivery and handling costs
- Installation costs
- Cost of testing whether the asset is functioning properly after the net proceeds from the sale of any trial production (samples produced while testing equipment)
- Professional fees (architects, engineers)
- Borrowing costs in accordance with IAS 23, Borrowing Costs.

Where these costs are incurred over a period of time (such as employee benefits), the period for which the costs can be included in the cost of PPE ends when the asset is ready for use, even if the asset is not brought into use until a later date. As soon as an asset is capable of operating it is ready for use. The fact that it may not operate at normal levels immediately, because demand has not yet built up does not justify further capital is action of costs in this period. Any abnormal costs (for example, wasted material) cannot be included in the cost of PPE.

IAS 16 does not specifically address the issue of whether borrowing costs associated with the financing of a constructed asset can be regarded as a directly attributable cost of construction. This issue is addressed in IAS 23, Borrowing Costs. IAS 23 requires the inclusion of borrowing costs as part of the cost of constructing the asset. In order to be consistent with the treatment of other costs‘, only those finance costs that would have been avoided if the asset had not been constructed are eligible for inclusion. If the entity has borrowed funds specifically to finance the construction of an asset, then the amount to be capitalised is the actual finance costs incurred. Where the borrowings form part of the general borrowing of the entity, then a capitalisation rate that represents the weighted average borrowing rate of the entity should be used. (IAS 23 discussed in detail later)

The cost of the asset will include the best available estimate of the costs of dismantling and removing the item and restoring the site on which it is located, where the entity has incurred an obligation to incur such costs by the date on which the cost is initially established. This is a component of cost to the extent that it is recognised as a provision under IAS 37, Provisions, Contingent Liabilities and Contingent Assets. In accordance with the principles of IAS 37, the amount to be capitalised in such circumstances would be the amount of foreseeable expenditure appropriately discounted where the effect is material.

Measurement of self -constructed and exchanged assets

- Cost of self-constructed assets will be the cost of its production
- If an asset is exchanged, the cost will be measured at the fair value unless

(a) The exchange transaction lacks commercial substance or

(b) The fair value of neither the asset received nor the asset given up is reliably measurable. If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

SUBSEQUENT COSTS (SUBSEQUENT RECOGNITION)

Once an item of PPE has been recognised and capitalised in the financial statements, a company may incur further costs on that asset in the future. IAS 16 requires that subsequent costs should be capitalized if:

- It is probable that future economic benefits associated with the extra costs will flow to the entity

- The cost of the item can be reliably measured.

All other subsequent costs should be recognised as an expense in the statement of profit or loss in the period that they are incurred.

MEASUREMENT SUBSEQUENT TO INITIAL RECOGNITION:

IAS 16 permits two accounting models:

- Cost Model
- Revaluation Model

Under both models, the assets are reflected in statement of financial position at carrying value.
Carrying value:

Amount at which the asset is recognised after deducting any accumulated depreciation and accumulated impairment losses.

DEPRECIATION OF PPE

IAS 16 defines depreciation as = the systematic allocation of the depreciable amount of an asset over its useful life.

'Depreciable amount 'is the cost of an asset, cost less residual value, or other amount.

Depreciation is not providing for loss of value of an asset, but is an accrual technique that allocates the depreciable amount to the periods expected to benefit from the asset. Therefore assets that are increasing in value still need to be depreciated.

The depreciation method used should reflect the pattern in which the asset's economic benefits are consumed by the entity; a depreciation method that is based on revenue that is generated by an activity that includes the use of an asset is not appropriate.

IAS 16 requires that depreciation should be recognised as an expense in the statement of profit or loss, unless it is permitted to be included in the carrying amount of another asset.

Depreciation begins when the asset is available for use and continues until the asset is derecognised, even if it is idle.

Depreciation methods

A number of methods can be used to allocate depreciation to specific accounting periods. Two of the more common methods, specifically mentioned in IAS 16, are the straight line method, and the reducing (or diminishing) balance method

- Straight line
    - % on cost, or
    - Cost – residual value Useful economic life
- Reducing balance
    - % on carrying value

Useful economic lives and residual value

The assessments of the useful life (UL) and residual value (RV) of an asset are extremely subjective. They will only be known for certain after the asset is sold or scrapped, and this is too late for the purpose of computing annual depreciation. Therefore, IAS 16 requires that the estimates should be reviewed at the end of each reporting period. If either changes significantly, then that change should be accounted for over the remaining estimated useful economic life.

Component depreciation

If an asset comprises two or more major components with different economic lives, then each component should be accounted for separately for depreciation purposes and depreciated over its own useful economic life.

Impairment:

An item of PPE shall not be carried at more than recoverable amount. Recoverable amount is the higher of an asset's fair value less costs to sell and its value in use (Discussed in detail later).

MODELS FOR SUBSEQUENT MEASUREMENT

Cost Model

The asset is carried at cost less accumulated depreciation and impairment.

Revaluation Model

The asset is carried at a revalued amount, being its fair value at the date of revaluation less subsequent depreciation and impairment, provided that fair value can be measured reliably.

The change from cost model to revaluation model is a change in accounting policy but is dealt with prospectively.

REVALUATION MODEL

If the revaluation policy is adopted this should be applied to all assets in the entire category, i.e. if you revalue a building, you must revalue all land and buildings in that class of asset. Revaluations must also be carried out with sufficient regularity so that the carrying amount does not differ materially from that which would be determined using fair value.

- Revalued assets are depreciated in the same way as under the cost model.

Accounting for a revaluation

There are a series of accounting adjustments that must be undertaken when revaluing a noncurrent asset. These adjustments are indicated below.

The initial revaluation

You may find it useful in the exam to first determine if there is a gain or loss on the revaluation with a simple calculation to compare:

Carrying value of non-current asset at revaluation date	X
Valuation of non-current asset	X
Difference = gain or loss revaluation	X

Gain on revaluation should be credited to other comprehensive income and accumulated in equity under the heading "revaluation surplus" unless it represents the reversal of a revaluation decrease of the same asset previously recognized as an expense, in which case it should be recognized as income.

Double entry:

- Dr Non-current asset cost (difference between valuation and original cost/valuation)
- Dr Accumulated depreciation (with any historical cost accumulated depreciation) Cr Revaluation reserve (gain on revaluation)

A loss on revaluation should be recognized as an expense to the extent that it exceeds any amount previously credited to the revaluation surplus relating to the same asset.

A revaluation loss should be charged against any related revaluation surplus to the extent that the decrease does not exceed the amount held in the revaluation reserve in respect of the same asset. Any additional loss must be charged as an expense in the income statement.
Double entry:

- Dr Revaluation reserve (to maximum of original gain)
- Dr Statement of profit or loss (any residual loss)
- Cr Non-current asset (loss on revaluation)

Depreciation
The asset must continue to be depreciated following the revaluation. However, now that the asset has been revalued the depreciable amount has changed. In simple terms the revalued amount should be depreciated over the assets remaining useful economic life.

Reserves transfer
The depreciation charge on the revalued asset will be different to the depreciation that would have been charged based on the historical cost of the asset. As a result of this, IAS 16 permits a transfer to be made of an amount equal to the excess depreciation from the revaluation reserve to retained earnings.
Double entry: Dr Revaluation reserve Cr Retained earnings
This movement in reserves should also be disclosed in the statement of changes in equity.

EXAM FOCUS

In the exam make sure you pay attention to the date that the revaluation takes place. If the revaluation takes place at the start of the year then the revaluation should be accounted for immediately and depreciation should be charged in accordance with the rule above.

If however the revaluation takes place at the year-end then the asset would be depreciated for a full 12 months first based on the original depreciation of that asset. This will enable the carrying amount of the asset to be known at the revaluation date, at which point the revaluation can be accounted for.

A further situation may arise if the examiner states that the revaluation takes place mid-way through the year. If this were to happen the carrying amount would need to be found at the date of revaluation, and therefore the asset would be depreciated based on the original depreciation for the period up until revaluation, then the revaluation will take place and be accounted for. Once the asset has been revalued you will need to consider the last period of depreciation. This will be found based upon the revaluation rules (depreciate the revalued amount over remaining useful economic life). This will be the most complicated situation and you must ensure that your working is clearly structured for this; i.e. depreciate for first period based on old depreciation, revalue, then depreciate last period based on new depreciation rule for revalued assets.

DERECOGNITION

Property, plant and equipment should be derecognised when it is no longer expected to generate future economic benefit or when it is disposed of.

When property, plant and equipment is to be derecognised, a gain or loss on disposal is to be calculated. This can be found by comparing the difference between:

Carrying value X Disposal proceeds X

Profit or loss on disposal X

When the disposal proceeds are greater than the carrying value there is a profit on disposal and when the disposal proceeds are less than the carrying value there is a loss on disposal.

Remove the asset from statement of financial position when disposed of or abandoned.

Recognize any resulting gain or loss in the statement of profit or loss.

Disposal of previously revalued assets

When an asset is disposed of that has previously been revalued, a profit or loss on disposal is to be calculated (as above). Any remaining surplus on the revaluation reserve is now considered to be a realized ‘gain and therefore should be transferred to retained earnings as:

- Dr Revaluation reserve
- Cr Retained earnings

Non-current asset

Test your understanding 1 – Cap

Cap bought a building on 1 January 2001. The purchase price was $2.9m, associated legal fees were $0.1m and general administrative costs allocated to the purchase were $0.2m. Cap also paid sales tax of $0.5m, which was recovered from the tax authorities. The building was attributed a useful economic life of 50 years. It was revalued to $4.6m on 31 December 2004 and was sold for $5m on 31 December 2005.

Cap purchased a machine on 1 January 2003 for $100,000 and attributed it with a useful life of 10 years. On a January 2005, Cap reduced the estimated remaining useful life to 4 years.

Required:

Explain how the above items of property, plant and equipment would have been accounted for in all relevant reporting periods up until 31 December 2005.

Answer:

Test your understanding 1 – Cap

The building

The building would have been recognised on 1 January 2001 at a cost of $3m ($2.9m purchase price + $0.1m legal fees). Recoverable sales tax is excluded from the cost of property, plant and equipment. General administrative costs of $0.2m will have been expensed to profit or loss as incurred.

Depreciation of $0.06m ($3m/50years) would have been charged to profit or loss in each of the years ended 31 December 2001, 2002, 2003 and 2004.

Prior to the revaluation on 31 December 2004, the carrying amount of the building was $2.76m (46/50 x $3m). In the year ended 31 December 2004, a gain on revaluation of $1.84m ($4.6m - $2.76m) would have been recognised in other comprehensive income and held within equity.

In the year ended 31 December 2005, the building would have been depreciated over its remaining useful life of 46 (50 – 4) years. The depreciation charge in the year ended 31 December 2005 would therefore have been $0.1m ($4.6m/46) leaving a carrying amount at the disposal date of $4.5m ($4.6m - $0.1m).

On 31 December 2005, a profit on disposal of $0.5m ($5m – 44.5m) would be recorded in the statement of profit or loss.

The revaluation gains previously recognised within OCI and held within equity are not reclassified to profit or loss on the disposal of the asset. However, Cap could do a transfer within equity as follows:

Dr other components of equity	$1.84m
Cr Retained earnings	$1.84m

The machine

The machine would be recognised on 1 January 2003 at $100,000 and depreciated over 10 years. Depreciation of $10,000 ($100,000/10) will be charged in the years ended 31 December 2003 and December 2004.

On 1 January 2005, Cap changes its estimate of the machine's useful economic life. This is a change in accounting estimate and therefore dealt with prospectively. The carrying amount of the asset at the date of the estimate change is $80,000 (8/10 x $100,000). This remaining carrying amount will be written off over the revised life of 4 years. This means that the depreciation charge is $20,000 ($80,000/4) in the year ended 31 December 2005.

IAS 38 - INTANGIBLE ASSETS

OBJECTIVE

The objective of this IAS is to prescribe accounting treatment for intangible assets.

INTANGIBLE ASSET - DEFINITION

An intangible asset is an identifiable non-monetary asset without physical substance held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

Thus, the three critical attributes of an intangible asset are:

- Identifiability
- control (power to obtain benefits from the asset)
- Future economic benefits (such as revenues or reduced future costs)
- Intangible assets are business assets that have no physical form. Unlike a tangible asset, such as a computer, you can‘t see or touch an intangible asset.

Identifiability:

An intangible asset can be termed identifiable if it:

- is separable or
- arises from contractual or other legal rights

An intangible asset needs to be identifiable to be recorded in financial statements. To be separable, the asset should be capable of being disposed of on its own, with the remainder of the business being retained.

Goodwill can only be disposed of as part of the sale of a business, so is not separable. The lack of identifiability prevents internally generated goodwill from being recognized.

Examples of intangible assets include:

o Computer software o Patents
o Copyrights o Motion picture films o Mortgage servicing rights o Licenses o Important quotes o Franchises o Marketing rights

Level of control

Another aspect of the definition of an intangible asset is that it must be under the control of the entity as a consequence of a past event. The entity must be able to enjoy the future benefits from the asset and deter external parties from access to those benefits. A legally enforceable right is an example of such control but isn‘t a necessary prerequisite for determining control.

Some notable points to consider are:

a) Control over technical knowledge only exists if it is protected by a legal right
b) The skill of employees, arising out of the benefits of training costs, are unlikely to be considered as intangible assets because of the relative uncertainty over the future actions of staff. The problem from a control point of view is that the staff can leave at any point in time, taking their new skills with them.
c) Market share and customer loyalty are also fickle by nature and cannot be considered as intangible assets.

RECOGNITION AND MEASUREMENT

RECOGNITION CRITERIA

The recognition of an intangible asset requires an entity to demonstrate that the item meets:- a) The definition of an intangible asset

b) The recognition criterion that:-

- It is probable that the expected economic benefits that are attributable to the asset will flow to the entity; and
- The cost of the asset can be measured reliably

MEASUREMENT CRITERIA

An intangible asset shall be measured initially at cost.

There are two types of intangible assets: those that are purchased and those that are internally generated. The accounting treatment of purchased intangibles is relatively straightforward in that the purchase price is capitalised in the same way as for a tangible asset. Accounting for internally-generated assets, however, requires more thought.

Research & Development costs fall into the category of internally-generated intangible assets, and are therefore subject to specific recognition (Discussed later).

Separate rules for recognition and initial measurement exist for intangible assets depending on whether they were:

- Acquired separately: At cost
- Acquired as part of a business combination: At fair value
- Acquired by way of a government grant: As per IAS 20
- Obtained in an exchange of assets: At fair value
- Generated internally (Discussed later)

Separate acquisition

The cost of a separately acquired intangible asset can be measured reliably when purchase consideration is in the form of cash or other monetary assets. The cost comprises:-

a) Its purchase price, including import duties and non-refundable purchase taxes after deducting trade discounts and rebates; and
b) Professional fees arising directly from bringing the asset to its working condition; and
c) Costs of testing whether the asset is functioning properly

Examples of expenditures that are NOT part of cost of an intangible asset are:-

a) Costs of introducing a new product or service (advertising cost)
b) Costs of conducting business in a new location or with a new class of customers (training cost of staff)
c) Pre-operating losses, Administration and other general overheads

The capitalization of expenses ceases when the asset is ready for its intended use therefore; the expenditures incurred afterwards are not capitalized.

Deferred payments

If the payment for an intangible asset is deferred beyond normal credit terms, its cost will be the cash price equivalent. The difference between this amount and the total payments will be recognized as interest expense or will be capitalized if meets the requirements of IAS-23.

Acquisition as part of business combination

An acquirer recognizes an intangible asset, distinct from goodwill, on the acquisition date if the asset‘s fair value can be measured reliably, irrespective of whether the asset had been recognized by the acquire before the business combination (Research and development).

The circumstances when an entity cannot measure the fair value are when the intangible asset arises from legal or other contractual rights and either:-

a) Is not separable; or
b) Is separable, but there is no history or evidence of exchange transactions for the same or similar assets, and otherwise estimating fair value would be depended on immeasurable variables.

Acquisition by way of Government Grant

If an intangible asset is acquired through a government grant then the related asset and government grant will be recognized as per the requirements of IAS-20.

Exchanges of asset

An asset may be acquired in exchange or part exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets.

The cost of such an item is the fair value unless the exchange transaction lacks commercial substance or the fair value of the asset given up/ acquired is not reliably measureable, in which case the cost of the asset acquired will be the carrying value of the asset given up.

The entity determines whether the exchange transaction has the commercial substance by considering the extent to which its cash flows differ as a result of the transaction.

A transaction has commercial substance if:-

- The risk, timing and amount of cash flows of the asset acquired differ from the asset transferred.
- The entity specific value of the portion of the entity=s operations affected by the transaction changes as a result of the exchange (post tax cash flows).
- The difference in above two is significant relative to the fair value of the assets exchanged.

If the entity is able to measure the fair value of any of the asset given up/acquired then the cost of the new asset is the fair value of the asset given up unless the fair value of the asset acquired is more reliable.

INTERNALLY GENERATED INTANGIBLE ASSETS

To assess whether an internally generated intangible assets meets the criteria for recognition, an enterprise classifies the generation of the asset into RESEARCH and DEVELOPMENT.

Reason for spending money on R&D

Many businesses in the commercial world spend vast amounts of money, on an annual basis, on the research and development of products and services. These entities do this with the intention of

developing a product or service that will, in future periods, provide significant amounts of income for years to come.

DEFINITIONS

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

An example of research could be a company in the pharmaceuticals industry undertaking activities or tests aimed at obtaining new knowledge to develop a new vaccine. The company is researching the unknown, and therefore, at this early stage, no future economic benefit can be expected to flow to the entity.

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

An example of development is a car manufacturer undertaking the design, construction, and testing of a pre-production model.

ACCOUNTING TREATMENT

RESEARCH PHASE

It is impossible to demonstrate whether or not a product or service at the research stage will generate any probable future economic benefit. As a result, IAS 38 states that all expenditure incurred at the research stage should be written off to the statement of profit or loss as an expense when incurred, and will never be capitalised as an intangible asset.

DEVELOPMENT PHASE

An intangible asset arising from development (or from the development phase of an internal project) should be recognized as asset (capitalized) if, and only if, an enterprise can demonstrate all of the following:

a) The technical feasibility of completing the intangible asset so that it will be available for use or sale;
b) Its intention to complete the intangible asset and use or sell it;
c) Its ability to use or sell the intangible asset;
d) How the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;
e) The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and
f) Its ability to measure the expenditure attributable to the intangible asset during its development reliably.

If any of the recognition criteria are not met then the expenditure must be charged to the statement of profit or loss as incurred. Note that if the recognition criteria have been met, capitalisation must take place.

Internally generated brands, mastheads, publishing titles, customer lists and similar items should not be recognised as intangible assets.

Treatment of capitalised development costs

Once development costs have been capitalised, the asset should be amortised in accordance with the accruals concept over its finite life. Amortisation must only begin when commercial production has commenced (hence matching the income and expenditure to the period in which it relates).

Each development project must be reviewed at the end of each accounting period to ensure that the recognition criteria are still met. If the criteria are no longer met, then the previously capitalised costs must be written off to the statement of profit or loss immediately.

Past expense not be recognized as an asset

Expenditure on an intangible asset that was initially recognized as an expense shall not be recognized as part of the cost of an intangible asset.

Cost of an internally generated intangible asset

The cost comprises all directly attributable costs necessary to create, produce and prepare the asset to be capable of operating in the manner intended by the management.

a) Costs, of materials and services used or consumed in generating the intangible asset;
b) Costs of employee benefits arising from the generation of intangible assets
c) Fees to register a legal right; and
d) Amortization of patents and licenses that are used to generate the intangible asset

The following are NOT components of the cost of an internally generated intangible asset:

(a) Selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to preparing the asset for use;
(b) Clearly identified inefficiencies and initial operating losses incurred before an asset achieves planned performance; and
(c) Expenditure on training staff to operate the asset.

SUBSEQUENT MEASUREMENT OF INTANGIBLE ASSETS

COST MODEL

After initial recognition, an intangible asset shall be carried at its cost less any accumulated amortization and any accumulated impairment loss.

REVALUATION MODEL

After initial recognition an intangible asset whose fair value can be determined with reference to the active market shall be carried at revalued amount, less subsequent accumulated amortization and subsequent accumulated impairment losses.

ACCOUNTING TREATMENT

Classification of intangible assets based on useful life

Intangible assets are classified as having:

- Indefinite life: no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.
- Finite life: a limited period of benefit to the entity.

An entity shall assess whether the useful life of an intangible asset is finite or indefinite and if finite, the length of, or number of production or similar units constituting, that useful life.

An intangible asset shall be regarded by the entity as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity

The useful life of an intangible asset that is not being amortized shall be reviewed in each period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from indefinite to finite shall be accounted for as change in an accounting estimate in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

Amortisation and Impairment

- The depreciable amount of an intangible asset with a finite useful life shall be allocated on a systematic basis over its useful life.
- The amortization method should reflect the pattern of benefits
- Amortise when commercial production begins
- The amortization period and the amortization method for an intangible asset with a finite useful life shall be reviewed at least at each financial year end.
- An intangible asset with an indefinite useful life shall not be amortized but will be tested for impairment at every reporting date.
- The recoverable amount of the asset should be determined at least at each financial year end and any impairment loss should be accounted for in accordance with IAS 36.

DISPOSAL

Remove from statement of financial position when disposed of or abandoned. Recognize any gain or loss in the statement of profit or loss.

GOODWILL

Goodwill is not normally recognised in the accounts of a business at all. The reason for this is that goodwill is considered inherent in a business and it does not have any objective value.

Purchased goodwill

There is one exception to the principle that goodwill has no objective value, this is when a business is sold.

Purchased goodwill is shown in the statement of financial position because it has been paid for. It has no tangible substance, and so it is an intangible non-current asset. It is dealt with under IFRS 3 Business Combinations

SUBSEQUENT EXPENDITURE

Due to the nature of intangible assets, subsequent expenditure will only rarely meet the criteria for being recognised in the carrying amount of an asset. Subsequent expenditure on brands, mastheads, publishing titles, customer lists and similar items must always be recognised in profit or loss as incurred.

Test your understanding 1 – Innovate

Ten year ago, Innovate developed a new game called ‘Our Sports’. This game sold over 10 million copies around the world and was extremely profitable. Due to its popularity, Innovate release a new game in the Our Sports series every year. The games continue to be best-sellers.

The directors have produced cash flow projections for the Our Sports series over the next five years. Based on these projections, they have prudently valued the Our Sports brand at $20 million and wish to recognise this in the statement of financial position as at 30 September 2003.

On 30 September 2003, Innovate also paid $1 million for the rights to the ‘Pets & Me’ videogame series after the original developer went into administration.

Required:

Discuss the accounting treatment of the above in the financial statements of Innovate for the year ended 30 September 2003.

Answer:

Test your understanding 1 – Innovate

According to IAS 38, an intangible asset can be recognised if:

- It is probable that expected future economic benefits attributable to the asset will flow to the entity
- The cost of the asset can be measured reliably.

Cash flow projections suggest that the Our Sports brand will lead to future economic benefits. However, the asset has been internally generated and therefore the cost of the asset cannot be measured reliably. This means that the Our Sports brand cannot be recognised in the financial statements.

The Pets & Me brand has been purchased for $1 million. Therefore, its cost can be measured reliably. An intangible asset should be recognised in respect of the Pets & Me brand at its cost of $1 million.

In subsequent periods, the Pets & Me brand will be amortised over its expected useful economic life.

Test your understanding 2 – Scone

During the year ended 31 December 2001, Scone spent $2 million on researching and developing a new product. The entity has recognised all $2 million as an intangible asset. A breakdown of the expenditure is provided below:

	$m
Research into materials	0.5

Market research 0.4 Employee training 0.2 Development activities 0.9

The expenditure on development activities was incurred evenly over the year. It was not until 1 May 2001 that market research indicated that the product was likely to be profitable. At the reporting date, the product development was not yet complete.

Required:

Discuss the correct accounting treatment of the research and development expenditure in the year ended 31 December 2001. Answer:

Test your understanding 2 – Scone

Expenditure on research, market research and employee training cannot be capitalized and so must be written off to profit or loss.
In relation to development activities, $0.3 million (4/12 x $0.9m) was incurred before the product was known to be commercially viable. This amount must also be written off to profit or loss.

In total, $1.4 million ($0.5m + $0.4m + $0.3m) must be written off from intangible assets to profit or loss:

Dr Profit or loss $1.4m Cr Intangible assets $1.4m

The intangible asset recognised on the statement of financial position will be $0.6 million ($2m - $1.4m). No amortisation will be charged because the product is not yet complete.

IAS 36 – IMPAIRMENT OF ASSETS

OBJECTIVE

The objective of this IAS is to set rules to ensure that the assets of an enterprise are carried at no more than their recoverable amount.

DEFINITIONS

- Recoverable amount is the higher of an asset's net selling price and its value in use.
- Value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.
- Net selling price the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.
- An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.
- A cash-generating unit is the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets.
- Corporate assets are assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units.

IMPAIRMENT ASSESSMENT

An enterprise should assess at each reporting date: -

a) Whether there is any indication that an asset may be impaired;

b) Irrespective of any indication of impairment, an entity shall also: -

- Test in case of intangible assets having indefinite life or under development; and
- Test goodwill acquired in business combination for impairment annually

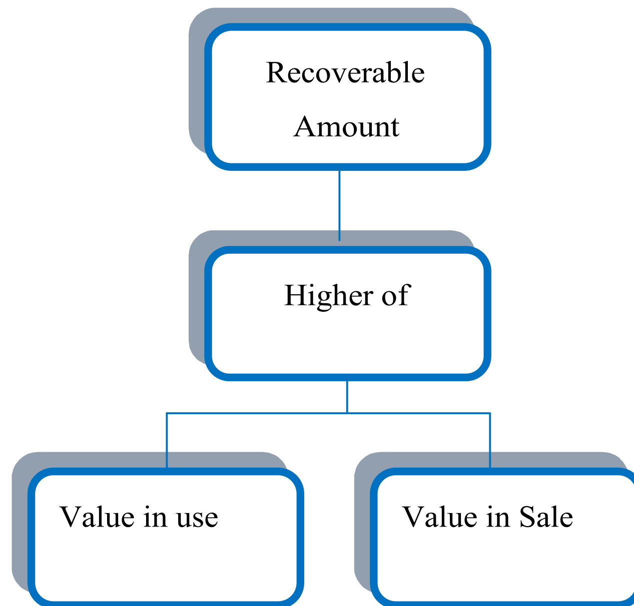
External sources of information include:

- Decline in asset's market value significantly more than expected
- Significant changes with an adverse effect in the technological, market, economic or legal environment in which the enterprise operates;
- Market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially

Internal sources of information include:

- Obsolescence or physical damage
- Significant changes with an adverse effect in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include plans to discontinue or restructure the operation to which an asset belongs.
- Economic performance of an asset is worse than expected.
- Other evidence from internal reporting may be: -
- Cash flows for acquiring and maintaining the asset are significantly higher than the originally budgeted;
- Actual cash flows are worst that the budgeted; and
- Operating losses or net cash outflows when current period amounts are aggregated with the budgeted amounts for the future

MEASURING RECOVERABLE AMOUNT



Entities have to bear in mind the following steps and considerations when evaluating an asset's recoverable amount:

(a) Recoverable amount is the higher of an asset's net selling price and its value in use

(b) It is not always necessary to determine both an asset's net selling price and its value in use. For example, if either of these amounts exceeds the asset's carrying amount, the asset is not impaired and it is not necessary to estimate the other amount.

(c) If asset is held for disposal then present value of cash flow from the use of asset until its disposal are likely to be negligible, in this case recoverable amount shall be equal to the selling price.

(d) If it is not possible to determine the fair value less costs to sell because there is no active market for the asset, the company can use the asset's value in use as its recoverable amount. Similarly, if there is no reason for the asset's value in use to exceed its fair value less costs to sell, then the latter amount may be used as its recoverable amount.

For example, where an asset is being held for disposal, the value of this asset is likely to be the net disposal proceeds. The future cash flows from this asset from its continuing use are likely to be negligible

(e) Recoverable amount is determined for an individual asset. If the asset does not generate cash flows independent from other assets. This asset is clubbed to cash generating unit and impairment loss is calculated of this cash-generating unit.

Measurement of net selling price (Value in sale)

- Price in Binding Sale Agreement less Disposal Cost.
- Cost of disposal includes legal costs, stamp duty and similar transaction taxes, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale.

Measurement of Value in Use

Estimating the value in use of an asset involves the following steps:

- Estimating the future cash inflows and outflows to be derived from continuing use of the asset and from its ultimate disposal; and
- Applying the appropriate discount rate to these future cash flows.

It is important that any cash flows projections are based upon reasonable and supportable assumptions over a maximum period of five years unless it can be proven that longer estimates are reliable. They should be based upon most recent financial budgets and forecasts.

Discount Rate

- The discount rate should be a pre-tax rate.
- It should reflect the current market assessments of the time value of money and the risks that relate to the asset for which the future cash flows have not yet been adjusted.

RECOGNITION AND MEASUREMENT OF IMPAIRMENT LOSS

If, and only if, the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset should be reduced to its recoverable amount. That reduction is an impairment loss.

An impairment loss should be recognized as an expense in the statement of profit or loss immediately, unless the asset is carried at revalued amount. An impairment loss on a revalued asset is recognized directly against any revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset.

After the recognition of an impairment loss, the depreciation (amortization) charge for the asset should be adjusted in future periods to allocate the asset‘s revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

CASH GENERATING UNIT

A cash generating unit (CGU) is the smallest identifiable group of assets for which independent cash flows can be identified and measured. For example, for a restaurant chain a CGU might be each individual restaurant.

Identification of Cash-Generating Unit to which an asset belongs

- If there is any indication that an asset may be impaired, recoverable amount should be estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an enterprise should determine the recoverable amount of the cash-generating unit to which the asset belongs (the asset‘s cash-generating unit).
- The recoverable amount of an individual asset cannot be determined if:
  - The asset‘s value in use cannot be estimated to be close to its net selling price (for example, when the future cash flows from continuing use of the assets cannot be estimated to be negligible); and
  - The asset does not generate cash inflows from use that are independent of those from other asset. In such cases, value in use and, therefore recoverable amount, can be determined only for the asset‘s cash-generating unit.
  - An asset‘s cash generating unit is the smallest group of assets that includes the asset and that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets.

Recoverable amount and carrying amount of cash generating unit

The recoverable amount of a cash-generating unit is the higher of the cash-generating unit‘s net selling price and value in use.

The carrying amount of a cash-generating unit includes the carrying amount of only those assets that can be attributed directly, or allocated on a reasonable and consistent basis, to the cashgenerating unit and that will generate the future cash inflows estimated in determining the cashgenerating unit‘s value in use.

Goodwill

- As goodwill acquired in a business combination does not generate cash flows independently of
- other assets, it must be allocated to each of the acquirer‘s cash generating units
- A CGU to which goodwill has been allocated is tested for impairment annually. The carrying amount of the CGU including the goodwill is compared with its recoverable amount.

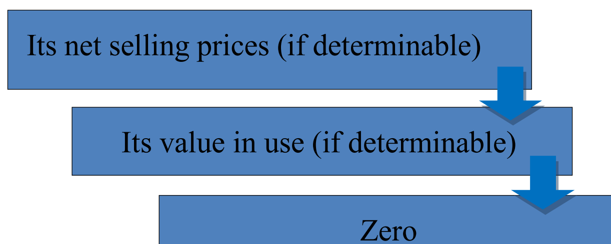
RECOGNITION OF IMPAIRMENT LOSS OF CASH-GENERATING UNIT

An impairment loss should be recognized for a cash-generating unit if, and only if, its recoverable amount is less than its carrying amount. The impairment loss should be allocated to reduce the carrying amount of the assets of the unit in the following order:

- First to any asset that is impaired (e.g. if an asset was specifically damaged)
- Second, to goodwill in the cash generating unit
- Third, to all other assets in the CGU on a pro rata basis based on carrying value

These reductions in carrying amounts should be treated as impairment losses on individual assets.

In allocating in impairment loss, the carrying amount of an asset should not be reduced below the highest of:



If this rule is applied then the impairment loss not allocated to the individual asset will be allocated on a pro-rata basis to the other assets of the group.

REVERSAL OF IMPAIRMENT LOSS

An enterprise should assess at each reporting date whether there is any indication that an impairment loss recognized for an asset in prior years may no longer exist or may have decreased. If any such indication exists, the enterprise should estimate the recoverable amount of that asset.

Considerations on reversal of an impairment loss for an individual asset:

- The increase in carrying value of the asset due to a reversal on impairment loss can only be up to should not exceed the carrying amount that would have been determined (net of amortization or depreciation) had no impairment loss been recognized for the asset in prior years.
- A reversal of an impairment loss been recognized as income immediately in the statement of profit or loss, unless the asset is carried at revalued amount (for example, under the allowed alternative treatment in IAS 16, Property, Plant and Equipment). Any reversal of an impairment loss on a revalued asset should be treated as a revaluation increase as per the respective standard.
- A reversal of an impairment loss on a revalued asset is credited directly to equity under the heading revaluation surplus. However, to the extent that an impairment loss on the same revalued asset was previously recognized as an expense in the statement of profit or loss, a reversal of that impairment loss is recognized, as income in the statement of profit or loss.

After a reversal of an impairment loss is recognized, the depreciation (amortization) charge for the asset should be adjusted in future periods to allocate the asset‘s revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

Considerations on reversal of an impairment loss for a cash generating unit:

A reversal of an impairment loss for a cash-generating unit should be allocated to increase the carrying amount of the asset of the unit in the following order:

- First, reverse on assets other than goodwill on a pro-rata basis based on the carrying amount of each asset in the unit; and
- An impairment loss recognized for goodwill shall not be reversed in a subsequent period.

Test your understanding 1 – Impaired asset

On 31 December 2001, an entity noticed that one of its items of plant and machinery is often left idle. On this date, the asset had a carrying amount of $500,000 and a fair value of $325,000. The estimated costs required to dispose of the asset are $25,000.

If the asset is not sold, the entity estimates that it would generate cash inflows of $200,000 in each of the next two years. The discount rate that reflects the risks specific to this asset is 10%.
Required:

(a) Discuss the accounting treatment of the above in the financial statements for the year ended 31 December 2001.
(b) How would the answer to part (a) be different if there was a balance of $10,000 in other components of equity relating to the prior revaluation of this specific asset?

Answer:

Test your understanding 1 – Impaired asset

(a) The value in use is calculated as the present value of the asset's future cash inflows and outflows.

	$000
Cash flow Year 1 (200 x 0.909)	182
Cash flow Year 2 (200 x 0.826)	165
	347

The recoverable amount is the higher of the fair value less costs to sell of $300,000 ($325,000 - $25,000) and the value in use of $347,000.

The carrying amount of the asset of $500,000 exceeds the recoverable amount of $347,000. Therefore, the asset is impaired and must be written down by $153,000 ($500,000 - $347,000). This impairment loss would be charged to the statement of profit or loss.

Dr Profit or loss $153,000

Cr PPE $153,000

(b) The asset must still be written down by $153,000. However, $10,000 of this would be recognised in other comprehensive income and the remaining $143,000 ($153,000 - $10,000) would be charged to profit or loss.

Dr Profit or loss $143,000

Dr Other comprehensive income $10,000

Cr PPE $153,000

Test your understanding 2 – Cash generating units An

entity has three stages of production:

- A – growing and felling trees
- B – creating parts of wooden future
- C – assembling the parts from B into finished goods.

The output of A is timber is partly transferred to B and partly sold in an external market. If A did not exist, B could buy its timber from the market. The output of B has no external market and is transferred to C at an internal transfer price. C sells the finished production in an external market and the sale revenue achieved by C is not affected by the fact that the three stages of production are all performed by the entity.

Required:

Identity the cash-generating units (s) Answer:

Test your understanding 2 – Cash generating units

A-forms a cash-generating unit and its cash inflows should be based on the market price for its output. B and C together form one cash-generating unit because there is no market available for the output of B. In calculating the cash outflows of the cash-generating unit B + C, the timber received by B from A should be priced by reference to the market, not any internal transfer price.

Illustration 1 – Impairment allocation within CGU

Tinud has identified an impairment loss of \$4.1m for one of its cash-generating units. The carrying amount of the unit's net assets was \$150m, whereas the unit's recoverable amount was only \$109m. The draft values of the net asset of the unit are as follows:

	\$m
Goodwill	13
Property	20
Machinery	49
Vehicles	35
Patents	14
Net monetary assets	19
	150

The net selling price of the unit's assets were insignificant except for the property, which had a market value of \$35m. The net monetary assets will be realized in full.

Required:

How is the impairment loss allocated to the assets within the cash-generating unit?

Solution

Firstly, the impairment loss is allowanced to the goodwill, reducing its carrying amount to nil.

The impairment loss cannot be set against the property because its net selling price is greater than its carrying amount.

Likewise, the impairment loss cannot be set against the net monetary assets (receivables, cash, etc.) because they will be realized in full.

The balance of the impairment loss of \$28 million (\$41m - \$13m) is apportioned between the remaining assets in proportion to their carrying amounts. So, example, the impairment allocated to the machinery is \$14 million ((49/(49 + 35 + 14)) x 28m)

The table below shows how the impairment will be allocated.

	Draft	Impairment	Revised values
		loss	value

	$m	$m	$m
Goodwill	13	(13)	-
Property	20	-	20
Machinery	49	(14)	35
Vehicles	35	(10)	25
Patents	14	(4)	10
Net monetary assets	19	-	19
	150	(41)	109

Test your understanding 3 – factory explosion

There was an explosion in a factory. The carrying amounts of its assets were as follows:

	$000
Goodwill	100
Patents	200
Machines	300
Computers	500
Buildings	1,500
	2,600

The factory operates as a cash-generating unit. An impairment review reveals a net selling price of $1.2 million for the factory and value in use of $1.95 million. Half of the machines have been blown

to pieces but the other half can be sold for at least carrying amount. The patents have been superseded and are now considered worthless.

Required:

Discuss, with calculations, how any impairment loss will be accounted for.

Answer:

Test your understanding 3 – factory explosion

The patents have been superseded and have a recoverable amount of $nil. They therefore should be written down to $nil and an impairment loss of $200,000 must be charged to profit or loss.
Half of the machines have been blown to pieces. Therefore, half of the carrying amount of the machines should be written off. An impairment loss of $150,000 will be charged to profit or loss.

The recoverable amount of the other assets cannot be determined so therefore they must be tested for impairment as part of their cash generating unit.

The total carrying amount of the CGU after the impairment of the patents and machines is $2,250,000 (see working below), whereas the recoverable amount is $1,950,000. A further impairment of $300,000 is therefore required.

This is firstly allocated to goodwill and then to other assets on a pro-rata basis. No further impairment should be allocated to the machines as these have already been written down to their recoverable amount.

Allocation of impairment loss to CGU

	Draft	Impairment	Revised
	$000	$000	$000
Goodwill	100	(100)	Nil
Patents	nil	-	Nil
Machines	150	-	150
Computers	500	(50)	450

Buildings	1,500	(150)	1,350
	2,250	(300)	1,950

The total impairment charged to profit or loss is $650,000 ($200,000 + $150,000 + $300,000).

Test your understanding 4 – Boxer

Boxer purchased a non-current asset on 1 January 2001 at a cost of $30,000. At the date, the asset had an estimated useful life of ten years. Boxer does not revalue this type of asset, but accounts for it on the basis of depreciated historical cost. At 31 December 2002, the asset was subject to an impairment review and had a recoverable amount of $16,000.
At 31 December 2005, the circumstances which caused the original impairment to be recognised have reversed and are no longer applicable, with the result that recoverable amount is now $40,000.

Required:

Explain, with supporting computations, the impact on the financial statements of the two impairment reviews.

Answer;

Test your understanding 4 – Boxer

Year ended 31 December 2002

	$
Asset carrying amount ($30,000 x 8/10)	24,000
Recoverable amount 16,000 Impairment loss 8,000	

The asset is written down to $16,000 and the loss of $8,000 is charged to profit or loss. The depreciation charge per annum in future periods will be $2,000 ($16,000 x 1/8). Year ended 31 December 2005

	$
Asset carrying amount (16,000 x 5/8)	10,000
Recoverable amount	40,000
Impairment loss	nil

There has been no impairment loss. In fact, there has been a complete reversal of the first impairment loss. The asset can be reinstated to its depreciated historical cost i.e. to the carrying value at 31 December 2005 if there never been an earlier impairment loss.
Year 5 depreciated historical cost (30,000 x 5/10) = $15,000

Carrying amount: $10,000

Reversal of the loss: $5,000

The reversal of the loss is now recognised. The asset will be increased by $5,000 ($15,000 - $10,000 and a gain of $5,000 will be recognised in profit or loss.

It should be noted that the whole $8,000 original impairment cannot be reversed. The impairment can only reversed to a maximum amount of depreciated historical cost, based upon the original cost and estimated useful life of the asset.

Test your understanding 5 – CGUs and impairment reversals

On 31 December 2002, an impairment review was conducted on a cash generating unit and the results were as follows:

Asset	Carrying amount pre-impairment	Impairment	Carrying amount post-impairment
	$000	$000	$000
Goodwill	100	(100)	Nil
Property, plant	300	(120)	180

And equipment			
	400	(220)	180

The property, plant and equipment was originally purchased for $400,000 on 1 January 2001 and was attributed a useful economic life of 8 years.

At 31 December 2003, the circumstances which caused the original impairment have reversed and are no longer applicable. The recoverable amount of the cash generating unit is now $420,000.
Required:

Explain, with supporting computations, the impact of the impairment reversal on the financial statements for the year ended 31 December 2003.

Answer:

Test your understanding 5 – CGUs and impairment reversals The

goodwill impairment cannot be reversed.

The impairment of the PPE can be reversed. However, this is limited to the carrying value of the asset had no impairment loss been previously recognised.

The carrying amount of the PPE as at 31 December 2003 is $150,000 ($180,000 x 5/6).

If the PPE had not been impaired, then its value at 31 December 2003 would have been $250,000 ($400,000 x 5/8).

Therefore, the carrying amount of the PPE can be increased from $150,000 to $250,000. This will give rise to a gain of $100,000 in profit or loss.

IAS 40-INVESTMENT PROPERTY

OBJECTIVE

The objective of this Standard is to prescribe the accounting treatment for investment property and related disclosure requirements.

DEFINITIONS:

Investment property is property held to earn rentals or for capital appreciation or both, rather than for:

a) Use in the production or supply of goods or services or for administrative purposes; or
b) Sale in the ordinary course of business.

Owner-occupied property is property held (by the owner or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes.

CLASSIFICATION

The following are examples of investment property:

a) Land held for long-term capital appreciation
b) Land held for a currently undetermined future use
c) Building leased out under operating lease
d) A building that is vacant but is held to be leased out under one or more-operating leases.
e) Property that is being constructed or developed for future use as investment property

The following are examples of items that are not investment property:

a) Property held for use in the production or supply of goods or services or for administrative purposes
b) Property held for sale in the ordinary course of business or in the process of construction of development for such sale (IAS 2 Inventories)
c) Property being constructed or developed on behalf of third parties
d) Owner-occupied property (IAS 16 Property, Plant and Equipment), including property held for future use as owner-occupied property, property held for future development and subsequent use as owner-occupied property, property occupied by employees and owner occupied property a waiting disposal
e) Property leased to another entity under a finance lease

Property held under an operating lease.

A property interest that is held by a lessee under an operating lease may be classified and accounted for as investment property provided that:

- The rest of the definition of investment property is met
- The operating lease is accounted for as if it were a finance lease in accordance with IFRS 16 Leases
- The lessee uses the fair value model set out in this Standard for the asset recognised

An entity may make the foregoing classification on a property-by-property basis.

Partial own use

If the owner uses part of the property for its own use, and part to earn rentals or for capital appreciation, and the portions can be sold or leased out separately, they are accounted for separately. Therefore the part that is rented out is investment property. If the portions cannot be sold or leased out separately, the property is investment property only if the owner-occupied portion is insignificant.

Ancillary services

If the entity provides ancillary services to the occupants of a property held by the entity, the appropriateness of classification as investment property is determined by the significance of the services provided. If those services are a relatively insignificant component of the arrangement as a

whole (for instance the building owner supplies security and maintenance services to the lessees), then the entity may treat the property as investment property. Where the services provided are more significant (such as in the case of an owner-managed hotel), the property should be classified as owner-occupied.

Intra-company rentals

Property rented to a parent, subsidiary, or fellow subsidiary is not investment property in consolidated financial statements that include both the less or and the lessee, because the property is owner-occupied from the perspective of the group. However, such property could qualify as investment property in the separate financial statements of the less or, if the definition of investment property is otherwise met.

RECOGNITION:

Investment property shall be recognized as an asset when

(a) It is probable that the future economic benefits that are associated with the investment property will flow to the entity; and
(b) The cost of the investment property can be measured reliably.

MEASUREMENT

Initial measurement

- An investment property shall be measured initially at its Cost + Transaction costs.
- The cost of a purchased investment property = Purchase price + any directly attributable expenditure.

The cost should not include start-up costs, abnormal waste, or initial operating losses incurred before the investment property achieves the planned level of occupancy.

Subsequent expenditure

This should be added to the carrying amount of the investment property when it is probable that future economic benefits in excess of the originally assessed standard of performance of the existing investment property will flow to the enterprise. All other subsequent expenditure should be recognized as an expense in the period in which it is incurred.

Exchanges of assets

An investment property may be acquired in exchange or part exchange for a non-monetary asset or assets or a combination of monetary and non-monetary assets.

The cost of such an item is the fair value unless the exchange transaction lacks commercial substance or the fair value of the asset given up / acquired is not reliably measurable. Then the cost of the asset acquired will be the carrying value of the asset given up

SUBSEQUENT MEASUREMENT

IAS 40 permits entities to choose between

- A fair value model, and
- A cost model.

COST MODEL:

Under cost model, investment property should be measured at depreciated cost, less any accumulated impairment losses.

FAIR VALUE MODEL

Under the fair value model the entity should:

- Revalue all its investment property to 'fair value' (open market value) at the end of each financial year, and
- Take the resulting gain or loss to profit or loss for the period in which it arises.

Fair value is the price that would be received to sell an asset or paid to transfer a liability, in an orderly transaction between market participants at the measurement date.

Investment property is remeasured at fair value, which is the amount for which the property could be exchanged between knowledgeable, willing parties in an arm's length transaction.

Fair value should reflect the actual market state and circumstances as of the reporting date. The best evidence of fair value is normally given by current prices on an active market for similar property in the same location and condition and subject to similar lease and other contracts. In the absence of

such information, the entity may consider current prices for properties of a different nature or subject to different conditions, recent prices on less active markets with adjustments to reflect changes in economic conditions, and discounted cash flow projections based on reliable estimates of future cash flows.

There is a rebuttable presumption that the entity will be able to determine the fair value of an investment property reliably on a continuing basis. However:

- If an entity determines that the fair value of an investment property under construction is not reliably determinable but expects the fair value of the property to be reliably determinable when construction is complete, it measures that investment property under construction at cost until either its fair value becomes reliably determinable or construction is completed.
- If an entity determines that the fair value of an investment property (other than an investment property under construction) is not reliably determinable on a continuing basis, the entity shall measure that investment property using the cost model in IAS 16. The residual value of the investment property shall be assumed to be zero. The entity shall apply IAS 16 until disposal of the investment property.

Where a property has previously been measured at fair value, it should continue to be measured at fair value until disposal, even if comparable market transactions become less frequent or market prices become less readily available.

COST MODEL

The cost model is the same treatment in IAS 16. Investment property should be measured at cost less accumulated depreciation less any accumulated impairment losses. An enterprise that chooses the cost model should disclose the fair value of its investment property.

Adoption and change of models

One method must be adopted for all of an entity's investment property. Change is permitted only if this results in a more appropriate presentation. IAS 40 notes that this is highly unlikely for a change from a fair value model to a cost model.

TRANSFERS:

Transfers to, or from, investment property should only be made when there is a change in use, evidenced by one or more of the following:

- Commencement of owner-occupation (transfer from investment property to owneroccupied property)
- Commencement of development with a view to sale (transfer from investment property to inventories)
- End of owner-occupation (transfer from owner-occupied property to investment property)
- Commencement of an operating lease to another party (transfer from inventories to investment property)
- End of construction or development (transfer from property in the course of construction/development to investment property

When an entity decides to sell an investment property without development, the property is not reclassified as inventory but is dealt with as investment property until it is derecognised.

RULES FOR TRANSFER:

- For a transfer from investment property carried at fair value to owner-occupied property or inventories, the fair value at the change of use is the 'cost' of the property under its new classification.
- For a transfer from owner-occupied property to investment property carried at fair value, IAS 16should be applied up to the date of reclassification. Any difference arising between the carrying amount under IAS 16 at that date and the fair value is dealt with as a revaluation under IAS 16
- For a transfer from inventories to investment property at fair value, any difference between the fair value at the date of transfer and it previous carrying amount should be recognized in profit or loss
- When an entity completes construction/development of an investment property that will be carried at fair value, any difference between the fair value at the date of transfer and the previous carrying amount should be recognized in profit or loss
- When an entity uses the cost model for investment property, transfers between categories do not change the carrying amount of the property transferred, and they do not change the cost of the property for measurement or disclosure purposes.

DISPOSAL

An investment property should be derecognized on disposal or when the investment property is permanently withdrawn from use and no future economic benefits are expected from its disposal.

- The gain or loss on disposal should be calculated as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognized as income or expense
- Compensation from third parties is recognized when it becomes receivable.

ACCOUNTING TREATMENT DIFFERENCE – Fair value model & Revaluation model

Superficially, the revaluation model and fair value sound very similar; both require properties to be valued at their fair value which is usually a market-based assessment (often by an independent value).

However, any gain (or loss) over a previous valuation is taken to profit or loss if it relates to an investment property, whereas for an owner-occupied property, any gain is taken to a revaluation reserve (via other comprehensive income and the statement of changes in equity).

A loss on the revaluation of an owner-occupied property is charged to profit or loss unless it has a previous surplus in the revaluation reserve which can be used to offset the loss until it is exhausted. A further difference is that owner-occupied property continues to be depreciated after revaluation, where as investment properties are not depreciated.

Illustration 1 – Investment property

Lavender owns a property, which it rents out to some of its employees. The property was purchased for $30 million on 1 January 2002 and had a useful life of 30 years at that date. On 1 January 2007 it had a market value of $50 million and its remaining useful life remained unchanged. Management wish to measure properties at fair value where this is allowed by accounting standards.

Required:

How should the-property be treated in the financial statements of Lavender for the year ended 31 December 2007

Solution

Property that is rented out to employees is deemed to be owner-occupied and therefore cannot be classified as investment property.

Management wish to measure the property at fair value, so Lavender adopts the fair value model in IAS 16 Property, Plant and Equipment, depreciating the asset over its useful life and recognizing the revaluation gain in other comprehensive income

Before the revaluation, the building had a carrying amount of $25m ($30m x 25/30). The building would have been revalued to $50m on 1 January 2007, with a gain of $25m ($50m - $25m) recognised in other comprehensive income.
The building would then be depreciated over its remaining useful life of 25 years (30 - 5), giving a depreciation charge of $2m ($50m/25) in the year ended 31 December 2007. The carrying amount of the asset as at 31 December 2007 is $48m ($50m - $2m).

Illustration 2 – ABC

ABC owns a building that it used as its head office. On 1 January 2001, the building, which was measured under the cost model, had a carrying amount of $500,000. On this date, when the fair value of the building was $600,000, ABC vacated the premises. However, the directors decided to keep the building in order to rent it out to tenants and to potentially benefit from increases in property prices. ABC measures investment properties at fair value. On 31 December 2001, the property has a fair value of $625,000.

Required:

Discuss the accounting treatment of the building in the financial statements of ABC for the year ended 31 December 2001.

Solution

When the building was owner-occupied, it was an item of property plant and equipment. From 1 January 2001, the property was held to earn rental income and for capital appreciation so it should be reclassified as investment property.

Per IAS 40, if owner occupied property becomes investment property that will be carried at fair value, then a revaluation needs to occur under IAS 16 at the date of the change in use.

The building must be revalued from $500,000 to $600,000 under IAS 16. This means that the gain of $100,000 ($600,000 - $500,000) will be recorded in other comprehensive income and held in a revaluation reserve within equity.

Investment properties measured at fair value must be revalued each year end, with the gain or loss recorded in profit or loss. At year end, the building will therefore be revalued to $625,000 with a gain of $25,000 ($625,000 - $600,000) recorded in profit or loss.

Investment properties held at fair value are not depreciated.

IAS 2 – INVENTORIES

OBJECTIVE

The objective of this IAS is to prescribe the accounting treatment of inventories.

DEFINITIONS

Inventories are assets; -

(a) Held for sale in the ordinary course of business
(b) In the process of production for such sale; or (work in progress, finished goods awaiting to be sold)
(c) In the form of materials or supplies to be consumed in the production process or in the rendering of services

Net Realizable Value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated cost necessary to make a sale.

MEASUREMENT OF INVENTORIES

Inventory shall be measured at the lower of cost and net realizable value.

COST OF INVENTORIES

The cost of inventories will comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

(a) Purchase cost comprise the;

i. Purchase price plus;
ii. Import duties and other non –refundable taxes;
iii. Transport, handling and any other cost directly attributable to the acquisition of finished goods, services and materials; less
iv. Trade discounts, rebates and other similar amounts

(b) Cost of conversion

i. Costs directly related to the units of production (direct labor); and
ii. Systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. (Factory rent, depreciation of machinery, supervisor salary, power consumption)

The allocation of fixed overheads to the costs of conversion is based on the normal capacity of the production facilities.

(c) Other cost incurred in bringing the inventories to their present location and condition (i.e. nonproduction overheads or costs of designing products for specific customers).

The Standard excludes the following from the cost of inventories

a) The abnormal amount of wasted material, labor or other production cost;
b) Storage costs unless necessary for production before the further production process/stage;
c) Administrative overheads that do not contribute to bringing inventories to their present location and condition;
d) Selling cost

e) Foreign exchange differences arising directly on the recent acquisition of inventories invoiced in a foreign currency
f) Interest cost when inventories are purchased with deferred settlement terms

Costs of Inventories of a service provider

The cost of inventories of service providers includes primarily the labour and other cost of the personnel directly engaged in providing the service including supervisory personnel and directly attributable overheads.

COST FORMULAS

For items that are interchangeable, IAS 2 allows the FIFO or weighted average cost formulas. The LIFO formula, which had been allowed prior to the 2003 revision of IAS 2, is no longer allowed.
NET REALIZABLE VALUE

As a general rule assets should not be carried at amounts greater than those expected to be realized from their sale or use. In case of inventories this amount could fall below cost when items are damaged or become wholly or partially obsolete, or where the costs to completion have increased in order to make the sale or the prices have declined. (Prudence Concept).

The principal situations in which NRV is likely to be less than cost, i.e. where there has been:

- An increase in costs or a fall in selling price
- A physical deterioration in conditions of inventory
- Obsolescence of products
- A decision as part of the company‘s marketing strategy to manufacture and sell products at a loss
- Errors in production or purchasing

RULES:

- The write down of inventories would normally take place on an item-by-item basis but similar or related items may be grouped together (in case of service provider each service will be treated as item).
- The NRV should be based on the most reliable evidence available at the time of estimates are made.
- Fluctuations after reporting date should also be taken into account to the extent they confirm the conditions existing at the reporting date.
- The estimate of NRV should also take into account the purpose for which the inventory is held (firm sale / purchase contracts).
- Materials or supplies held for use in the production process should not be written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. Otherwise, when the decline in the value of materials indicates that the cost of finished goods exceeds NRV, the materials should be written down to NRV.
- NRV should be reassessed at each reporting date and necessary adjustments such as further reduction or increase in NRV should be made however, reversal of write down is limited to the original write down of inventories.
- Material reductions should be disclosed separately

RECOGNITION AS EXPENSE

The following treatment is required, when inventories are sold.

a) The carrying amount is recognized as an expense in the period in which the related revenue is recognized (matching concept)
b) The amount of any write down of inventories to NRV and all losses of inventories are recognized as an expense in the period in which the related write down or loss occurred
c) The amount of any reversal of any write down of inventories, arising from the increase in NRV is recognized as a reduction in the amount of inventories recognized as an expense in the period in which the reversal occurs.

The inventories allocated to other assets i.e. when the inventory becomes the part of cost of self constructed assets, the inventories are recognized as an expense over the useful life of those assets.

IAS 41 – AGRICULTURE

OBJECTIVED

The objective of IAS 41 is to establish standards of accounting for agricultural activity

SCOPE

Within scope are Biological assets, Agricultural produce at the point of harvest and Government grants related to biological assets.

Excluded from scope are Land and Intangible assets related to agricultural activity

DEFINITIONS

ACTIVE MARKET:

Exists when; the items traded are homogenous, willing buyers and sellers can normally be found at any time and prices are available to the public.

AGRICULTURAL ACTIVITY:

The management of the transformation of a biological asset for sale into agricultural produce or another biological asset

Biological asset: A living animal or plant.

Agricultural produce: The harvested produce of the entity's biological assets.

Biological transformation: The process of growth, degeneration, production, and procreation that cause an increase in the value or quantity of the biological asset.

Harvest: The process of detaching produce from a biological asset or cessation of its life.

Bearer plant: A living plant that:

a) Is used in the production or supply of agricultural produce
b) Is expected to bear produce for more than one period, and
c) Has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.

Costs to sell: The incremental costs directly attributable to the disposal of an asset, excluding finance costs and income taxes

RECOGNITION

Biological assets or agricultural produce are recognised when:

- Entity controls the asset as a result of a past event
- Probable that future economic benefit will flow to the entity; and
- Fair value or cost of the asset can be measurement reliably.

MEASUREMENT

Biological assets

Biological assets within the scope of IAS 41 are measured on initial recognition and at subsequent reporting dates at fair value less estimated costs to sell, unless fair value cannot be reliably measured.

If no reliable measurement of fair value (no quoted market price in an active market and alternative fair value measurements unreliable), biological assets are stated at cost less accumulated depreciation and accumulated impairment losses.

If circumstances change and fair value becomes reliably measurable, a switch to fair value less costs is required.

Agricultural produce

Agricultural produce is measured at fair value less estimated costs to sell at the point of harvest.

Unlike a biological asset, there is no exception in cases in which fair value cannot be measured reliably. According to IAS 41 agricultural produce can always be measured reliably because harvested produce is a marketable commodity.

Point of-sale costs include brokers 'and dealers' commissions, any levies by regulatory authorities and commodity exchanges, and any transfer taxes and duties. They exclude transport and other costs necessary to get the assets to a market.

Treatment of gain/loss

- The gain on initial recognition of biological assets at fair value less costs to sell, and changes in fair value less costs to sell of biological assets during a period, are included in profit or loss.
- A gain on initial recognition (e.g. as a result of harvesting) of agricultural produce at fair value less costs to sell are included in profit or loss for the period in which it arises.
- All costs related to biological assets that are measured at fair value are recognised as expenses when incurred, other than costs to purchase biological assets.

Government grants

An unconditional government grant related to a biological asset measured at fair value less estimated point-of-sale costs is recognised as income when, and only when, the government grant becomes available

A conditional government grant, including where a government grant requires an entity not to engage in specified agricultural activity, is recognised as income in profit or loss when and only when, the conditions of the grant are met.

OTHER ISSUES

- The change in fair value of biological assets is part physical change (growth, etc.) and part unit price change. Separate disclosure of the two components is encouraged, not required.
- Agricultural produce is measured at fair value less costs to sell at harvest, and this measurement is considered the cost of the produce at that time (for the purposes of IAS 2 Inventories or any other applicable standard).
- Agricultural land is accounted for under IAS 16 Property, Plant and Equipment. However, biological assets (other than bearer plants) that are physically attached to land are measured as biological assets separate from the land. In some cases, the determination of the fair value less costs to sell of the biological asset can be based on the fair value of the combined asset (land, improvements and biological assets).
- Intangible assets relating to agricultural activity (for example, milk quotas) are accounted for under IAS 38 Intangible Assets.

Agriculture and inventories

Application of IAS 41 definitions

A farmer buys a dairy calf.	The calf is a biological asset.
The calf grows into a mature cow.	Growth is a type of biological transformation.
The farmer milks the cow.	The milk has been harvested. Milk is agricultural produce.

Test your understanding 1 – Cows

On 1 January 2001, a farmer had a herd of 100 cows, all of which were 2 years old. At this date, the fair value less point of sale costs of the herd was $10,000. On 1 July 2001, the farmer purchased 20 cows (each two and half years old) for $60 each.

As at 31 December 2001, three year old cows sell at market for $90 each.

Market auctioneers have charged a sales levy of 2% for many years.

Required:

Discuss the accounting treatment of the above in the financial statements for the year ended 31 December 2001.

Answer:

Test your understanding 1 – Cows

Cows are biological assets and should be initially recognised at fair value less costs to sell.

The cows purchased in the year should be initially recognised at $1,176 ((20 x $60) x 98%). This will give rise to an immediate loss of $24 ((120 x $60) - $1,176) in the statement of profit or loss. At year end, the whole herd should be revalued to fair value less costs to sell. Any gain or loss will be recorded in the statement of profit or loss.

The herd of cows will be held at $10,584 ((120 x $90) x 98%) on the statement of financial position.

This will give rise to a further loss of $592 (W1) in the statement of profit or loss

(W1) Loss on revaluation

	$
Value at 1 January 2001	10,000
New purchase	1,176
Loss (bal. fig)	(592)
Value at 31 December 2001	10,584

Test your understanding 2 – Good Wine

Good Wine is a company that grows and harvests grapes. Grape vines, which produce a new harvest of grapes each year, are typically replaced every 30 years. Harvested grapes are sold to wine

producers. With regards to property, plant and equipment, Good Wine accounts for land using the revaluation model and all other classes of assets using the cost model.

On 30 June 2001, its grape vines had a carrying amount of $300,000 and a remaining useful life of 20 years. The grapes on the vines, which are generally harvested in August each-year, had a fair value of $500,000. The land used for growing the grape vines had a fair value of $2m.

On 30 June 2002, grapes with a fair value of $100,000 were harvested early due to unusual weather conditions. The grapes left on the grape vines had a fair value of $520,000. The land had a fair value of $2.1m.

All selling costs are negligible and should be ignored.

Required:
Discuss the accounting treatment of the above in the financial statements of Good Wine for the year ended 30 June 2002.

Answer:

Test your understanding 2 – Good Wine

Land is accounted for in accordance with IAS 16 Property, Plant and Equipment. If the revaluation model is chosen, then gains in the fair value of the land should be reported in other comprehensive income.

At 30 June 2002, the land should be revalued to $2.1m and a gain of $100,000 ($2.1m - $2.0m) should be reported in other comprehensive income and held within a revaluation reserve in equity.

The grape vines are used to produce agricultural produce over many periods. This means that they are bearer plants and are therefore also accounted for under IAS 16. Except for land, Good Wine uses the cost model for property, plant and equipment. Therefore depreciation of $15,000 ($300,000/20 years) will be charged to profit or loss in the year and the grape vines will have a carrying amount of $285,000 ($300,000 - $15,000) at 30 June 2002.

The grapes growing on the vines are biological assets. They should be revalued at the year end to fair value less costs to sell with any gain or loss reported in profit or loss. Good Wine's biological

assets should therefore be revalued to $520,000. A gain of $ 20,000 ($520,000 - $500,000) should be reported in profit or loss.

The grapes are agricultural produce and should initially be recognised at fair value less costs to sell. Any gain or loss on initial recognition is reported in profit or loss. The harvested grapes should be initially recognised at $100,000 with a gain of $ 100,000 reported in profit or loss. The harvested grapes are now accounted for under IAS 2 Inventories and will have a deemed cost of $100,000.ss

Illustration 1 – Valuation of inventories

An entity has the following items for inventory.

(a) Raw materials costing $12,000 bought for processing and assembly for a profitable special order. Since buying these items, the cost price of the raw materials has fallen to $10,000. (b) Equipment constructed for a customer for an agreed price of $18,000. This has recently been completed at a cost of $16,800. It has now been discovered that, in order to meet certain regulations, conversion with an extra cost of $4,200 will be required. The customer has accepted partial responsibility and agreed to meet half the extra cost.

Required:

In accordance with IAS 2 Inventories, at what amount should the above items be valued?

Solution

(a) Raw materials are not written down below cost if the finished good they will form a part of will be sold at a profit. Therefore the inventory should be valued at its cost of $12,000

(b) The net realizable value is $15,900 (contract price $18,000 – constructor's share of modification cost $2,100). The net realizable value is below the cost price. Therefore the inventory should be held at $15,900.

IAS 23-BORROWING COST

OBJECTIVE:

To prescribe the accounting treatment for borrowing cost.

DEFINITIONS:

Borrowing costs are interest and other costs, incurred by an entity in connection with the borrowing of funds in order to construct an asset.

Borrowing cost includes

- Interest on bank overdraft and short term borrowing;
- Finance lease charges in respect of finance lease; and
- Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment of interest cost
- Issuance costs
- Discount on issuance and premium on redemption

Qualifying asset: A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale (e.g. inventories, manufacturing plants, power generation facilities, intangible assets, investment properties etc) However, financial assets, inventories produced over short period of time and assets ready for intended sale are not qualifying assets.

ACCOUNTING TREATMENT:

Recognition

An entity should capitalize the borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset and, therefore, should be capitalized.

Other borrowing costs are expensed in statement of profit or loss when occurred.

Return on any surplus funds invested is first deducted from the amount of interest and then the remaining amount is capitalized.

Specific Funds

The borrowing cost of funds, borrowed specifically for the qualifying asset, is the actual cost incurred on the funds during the period less any investment income on the temporary investment of funds.

General funds

The borrowing cost of funds, borrowed generally, will be determined by applying a capitalization rate to the expenditures incurred on those assets. The capitalization rate is the weighted average rate of the borrowings cost applicable to the borrowings of the entity outstanding during that period other than specific borrowings. The amount of borrowing cost capitalized during a period should not exceed the borrowing costs incurred during the period. (Group borrowings)

Excess of carrying amount of the qualifying asset over recoverable amount

When the carrying amount exceeds the recoverable amount of that asset, the asset should be written down to its recoverable value. (IAS 36)

PERIOD OF CAPITALIZATION

Commencement of capitalization

The capitalization commences: -

- Expenditures for the assets are being incurred;
- Borrowing costs are being incurred; and
- Activities necessary to prepare the asset for its intended use/sale are in progress

Expenditures on a qualifying asset include only those expenditures, which have resulted in transfer of cash/other asset or assumption of interest bearing liabilities and will be reduced by any Government Grant (IAS –20).

The activities necessary to complete the qualifying asset include beside physical construction the technical/administrative work such as obtaining permits prior to physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset‘s condition is taking place (e.g. borrowing cost incurred while land is under development are capitalized during the period when activities related to the development are in progress).

Suspension of capitalization

Capitalization should cease when during the extended period the active development is interrupted. Examples are:-

- Borrowing costs incurred during extended periods when activities to prepare an asset for its intended use/sale are interrupted (costs of holding partially completed assets)
- On temporary delays the capitalization is not suspended (Geographical region involved delays due to high water levels, inventories to mature for sale, due to bad weather, strikes etc.)

Cessation of capitalization

The capitalization should cease, when substantially all the activities necessary to complete the qualifying asset for its intended use/sale are complete (physical construction is complete, administrative or decorative work may continue).

When the construction of a qualifying asset is in parts the capitalization of borrowing cost should cease, when the relevant part is complete for its intended use/sale (building park).

DISCLOSURE

- The accounting policy adopted.
- Amount of borrowing cost capitalized during the period.
- Capitalization rate used.

Test your understanding 1 – Hi-Rise

On 1 January 2001, Hi-Rise obtained planning permission to build a new office building. Construction commenced on 1 March 2001. To help fund the cost of this building, a loan for $5 million was taken out from the bank on 1 April 2001. The interest rate on the loan was 10% per annum.
Construction of the building ceased during the month of July due to an unexpected shortage of labour and materials.

By 31 December 2001, the building was not complete. Costs incurred to date were $12 million (excluding interest on the loan).

Required:

Discuss the accounting treatment of the above in the financial statements of Hi-Rise for the year ended 31 December 2001.

Answer:

Test your understanding 1 – Hi-Rise

An entity must capitalize borrowing costs that are directly attributable to the production of a qualifying asset. The new office building is a qualifying asset because it takes a substantial period of time to get ready for its intended use.

Hi-Rise should start capitalizing borrowing costs when all of the following conditions have been met:

- It incurs expenditure on the asset – 1 March 2001.
- It incurs borrowing costs – 1 April 2001.
- It undertakes activities necessary to prepare the asset for intended use – 1 January 2001.

Capital is action of borrowing costs should therefore commence on 1 April 2001. Capital is action of borrowing costs ceases for the month of July because active development was suspended. In total, 8 months' worth of borrowing costs should be capital is used in the year ended 31 December 2001.

The total borrowing costs to be capital is used are $333,333 ($5m x 10% x 8/12). These will be added to the cost of the building, giving a carrying amount of $12,333,333 as at 31 December 2001. The building is not ready for use, so no depreciation is charged.

IAS-20 ACCOUNTING FOR GOVERNMENT GRANTS AND DISCLOSURE OF GOVERNMENT ASSISTANCE

OBJECTIVE

To prescribe the accounting for, and disclosure of, government grants and other forms of government assistance.

SCOPE

IAS 20 applies to all government grants and other forms of government assistance. However, it does not cover government assistance that is provided in the form of benefits in determining taxable income. It does not cover government grants covered by IAS 41 Agriculture, either. The benefit of a government loan at a below-market rate of interest is treated as a government grant.

DEFINITIONS

Government refers to government, government agencies and similar bodies whether local, national or international.

Government assistance is provision of economic benefits by government to a specific entity or range of entities which meet specific criteria. Government assistance for the purpose of this Standard does not include benefits provided only indirectly through action affecting general trading conditions, such as the provision of infrastructure in development areas or the imposition of trading constraints on competitors.

Government grants are transfer of resources to an entity, from government, in return for compliance with certain conditions.

It is the assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them an-transactions with government which cannot be distinguished from the normal trading transactions of the entity (subsidies, subvention, or premiums).

ACCOUNTING TREATMENT

RECOGNITION

A government grant is recognized only when there is reasonable assurance that

- The entity will comply with any conditions attached to the grant
- The grant will be received.

The grant is recognised as income over the period necessary to match them with the related costs, for which they are intended to compensate, on a systematic basis.

Non-monetary grants

Non-monetary grants such as land or other resources are usually accounted for at fair value, although recording both the asset and the grant at a nominal amount is also permitted.

Assistance without conditions

Even if there are no conditions attached to the assistance specifically relating to the operating activities of the entity (other than the requirement to operate in certain regions or industry sectors), such grants should not be credited to equity.

Compensation of already incurred costs

A grant receivable as compensation for costs already incurred or for immediate financial support, with no future related costs, should be recognised as income in the period in which it is receivable.

GRANT RELATED TO ASSET

Grant related to depreciable assets are recognized over the useful life of the assets in the proportion of depreciation charge.

Grant related to non-depreciable assets are also recognized over the period in which related expenses are made.

If grants are received as a package of financial or fiscal aids to which a number of conditions are attached then reasons giving rise to costs and expenses should be identified and it may be appropriate to allocate part of grant on one basis and part on another basis.

Presentation of grant related to asset

A grant relating to assets may be presented in one of two ways:

- As deferred income, or
- By deducting the grant from the asset's carrying amount.

GRANT RELATED TO INCOME

Such grants are recognized over the period and matched with the related expenses.

Presentation of grant related to income
A grant relating to income may be reported separately as 'other income' or deducted from the related expense.

Repayment:

- If the conditions of a grant are breached, it may need to be repaid.
- A government grant that becomes repayable shall be accounted for as a revision to an accounting estimate (IAS –8).
- Repayment of a grant related to income shall be applied first against any un-amortized deferred credit and if repayment exceeds the deferred credit the rest will be recognized immediately as expense.

- Repayment of grants related to assets shall be recorded by increasing the carrying amount of the asset or reducing the deferred income balance by the amount payable. The cumulative additional depreciation that would have been recognized to date as an expense in the absence of the grant shall be recognized immediately as an expense.

Disclosure:

The following must be disclosed:

- Accounting policy adopted for grants, including method of statement of financial position presentation
- Nature and extent of grants recognized in the financial statements
- Unfulfilled conditions and contingencies attaching to recognized grant

GOVERNMENT ASSISTANCE

Government grants do not include government assistance whose value cannot be reasonably measured, such as technical or marketing advice.

The government grants are not recognized because no value can be assigned to them or they are not distinguishable from the other transactions of the entity if material shall be disclosed.

Test your understanding 1 – Clock

On 1 January 2001, Clock received written confirmation from a local government agency that it would receive a $1 million grant towards the purchase price of a new office building. The grant becomes receivable on the date Clock transfers the $10 million purchase price to the vendor.

On 1 October 2001 Clock paid $10 million in cash for its new office building, which is estimated to have a useful life of 50 years. By 1 December 2001, the building was ready for use. Clock received the government grant on 1 January 2002.

Required:

Discuss the possible accounting treatments of the above in the financial statements of Clock for the year ended 31 December 2001.

Answer:

Test your understanding 1 – Clock

Government grants should be recognised when there is reasonable assurance that:

- The entity will comply with any conditions attached, and
- It us reasonably certain that the grant will be received.

The only condition attached to the grant is the purchase of the new building. Therefore, the grant should be accounted for on 1 October 2001.

A receivable will be recognised for the $1m due from the local government. Clock could then choose to either:

(a) Reduce the cost of the building by $1m

In this case, the building will have a cost of $9m ($10m - $1m). This will be depreciated over its useful life of 50 years. The depreciation charge in profit or loss for the year ended 31 December 2001 will be $15,000 ($9m/50 years) x 1/12) and the building will have a carrying value of $8,985,000 ($9m - $15,000) as at 31 December 2001.

(b) Recognise deferred income of $1m.

In this case the building is recognised at its cost of $10m. This will be depreciated over its useful life of 50 years. The depreciation charge in profit or loss for the year ended 31 December 2001 will be $16,667 (($10m/50 years) x 1/12) and the building will have a carrying value of $9,983,333 ($10m - $16,667) as at 31 December 2001.

The deferred income will be amortised to profit or loss over the building's useful economic life. Therefore, income of $ 1,667 (($1m/50) x 1/12) will be recorded in profit or loss for the year ended 31 December 2001. The carrying value of the deferred income balance within liabilities on the statement of financial position will be $998,333 ($1m - $1,667) as at 31 December 2001.

IAS-8 ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

OBJECTIVE

The objective of this Standard is to prescribe the criteria for selecting and changing accounting policies, the accounting treatment and disclosure of changes in accounting policies, accounting estimates and corrections of errors.

ACCOUNTING POLICIES

Definitions:

Accounting Policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

Material Omissions or misstatements of items are material if they could influence the economic decisions that users make on the basis of the financial statements.

SELECTION OF ACCOUNTING POLICIES

Management selects accounting policies by applying accounting standards or using judgment:

Compulsory - Where a specific standard relates to a transaction or event, the accounting policy applied to that item shall be determined by applying that standard.

Voluntary - Where there is no specific standard to deal with a particular transaction, event or condition, management shall develop and apply accounting policies resulting in reliable .and more relevant information.

In developing accounting policy management should consider:

a) The requirements and guidance of accounting standards dealing with similar and related issues; and

b) The contents of the Accounting Framework for the Preparation and Presentation of Financial statements (The Framework).

CHANGE IN ACCOUNTING POLICIES

The management can change accounting policy under the following circumstances:

Compulsory - Where a change is required by a specific standard or interpretation (external).

Voluntary - Management determines that a change in policy will result in the financial statements providing reliable and more relevant information (internal).

Consistency in accounting policies

Although accounting policies can and sometimes must be changed in order to achieve comparability there is an underlying requirement to be consistent in the selection and application of accounting policies.

To improve comparability, consistency requires that the same accounting policies should be applied to similar items within each period, and from one period to the next.

Meaning of Relevant and Reliable

Relevant information helps the user to make economic decisions.

Reliable financial statements:

- Present faithfully the effects of transaction on financial position, financial performance and cash flows;

- Reflect the economic substance or transactions, other events and conditions
- Be neutral (no bias or error)
- Be prudent
- Be complete in all material respects.

Application of Changes in Accounting Policy

The change in accounting policy is applied retrospectively

Compulsory/Specific - Where a new standard/Interpretation forces a change in accounting policy and that standard has specific transitional provisions then the entity must apply those provisions in accounting for the change.

Compulsory/ Non-Specific - Where the change in accounting policy is compulsory but with no specific transitional provisions, the change shall be applied retrospectively.

Voluntary - Where the change is voluntary, the change shall be applied retrospectively.

Retrospective application

It is applying a new accounting policy to transactions and other events as if that policy had always been applied, i.e. make prior period adjustments.

This means restating the opening balance of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.

Items NOT changes in accounting policy

IAS 8 states that the introduction of an accounting policy to account for transactions where circumstances have changed are not a change in accounting policy.

Similarly, a policy for transactions that did not occur previously or that were immaterial is not a change in policy and therefore would be applied prospectively.

Limitations of Retrospective Application

IAS 8 does not permit the use of hindsight when applying a new accounting policy, either in making assumptions about what management's intentions would have been in a prior period or in estimating amounts to be recognised measured or disclosed in a prior period.

When it is impracticable to determine the effect of a change in accounting policy on comparative information, the entity is required to apply the new policy to the carrying amounts of the assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable. This could actually be the current period but the entity should attempt to apply the policy from the earliest date possible.

The application of the requirement of a standard or interpretation is "impracticable" if the entity cannot apply it after making every effort to do so.

Disclosures for Changes in Accounting Policies

When initial application of the standard or interpretation has an effect on current or prior periods, would have an effect but it is impracticable to determine, or might have an effect, then entities shall disclose:

- The title of the Standard or Interpretation;
- If applicable, that the changes were made in accordance with the transitional provisions; The nature of the change;

In addition, for voluntary changes in accounting policies, a description must be provided of the reason for the new policy providing reliable and more relevant information.

CHANGES IN ACCOUNTING ESTIMATES

Definition

A change in accounting estimate is an adjustment of the carrying amount of an asset or liability, or related expense, resulting from reassessing the expected future benefits and obligations associated with that asset or liability.

Where the basis of measurement for the amount to be recognised is uncertain, an entity will use an estimation technique, which is a normal part of the preparation of the financial statements without undermining their reliability.

Estimates involve judgments based on the latest available, reliable information and are applied in determining the useful lives of property, plant and equipment, provisions, fair values of financial assets and liabilities and actuarial assumptions relating to defined benefit pension schemes.
Many items in financial statements cannot be measured with precision but will be estimated. Estimation involves judgment based on the latest available reliable information. Examples include:

- Estimating the recoverability of receivables at the year end, i.e. bad debts
- Inventory obsolescence
- Fair values of assets/liabilities
- Determining the remaining useful lives of; or the expected patterns of consumption of depreciable assets
- Estimating Income tax expenses

Comparison between change in accounting policy and estimate

Accounting estimates need to be distinguished from accounting policies as the effect of a change in an estimate is reflected in the Statement of profit or loss and other comprehensive income, whereas a change in accounting policy will generally require a prior period adjustment. If there is a change in the circumstances on which the estimate was based or new information has arisen or more experience relating to the estimation process has occurred, then the estimate may need to be changed. A change in the measurement basis is not a change in an accounting estimate, but is a change in accounting policy. For example, if there is a move from historical cost to fair value, this is a change in accounting policy but a change in the method of depreciation is a change in accounting estimate.

Accounting for changes in estimates

The effect of a change in an accounting estimate shall be recognized prospectively by including it in profit or loss in:

- The period of the change, if the change affects that period only e.g. change is estimated irrecoverable and doubtful debts; or

- The period of the change and future periods, if the change affects both e.g. change in useful life of a depreciable asset.
- To the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it shall be recognized by adjusting the carrying amount of the related asset, liability or equity item in the period of the change.

ERRORS

Prior period errors are omissions from, and misstatements in, the entity‘s financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

- Was available when financial statements for those periods were authorized for issue; and
- Could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Accounting for errors

An entity shall correct material prior period errors retrospectively in the first set of financial statements authorized for issue after their discovery by:

- restating the comparative amounts for the prior period(s) presented in which the error occurred; or
- If the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

IAS 10 - EVENTS AFTER REPORTING DATE

OBJECTIVE

To prescribe:

- When an entity should adjust its financial statements for events after the reporting period; and
- The disclosures that an entity should give about the date when the financial statements were authorized for issue and about events after the reporting period.

The Standard also requires that an entity should not prepare its financial statements on a going concern as is if events after the reporting period indicate that the going concern assumption is not appropriate.

DEFINITIONS

Event after the reporting period occurs between the end of the reporting period and the date that the financial statements are authorized for issue.

These include:

- Adjusting events provide evidence of conditions that existed at the end of the reporting period.

- Non-adjusting events are those that are indicative of conditions that arose after the reporting period.

ACCOUNTING TREATMENT:

- Adjust financial statements for adjusting events
- Do not adjust for non-adjusting events
- If an entity declares dividends after the reporting period, the entity shall not recognize those dividends as a liability at the end of the reporting period. That is a non-adjusting event.
- An entity shall not prepare its financial statements on a going concern basis if management determines after the reporting period either that it intends to liquidate the entity or to cease trading.

ADJUSTING EVENTS – EXAMPLES

Adjusting events, as is evident by the name, require adjustments in the financial statements. Following are some examples:

- Invoices received in respect of goods or services received before the year end
- The resolution after the reporting date of a court case giving rise to a liability
- Evidence of impairment of assets, such as news that a major customer is going into liquidation or the sale of inventories below cost
- Discovery of fraud or errors showing that financial statements were incorrect
- Determination of employee bonuses/profit shares
- The tax rates applicable to the financial year are announced
- The auditors submit their fee
- The sale of a non-current asset at a loss indicates that it was impaired at the reporting date
- The bankruptcy of a customer indicates that their debt was irrecoverable at the reporting date
- The sale of inventory at less than cost indicates that it should have been valued at NRV in the accounts
- The determination of cost or proceeds of assets bought/sold during the accounting period indicates at what amount they should be recorded in the accounts

NON-ADJUSTING EVENTS – EXAMPLES

Usually non-adjusting events do not require adjustments. However, if the event is of such importance that its non-disclosure will affect the economic decision making of users it should be disclosed in the notes to the accounts.

Some examples of non-adjusting events are as follows:

- Business combinations
- Discontinuance of an operation
- Major sale/purchase of assets
- Destruction of major assets in natural disasters
- Major restructuring
- Major share transactions
- Unusual changes in asset prices/foreign exchange rates
- Commencing major litigation
- A purchase or sale of a non-current asset
- The destruction of assets due to fire or flood
- The announcement of plans to discontinue an operation
- An issue of shares

Dividends

If an entity declares dividends to holders of equity instruments after the reporting period but before the financial statements, the entity shall not recognise those dividends as a liability at the end of the reporting period. This is because no obligation exists at that time. Such dividends are disclosed in the notes.

Going concern

An entity shall not prepare its financial statements on a going concern basis if management determines after the reporting period either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so.

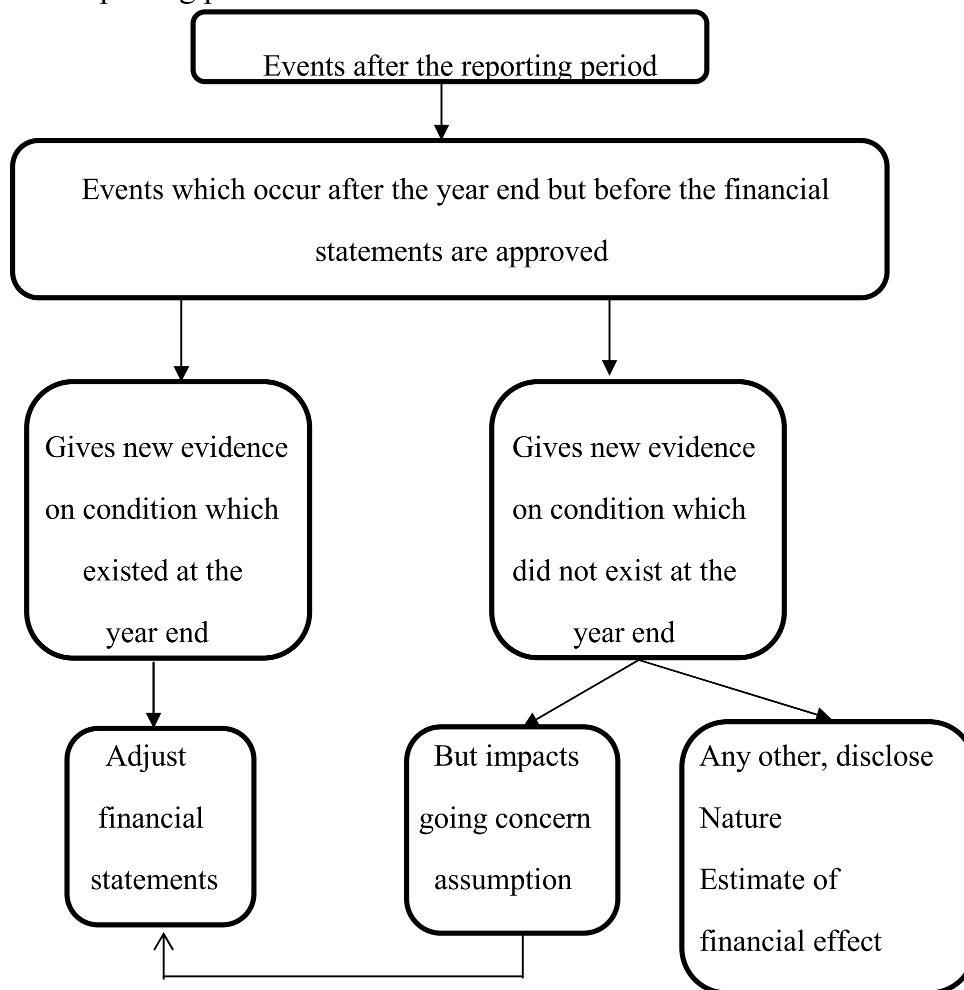
DISCLOSURE

Non-adjusting events should disclose the nature and financial effect of the event if its nondisclosure would affect the judgment of users in making decisions.

Companies must disclose the following

- When the financial statements were authorized for issue
- Who gave that authorization
- Who has the power to amend the financial statements after issuance

Events after the reporting period



Test your understanding 1 – Adjusting events

The following material events have occurred after the reporting period and prior to the date of approval of the financial statements by the directors. (i) The insolvency of a major credit customer

(ii) The uninsured loss of inventory in a fire

(iii) The proposal of a final equity dividend (iv)

A change in foreign exchange rates.

Required:
State whether the above are adjusting or non-adjusting events.
Answer:
Test your understanding 1 – Adjusting events (i)
Adjusting.

(ii) Non-adjusting.

(iii) Non-adjusting. (iv) Non-adjusting.

IAS 37 – PROVISONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

OBJECTIVE

The objective of this IAS is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets.

PROVISIONS

DEFINITIONS

- A provision is a liability of uncertain timing or amount.
- An obligating event is an event that creates a legal or constructive obligation that results in an enterprise having no realistic alternative to settling that obligation.
- A legal obligation is an obligation that derives from:
  o A contract (through its explicit or implicit terms); o
  Legislation; or o Other operation of law.
- A constructive obligation is an obligation that derives from an enterprise‘s action where:

- By an established pattern of past practice, published policies or a sufficiently specific current statement, the enterprise has indicated to other parties that it will accept certain responsibilities; and
- As a result, the enterprise has created a valid expectation on the part of those other parties that it will discharge those responsibilities.
- An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.
- A restructuring is a program that is planned and controlled by management, and materially changes either:

(a) The scope of a business undertaken by an enterprise; or (b)
The manner in which that business is conducted.

RECOGNITION

A provision shall be recognized when:

a) An entity has a present obligation (legal or constructive) as a result of a past event;
b) It is possible than an outflow of resources embodying economic benefits will be required to settle the obligation; and
c) A reliable estimate can be made of amount of the obligation.

If these conditions are not met, no provision shall be recognized.

Present obligation

In rare cases it is not clear whether there is a present obligation. In the cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the reporting date.

Past event

A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the case only:

a) Where the settlement of the obligation can be enforced by law; or
b) In the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation.

MEASUREMENT

The amount recognized as a provision shall be the best estimate of the expenditure required to settle the present obligation at the reporting date. This means that:

- Provisions for one-off events (restructuring, environmental clean-up, settlement of a lawsuit) are measured at the most likely amount.
- Provisions for large populations of events (warranties, customer refunds) are measured at a probability-weighted expected value.
- Both measurements are at discounted present value using a pre-tax discount rate that reflects the current market assessments of the time value of money and the risks specific to the liability.

In reaching its best estimate, the enterprise should take into account the risks and uncertainties that surround the underlying events. Expected cash outflows should be discounted to their present values, where the effect of the time value of money is material.

Reimbursement

If some or all of the expenditure required to settlea provision is expected to be reimbursed by another party, the reimbursement should be recognized as a reduction of the required provision when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The amount recognized should not exceed the amount of the provision. In SOFP, reimbursement should be shown as an asset and provision should be shown at gross amount however, in statement of profit or loss they can be netted off.

Re-measurement of provisions

- Review and adjust provisions at each reporting date
- If outflow is no longer probable, reverse the provision to income statement.

Application of recognition and measurement rules

Some specific requirements on applying recognition and measurement rules are as follows:

- Future operating losses

Provisions shall not be recognized for future operating losses.

- Onerous contracts

If an entity has a contract that is onerous, the present obligation under the contract shall be recognized and measured as a provision.

RESTRUCTURING

The following are examples of events that may fall under the definition of restructuring:

- Sale or termination of a line of business
- Closure of business locations
- Changes in management structure
- Fundamental re-organization of company

Restructuring provisions should be accrued as follows:

Sale of operation: Accrue provision only after a binding sale agreement. If the binding sale agreement is after reporting date, disclose but do not accrue

Closure or re-organization: Accrue only after a detailed formal plan is adopted and announced publicly. A board decision is not enough.

Restructuring provision on acquisition (merger):

Accrue provision for terminating employees, closing facilities, and eliminating product lines only if announced at acquisition and, then only if a detailed formal plan is adopted 3 months after acquisition.

A management or board decision to restructure taken before the reporting date does not give rise to a constructive obligation at the reporting date unless the entity has, before the reporting date:

a) Stated to implement the restructuring plan; or
b) Announced the main features the restructuring plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will carry out the restructuring.

If an entity starts to implement a restructuring plan, or announces its main features to those affected, only after the reporting date, disclosure is required under IAS 10 Events after the Reporting Date, if the restructuring is material and non-disclosure could influence the economic decisions of users taken on the basis of the financial statements.

Restructuring provisions should include only direct expenditures caused by the restructuring, not costs that associated with the ongoing activities of the enterprise such as: -

a) Retraining or relocating continuing staff;
b) Marketing; or
c) Investment in new systems and distribution networks

CONTINGENT LIABILITIES

Definition

A contingent liability is:

a) A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or
b) A present obligation that arises from past events but is not recognized because:

i. It is not probably that an outflow of resources embodying economic benefits will be required to settle the obligation; or
ii. The amount of the obligation cannot be measured with sufficient reliability.

Accounting treatment

- An enterprise should not recognize a contingent liability.
- A contingent liability is disclosed in financial statements, unless the possibility of an outflow of resources embodying economic benefits is remote.

Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability.

The enterprise recognizes a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made.

Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an

item previously dealt with as a contingent liability, a provision is recognized in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made.)

CONTINGENT ASSETS

Definition

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.

Accounting treatment

- An enterprise should not recognize a contingent asset.
- A contingent asset is disclosed in financial statements, where an inflow of economic benefits is probable.

Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the enterprise. An example is a claim that an enterprise is pursuing through legal processes, where the outcome is uncertain. Contingent assets are not recognized in financial statements since may result in the recognition of income that may never be realized. However, when the realization of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

Contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognized in the financial statements of the period in which the change occurs. If an inflow of economic benefits has become probable, an enterprise discloses the contingent asset.

Examples of Provisions

Situation	Accrue a Provision?
Restructuring by sale of an operation	Accrue a provision only after a binding sale agreement

Restructuring by closure or re-organization	Accrue a provision only after a detailed formal plan is adopted and announced publicly. A Board decision is not enough
Warranty	Accrue a provision (past event was the sale of defective goods)
Land contamination	Accrue a provision if the company's policy is to clean up even if there is no legal requirement to do so (past event is the obligation and public expectation created by the company's policy)
Offshore oil rig must be removed and sea bed restored	Accrue a provision when installed, and add to the cost of the asset
Abandoned leasehold, four years to run	Accrue a provision
ACCA firm staff training for recent changes in tax law	No provision (there is no obligation to provide the training)
A chain of retail stores is self-insured for fire loss	No provision until a an actual fire (no past event)
Self-insured restaurant, people were poisoned, lawsuits are expected but none have been filed yet	Accrue a provision (the past event is the injury to customers)
Major overhaul or repairs	No provision (no obligation)
Onerous (loss-making) contract	Accrue a provision

Test your understanding 1 – Warranty

Clean sells domestic appliances such as washing machines.

On 31 December 2001, Clean decides to start selling washing machines with a warranty. Under the terms of the warranty, Clean will repair washing machines at no charge to the customer if they break within the warranty period. The entity estimates, based on past-correspondence with customers, that 20% of the washing machines sold will require repair within the warranty period at an average cost to Clean of $50 per machine. Clean sold 200 washing machines on 31 December 2001 The time value of money should be ignored.

Required:

Calculate the warranty provision required.

Answer:

Test your understanding 1 – Warranty A

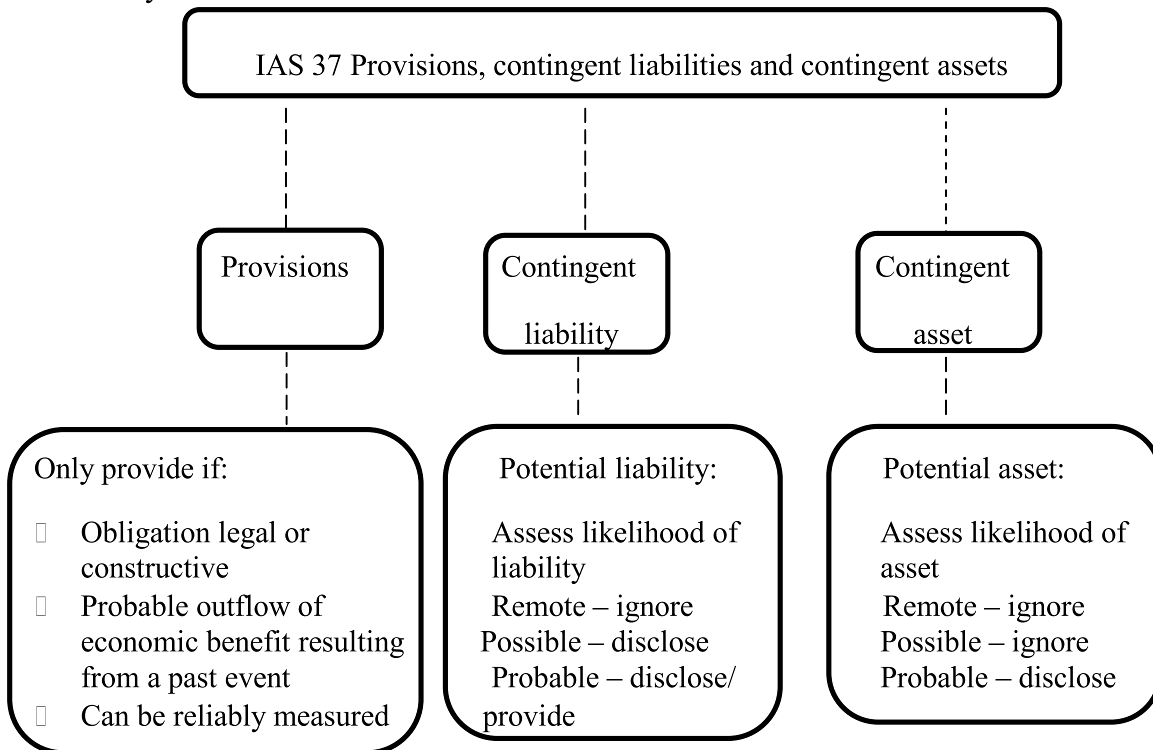
provision is required.

A past event (the sale) has created a legal obligation to spend money on repairing machines in the future.

The best estimate can be determined using an expected value:

200 machines x 20% x $50 = $2,000

Summary



Test your understanding 2 – Dan boy

Dan boy is a company that owns several shops and which has a year end of December 2001.

One of the shops is loss-making. At 31 December 2001, Dan boy forecasts that this shop will make a loss of $50,000 in the year ended 31 December 2002.

As at 31 December 2001, one of the shop buildings requires repair. The cost has been estimated at the reporting date at $10,000. The repair is made in the following accounting period at a cost $12,000.

Required:

Discuss the accounting treatment of the above in the financial statements for the year ended 31 December 2001.

Answer:

Test your understanding 2 – Don boy

IAS 37 states that no provision should be made for future operating losses. Therefore, no provision should be made for the $50,000 forecast losses.

No provision should be made for future repairs despite it being probable and capable of being reliably measured. This is because there is no obligation at the year end. The repairs expenditure of $12,000 is expensed to profit or loss as it is incurred.

Test your understanding 3 – Smoke filters

Under new legislation, an entity is required to fit smoke filters to its factories by 31 December 2007. At the reporting date of 30 June 2007, the entity has not fitted the smoke filters.

Required:

Should a provision be made at the reporting date for the estimated cost of fitting the filters?

Answer:

Test your understanding 3 – Smoke filters

No provision should be made for this future expenditure despite it being probable and capable of being reliably measured. There has been no obligating past event (the fitting of the filters).

Test your understanding 4 – Environmental provisions

(a) An entity has a policy of only carrying out work to rectify damage caused to the environment when it is required to do so by local law. For several years the entity has been operating an overseas oil rig which causes environmental damage. The country in which the oil rig is located has not had legislation in place that required this damage to be rectified.

A new government has recently been elected in the country. At the reporting date, it is virtually certain that legislation will be enacted that will require damage rectification. This legislation will have retrospective effect.

(b) Under a licence granted by a local government, an entity has constructed a rock-crushing plant to process material mined from the surrounding area. Mining activities have already started. Under the terms of the licence the entity must remove the rock-crushing plant when mining activities have been completed and must landscape the mined area, so as to create a national park.

Required:

For each of the situations, explain whether a provision should be recognised.

Answer:

Test your understanding 4 – Environmental provisions For each

situation, ask two questions.

(a) Is there a present obligation as the result of a past event?
(b) Is an outflow of economic benefits probable as a result?

A provision should be recognised if the answer to both questions is yes. In the absence of information to the contrary, it is assumed that any future costs can be estimated reliably.

(a) Present obligation? Yes. Because the new legislation with retrospective effect is virtually certain to be enacted, the damage caused by the oil rig is the past event that gives rise to a present obligation.

Outflow of economic benefits probable? Yes.

Conclusion – Recognise a provision

(b) Present obligation? Yes. There is a legal obligation under the licence to remove the rockcrushing plant and to make good damage caused by the mining activities to date (but not any that may be caused by these activities in the future, because mining activities could be stopped and no such damage caused).

Conclusion – Recognise a provision for the best estimate of the eventual costs of rectifying the damage caused up to the reporting date.

Test your understanding 5 – Scrubber

On 1 January 2006, Scrubber spent $5m on erecting infrastructure and machinery near to an area of natural beauty. These assets will be used over the next three years. Scrubber is well-known for its environmentally friendly behavior and is therefore expected to restore the site after its use.

The estimated cost of removing these assets and cleaning up the area on 1 January 2009 is $3m.

The pre-tax, risk-specific discount rate is 10%. Scrubber has a reporting date of 31 December.
Required:

Explain how the above should be treated in the financial statements of Scrubber.

Answer:

Test your understanding 5 – Scrubber

Scrubber has a constructive obligation to restore the area to its original condition as a result of a past event (erecting the infrastructure). Therefore, it should recognise a provision at 1 January 2006. The best estimate of the expenditure is $3m, but this must be discounted to its present value of $2,253,000 ($3m x 0.751).

Scrubber could not carry out its operations without incurring the clean-up costs. This means that incurring the costs gives it access to future economic benefits. The estimated clean-up costs are therefore included in the cost of the property, plant and equipment (PPE):

Dr PPE	$2,253,000
Cr Provisions	$2,253,000

Each year, the discount unwinds and the provision increases. The unwinding of the discount is charged to the statement of profit or loss as a finance cost.

Movement on provision	2006	2007	2008	2009
	$000	$000	$000	$000
Opening balance	2,253	2,478	2,727	3,000
Finance cost at 10%	225	249	273	-
Utilisation	-	-	-	(3,000)

Closing balance	2,478	2,727	3,000	-

	$000
Initial cost of PPE	
Cash paid 1 January 2006	5,000
PV of clean-up costs	2,253
Total	7,253

The effect on the financial statements is shown below:

Statements of profit or loss	2006	2007	2008	2009
	$000	$000	$000	$000
Operating costs				
Depreciation ($7,263/3 years)	2,418	2,418	2,417	-
Finance costs				
Unwinding of discount	225	249	273	-

Statement of financial position	$000	$000	$000	$000
PPE				
Cost	7,253	7,253	7,253	-
Depreciation	(2,418)	(4,836)	(7,253)	-
Carrying value	4,835	2,417	-	-

Liabilities

Clean-up provision	2,478	2,727	3,000	-

Test your understanding 6 – Restructuring provisions

On 15 January 2005, the Board of Directors of Shane voted to proceed with two reorganization schemes involving the closure of two factories. Shane's reporting date is 31 March, and the financial statements will be authorised for issue on 30 June.

Scheme 1

The closure costs will amount to $125,000. The closure will be announced in June, and will commence in August.

Scheme 2

The costs will amount to $45,000 (after crediting $105,000 profit on disposal of certain machines). The closure will take place in July, but redundancy negotiations began with the staff in March.

Required:

For each of the two schemes discuss whether a provision should be recognised and, if so, at what amount.

Answer:

Test your understanding 6 – Restructuring provisions

Scheme 1

The obligation event is the announcement of the plan, which occurs in June. This is after the year-end, so there can be no provision. However, the announcement in June should be disclosed as a non-adjusting event after the reporting date.

Scheme 2

Although the closure will not begin until July, the employees will have had a valid expectation that it would happen when the redundancy negotiations began in March. Therefore, a provision should be recognised. The provision will be for $150,000 because the expected profit on disposal cannot be netted off against the expected costs.

Test your understanding 7 – Delta

On 30 June 2002, the directors of Delta decided to close down a division. This decision was announced to the employees affected on 15 July 2002 and the actual closure occurred on 31 August 2002, prior to the 2002 financial statements being authorized for issue on 15 September.

Expenses and other items connected with the closure were as follows:

	$m
Redundancy costs (estimated)	22
Staff retraining (actual)	10
Operating loss for the 2 months to 31 August 2002	
(estimated at 30 June)	12
Profit on sale of property	5

The actual redundancy costs were $20 million and the actual operating loss of the two months to 31 August 2002, was $15 million.

Required:

What is the amount of the restructuring provision to be recognised in the financial statements of Delta plc for the year ended 31 July 2002?

Answer:

Test your understanding 7 – Delta

The only item which can be included in the provision is the redundancy costs, measured at their actual amount of $20 million.

IAS 37 prohibits the recognition of future operating losses, staff retraining and profits on disposals of assets.

7 Criticisms of IAS 37

The following criticisms have been made of IAS 37:

- Judgement – provisions are estimated liabilities and IAS 37 requires the exercise of judgement. This may increase the risk of bias and reduce comparability between entities.
- Inconsistent – before recognizing a provision, an entity must assess if the outflow of economic benefits is probable. This is inconsistent with other standards, such as IFRS 9 Financial Instruments.
- Out-dated – IAS 37 was issued many years ago and does not reflect the current thinking of the international Accounting Standards Board.
- Best estimates – provisions for single obligations are recognised at the 'best estimate' of the expenditure that will be incurred, but guidance in this area is lacking.
- Types of costs – IAS 37 does not specify what types of costs should be included when measuring a provision. For example, some entities include legal costs within provisions, but others do not.
- Risk – IAS 37 states that entities may need to make a risk adjustment to provisions, but it does not explain when to do this or how to calculate the adjustment.
- Contingent assets – these are not recognised unless the inflow of benefits is 'virtually certain'. There is a lack of guidance about the meaning of 'virtually certain'.
- Timing – there can be timing differences between when one entity recognises a contingent liability and when the other entity recognises a contingent asset.
- Revised Framework – the Exposure Draft on the Framework proposes removing the 'probable outflow' criteria from the definition of a liability. IAS 37 would therefore be inconsistent with the revised Framework.
- Contradictory guidance. IAS 37 defines an obligating event as one where the entity has no realistic alternative but to settle the obligation. However, the standard also states that no provision should be recognised if the liability can be avoided by future actions – even if those actions are unrealistic (e.g. a change in the nature of the entity's operations).

Investor perspective

IAS 37 requires entities to provide a description of the nature of each class of provision, and to include information amount uncertainties relating to the expected timing or amount of the expenditure required. An example is provided below:

Provisions disclosure note

	Service Guarantee	Restructuring
	$m	$m
31 December 2001	14	-
Charged to profit or loss	4	5
Utilised	(3)	-
31 December 2002	15	5

Provision for service guarantee costs reflect the entity's expected liability for future repair costs for warranties and extended warranties based on estimated failure rates and unit repair costs for the classes of goods sold. The Directors estimate that $5 million of this amount will be settled within the next twelve months.

The Restructuring provision relates to amounts provided as a result of the cost reduction programme initiated during 2002. The provision represents the Directors' best estimate of the liability arising. The Directors believe these amounts will be settled within the next twelve months.

Provisions are obligations where the measurement or timing involves a degree of uncertainty. This provisions disclosure provides relevant information to current and potential investors because it will help them to assess the risks to which the entity is exposed. In fact, disclosures related to provisions and contingencies are one of the few areas where financial statements provide information that is not solely historical.

IFRS 16 - LEASES

OBJECTIVE

IFRS 16 establishes principles for the recognition, measurement, presentation and disclosure of leases, with the objective of ensuring that lessees and lessors provide relevant information that faithfully represents those transactions.

SCOPE

IFRS 16 Leases applies to all leases, including subleases, except for:

- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;
- Leases of biological assets held by a lessee (see IAS 41 Agriculture);
- Licences of intellectual property granted by a lessor (see IFRS 15 Revenue from Contracts with Customers); and
- Rights held by a lessee under licensing agreements for items such as films, videos, plays, manuscripts, patents and copyrights within the scope of IAS 38 Intangible Assets

KEY DEFINITIONS

Interest rate implicit in the lease

The interest rate that yields a present value of (a) the lease payments and (b) the unguaranteed residual value equal to the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor.

Lease term

The non-cancellable period for which a lessee has the right to use an underlying asset, plus:

i. Periods covered by an extension option if exercise of that option by the lessee is reasonably certain; and

ii. Periods covered by a termination option if the lessee is reasonably certain not to exercise that option

Lessee’s incremental borrowing rate

The rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.

LEASE – IMPORTANCE OF IFRS 16

A leaseis an agreement whereby the lessor (the legal owner of an asset) conveys to the lessee (the user of the asset) the right to use an asset for an agreed period of time in exchange for consideration (return for a payment or series of payments)

The approach of IAS 17 was to distinguish between two types of lease. Leases that transfer substantially all the risks and rewards of ownership of an asset were classified as finance leases. All other leases were classified as operating leases. The lease classification set out in IAS 17 was subjective and there was a clear incentive for the preparers of lessee‘s financial statements to =argue‘ that leases should be classified as operating rather than finance leases in order to enable leased assets and liabilities to be left out of the financial statements.

It was for this reason that IFRS 16 was introduced.

IFRS 16 - ASSETS

IFRS 16 defines a lease as 'A contract, or part of a contract, that conveys the right to use an asset for a period of time in exchange for consideration'. In order for such a contract to exist the user of the asset needs to have the right to:

- Obtain substantially all of the economic benefits from the use of the asset.
- The right to direct the use of the asset.

An ‘identified asset’

One essential feature of a lease is that there is an =identified asset‘. This normally takes place through the asset being specified in a contract, or part of a contract.

A contract is, or contains, a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

Control is conveyed where the customer has both the right to direct the identified asset's use and to obtain substantially all the economic benefits from that use.
An asset is typically identified by being explicitly specified in a contract, but an asset can also be identified by being implicitly specified at the time it is made available for use by the customer. For the asset to be identified "the supplier of the asset must not have the right to substitute the asset for an alternative asset throughout its period of use" The fact that the supplier of the asset has the right or the obligation to substitute the asset when a repair is necessary does not preclude the asset from being an identified asset'.

A capacity portion of an asset is still an identified asset if it is physically distinct (e.g. a floor of a building).

A capacity or other portion of an asset that is not physically distinct (e.g. a capacity portion of a fiber optic cable) is not an identified asset, unless it represents substantially all the capacity such that the customer obtains substantially all the economic benefits from using the asset.

Example – identified assets
Under a contract between a local government authority (L) and a private sector provider (P), P provides L with 20 trucks to be used for refuse collection on behalf of L for a six-year period. The trucks, which are owned by P, are specified in the contract. L determines how they are used in the refuse collection process.

When the trucks are not in use, they are kept at L's premises. L can use the trucks for another purposes if it so chooses. If a particular truck needs to be serviced or repaired, P is required to substitute a truck of the same type. Otherwise, and other than on default by L, P cannot retrieve the trucks during the six-year period.

Conclusion: The contract is a lease. L has the right to use the 20 trucks for six years which are and explicitly specified in the contract. Once delivered to L, the trucks can be substituted only when they need to be serviced or repaired.

The right to direct the use of the asset

IFRS 16 states that a customer has the right to direct the use of an identified asset if either:

- The customer has the right to direct how and for what purpose the asset is used throughout its period of use, or
- The relevant decisions about use are pre-determined and the customer has the right to operate the asset throughout the period of use without the supplier having the right to change these operating instructions.

Example – the right to direct the use of an asset

A customer (C) enters into a contract with a road haulier (H) for the transportation of goods from London to Edinburgh on a specified truck. The truck is explicitly specified in the contract and H does not have substitution rights. The goods will occupy substantially all of the capacity of the truck. The contract specifies the goods to be transported on the truck and the dates of pickup and delivery.

H operates and maintains the truck and is responsible for the safe delivery of the goods. C is prohibited from hiring another haulier to transport the goods or operating the truck itself.

Conclusion: This contract does not contain a lease.

There is an identified asset. The truck is explicitly specified in the contract and H does not have the right to substitute that specified truck.

C does have the right to obtain substantially all of the economic benefits from use of the truck over the contract period. Its goods will occupy substantially all of the capacity of the truck, thereby preventing their parties from obtaining economic benefits from use of the truck.

However, C does not have the right to control the use of the truck because C does not have the right to direct its use. C does not have the right to direct how and for what purpose the truck is used. How and for what purpose the truck will be used (i.e. the transportation of specified goods from London to Edinburgh within a specified timeframe) is predetermined in the contract. C has the same rights regarding the use of the truck as if it were one of many customers transporting goods using the truck.

Separating components of a contract

For a contract that contains a lease component and additional lease and non-lease components, such as the lease of an asset and the provision of a maintenance service, lessees shall allocate the consideration payable on the basis of the relative stand-alone prices, which shall be estimated if observable prices are not readily available.

As a practical expedient, a lessee may elect, by class of underlying asset, not to separate nonlease components from lease components and instead account for all components as a lease.
Lessors shall allocate consideration in accordance with IFRS 15 Revenue from Contracts with Customers.

ACCOUNTING FOR LEASES

With a very few exceptions (discussed later) IFRS 16 basically abolishes the distinction between an operating lease and a finance lease in the financial statements of lessees. Lessees will recognise a right of use asset and an associated liability at the inception of the lease.

IFRS 16 basically requires that the 'right of use asset' and the lease liability should initially be measured at the present value of the minimum lease payments. The discount rate used to determine present value should be the rate of interest implicit in the lease.

RECORDING THE ASSET

The right of use asset 'would include the following amounts, where relevant:

- Any payments made to the lessor at, or before, the commencement date of the lease, less any lease incentives received.
- Any initial direct costs incurred by the lessee.
- An estimate of any costs to be incurred by the lessee in dismantling and removing the underlying asset, or restoring the site on which it is located (unless the costs are incurred to produce inventories, in which case they would be accounted for in accordance with IAS 2 – Inventories).

Costs of this nature are recognised only when an entity incurs an obligation for them. IAS 37 – Provisions, Contingent Liabilities and Contingent Assets would be applied to ascertain if an obligation existed.

Depreciation

The right of use asset is subsequently depreciated. Depreciation is over the shorter of the useful life of the asset and the lease term, unless the title to the asset transfers at the end of the lease term, in which case depreciation is over the useful life.

LEASE LIABILITY

The lease liability is effectively treated as a financial liability which is measured at amortised cost, using the rate of interest implicit in the lease as the effective interest rate.

Example – accounting for leases

A lessee enters into a 20-year lease of one floor of a building, with an option to extend for a further five years. Lease payments are $80,000 per year during the initial term and $100,000 per year during the optional period, all payable at the end of each year. To obtain the lease, the lessee incurred initial direct costs of $25,000.

At the commencement date, the lessee concluded that it is not reasonably certain to exercise the option to extend the lease and, therefore, determined that the lease term is 20 years. The interest rate implicit in the lease is 6% per annum. The present value of the lease payments is $917,600. At the commencement date, the lessee incurs the initial direct costs and measures the lease liability $917,600.

The carrying amount of the right of use asset after these entries is $942,600 ($917,600 + $25,000) and consequently the annual depreciation charge will be $47,130 ($942,600 x 1/20). The lease liability will be measured using amortised cost principles. In order to help us with the example in the following section, we will measure the lease liability up to and including the end of year two. This is done in the following table:

Year	Balance B/fwd $	Finance cost (6%) $	Rental $	Balance C / fwd $
1	917,600	55,056	(80,000)	892,656

2	892,656	53,559	(80,000)	866,215

At the end of year one, the carrying amount of the right of use asset will be $895,470 ($942,600 less $47,130 depreciation).

The interest cost of $55,056 will be taken to the statement of profit or loss as a finance cost.
The total lease liability at the end of year one will be $892,656. As the lease is being paid off over 20 years, some of this liability will be paid off within a year and should therefore be classed as a current liability.
To find this figure, we look at the remaining balance following the payment in year two. Here, we can see that the remaining balance is $866,215. This will represent the non-current liability, being the amount of the $892,656 which will still be outstanding in over a year. The current liability element is therefore $26,441. This represents the $80,000 paid in year two less year two‘s finance costs of $53,559 (or $892,656-$866,215).

Points to remember
Upon lease commencement a lessee recognises a right-of-use asset and a lease liability. The right-of-use asset is initially measured at the amount of the lease liability plus any initial direct costs incurred by the lessee. Adjustments may also be required for lease incentives, payments at or prior to commencement and restoration obligations or similar.

After lease commencement, a lessee shall measure the right-of-use asset using a cost model, unless:

b. The right-of-use asset is an investment property and the lessee fair values its investment property under IAS 40; or
c. The right-of-use asset relates to a class of PPE to which the lessee applies IAS 16‘srevaluation model, in which case all right-of-use assets relating to that class of PPE can berevalued.

Under the cost model a right-of-use asset is measured at cost less accumulated depreciation and accumulated impairment.

The lease liability is initially measured at the present value of the lease payments payable over the lease term, discounted at the rate implicit in the lease if that can be readily determined. If that rate cannot be readily determined, the lessee shall use their incremental borrowing rate.

Variable lease payments

Variable lease payments are the payments that depend on an index or a rate are included in the initial measurement of the lease liability and are initially measured using the index or rate as at the commencement date. Amounts expected to be payable by the lessee under residual value guarantees are also included.

Variable lease payments that are not included in the measurement of the lease liability are recognised in profit or loss in the period in which the event or condition that triggers payment occurs, unless the costs are included in the carrying amount of another asset under another Standard.

The lease liability is subsequently remeasured to reflect changes in:

- The lease term (using a revised discount rate);
- The assessment of a purchase option (using a revised discount rate);
- The amounts expected to be payable under residual value guarantees (using an unchanged discount rate); or
- Future lease payments resulting from a change in an index or a rate used to determine those payments (using an unchanged discount rate).

The re-measurements are treated as adjustments to the right-of-use asset.

Lease modifications may also prompt re-measurement of the lease liability unless they are to be treated as separate leases.

RECOGNITION EXEMPTIONS

A simplified approach for short-term or low-value leases – Exception

Instead of applying the recognition requirements of IFRS 16 described above, a lessee may elect to account for lease payments as an expense on a straight-line basis over the lease term or another systematic basis for the following two types of leases:

i) Leases with a lease term of 12 months or less and containing no purchase options – this election is made by class of underlying asset; and

ii) Leases where the underlying asset has a low value when new (such as personal computers or small items of office furniture) – this election can be made on a leaseby-lease basis.

A lease of an underlying asset does not qualify as a lease of a low-value asset if the nature of the asset is such that, when new, the asset is typically not of low value. For example, leases of cars would not qualify as leases of low-value assets because a new car would typically not be of low value.

Examples of low-value underlying assets can include tablet and personal computers, small items of office furniture and telephones.

SALE AND LEASEBACK TRANSACTIONS

Introduction

The treatment of sale and leaseback transactions depends on whether or not the sale 'constitutes the satisfaction of a relevant performance obligation under IFRS 15 – Revenue from Contracts with Customers. The relevant performance obligation would be the effective transfer 'of the asset to the lessor by the previous owner (now the lessee).

Transaction constituting a sale

If the transaction does constitute a sale 'under IFRS 15 then the treatment is as follows:

- The seller-lessee shall recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor.
- The buyer-lessor shall account for the purchase of the asset applying applicable Standards, and for the lease applying the lessor accounting requirements in IFRS 16 (these being essentially unchanged from the predecessor standard).

If the fair value of the consideration for the sale of an asset does not equal the fair value of the asset, or if the payments for the lease are not at market rates, an entity shall make the following adjustments to measure the sale proceeds at fair value:

- Any below-market terms shall be accounted for as a prepayment of lease payments; and

- Any above-market terms shall be accounted for as additional financing provided by the buyer lessor to the seller-lessee.

Example – sale and leaseback

Entity X sells a building to entity Y for cash of $5 million. Immediately before the transaction, the carrying amount of the building in the financial statements of entity X was $3.5 million. At the same time, X enters into a contract with Y for the right to use the building for 20 years, with annual payments of $200,000 payable at the end of each year. The terms and conditions of the transaction are such that the transfer of the building by X satisfies the requirements for determining when a performance obligation is satisfied in IFRS 15, Revenue from Contracts with Customers. Accordingly, X and Y account for the transaction as a sale and leaseback.

The fair value of the building at the date of sale is $4.5 million. Because the consideration for the sale of the building is not at fair value, X and Y make adjustments to measure the sale proceeds at fair value. The amount of the excess sale price of $500,000 ($5 million – $4.5 million) is recognised as additional financing provided by Y to X.

The annual interest rate implicit in the lease is 5%. The present value of the annual payments (20payments of $200,000, discounted at 5%) amounts to $2,492,400, of which $500,000 relates to the additional financing and $1,992,400 ($2,492,200 – $500,000) relates to the lease (as adjusted for the fair value difference already identified). The annual payment that would be required to be made 20 times in arrears to repay additional financing of $500,000 when the rate of interest is 5% per annum would be $40,122 ($500,000/12.462 (the cumulative discount factor for 5% for 20 years)). Therefore the residual would be regarded as a =lease rental ‘at an amount of $159,878 ($200,000 – $40,122).

Given the IFRS 15 treatment as a sale ‘Y would almost certainly regard the lease of the building as an operating lease. This means that Y would recognise the lease rentals ‘of $159,878 as income.

Transaction not constituting a ‘sale’

In these circumstances the seller does not transfer ‘the asset and continues to recognise it, without adjustment. The sales proceeds ‘are recognised as a financial liability and accounted for by applying

IFRS 9, Financial Instruments. In the same circumstances, the buyer recognizes a financial asset equal to the sales proceeds‘.

IMPACT OF IFRS 16 ON ACCOUNTING RATIOS

The requirements of IFRS 16 will have significant impacts on key accounting ratios of lessees. The greater recognition of leased assets and lease liabilities on the statement of financial position will reduce return on capital employed and increase gearing. Initial measures of profit are likely to be reduced, as in the early years of a lease the combination of depreciation of the right of use asset and the finance charge associated with the lease liability will exceed the lease rentals (normally charged on a straight-line basis).

ACCOUNTING BY LESSORS

Lessors shall classify each lease as an operating lease or a finance lease.

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. Otherwise a lease is classified as an operating lease.

Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:

- The lease transfers ownership of the asset to the lessee by the end of the lease term
- The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain that the option will be exercised
- The lease term is for the major part of the economic life of the asset, even if title is not transferred
- At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset
- The leased assets are of a specialised nature such that only the lessee can use them without major modifications being made

Upon lease commencement, a less or shall recognise assets held under a finance lease as a receivable at an amount equal to the net investment in the lease.

A lessor recognizes finance income over the lease term of a finance lease, based on a pattern reflecting a constant periodic rate of return on the net investment
At the commencement date, a manufacturer or dealer less or recognises selling profit or loss in accordance with its policy for outright sales to which IFRS 15 applies.
A less or recognizes operating lease payments as income on a straight-line basis or, if more representative of the pattern in which benefit from use of the underlying asset is diminished, another systematic basis.

DISCLOSURE

The objective of IFRS 16‘s disclosures is for information to be provided in the notes that, together with information provided in the statement of financial position, statement of profit or loss and statement of cash flows, gives a basis for users to assess the effect that leases have.
Test your understanding 1 – Coffee Bean
Coffee Bean enters into a contract with an airport operator to use some space in the airport to sell its goods form portable kiosks for a three-year period. Coffee Bean owns the portable kiosks. The contract stipulates the amount of space and states that the space may be located at any one of several departure areas within the airport. The airport operator can change the location of the space allocated to Coffee Bean at any time during the period of use, and the costs that the airport operator would incur to do this would be minimal. There are many areas in the airport that are suitable for the portable kiosks.

Required:
Does the contract contain a lease?

Answer:
Test your understanding 1 – Coffee Bean
The contract does not contain a lease because there is no identified asset.
The contract is for space in the airport, and the airport operator has the practical right to substitute this during the period of use because:

- There are many areas available in the airport that would meet the contract terms, providing the operator with a practical ability to substitute

- The airport operator would benefit economically from substituting the space because there would be minimal cost associated with it. This would allow the operator to make the most effective use of its available space, thus maximizing profits.

Test your understanding 2 – AFG

AFG enters into a contract with Splash, the supplier, to use a specified ship for a five-year period. Splash has no substitution rights. During the contract period, AFG decides what cargo will be transported, when the ship will sail, and to which ports it will sail. However, there are some restrictions specified in the contract. Those restrictions prevent AFG from carrying hazardous materials as cargo or from sailing the ship into waters where piracy is a risk.

Splash operates and maintains the ship and is responsible for the safe passage of the cargo on board the ship. AFG is prohibited from hiring another operator for the ship, and from operating the ship itself during the term of the contract.

Required:

Does the contract contain a lease? Answer:

Test your understanding 2 – AFG

AFG has the right to use an identified asset (a specific ship) for a period of time (five years).

Splash cannot substitute the specified ship for an alternative.

AFG has the right to control the use of the ship throughout the five-year period of use because:

- It has the right to obtain substantially all of the economic benefits from use of the ship over the five-year period due to its exclusive use of the ship throughout the period of use.
- It has the right to direct the use of the ship. Although contractual terms exist that limit where the ship can sail and what cargo can be transported, this acts to define the scope of AFG's right to use the ship rather than restricting AFG's ability to direct the use of the ship. Within the scope of its right of use, AFG makes the relevant decisions about how and for what purpose the ship is used throughout the five-year period of use because it decides whether, where and when the ship sails, as well as the cargo it will transport.

Splash's operation and maintenance of the ship does not prevent AFG from directing how, and for what purpose, the ship is used.

Therefore, based on the above, the contract contains a lease.

Test your understanding 3 – Dynamic

On 1 January 2001, Dynamic entered into a two year lease for a lorry. The contract contains an option to extend the lease term for a further year. Dynamic believes that it is reasonably certain to exercise this option. Lorries have a useful economic life of ten years.

Lease payments are $10,000 per year for the initial term and $15,000 per year for the option period. All payments are due at the end of the year. To obtain the lease, Dynamic incurs initial direct costs of $3,000. The lessor immediately reimburses $1,000 of these costs.

The interest rate within the lease is not readily determinable. Dynamic's incremental rate of borrowing is 5%.

Required:

Calculate the initial carrying amount of the lease liability and the right-of-use asset and provide the double entries needed to record these amounts in Dynamic's financial records.

Answer:

Test your understanding 3 – Dynamic

The lease term is three years. This is because the option to extent the lease is reasonably certain to be exercised.

The lease liability calculated as follows;

Date	Cash flow ($)	Discount rate	Present value ($)
31/12/X1	10,000	1/1.05	9,524
31/12/X2	10,000	$1/1.05^2$	9,070
31/12/X3	15,000	$1/1.05^2$	12,958

31,552 The initial cost of the right-of-use asset is calculated as follows:

	$
Initial liability value	31,552
Direct costs	3,000
Reimbursement	(1,000)
	33,552

The double entries to record this are as follows:

Dr Right-of-use asset $31,552

Cr Lease liability $31,552

Dr Right-of-use asset $3,000

Cr Lease liability $3,000

Dr Cash $1,000

Cr Right-of-use asset $1,000

Test your understanding 4 – Dynamic (cont.)

This question follows on from the previous 'test your understanding'.

Required:

Explained the subsequent treatment of Dynamic's lease in the year ended 31 December 2001

Answer:

Test your understanding 4 – Dynamic (cont.)

Interest of $1,578 (W1) is charged on the lease liability.

Dr Finance costs (P/L) $1,578 Cr

Lease liability $1,578

The cash payment reduces the liability.

Dr Liability $10,000 Cr Cash $10,000

The liability has a carrying amount of $23,130 at the reporting date. Of this, $14,287 (W1) is non-current and $8,843 ($23,130 - $14,287) is current.

The right-of-use asset is depreciated over the three year lease term, because it is shorter than the useful economic life. This gives a charge of $11,148 ($33,552/ 3years).

Dr Depreciation (P/L) $11,184 Cr

Right-of-use asset $11,184

The carrying amount of the right-of-use asset will be reduced to $22,368 ($33,552 - $11,184) (W1)

Lease Liability table

Year-ended	Opening	Interest (5%)	Payments	Closing
	$	$	$	$
31/12/X1	31,552	1,578	(10,000)	23,130

31/12/X2	23,130	1,157	(10,000)	14,287

Illustration 1 – Swish

On 1 January 2001 Swish entered into a contract to lease a crane for three years. The lessor agrees to maintain the crane during the three year period. The total contract cost is $180,000. Swish must pay $60,000 each year with the payments commencing on 31 December 2001. Swish account for non-lease components separately from leases.

If contracted separately it has been determined that the standalone price for the lease of the crane is $160,000 and the standalone price for the maintenance services is $40,000.

Swish can borrow at a rate of 5% a year.

Required:

Explain how the above will be accounted for by Swish in the year ended 31 December 2001.

Solution

Allocation of payments

The annual payments of $60,000 should be allocated between the lease and non-lease components of the contract based on their standalone selling prices:

Lease of Crane: ($160/$160 + $40) x $60,000 = $48,000

Maintenance ($40/$160 + $40) x $60,000 = $12,000

Lease of Crane

The lease liability is calculated as the present value of the lease payments, as follows:

Date	Cash flow ($)	Discount rate	Present value ($)
31/12/X1	48,000	1/1.05	45,714
31/12/X2	48,000	1/1.052	43,537
31/12/X3	48,000	1/1.053	41,464
			130,715

There are no direct costs so the right-of-use asset is recognised at the same amount:

Dr Right-of-use asset	$130,715
Cr Lease liability	$130,715

Interest of $6,536 (W1) is charged on the lease liability.

Dr Finance costs (P/L) $6,536 Cr

Lease liability $6,536

The cash payment reduces the liability.

Dr Lease liability $48,000

Cr Cash $48,000

The liability has a carrying amount of $89,251 at the reporting date.

The right-of-use asset is depreciated over the three year lease term. This gives a charge of $43,572 ($130,715/ 3 years).

Dr Depreciation (P/L) $43,572 Cr

Right-of-use asset $43.572

The carrying amount of the right-of-use asset will be reduced to $87,143 ($130,715 - $43,572). (W1)

Lease liability table

Year-ended	Opening	Interest (5%)	Payments	Closing
	$	$	$	$
31/12/01	130,715	6,536	(48,000)	89,251

Maintenance

The cost of one year's maintenance will be expensed to profit or loss:

Dr P/L $12,000 Cr Cash $12,000

Test your understanding 5 – Kingfisher

On 1 January 2001, Kingfisher enters into a four year lease of property with annual lease payments of $1 million, payable at the beginning of each year. According to the contract, lease payments will increase every year on the basis of the increase in the Consumer Price Index for the preceding 12 months. The Consumer Price Index at the commencement date is 125. The interest rate implicit in the lease is not readily determinable. Kingfisher's incremental borrowing rate is 5 per cent per year.

At the beginning of the second year of the lease the Consumer Price Index is 140.

Required:

Discuss how the lease will be accounted for:

- During the first year of the contract

- On the first day of the second year of the contract.

Answer:

Test your understanding 5 – Kingfisher

The first year

The first payment occurs on the commencement date so is included in the initial cost of the rightof-use asset:

Dr Right-of-use asset $1m

Cr Cash $1m

The liability should be measured at the present value of the lease payments not yet made. The payments are variable as they depend on an index. They should be valued using the index at the commencement date (i.e. it is assumed that the index will remain at 125 and so the payments will remain at $1 million a year).

Date	Cash flow ($m)	Discount rate	Present value ($m)
1/1/X2	1.0	1/1.05	0.95
1/1/X3	1.0	$1/1.05^2$	0.91
1/1/X4	1.0	$1/1.05^3$	0.86
			2.72

Dr Right-of-use asset $2.72m

Cr Lease liability $2.72m

The asset is depreciated over the lease term of four years, giving a charge of $0.93 million (($1m + $2.72m) / 4).

Dr Depreciation (P/L) $0.93m Cr

Right-of-use asset $0.93m

The asset has carrying amount at the reporting date of $2.79 million ($1m + 2.72m - $0.93m).

The interest charge on the liability is $0.14 million (W1).

Dr Finance costs (P/L) $0.14m Cr

Lease liability $0.14m

The liability has a carrying amount at the reporting date of $2.86m (W1).

(W1) Lease liability table

Year-ended	Opening	Interest (5%)	Closing
	$m	$m	$m
31/12/X1	2.72	0.14	2.86

The first day of the second year

There are three remaining payments to make. The payment for the second year that is now due is $1.12 million ($1m x 140/125). The lease liability is remeasured to reflect the revised lease payments (three payments of $1.12 million).

Date Cash flow ($m) Discount rate Present value ($m)

1/1/X2 1.12 1 1.12 1/1/X3 1.12 1/1.05 1.07

1/1/x4 1.12 $1/1.05^2$ 1.02

3.21

The lease liability must be increased by $0.35 million ($3.21 - $2.86m). A corresponding adjustment is made to the right-of-use asset:

Dr Right-of-use asset	$0.35m
Cr Lease liability	$0.35m

The payment of $1.12 million will then reduce the lease liability:

Dr Lease liability	$1.12m
Cr Cash	$1.12m

The right-of-use asset's carrying amount of $3.14 million ($2.79 + $0.35m) will be depreciated over the remaining lease term of three years.

Test your understanding 6 – Dan Bob

Dan Bob is a lessor and is drawing up a lease agreement for a building.

The building has a remaining useful economic life of 50 years. The lease term, which would commence on 1 January 2000, is for 30 years.

Dan Bob would receive 40% of the asset's value upfront from the lessee. At the end of each of the 30 years, Dan Bob will receive 6% of the asset's fair value as at 1 January 2000.

Legal title at the end of the lease remains with Dan Bob, but the lessee can continue to lease the asset indefinitely at a rental that is substantially below its market value. If the lessee cancels the lease, it must make a payment to Dan Bob to recover its remaining investment.

Required:

Per IFRS 16 Leases, should the lease be classified as an operating lease or a finance lease?

Answer:

Test your understanding 6 – Dan Bob

A finance lease is defined by IFRS 16 as a lease where the risks and rewards of ownership transfer from the lessor to the lessee.

Key indications, according to IFRS 16, that a lease is a finance lease are as follows:

- The lease transfers ownership of the asset to the lessee by the end of the lease term.
- The lease term is for the major part of the asset's economic life.
- At the inception of the lease, the present value of the lease payments amounts to at least substantially all of the fair value of the leased asset.
- If the lessee can cancel the lease, the lessor's losses are borne by the lessee.
- The lessee can continue the lease for a secondary period in exchange for substantially lower than market rent payments.

The lease term is only for 60% (30 year/50 years) of the asset's useful life. Legal title also does not pass at the end of the lease. These factors suggest that the lease is an operating lease.

However, the lessee can continue to lease the asset at the end of the lease term for a value that is substantially below market value. This suggests that the lessee will benefit from the building over its useful life and is therefore an indication of a finance lease.

The lessee is also unable to cancel the lease without paying Dan Bob. This is an indication that Dan Bob is guaranteed to recoup its investment and therefore that they have relinquished the risks of ownership.

It also seems likely that the present value of the minimum lease payments will be substantially all of the asset's fair value. The minimum lease payments (ignoring discounting) equate to 40% of the fair value, payable upfront, and then another 180% (30 years x 6%) of the fair value over the lease term. Therefore this again suggests that the lease is a finance lease.

All things considered, it would appear that the lease is a finance lease.

Test your understanding 7 – Vache

Vache leases machinery to Toro. The lease is for four years at an annual cost of $2,000 payable annually in arrears. The present value of the lease payments is $5,710. The implicit rate of interest is 15%.

Required:

How should Vache account for their net investment in the lease?

Answer

Test your understanding 7 – Vache

Vache recognises the net investment in the lease as a receivable. This is the present value of the lease payments of $5,710.

The receivable is increased by finance income. The receivable is reduced by the cash receipts.

Year	Opening balance	Finance income (15%)	Cash receive	Clothing balance
	$	$	$	$
1	5,710	856	(2,000)	4,566
2	4,566	685	(2,000)	3,251
3	3,251	488	(2,000)	1,739
4	1,739	261	(2,000)	–

Extract from the statement of financial position at the end of Year1

	$
Non-current assets:	
Net investment in finance leases (see note)	3,251
Current assets:	
Net investment in finance leases	1,315

Note: the current asset is the next instalment less next year's interest ($2,000 - $685). The non – current asset is the remainder ($4,566 - $1,315).

Test your understanding 8 – Oroc

Oroc hires out industrial plant on long-term operating leases. On 1 January 2001, it entered into a seven-year lease on a mobile crane. The terms of the lease are $175,000 payable on 1 January 2001, followed by six rentals of $70,000 payable on 1 January 2002 – 2007. The crane will be returned to Oroc on 31 December 2007. The crane originally cost $880,000 and has a 25-year useful life with no residual value.

Required:

Discuss the accounting treatment of the above in the year ended 31 December 2001.

Answer:

Test your understanding 8 – Oroc

Oroc holds the crane in its statement of financial position and depreciates it over its useful life. The annual depreciation charge is $35,200 ($880,000/25 years).

Rental income must be recognised in profit or loss on a straight line basis. Total lease receipts are $595,000 ($175,000 + ($70,000 x 6 years)). Annual rental income is therefore $85,000 ($595,000/ 7 years). The statement of financial position includes a liability for deferred income of $ 90,000 ($175,000 - $85,000).

Test your understanding 9 – Painting

On 1 January 2001, Painting sells an item of machinery to Collage for its fair value of $3 million. The asset had a carrying amount of $1.2 million prior to the sale. This sale represents the satisfaction of a performance obligation, in accordance with IFRS 15 Revenue from Contracts with Customers. Painting enters into a contract with Collage for the right to use the asset for the next five years. Annual payments of $ 500,000 are due at the end of each year. The interest rate implicit in the lease is 10%.

The present value of the annual lease payments is ₤1.9 million. The remaining useful economic life of the machine is much greater than the lease term.

Required:

Explain how the transaction will be accounted for on 1 January 2001 by both Painting and Collage.

Answer:

Test your understanding 9 – Painting

Painting

Painting must remove the carrying amount of the machine from its statement of financial position. It should instead recognise a right-of-use asset. This right-of-use asset will be measured as the proportion of the previous carrying amount that relates to the rights retained by painting:

(1.9m/3m) x $ 1.2 million = $0.76 million.

The entry required is as follows:

Dr Cash	$3.00m	
Dr Right-of-use asset	$0.76m	
Cr Machine	$1.20m	
Cr Lease liability		$1.90m
Cr Profit or loss (bal. fig)		$0.66m

Note: The gain in profit or loss is the proportion of the overall $1.8 million gain on disposal ($3m - $1.2m) that relates to the rights transferred to Collage. This can be calculated as follows:

((3m – 1.9m) x $1.8m = $0.66 million.

The right of use asset and the lease liability will then be accounted for using normal lessee accounting rules.

Collage

Collage will post the following:

Dr Machine $3.00m Cr Cash $3.00m

Normal lessor accounting rules apply. The lease is an operating lease because the present value of the lease payments is not substantially the same as the asset's fair value, and the lease term is not for the majority of the asset's useful life. Collage will record rental income in profit or loss on a straight line basis.

Illustration 2 – Mosaic

On 1 January 2001, Mosaic sells an item of machinery to Ceramic for $3 million. Its fair value was $2.8 million. The asset had a carrying amount of $1.2 million prior to the sale. This sale represents the satisfaction of performance obligation, in accordance with IFRS 15 Revenue from Contracts with Customers.

Mosaic enters into a contract with Ceramic for the right to use the asset for the next five years. Annual payments of $500,000 are due at the end of each year. The interest rate implicit in the lease is 10%. The present value of the annual lease payments is ₤ 1.9 million.

Required:

Explain how the transaction will be accounted for on 1 January 2001 by both Mosaic and Ceramic.

Solution

The excess sales proceeds are \$0.2 million (\$3m - \$2.8m). This is treated as additional financing. The present value or the lease payments was \$1.9 million. It is assumed that \$0.2 million relates to the additional financing that Mosaic has been given. The remaining \$1.7 million relates to the lease.

Mosaic

Mosaic must remove the carrying amount of the machine from its statement of financial position. It should instead recognise a right-of-use asset. This right-of-use asset will be measured as the proportion of the previous carrying amount that relates to the rights retained by Mosaic:

(1.7m/ 2.8 million = \$0.73 million.

The entry required is as follows:

Dr Cash	\$3.00m
Dr Right-of-use asset	\$0.73m
Cr Machine	\$1.20m
Cr Lease liability	\$1.70m
Cr Financial liability	\$0.20m Cr
Profit or loss (bal. fig.)	\$0.63m

Note: The gain in profit or loss is the proportion of the overall \$1.6 million gain on disposal (\$2.8m - \$1.2m) that relates to the rights transferred to Ceramic. This can be calculated as follows:

((2.8m – 1.7m) / 2.8m) x \$1.6 million = \$0.63 million.

The right of use asset and the lease liability will then be accounted for using normal lessee accounting rules. The financial liability is accounted for in accordance with IFRS 9 Financial Instruments.

Ceramic

Ceramic will post the following:

Dr Machine	$2.80m
Cr Financial asset	$0.20m
Cr Cash	$3.00m

It will then account for the lease using normal lessor accounting rules.

Note

The payments/receipts will be allocated between the lease and the additional finance. This is based on the proportion of the total present value of the payments that they represent:

- The payment / receipt allocated to the lease will be $447,368 ((1.7/1.8) x $500,000).
- The payment/receipt allocated to the additional finance will be $52,632 ((0.2 / 1.9) x $500,000).

IFRS 15 – REVENUE FROM CONTRACTS WITH CUSTOMERS

IFRS 15 specifies how and when an IFRS reporter will recognise revenue.

THE FIVE-STEP MODEL FRAMEWORK

The core principle of IFRS 15 is that an entity shall recognise revenue from the transfer of promised good or services to customers at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. The standard introduces a five-step model for the recognition of revenue.

The five-step model applies to revenue earned from a contract with a customer with limited exceptions, regardless of the type of revenue transaction or the industry.

STEP 1: IDENTIFY THE CONTRACT WITH THE CUSTOMER

Step one in the five-step model requires the identification of the contract with the customer. A contract with a customer will be within the scope of IFRS 15 if all the following conditions are met:

- The contract has been approved by the parties to the contract;
- Each party‗s rights in relation to the goods or services to be transferred can be identified;
- The payment terms for the goods or services to be transferred can be identified;
- The contract has commercial substance; and
- It is probable that the consideration to which the entity is entitled to in exchange for the goods or services will be collected.

Contracts may be in different forms (written, verbal or implied). If a contract with a customer does not meet these criteria, the entity can continually reassess the contract to determine whether it subsequently meets the criteria.

Two or more contracts that are entered into around the same time with the same customer may be combined and accounted for as a single contract, if they meet the specified criteria. The standard provides detailed requirements for contract modifications. A modification may be accounted for as a separate contract or as a modification of the original contract, depending upon the circumstances of the case.

STEP 2: IDENTIFY THE PERFORMANCE OBLIGATIONS IN THE CONTRACT

Step two requires the identification of the separate performance obligations in the contract. This is often referred to as =unbundling‗, and is done at the beginning of a contract. The key factor in identifying a separate performance obligation is the distinctiveness of the good or service, or a bundle of goods or services.

At the inception of the contract, the entity should assess the goods or services that have been promised to the customer, and identify as a performance obligation:

- A good or service (or bundle of goods or services) that is distinct; or
- A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

A series of distinct goods or services is transferred to the customer in the same pattern if both of the following criteria are met:

- Each distinct good or service in the series that the entity promises to transfer consecutively to the customer would be a performance obligation that is satisfied over time; and
- A single method of measuring progress would be used to measure the entity‘s progress towards complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

A good or service is distinct if both of the following criteria are met:

- The customer can benefit from the good or services on its own or in conjunction with other readily available resources; and
- The entity‘s promise to transfer the good or service to the customer is separately identifiable from other promises/elements in the contract.

IFRS 15 requires that a series of distinct goods or services that are substantially the same with the same pattern of transfer, to be regarded as a single performance obligation. A good or service which has been delivered may not be distinct if it cannot be used without another good or service that has not yet been delivered. Similarly, goods or services that are not distinct should be combined with other goods or services until the entity identifies a bundle of goods or services that is distinct.

IFRS 15 provides indicators rather than criteria to determine when a good or service is distinct within the context of the contract. This allows management to apply judgment to determine the separate performance obligations that best reflect the economic substance of a transaction. Factors for consideration as to whether a promise to transfer the good or service to the customer is separately identifiable include, but are not limited to:

- The entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract.
- The good or service does not significantly modify or customise another good or service promised in the contract.
- The good or service is not highly interrelated with or highly dependent on other goods or services promised in the contract.

STEP 3: DETERMINE THE TRANSACTION PRICE

Step three requires the entity to determine the transaction price, which is the amount of consideration that an entity expects to be entitled to in exchange for the promised goods or services.

When making this determination, an entity will consider past customary business practices. This amount excludes amounts collected on behalf of a third party – for example, government taxes. An entity must determine the amount of consideration to which it expects to be entitled in order to recognise revenue.

Additionally, an entity should estimate the transaction price, taking into account non-cash consideration, consideration payable to the customer and the time value of money if a significant financing component is present. The latter is not required if the time period between the transfer of goods or services and payment is less than one year. In some cases, it will be clear that a significant financing component exists due to the terms of the arrangement.

In other cases, it could be difficult to determine whether a significant financing component exists. This is likely to be the case where there are long-term arrangements with multiple performance obligations such that goods or services are delivered and cash payments received throughout the arrangement. For example, if an advance payment is required for business purposes to obtain a longer-term contract, then the entity may conclude that a significant financing obligation does not exist.

If an entity anticipates that it may ultimately accept an amount lower than that initially promised in the contract due to, for example, past experience of discounts given, then revenue would be estimated at the lower amount with the collectability of that lower amount being assessed. Subsequently, if revenue already recognised is not collectable, impairment losses should be taken to profit or loss.

Where a contract contains elements of variable consideration, the entity will estimate the amount of variable consideration to which it will be entitled under the contract.

However, a different, more restrictive approach is applied in respect of sales or usage-based royalty revenue arising from licences of intellectual property. Such revenue is recognised only when the underlying sales or usage occur.

STEP 4: ALLOCATE THE TRANSACTION PRICE TO THE PERFORMANCE OBLIGATIONS
IN THE CONTRACTS

Step four requires the allocation of the transaction price to the separate performance obligations. Where a contract has multiple performance obligations, an entity will allocate the transaction price to the performance obligations in the contract by reference to the relative standalone selling prices of the goods or services promised. This allocation is made at the inception of the contract. It is not adjusted to reflect subsequent changes in the standalone selling prices of those goods or services.

The best evidence of standalone selling price is the observable price of a good or service when the entity sells that good or service separately. If that is not available, an estimate is made by using an approach that maximises the use of observable inputs – for example, expected cost plus an appropriate margin or the assessment of market prices for similar goods or services adjusted for entity-specific costs and margins or in limited circumstances a residual approach. The residual approach is different from the residual method that is used currently by some entities, such as software companies.

When a contract contains more than one distinct performance obligation, an entity should allocate the transaction price to each distinct performance obligation on the basis of the standalone selling price.

This will be a major practical issue as it may require a separate calculation and allocation exercise to be performed for each contract. For example, a mobile telephone contract typically bundles together the handset and network connection and IFRS 15 will require their separation.

STEP 5: RECOGNISE REVENUE WHEN (OR AS) THE ENTITY SATISFIES A PERFORMANCE OBLIGATION

Step five requires revenue to be recognised as each performance obligation is satisfied. This differs from IAS 18 where, for example, revenue in respect of goods is recognised when the significant risks and rewards of ownership of the goods are transferred to the customer.
Revenue is recognised as control is passed. An entity satisfies a performance obligation by transferring control of a promised good or service to the customer, which could occur over time or at a point in time.

Control of an asset is defined as the ability to direct the use of and obtain substantially all of the remaining benefits from the asset. The benefits related to the asset are the potential cash flows that may be obtained directly or indirectly. These include, but are not limited to:

- Using the asset to produce goods or provide services;
- Using the asset to enhance the value of other assets;
- Using the asset to settle liabilities or to reduce expenses;
- Selling or exchanging the asset; Pledging the asset to secure a loan; and
- Holding the asset.

A performance obligation is satisfied at a point in time unless it meets one of the following criteria, in which case, it is deemed to be satisfied over time. So, an entity recognizes revenue over time if one of the following criteria is met:

- The customer simultaneously receives and consumes the benefits provided by the entity‘s performance as the entity performs.
- The entity‘s performance creates or enhances an asset that the customer controls as the asset is created or enhanced.
- The entity‘s performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

Revenue is recognised in line with the pattern of transfer. Whether an entity recognises revenue over the period during which it manufactures a product or on delivery to the customer will depend on the specific terms of the contract.

If an entity does not satisfy its performance obligation over time, it satisfies it at a point in time. Revenue will therefore be recognised when control is passed at a certain point in time. Factors that may indicate the point in time at which control passes include, but are not limited to:

- The entity has a present right to payment for the asset;
- The customer has legal title to the asset;
- The entity has transferred physical possession of the asset;
- The customer has the significant risks and rewards related to the ownership of the asset; and
- The customer has accepted the asset.

As a consequence of the above, the timing of revenue recognition may change for some point-intime transactions when the new standard is adopted.

CONTRACT COSTS

The incremental costs of obtaining a contract must be recognised as an asset if the entity expects to recover those costs.

Costs incurred to fulfill a contract are recognised as an asset if and only if all of the following criteria are

- The costs relate directly to a contract (or a specific anticipated contract);
- The costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future; and
- The costs are expected to be recovered.

The asset recognised in respect of the costs to obtain or fulfill a contract is amortised on a systematic basis that is consistent with the pattern of transfer of the goods or services to which the asset relates.

PRINCIPLES OF REVENUE RECOGNITION

Sale on return basis

- In case of sale on return basis, an estimate should be made of the amount of goods expected to be returned.

- The most likely amount of return can be determined by past experience or by assigning probability to estimated figures
- For the goods expected to be returned, sale is not recognized. A refund liability is recorded with the amount.
- The right to receive inventory with a corresponding adjustment to cost of sales
- If the item is ultimately not returned, then it will be recognized as sale at the point of confirmation of no return.

Warranty

- In case of option to purchase warranty separately (extended), warranty is distinct and should be recognized as a separate performance obligation
- If a customer does not have the option to purchase a warranty separately, an entity shall account for the warranty in accordance with IAS 37 Provisions,Contingent Liabilities and Contingent Asset

Principal versus agent considerations

- When another party is involved in providing goods or services to a customer, the entity shall determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (i.e. the entity is a principal) or to arrange for the other party to provide those goods or services (i.e. the entity is an agent).
- An entity is a principal if the entity controls a promised good or service before the entity transfers the good or service to a customer. However, an entity is not necessarily acting as a principal if the entity obtains legal title of a product only momentarily before legal title is transferred to a customer.
- When an entity that is a principal satisfies a performance obligation, the entity recognises revenue in the gross amount of consideration to which it expects to be entitled in exchange for those goods or services transferred.
- An entity is an agent if the entity‘s performance obligation is to arrange for the provision of goods or services by another party. When an entity that is an agent satisfies a performance obligation, the entity recognises revenue in the amount of any fee or commission to which

it expects to be entitled in exchange for arranging for the other party to provide its goods or services.

Indicators that an entity is an agent are as follows:

a) Another party is primarily responsible for fulfilling the contract;
b) The entity does not have inventory risk before or after the goods have been ordered by a customer, during shipping or on return;
c) The entity does not have discretion in establishing prices for the other party‘s goods or services and, therefore, the benefit that the entity can receive from those goods or services is limited;
d) The entity‘s consideration is in the form of a commission; and
e) The entity is not exposed to credit risk for the amount receivable from a customer in exchange for the other party‘s goods or services.

Repurchase agreements

A repurchase agreement is a contract in which an entity sells an asset and also promises or has the option (either in the same contract or in another contract) to repurchase the asset. The repurchased asset may be the asset that was originally sold to the customer, an asset that is substantially the same as that asset, or another asset of which the asset that was originally sold is a component.

Repurchase agreements generally come in three forms:

a) An entity‘s obligation to repurchase the asset (a forward);
b) An entity‘s right to repurchase the asset (a call option); and
c) An entity‘s obligation to repurchase the asset at the customer‘s request (a put option).

Forward & Call option

- In case of forward and call option, the customer does not obtain control
- If entity can or must repurchase at an amount less than original selling price of asset, then it will be accounted for as lease
- If entity can or must repurchase at an amount equal to or more than original selling price of asset, then accounting done as financing arrangement —recognize the asset and a financial liability

Put option

- If repurchase price lower than original selling price then see does customer have significant economic incentive to exercise right
- If yes then account for as lease. If no, then recognize as sale of product with right of return
- If repurchase price is equal or greater than original selling price following two options arise
- If repurchase price is more than expected market value then accounting done as financing arrangement —recognize the asset and a financial liability
- If Repurchase price is less than expected market value and no significant economic incentive to exercise right then record as sale of product with right of return

Bill and hold arrangement

- Bill-and-hold arrangements are those whereby an entity bills a customer for the sale of a particular product, but the entity retains physical possession until it is transferred to the customer at a later date.
- In assessing whether revenue can be recognized in a bill-and-hold transaction, entities must first determine whether control has transferred to the customer (as with any other sale under IFRS 15) through review of the indicators for the transfer of control. One indicator is physical possession of the asset; however, physical possession may not coincide with control in all cases (e.g., in bill and-hold arrangements).
- In determining whether control has transferred in such arrangements, the specific criteria included in IFRS 15 for bill-and-hold transactions must all be met in order for revenue to be recognized.

o The reason for the bill-and-hold arrangement must be substantive (e.g., the customer has requested the arrangement).

o The product must be identified separately as belonging to the customer. o The product currently must be ready for physical transfer to the customer.

o The entity cannot have the ability to use the product or to direct it to another customer. o An entity that has transferred control of the goods and met the bill-and-hold criteria to recognize revenue will also need to consider whether it is providing other services (e.g., custodial services).

- o If so, a portion of the transaction price should be allocated to each of the separate performance obligations (i.e., the goods and the custodial service).

Non-refundable up-front fees

Although the accounting conclusion may not change with respect to non-refundable upfront fees for retailers, the assessment process for such fees differs under IFRS 15.

Set up activities (e.g. retailers 'club' fees, health-club joining fees, set-up fees, etc.) are not generally considered to be distinct performance obligations because the customer‘s ability to benefit from them is highly dependent upon other goods or services in the contract. In such circumstances, the related upfront fees are considered to be advance payments for future goods and services and therefore comprise part of the overall transaction price. The entity allocates the overall transaction price among the identified performance obligations (as discussed above) and recognises revenue as those performance obligations are satisfied (Step 5).

Consignment arrangements

When an entity delivers a product to another party (such as a dealer or a distributor) for sale to end customers, the entity shall evaluate whether that other party has obtained control of the product at that point in time. A product that has been delivered to another party may be held in a consignment arrangement if that other party has not obtained control of the product.

Accordingly, an entity shall not recognise revenue upon delivery of a product to another party if the delivered product is held on consignment.

Indicators that an arrangement is a consignment arrangement include, but are not limited to, the following:

a) The product is controlled by the entity until a specified event occurs, such as the sale of the product to a customer of the dealer or until a specified period expires;
b) The entity is able to require the return of the product or transfer the product to a third party (such as another dealer); and
c) The dealer does not have an unconditional obligation to pay for the product (although it might be required to pay a deposit).

Illustration 1 – The five steps

On 1 December 2001, Wade receives order from a customer for a computer as well as 12 months' of technical support. Wade delivers the computer (and transfers its legal title) to the customer on the same day.

The customer paid $420 upfront. If sold individually, the selling price of the computer is $300 and the selling price of the technical support is $120.

Required:

Apply the 5 stages of revenue recognition, per IFRS 15, to determine how much revenue Wade should recognize in the year ended 31 December 2001.

Solution

Step 1 – Identify the contract

There is an agreement between Wade and its customer for the provision of goods and services.

Step 2 – Identify the separate performance obligations within a contract

There are two performance obligations (promises) within the contract:

- The supply of a computer
- The supply of technical support.

Step3 – Determine the transaction price

The total transaction price is $420.

Step 4 – Allocate the transaction price to the performance obligations in the contract

Based on standalone selling prices, $300 should be allocated to the sale of the computer and $120 should be allocated to the technical support.

Step 5 – Recognise revenue when (or as) a performance obligation is satisfied

Control over the computer has been passed to the customer so the full revenue of $300 allocated to the supply of the computer should be recognised on 1 December 2001.

The technical support is provided over time, so the revenue allocated to this should be recognised over time. In the year ended 31 December 2001, revenue of $ 10 (1/12 x $ 120) should be recognised from the provision of technical support.

The contract

Aluna has a year end of 31 December 2001.

On 30 September 2001, Aluna signed a contract with a customer to provide them with an asset on 31 December 2001. Control over the asset passed to the customer on 31 December 2001. The customer will pay $ 1 million on 30 June 2002.

By 31 December 2001, as a result of changes in the economic climate, Aluna did not believe it was probable that it would collect the consideration that it was entitled to. Therefore, the contract cannot be accounted for and no revenue should be recognised.

Test your understanding 1 – Bristow

On 1 December 2001, Bristow provides a service to a customer for the next 12 months. The consideration is $ 12 million. Bristow is entitled to an extra $ 3 million if, after twelve months, the number of mistakes made falls below a certain threshold.

Required:

Discuss the accounting treatment of the above in Bristow's financial statements for the year ended 31 December 2001 if:

(a) Bristow has experience of providing identical services in the past and it is highly probable that the number of mistakes made will fall below the acceptable threshold.

(b) Bristow has no experience of providing this service and is unsure if the number of mistakes made will fall below the threshold.

Answer

Test your understanding 1 – Bristow

The $ 12 million consideration is fixed. The $ 3 million consideration that is dependent on the number of mistakes made is variable.

Bristow must estimate the variable consideration. It could use an expected value or a most likely amount. Since there are only two outcomes, $0 or $3 million, then a most likely amount would better predict the entitled consideration.

(a) Bristow expects to hit the target. Using a most likely amount, the variable consideration would be valued at $3 million.

Bristow must then decide whether to include the estimate of variable consideration in the transaction price.

Based on past experience, it seems highly probable that a significant reversal in revenue recognised would not occur. This means that the transaction price is $ 15 million ($ 12m + $3m).

As a service, it is likely that the performance obligation would be satisfied over time. The revenue recognised in the year ended 31 December 2001 would therefore be $ 1.25 million ($ 14m x 1/12).

(b) Depending on the estimated likelihood of hitting the target, the variable consideration would either be estimated to be $0 or $3 million.
Whatever the amount, the estimated variable consideration cannot be included in the transaction price because it is not highly probable that a significant reversal in revenue would not occur. This is because Bristow has no experience of providing this service. Therefore, the transaction price is $ 12 million.

As a service, it is likely that the performance obligation would be satisfied over time. The revenue recognised in the year ended 31 December 2001 would be $ 1 million ($ 12m x 1/12).

Test your understanding 2 – Nardone

Nardone enters into 50 contracts with customers. Each contract includes the sale of one product for $ 1,000. The cost to Nardone of each product is $400. Cash is received upfront and control or the

product transfers on delivery. Customers can return the product within 30 days to receive a full refund. Nardone can sell the returned products at a profit.

Nardone has significant experience in estimating returns for this product. It estimates that 48 products will not be returned.

Required:

How should the above transaction be accounted for?

Answer:

Test your understanding 2 – Nardone

The fact that the customer can return the product means that the consideration is variable.

Using an expected value method, the estimated variable consideration is $48,000 (48 products x $1,000). The variable consideration should be included in the transaction price because, based on Nardone's experience, it is highly probable that a significant reversal in the cumulative amount of revenue recognised ($48,000) will not occur.

Therefore, revenue of $ 48,000 and a refund liability of $ 2,000 ($1,000 x 2 products expected to be returned) should be recognised. Nardone will derecognize the inventory transferred to its customers. However, it should recognise an asset of $800 (2 products x $400), as well as a corresponding credit to cost of sales, for its right to recover products from customers on settling the refund liability.

Test your understanding 3 – Rudd

Rudd enters into a contract with a customer to sell equipment on 31 December 2001. Control of the equipment transfers to the customer on that date, The price stated in the contract is $ 1 million and is due on 31 December 2003.

Market rates of interest available to this particular customer are 10%.

Required:

Explain how this transaction should be accounted for in the financial statements of Rudd for the year ended 31 December 2001.

Answer:

Test your understanding 3 – Rudd

Due to the length of time between the transfer of control of the asset and the payment date, this contract includes a significant financing component.

The consideration must be adjusted for the impact of the financing transaction. A discount rate should be used that reflects the characteristics of the customer i.e. 10%.

Revenue should be recognised when the performance obligation is satisfied.

As such revenue, and a corresponding receivable, should be recognised at $826,446 ($ 1m x $1/1.10^2$) on 31 December 2001.

The receivable is subsequently accounted for in accordance with IFRS 9 Financial Instruments.

Test your understanding 4 – Dan and Stan

Dan sells a good to Stan. Control over the good is transferred on 1 January 2001. The consideration received by Dan is 1,000 shares in Stan with a fair value of $4 each. By 31 December 2001, the shares in Stan have a fair value of $5 each.

Required:

How much revenue should be recognised from this transaction in the financial statements of Dan for the year ended 31 December 2001?

Answer:

Test your understanding 4 – Dan and Stan

The contract contains a single performance obligation.

Consideration for the transaction is non-cash. Non-cash consideration is measured at fair value.

Revenue should be recognised at $4,000 (1,000 shares x $4) on 1 January 2001.

Any subsequence change in the fair value of the shares received is not recognised within revenue but instead accounted for in accordance with IFRS 9 Financial Instruments.

Test your understanding 5 – Golden Gate

Golden Gate enters into a contract with a major chain of retail stores. The customer commits to buy at least $20 million of products over the next 12 months. The terms of the contract requires Golden Gate to make a payment of $1 million to compensate the customer for changes that it will need to make to its retail stores to accommodate the products.

By the 31 December 2001, Golden Gate has transferred products with a sales value of $4 million to the customer.

Required

How much revenue should be recognised by Golden Gate in the year ended 31 December 2001?

Answer:

Test your understanding 5 – Golden Gate

The payment made to the customer is not in exchange for a distinct good or service. Therefore, the $1 million paid to the customer must be treated as a reduction in the transaction price.

The total transaction price is essentially being reduced by 5% ($ 1m/$20m). Therefore, Golden Gate reduces the price allocated to each good by 5% as it is transferred.

By 31 December 2001, Golden Gate should have recognised revenue of $ 3.8 million ($4m x 95%).
Test your understanding 6 – Shred

Shred sells a machine and one year's free technical support for $ 100,000. The sale of the machine and the provision of technical support have been identified as separate performance obligations. Shred usually sells the machine for $95,000 but it has not yet started selling technical support for this machine as a stand-alone product. Other support services offered by Shred attract a mark-up of 50%. It is expected that the technical support will cost Shred $20,000.

Required:

How much of the transaction price should be allocated to the machine and how much should be allocated to the technical support?

Answer:

Test your understanding 6 – Shred

The selling price of the machine is $95,000 based on observable evidence.

There is no observable selling price for the technical support. Therefore, the stand-alone selling price needs to be estimated.

A residual approach would attribute $5,000 ($ 100,000 - $95,000) to the technical support. However, this does not approximate the stand-alone selling price of similar services (which normally makes a profit).

A better approach for estimating the selling price of the support would be an expected cost plus a margin (or mark-up) approach. Based on this, the selling price of the service would be $30,000 ($20,000 x 150%).

The total of standalone selling prices of the machine and support is $ 125,000 ($95,000 + $30,000). However, total consideration receivable is only $100,000. This means that the customer is receiving a discount for purchasing a bundle of goods and services of 20% ($25,000/ $125,000).

IFRS 15 assumes that discounts relate to all performance obligations within a contract, unless evidence exists to the contrary.

The transaction price allocated to the machine is $ 76,000 ($95,000 x 80%).
The transaction price allocated to the technical support is $ 24,000 ($30,000 x 80%).

The revenue will be recognised when (or as) the performance obligations are satisfied.

Test your understanding 7 – Evans

On 1 January 2001, Evans enters into a contract with a customer to provide monthly payroll services. Evans charges $120,000 per year.

Required:

What is the accounting treatment of the above in the financial statements of Evans for the year ended 30 June 2001?

Answer:

Test your understanding 7 – Evans

The payroll services are a single performance obligation.

This performance obligation is satisfied over time because the customer simultaneously receives and consumes the benefits of the payroll processing. This is evidenced by the fact that the payroll services would not need to be re-performed if the customer changed its payroll service provider.

Evans must therefore recognise revenue from the service over time. In the year ended 30 June 2001, they would recognise revenue of $60,000 (6/ 12 x $120,000).

Test your understanding 8 – Crawford

On 31 March 2001, Crawford enters into a contract to construct a specialized factory for a customer. The customer paid an upfront deposit which is only refundable if Crawford fails to complete construction in line with the contract. The remainder of the price is payable when the customer takes possession of the factory. If the customer defaults on the contract before completion of the factory, Crawford only has the right to retain the deposit.

Required:

Should Crawford recognise revenue from the above transaction over time or at a point in times?

Answer:

Test your understanding 8 – Crawford

In assessing whether revenue is recorded over time, it is important to note that the factory under construction is specialised. Therefore, the asset being created has no alternative use to the entity.

However, Crawford only has an enforceable right to the deposit received and therefore does not have a right to payment for work completed to date.

Consequently, Crawford must account for the sales of the unit as a performance obligation satisfied at a point in time, rather than over time. Revenue will most likely be recognised when the customer takes possession of the factory (although a detailed assessment should be made of the date when the customer assumes control).

Test your understanding 9 – Baker

On 1 January 2001, Baker enters into a contract with a customer to construct a specialised building for consideration of $2 million plus a bonus of $0.4 million if the building is completed within 18

months. Estimated costs to construct the building are $1.5 million. If the contract is terminated by the customer, Baker can demand payment for the costs incurred to date plus a mark-up of 30%. On 1 January 2001, as a result of factors outside of its control, such as the weather and regulatory approval, Baker is not sure whether the bonus will be achieved.

At 31 December 2001, Baker is still unsure whether the bonus target will be met. Baker decides to measure progress towards completion based on costs incurred. Costs incurred on the contract to date are $ 1.0 million.

Required:

How should Baker account for this transaction in the year ended 31 December 2001?

Answer:

Test your understanding 9 – Baker

Constructing the building is a single performance obligation.
The bonus is variable consideration. Whatever its estimated value, it must be excluded from the transaction price because it is not highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur.

The construction of the building should be accounted for as an obligation settled over time. This is because the building has no alternative uses for Baker, and because payment can be enforced for the work completed to date.

Baker should recognise revenue based on progress towards satisfaction of the construction of the building. Using costs incurred, the performance obligation is 2/3 ($1.0m/ $1.5m) complete.
Accordingly, the revenue and costs recognised at the end of the year are as follows:

	$m
Revenue ($2m x 2/3)	1.3
Costs ($1.5m x 2/3)	(1.0)
Gross profit	0.3

Test your understanding 10 – Clarence

On 31 December 2001, Clarence delivered the January edition of a magazine (with a total sales value of $100,000) to a supermarket chain. Legal title remains with Clarence until the supermarket sells a magazine to the end consumer. The supermarket will start selling the magazines to its customers on 1 January 2002. Any magazines that remain unsold by the supermarket on 31 January 2002 are returned to Clarence.

The supermarket will be invoiced by Clarence in February 2002 based on the difference between the number of issues they received and the number of issues that they return.

Required:

Should Clarence recognise revenue from the above transaction in the year ended 31 December 2001?

Answer:

Test your understanding 10 – Clarence
The performance obligation is not satisfied over time because the supermarket does not simultaneously receive and benefit from the asset. Clarence therefore satisfies the performance obligation at a point in time and will recognise revenue when it transfers control over the assets to the supermarket.

The fact that the supermarket has physical possession of the magazines at 31 December 2001 is an indicator that control has passed. Also, Clarence will invoice the supermarket for any issues that are stolen and so the supermarket does bear some of the risks of ownership.

However, as at 31 December 2001, legal title of the magazines has not passed to the supermarket. Moreover, Clarence has no right to receive payment until the supermarket sells the magazines to the end consumer. Finally, Clarence will be sent any unsold issued and so bears significant risks of ownership (such as the risk of obsolescence).

All things considered, it would seem that control of the magazines has not passed from Clarence to the supermarket chain. Therefore, Clarence should not recognise revenue from this contract in its financial statements for the year ended 31 December 2001.

IFRS 13 – FAIR VALUE MEASUREMENTS

NEED FOR FAIR VALUE GUIDANCE & IFRS 13:

IFRS 13 provides a single source of guidance for all fair value measurements, clarifying the definition of fair value and enhancing disclosures requirements about reported fair value estimates.

OBJECTIVE

IFRS 13, Fair Value Measurement was issued in May 2011 and defines fair value, establishes a framework for measuring fair value and requires significant disclosures relating to fair value measurement. The International Accounting Standards Board (IASB) wanted to enhance disclosures for fair value in order that users could better assess the valuation techniques and inputs that are used to measure fair value. There are no new requirements as to when fair value accounting is required but rather it relies on guidance regarding fair value measurements in existing standards.

The guidance in IFRS 13 does not apply to transactions dealt with by certain standards. For example share based payment transactions in IFRS 2, Share-based Payment, leasing transactions in IFRS 16, Leases, or to measurements that are similar to fair value but are not fair value – for example, net realisable value calculations in IAS 2, Inventories or value in use calculations in IAS 36, Impairment

of Assets. Therefore, IFRS 13 applies to fair value measurements that are required or permitted by those standards not scoped out by IFRS 13. It replaces the inconsistent guidance found in various IFRSs with a single source of guidance on measurement of fair value

FAIR VALUE DEFINITION

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

From the above definition, it can be inferred that fair value is an exit price. Consequently, fair value is focused on the assumptions of the market place, is not entity specific and so takes into account any assumptions about risk. This means that fair value is measured using the same assumptions used by market participants and takes into account the same characteristics of the asset or liability. Such conditions would include the condition and location of the asset and any restrictions on its sale or use.

An entity cannot argue that prices are too low relative to its own valuation of the asset and that it would be unwilling to sell at low prices. The prices to be used are those in =an orderly transaction'. An orderly transaction is one that assumes exposure to the market for a period before the date of measurement to allow for normal marketing activities to take place and to ensure that it is not a forced transaction. If the transaction is not = orderly 'then there will not have been enough time to create competition and potential buyers may reduce the price that they are willing to pay. Similarly if a seller is forced to accept a price in a short period of time, the price may not be representative. Therefore, it does not follow that a market in which there are few transactions is not orderly. If there has been competitive tension, sufficient time and information about the asset, then this may result in an acceptable fair value.

Unit of account

IFRS 13 does not specify the unit of account that should be used to measure fair value. This means that it is left to the individual standard to determine the unit of account for fair value measurement. A unit of account is the single asset or liability or group of assets or liabilities. The characteristic of an asset or liability must be distinguished from a characteristic arising from the holding of an asset or liability by an entity. An example of this is where an entity sells a large block of shares, and it

has to sell them at a discount price to the market price. This is a characteristic of holding the asset rather than a characteristic of the asset itself and should not be taken into account when fair valuing the asset.

MARKETS – ACTIVE MARKET

A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis

MARKETS – PRINCIPAL MARKET

Fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place in the principal market for the asset or liability or, in the absence of a principal market, in the most advantageous market for the asset or liability. The principal market is the one with the greatest volume and level of activity for the asset or liability that can be accessed by the entity.

IFRS 13 provides a new framework to estimate fair value in a consistent manner across standards. For a fair value measurement, an entity has to determine:

- The particular asset or liability that is the subject of the measurement
- For an asset, the valuation premise that is appropriate for the measurement
- The most advantageous market for the asset or liability and
- The valuation technique appropriate for measurement

MARKETS – THE MOST ADVANTAGEOUS MARKET

It is assumed that transactions take place in the most advantageous market to which the entity has access.

This means that the entity is in a position to receive the maximum amount on sale of the asset or pay the minimum amount to transfer a liability after considering transaction and transport costs. While transaction and transport costs are relevant to identify the market, they are not considered in determining the fair value.

MEASUREMENT ASSUMPTIONS

Fair value measurement of an asset or liability should use the assumptions that market participants would use in pricing the asset or liability. These assumptions include:

- Buyers and sellers are independent of each other They have knowledge about the asset or liability
- They are capable of entering into a transaction
- They are willing to enter into a transaction, rather than being forced or otherwise compelled.

VALUATION TECHNIQUES

An entity uses valuation techniques appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs.

Where fair value is determined using a valuation technique, IFRS 13 prescribes that the technique should be one of the following.

i. Market approach: uses price and other relevant market information for identical or comparable assets or liabilities
ii. Income approach: converts future amounts to a single discounted present value amount or
iii. Cost approach: amount that would currently be required to replace the service capacity of the asset

When measuring fair value, the entity is required to maximise the use of observable inputs and minimize the use of unobservable inputs. To this end, the standard introduces a fair value hierarchy, which prioritises the inputs into the fair value measurement process.

FAIR VALUE HIERARCHY

IFRS 13 seeks to increase consistency and comparability in fair value measurements and related disclosures through a 'Fair Value Hierarchy'. The hierarchy categorises the inputs used in valuation techniques into three levels.

Level 1 Inputs

Level 1inputs are unadjusted quoted prices in active markets for items identical to the asset or liability being measured. As with current IFRS, if there is a quoted price in an active market, an entity uses that price without adjustment when measuring fair value. An example of this would be

prices quoted on a stock exchange. The entity needs to be able to access the market at the measurement date. Active markets are ones where transactions take place with sufficient frequency and volume for pricing information to be provided. An alternative method may be used where it is expedient. The standard sets out certain criteria where this may be applicable. For example where the price quoted in an active market does not represent fair value at the measurement date. An example of this may be where a significant event takes place after the close of the market such as a business reorganisation or combination.

The determination of whether a fair value measurement is based on level 2 or level 3 inputs depends on (i) whether the inputs are observable inputs or unobservable and (ii) their significance.

Level 2 Inputs

Level 2 inputs are inputs other than the quoted prices in determined in level 1 that are directly or indirectly observable for that asset or liability. They are likely to be quoted assets or liabilities for similar items in active markets or supported by market data. For example interest rates credit spreads or yields curves. Adjustments may be needed to level 2 inputs and, if this adjustment is significant, then it may require the fair value to be classified as level 3.

Level 3 Inputs

Finally, level 3 inputs are unobservable inputs. These inputs should be used only when it is not possible to use Level 1 or 2 inputs. The entity should maximise the use of relevant observable inputs and minimize the use of unobservable inputs.

However, situations may occur where relevant inputs are not observable and therefore these inputs must be developed to reflect the assumptions that market participants would use when determining an appropriate price for the asset or liability.

The general principle of using an exit price remains and IFRS 13 does not preclude an entity from using its own data. For example cash flow forecasts may be used to value an entity that is not listed. Each fair value measurement is categorised based on the lowest level input that is significant to it.

ASSET -SPECIFIC VALUATIONS

For a fair value measurement of an asset, it is assumed that the asset will be sold to a market participant who will use it at its highest and best use.

LIABILITY or EQUITY – SPECIFIC VALUATION

Fair value measurement of a liability, or owner‘s own equity assumes that the liability is transferred to a market participant at the measurement date. In many cases there is no observable market to provide pricing information and the highest and best use is not applicable. In this case, the fair value is based on the perspective of a market participant who holds the identical instrument as an asset.
Where there is no observable market price for the transfer of a liability, an entity would be required to measure the fair value of the liability using the same methodology that the counterparty would use to measure the fair value of the corresponding asset.

If there is no corresponding asset, then a corresponding valuation technique may be used. This would be the case with a decommissioning activity.

The fair value of a liability reflects the non-performance risk based on the entity‘s own credit standing plus any compensation for risk and profit margin that a market participant might require to undertake the activity. Transaction price is not always the best indicator of fair value at recognition because entry and exit prices are conceptually different.

Valuation concepts

IFRS 13 also sets out certain valuation concepts to assist in the determination of fair value. For nonfinancial assets only, fair value is determined based on the highest and best use of the asset as determined by a market participant.

Highest and best use is a valuation concept that considers how market participants would use a nonfinancial asset to maximise its benefit or value. The maximum value of a non-financial asset to market participants may come from its use in combination with other assets and liabilities or on a standalone basis.

In determining the highest and best use of a non-financial asset, IFRS 13 indicates that all uses that are physically possible, legally permissible and financially feasible should be considered. As such,

when assessing alternative uses, entities should consider the physical characteristics of the asset, any legal restrictions on its use and whether the value generated provides an adequate investment return for market participants.

RULES IN BUSINESS COMBINATION:

IFRS 3 sets out general principles for arriving at the fair values of a subsidiary's assets and liabilities only if they satisfy the following criteria:

- In the case of an asset other than an intangible asset, it is probable that any associated future economic benefits will flow to the acquirer, and its fair value can be measured reliably. Vice versa for liabilities
- In the case of an intangible asset or a contingent liability, its fair value can be measured reliably.
- The acquiree's identifiable assets and liabilities might include assets and liabilities not previously recognised in the acquiree's financial statements
- An acquirer should not recognise liabilities for future losses or other costs expected to be incurred as a result of the business combination.
- The acquiree may have intangible assets which can only be recognised separately from goodwill if they are identifiable. They must be able to be capable of being separated from the entity.
- The acquirer should measure the cost of a business combination as the total of the fair values at the date of acquisition.
- If part of the consideration is payable at a later date, this deferred consideration is discounted to present value at the date of exchange.
- In case of equity instruments as cost of investment, the published price at the date of exchange normally provides the best evidence of the instrument's fair value.
- Costs attributable to the combination, for example professional fees and administrative costs, should not be included: they are recognised as an expense when incurred.
- If an asset or liability has been recognised at fair value at acquisition, it must be recorded in the subsidiary‘s statement of financial position at fair value consequently also
- Some fair value adjustments are made on depreciable assets such as buildings, the assets with fair value adjustment must be depreciated at its fair value so there will be an adjustment, which flows through to profit or loss for this additional depreciation.

Disclosures

The guidance includes enhanced disclosure requirements that include:

- Information about the hierarchy level into which fair value measurements fall
- Transfers between levels 1 and 2
- Methods and inputs to the fair value measurements and changes in valuation techniques, and
- Additional disclosures for level 3 measurements that include a reconciliation of opening and closing balances, and quantitative information about unobservable inputs and assumptions used.

Inputs to determine fair value

IFRS 13 gives the following examples of inputs use to determine fair value:

	Asset	Example
Level 1	Equity shares in a listed entity	Unadjusted quoted prices in an active market.
Level 2	Building held and used	Price per square meter for the building from observable market data, such as observed transactions for similar buildings in similar locations.
Level 3	Cash-generating unit	Profit or cash flow forecast using own data.

Test your understanding 1 – Baklava

Baklava has an investment property that is measured at fair value. This property is rented out on short-term leases.

The directors wish to fair value the property by estimating the present value of the net cash flows that the property will generate for Baklava. They argue that this best reflects the way in which the building will generate economic benefits for Baklava.

The building is unique, although there have been many sales of similar buildings in the local area.

Required:

Discuss whether the valuation technique suggested by the directors complies with International Financial Reporting Standards.

Answer:

Test your understanding 1 – Baklava

The directors' estimate of the future net cash flows that the building will generate is a level 3 input. IFRS 13 gives lowest priority to level 3 inputs. These should not be used if a level 1 or level 2 input exists.

Observables data about the recent sales prices of similar properties is a level 2 input. The fair value of the building should therefore be based on these prices, with adjustments made as necessary to reflect the specific location and condition of Baklava's building.

Test your understanding 2 – Markets

An asset is sold in two different active markets at different prices. An entity enters into transactions in both markets and can access the price in those markets for the asset at the measurement date as follows:

	Market 1	Market 2
	$	$
Price	26	25
Transaction costs	(3)	(1)
Transport costs	(2)	(2)
Net price received	21	22

What is the fair value of the asset if:

(a) Market 1 is the principal market for the asset?

(b) No principal market can be determined?

Answer:

Test your understanding 2 – Markets

(a) If Market 1 is the principal market then the fair value would be measured using the price that would be received in that market less transport costs. The fair value would therefore be $24 ($26 - $2). Transaction costs are ignored as they are not a characteristic of the asset.

(b) If neither market is the principal market for the asset then the fair value would be measured in the most advantageous market. The most advantageous market is the market that maximizes the net amount received from the sale.

The net amount received in Market 2 ($22) is higher than the net amount received in Market 1 ($21). Market 2 is therefore the most advantageous market. This result in a fair value measurement of $23 ($25 - $2) IFRS 13 specifies that transaction costs play a role when determining which market is most advantageous but that they are not factored into the fair value measurement itself.

Test your understanding 3 – Five Quarters

Five Quarters has purchased 100% of the ordinary shares of Three Halves and is trying to determine the fair value of the net assets at the acquisition date.

Three Halves owns land that is currently developed for industrial use. The fair value of the land if used in a manufacturing operation is $5 million.

Many nearby plots of land have been developed for residential use (as high-rise apartment buildings). The land owned by Three Halves does not have planning permission for residential use, although permission has been granted for similar plots of land. The fair value of Three Halves' land as a vacant site for residential development is $6 million. However, transformation costs of $0.3 million would need to be incurred to get the land into this condition.

Required:

How should the fair value of the land be determined?

Answer:

Test your understanding 3 – Five Quarters

Land is a non-financial asset. IFRS 13 says that the fair value of a non-financial asset should be based on its highest and best use. This is presumed to be its current use, unless evidence exists to the contrary.

The current use of the asset would suggest a fair value of $5 million.

However, there is evidence that market participants would be interested in developing the land for residential use.

Residential use of the land is not legally prohibited. Similar pots of land have been granted planning permission, so likely that this particular plot of land will also be granted planning permission.

If used for residential purposes, the fair value of the land would be $5.7 million ($6m - $0.3m).

It would seem that the land's highest and best use is for residential development. Its fair value is therefore $5.7 million.

IAS 19 EMPLOYEE BENEFITS

OBJECTIVE

The objective of this Standard is to prescribe the accounting and disclosure for employee benefits.

SCOPE

Employee benefits include:

(a) Short-term employee benefits

(b) Post-employment benefits (c) Other long-term employee benefits

(d) Termination benefits.

IAS 19 should be applied by all entities in accounting for the provision of all employee benefits, except those benefits which are equity-based (awarding shares, share appreciation rights etc) and to which IFRS2 applies. The Standard applies regardless of whether the benefits have been provided as part of a formal contract or an informal arrangement (constructive obligation). Considerations given to an employee by an entity in exchange for the employee's services is in following forms.

i. Cash bonuses
ii. Retirement benefits
iii. Private health care

A number of accounting issues arise due to actuarial complexities and the impact of deferred taxes:

- The valuation problems linked to some forms of employee benefits; and
- The timing of benefits, which may not always be provided in the same period as the one in which the employee's services are provided.

DEFINITIONS

Employee benefits are all forms of consideration given by an entity in exchange for service rendered by employees or for the termination of employment.

Short-term employee benefits are employee benefits (other than termination benefits) that are expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service.

Post-employment benefits are employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment.

Other long-term employee benefits are all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits.

Termination benefits are employee benefits provided in exchange for the termination of anemployees employment as a result of either

(a) An entity‘s decision to terminate an employee‘s employment before the normal retirement date; or

(b) An employee‘s decision to accept an offer of benefits in exchange for the termination of employment.

Investment risk: This is defined as the risk that there will be insufficient funds in the plan to meet the expected benefits.

Actuarial risk: This is the risk that the actuarial assumptions such as those on employee turnover, life expectancy or future salaries vary significantly from that actually happens.

SHORT TERM EMPLOYEE BENEFITS

Short-term employee benefits are employee benefits (other than termination benefits) that are expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service and expense is recognized on accrual basis..

Short-term employee benefits include items such as:

(a) Wages, salaries and social security contributions;
(b) Short-term compensated absences (such as paid annual vacation, paid sick leave and paid maternity/paternity leave. To fall within the definition, the absences should be expected to occur within 12 months of the end of the period in which the employee services were provided;
(c) Profit-sharing and bonuses payable within 12 months of the end of the period
(d) Non-monetary benefits (such as medical care, housing, cars and free or subsidized goods or services) for current employees.

Recognition and Measurement: All Short Term Employee Benefits

The undiscounted amount of short-term employee benefits expected to be paid in exchange for the service during the period is recognized as:

(a) As a liability (accrued expense), after deducting any amount already paid (As an asset if prepaid expense)

(b) As an expense, unless another IFRS requires or permits the inclusion of the benefits in the cost of an asset.

Short Term Compensated Absences

Definition

Short-term compensated absences: Compensated absences are periods of absence from work for which the employee receives some form of payment and which are expected to occur within 12 months of the end of the period in which the employee renders the services.

Examples of short-term compensated absences are paid annual vacation and paid sick leave.

Short-term compensated absences fall into two categories:

- Accumulating absences. These are benefits, such as paid annual vacation, that accrue over an employee‘s period of service and can be potentially carried forward and used in future periods if not taken: and
- Non-accumulating absences. These are benefits that an employee is entitled to, but they elapse if not taken in the current period. Where an employee has an unused entitlement at the end of the reporting period and the entity expects to provide the benefit, a liability should be created.

Profit-sharing and bonus plans

An entity should recognise an expense and a corresponding liability for the cost of providing profit sharing arrangements and bonus payments when:

(i) The entity has a present legal or constructive obligation. The legal obligation arises when payment is part of an employee's employment contract. The constructive obligation arises where past performance has led to the expectation that benefits will be payable in the current period.

(ii) A reliable estimate of the obligation can be made.

Conditions may be attached to such bonus payments; commonly, the employee must still be in the entity's employment when the bonus becomes payable. An estimate should be made based on the expectation of the level of bonuses that will ultimately be paid. IAS 19 sets out that a reliable estimate for bonus or profit sharing arrangements can be made only when:

- There are formal terms setting out determination of the amount of the benefit:
- The amount payable is determined by the entity before the financial statements are authorised for issue; or
- Past practice provides clear evidence of the amount of a constructive obligation.

POST-EMPLOYMENT BENEFITS

Post-employment benefits are employee benefits other than termination benefits, which are payable after the completion of employment.

Post-employment benefits include, for example:

(a) Retirement benefits, such as pensions; and

(b) Other post-employment benefits, such as post-employment life insurance and postemployment medical care.

Post-employment benefit plans are formal or informal arrangements under which an entity provides postemployment benefits for one or more employees.

There are two main types of post-employment benefit schemes:

- o Defined contribution schemes where the future pension depends on the value of the fund
- o Defined benefit schemes where the future pension depends on the final salary and years worked
- o These two alternative schemes are discussed in more detail below.
- o A pension scheme will normally be held in the form of a trust (pension fund) separate from the sponsoring employer. Although the directors of the sponsoring company may also be trustees of the pension scheme, the sponsoring company and the pension scheme are separate legal entities that are accounted for separately. IAS 19 covers accounting for the pension scheme in the sponsoring company's accounts.

Defined contribution plans are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

Defined benefit plans are post-employment benefit plans other than defined contribution plans.

Multi-employer plans are defined contribution plans (other than state plans) or defined benefit plans (other than state plans) that:

(a) Pool the assets contributed by various entities that are not under common control; and

(b) Use those assets to provide benefits to employees of more than one entity, on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employs the employees.

DEFINED CONTRIBUTION PLANS

Characteristics of a defined contribution plan are:

- Contributions into the plan are fixed, normally at a percentage of an employee‘s salary
- The amount of pension paid to retirees is not guaranteed and will depend upon the size of the plan, which in turn depends upon the performance of the pension fund investments.

Risk Associated with Defined Contribution Schemes

Contributions are usually paid into the plan by both the employer and the employee. The expectation is that the investments made will grow through capital appreciation and the reinvestment of returns and that on a member‘s retirement, the plan should have grown to be sufficient to provide the anticipated benefits. If the investments have not performed as anticipated (Investment risk), the size of the plan will be smaller than initially anticipated and therefore there will be insufficient assets to meet the expected benefits. The insufficiency of assets is described as the investment risk and is carried by the employee.

The other main risk with retirement plans is that a given amount of annual benefit will cost more than expected if, for example, life expectancy has increased markedly by the time benefits come to be drawn.

So, the actuarial assumptions regarding pension may deviate from actual results (Actuarial risk) e.g. employee turnover, average age of employees etc. This is described as the actuarial and, in the case of defined contribution plans this is also carried by the employee.

Variables-returns on investments

Accounting for defined contribution plans is straightforward as the obligation is determined by the amount paid into the plan in each period.

Recognition and measurement

Contributions into a defined contribution plan by an employer are made in return for services provided by an employee during the period. The employer has no further obligation for the value of the assets of the plan or the benefits payable.

- The entity should recognise contributions payable as an expense in the period in which the employee provides services (except to the extent that labour costs may be included within the cost of assets).
- A liability should be recognised where contributions arise in relation to an employee's service, but remain unpaid at the period end.

In the unusual situation where contributions are not payable during the period (or within 12 months of the end of the period) in which the employee provides his or her services on which they accrue, the amount recognised should be discounted, to reflect the time value of money.

Any excess contributions paid should be recognised as an asset (prepaid expenses) but only to the extent that the prepayment will lead to a reduction in future payments or cash refund.

Disclosure requirements

Where an entity operates a defined contribution plan during the period, it should disclose:

- The amount that has been recognised as an expense during the period in relation in relation to the plan
- A description of the plan

DEFINED BENEFIT PLANS

These are defined by IAS 19 as all post-employment plans other than defined contribution plans.

These are defined by IAS 19 as all plans other than defined contribution plans.

Characteristics of defined benefit plan are:

- The amount of pension paid to retirees is defined by reference to factors such as length of service and salary levels (i.e. it is guaranteed)
- Contributions into the plan are therefore variable depending upon how the plan is performing in relation to the expected future obligation (i.e. if there is a shortfall, contribution will increase and viceversa)

Contribution Levels

The actuary advises the company on contributions necessary to produce the defined benefits (the funding plan‘). Contributions may be varied as a result.

Risk associated with defined benefit schemes

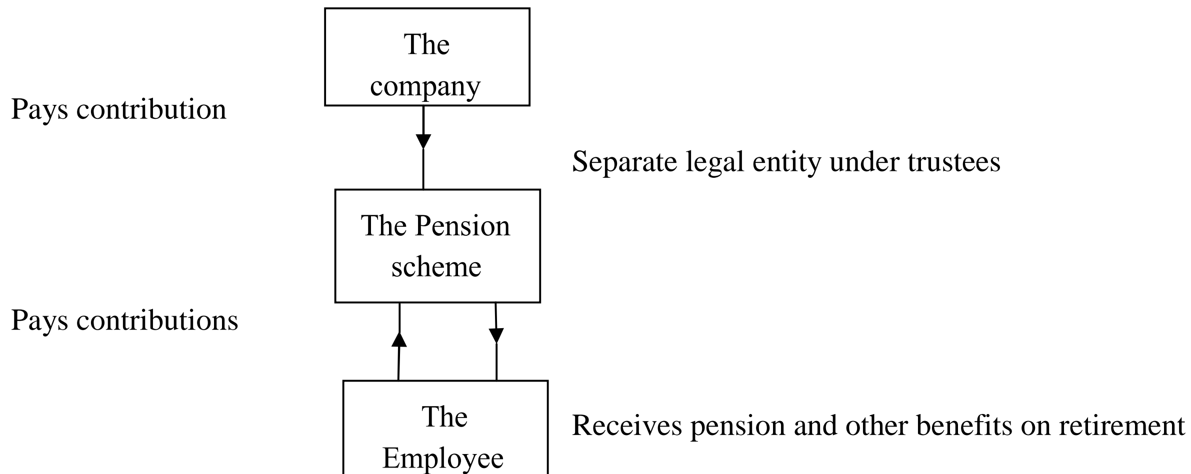
As the employer is obliged to make up any shortfall in the plan, it is effectively underwriting the investment and actuarial risk associated with the plan. Thus in a defined benefit plan, the employer carries both the investment and the actuarial risk.

Types of Defined Benefit Plans

There are two types of defined benefit plan:

- Funded plans: These plans are set up as separate legal entities and are managed independently, often by trustees. Contributions paid by the employer and employee are paid into the separate legal entity. The assets held within the separate legal entities are effectively ring-fenced for the payments of benefits.

Illustration:



Unfunded plans:

These plans are held within employer legal entities and are managed by the employer 'management teams. Assets may be allocated towards the satisfaction of retirement benefit obligations, although these assets are not ring-fenced for the payment of benefits and remain the assets of the employer entity.

DEFINITIONS RELATING TO THE NET DEFINED BENEFIT LIABILITY (ASSET)

The net defined benefit liability (asset) is the deficit or surplus, adjusted for any effect of limiting a net defined benefit asset to the asset ceiling.

The deficit or surplus is:

(a) The present value of the defined benefit obligation less (b)

The fair value of plan assets (if any).

The asset ceiling is the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.

The present value of a defined benefit obligation is the present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.

Plan assets comprise:

(a) Assets held by a long-term employee benefit fund; and (b)

Qualifying insurance policies.

Assets held by a long-term employee benefit fund are assets (other than non-transferable financial instruments issued by the reporting entity) that:

(a) Are held by an entity (a fund) that is legally separate from the reporting entity and exists solely to pay or fund employee benefits; and

(b) Are available to be used only to pay or fund employee benefits, are not available to the reporting entity‘s own creditors (even in bankruptcy), and cannot be returned to the reporting entity, unless either:

- (i) The remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting entity; or
- (ii) The assets are returned to the reporting entity to reimburse it for employee benefits already paid.

A qualifying insurance policy is an insurance policy11issued by an insurer that is not a related party (as defined in IAS 24 Related Party Disclosures) of the reporting entity, if the proceeds of the policy: (a) Can be used only to pay or fund employee benefits under a defined benefit plan; and (b) Are not available to the reporting entity‘s own creditors (even in bankruptcy) and cannot be paid to the reporting entity, unless either:

(i) The proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations; or

(ii) The proceeds are returned to the reporting entity to reimburse it for employee benefits already paid.

DEFINITIONS RELATING TO DEFINED BENEFIT COST

Service cost comprises:

(a) Current service cost, which is the increase in the present value of the defined benefit obligation resulting from employee service in the current period;

(b) Past service cost, which is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment (the introduction or withdrawal of, or changes to, a defined benefit plan) or a curtailment (a significant reduction by the entity in the number of employees covered by a plan); and (c) Any gain or loss on settlement.

Net interest on the net defined benefit liability (asset) is the change during the period in the net defined benefit liability (asset) that arises from the passage of time.

Re-measurement of the net defined benefit liability (asset) comprise

(a) Actuarial gains and losses;
(b) The return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset); and 1 A qualifying insurance policy is not necessarily an insurance contract, as defined in IFRS 4 Insurance Contracts.
(c) Any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset).

Actuarial gains and losses are changes in the present value of the defined benefit obligation resulting from:

(a) Experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred); and
(b) The effects of changes in actuarial assumptions.

The return on plan assets is interest, dividends and other income derived from the plan assets, together with realised and unrealised gains or losses on the plan assets, less:

(a) Any costs of managing plan assets; and
(b) Any tax payable by the plan itself, other than tax included in the actuarial assumptions used to measure the present value of the defined benefit obligation.

A settlement is a transaction that eliminates all further legal or constructive obligations for part or all of the benefits provided under a defined benefit plan, other than a payment of benefits to, or on behalf of, employees that is set out in the terms of the plan and included in the actuarial assumptions.

RECOGNITION AND MEASUREMENT – A SUMMARY

IAS 19 requires the following.

(a) Contributions to a defined contribution plan should be recognised as an expense in the period they are payable (except to the extent that labour costs may be included within the cost of assets).

(b) Any liability for unpaid contributions that are due as at the end of the period should be recognized as a liability (accrued expense).

(c) Any excess contributions paid should be recognised as an asset (prepaid expense), but only to the extent that the prepayment will lead to, e.g. a reduction in future payments or a cash refund.

In the (unusual) situation where contributions to a defined contribution plan do not fall due entirely within 12 months after the end of the period in which the employees performed the related service, then these should be discounted.

RECOGNITION AND MEASUREMENT - DETAILS

Accounting by an entity for defined benefit plans involves the following steps:

(a) Determining the deficit or surplus. This involves:
   (i) Using an actuarial technique, the projected unit credit method is used to make a reliable estimate of the ultimate cost to the entity of the benefit using estimates (actuarial assumptions) about demographic variables (such as employee turnover and mortality) and financial variables (such as future increases in salaries and medical costs).
   (ii) Calculating the present value of the defined benefit obligation and the current service cost
   (iii)Deducting the fair value of any plan assets from the present value of the defined benefit obligation.

(b) Determining the amount of the net defined benefit liability (asset) as the amount of the deficit or surplus determined in (a), adjusted for any effect of limiting a net defined benefit asset to the as setceiling.

(c) Determining amounts to be recognised in profit or loss:
   (i) Current service cost.
   (ii) Any past service cost and gain or loss on settlement.
   (iii)Net interest on the net defined benefit liability (asset).

(d) Determining the re-measurements of the net defined benefit liability (asset), to be recognized in other comprehensive income, comprising:
   (i) Actuarial gains and losses;

(ii) Return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset); and

(iii) Any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset).

Accounting For the Constructive Obligation

An entity shall account for any constructive obligation also that arises from the entity‘s informal practices.

The Statement of Financial Position

In the statement of financial position, the amount recognised as a defined benefit liability (which may be a negative amount, i.e. an asset) should be the following.

(a) The present value of the defined obligation at the year end, minus

(b) The fair value of the assets of the plan as at the yearend (if there are any) out of which the future obligations to current and past employees will be directly settled.

Recognition and Measurement: Present Value of Defined Benefit Obligation and Current Service Cost

The ultimate cost of a defined benefit plan may be influenced by many variables, such as final salaries, employee turnover and mortality, employee contributions and medical cost trends. The ultimate cost of the plan is uncertain and this uncertainty is likely to persist over a long period of time. In order to measure the present value of the post-employment benefit obligations and the related current service cost, it is necessary: (a) To apply an actuarial valuation method; (b) To attribute benefit to periods of service; and

(c) To make actuarial assumptions.

Attributing benefits to periods of service

- Where a plan provides for a lump sum benefit payment at a specified time in the future, IAS 19 requires that the benefits are attributed to periods of service on a straight line basis over the period in which the benefit accrues.

- Benefits accruing in later periods may be greater than those accruing in earlier periods. Where this is the case, IAS 19 again requires benefits to be attributed to periods of service on a straight line basis over the period in which the benefit accrues.
- If the benefit is to be based on a constant proportion of final salary for each year of service, the amount of benefit attributable to each period of service is a constant proportion of the estimated final salary.

The Statement of Profit or Loss and Other Comprehensive Income

All of the gains and losses that affect the plan obligation and plan asset must be recognised. The components of defined benefit cost must be recognised as follows in the statement of profit or loss and other comprehensive income:

Component	Recognised in
(a) Service cost	Profit or loss
(b) Net interest on the net defined benefit liability	Profit or loss
(c) Re-measurements of the net defined benefit liability	Other comprehensive income (not reclassified to P/L)

Unwinding of Interest

IAS 19 requires that the interest should be calculated on the net defined benefit liability (asset). This means that the amount recognised in profit or loss is the net of the interest charge on the obligation and the interest income recognised on the assets.

The calculation is as follows:

Net defined benefit liability/ (asset) x Discount Rate

The net defined benefit liability/ (asset) should be determined as at the start of the accounting period, taking account of changes during the period as a result of contributions paid into the scheme and benefits paid out.

Discount Rate

The discount rate adopted should be determined by reference to market yields on high quality fixed-rate corporate bonds.

Dr. Interest cost

Cr. PV of defined benefit obligation

Service Costs

These comprise:

(a) Current service cost, this is the increase in the present value of the defined benefit obligation resulting from employee services during the period.
(b) Past service cost, is the change in the obligation relating to service in prior periods. This results from amendments or curtailments to the pension plan, and
(c) Any gain or loss on settlement.

Current Service Cost

The amount of pension paid out by defined benefit schemes is often calculated based on the number of years of service of an employee. Therefore, with each year that an employee remains in employment, the pension liability will increase.

The current service cost is accounted for by

Dr. Current service cost expense

Cr. PV of Defined Benefit Obligation

Past Service Costs

Past service cost is the change in the present value of the defined benefit obligation resulting from a plan amendment or curtailment.

An entity shall recognise past service cost as an expense at the earlier of the following dates:

(a) When the plan amendment or curtailment occurs; and
(b) When the entity recognises related restructuring costs (see IAS 37) or termination benefits.

A plan amendment occurs when an entity introduces, or with draws, a defined benefit plan or changes the benefits payable under an existing defined benefit plan.
A curtailment occurs when an entity significantly reduces the number of employees covered by a plan. A curtailment may arise from an isolated event, such as the closing of a plant, discontinuance of an operation or termination or suspension of a plan.

Where an entity reduces benefits payable under an existing defined benefit plan and, at the same time, increases other benefits payable under the plan for the same employees, the entity treats the change as a single net change.

Gains and Losses on Settlement
The gain or loss on a settlement is the difference between:
(a) The present value of the defined benefit obligation being settled, as determined on the date of settlement; and
(b) The settlement price, including any plan assets transferred and any payments made directly by the entity in connection with the settlement.
An entity shall recognise a gain or loss on the settlement of a defined benefit plan when the settlement occurs.

RECOGNITION AND MEASUREMENT: PLAN ASSETS
Fair Value of Plan Assets Plan
assets are:
(a) Assets such as stocks and shares, held by a fund that is legally separate from the reporting entity, which exists solely to pay employee benefits.
(b) Insurance policies, issued by an insurer that is not a related party, the proceeds of which can only be used to pay employee benefits.

Points to Remember
1. The fair value of any plan assets is deducted from the present value of the defined benefit obligation in determining the deficit or surplus.
2. When no market price is available, the fair value of plan assets is estimated, for example, by discounting expected future cash flows using a discount rate that reflects both the risk associated

with the plan assets and the maturity or expected disposal date of those assets (or, if they have no maturity, the expected period until the settlement of the related obligation).

3. Plan assets exclude unpaid contributions due from the reporting entity to the fund, as well as any non-transferable financial instruments issued by the entity and held by the fund.

4. Plan assets are reduced by any liabilities of the fund that do not relate to employee benefits, for example, trade and other payables and liabilities resulting from derivative financial instruments.

Retirement Benefits Paid Out

During an accounting year, some of the plan assets will be paid out to retirees, thus discharging part of the benefit obligation. This is accounted for by:

Dr PV of defined benefit obligation	X	
CR FV of plan assets		X

There is no cash entry as the pension plan itself rather than the sponsoring employer pays money out.

Contributions Paid Into Plan

Contributions will be made into the plan as advised by the actuary. This is accounted for by:

DR FV of plan assets	X	
CR Cash		X

Re-measurements of the net defined benefit liability (asset)

Re-measurements of the net defined benefit liability (asset) comprise:

(a) Actuarial gains and losses;

(b) The return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset); and

(c) Any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset).

Return on Plan Assets

In determining the return on plan assets, an entity deducts the costs of managing the plan assets

(except other administration costs) and any tax payable by the plan itself

Exam Focus

The opening and closing obligation and plan assets can be reconciled as follows:

	PV of defined obligation	PV of plan benefit assets
	$	$
B/f at start of year (advised by actuary)	(X)	X
Retirement benefits paid out	X	(X)
Contributions paid into plan X Expected return on plan assets		X
Unwinding of interest	(X)	
Current service cost	(X)	____
	(X)	X
Re-measurement gains / losses (Balancing figure)	X(X)	X(X)
C/f at end of year (advised by actuary)	(X)	X

Asset Ceiling Test

When we looked at the recognition of the net defined benefit liability/ (asset) in the statement of financial position stated above, the term =asset ceiling ‘was mentioned.

This term relates to a threshold established by IAS 19 to ensure that any defined benefit asset (i.e. a pension surplus) is carried at no more than its recoverable amount. In simple terms, this means that any net asset is restricted to the amount of cash savings that will be available to the entity in future.

Net Defined Benefit Assets

A net defined benefit asset may arise if the plan has been overfunded or if actuarial gains have arisen. This meets the definition of an asset (as stated in the Framework) because all of the following apply. (a) The entity controls a resource (the ability to use the surplus to generate future benefits). (b) That control is the result of past events (contributions paid by the entity and service rendered by the employee).

(c) Future benefits are available to the entity in the form of a reduction in future contributions or a cash refund, either directly or indirectly to another plan in deficit.

The asset ceiling is the present value of those future benefits. The discount rate used is the same as that used to calculate the net interest on the net defined benefit liability/ (asset). The net defined benefit asset would be reduced to the asset ceiling threshold.

Any related write down would be treated as a re-measurement and recognised in other comprehensive income.

FV of plan assets

If the asset ceiling adjustment was needed in a subsequent year, the changes in its value would be treated, as follows:

(a) Interest (as it is a discounted amount) recognised in profit or loss a sprat of the net interest amount

(b) Other changes recognised in profit or loss.

Suggested approach and question

The suggested approach to defined benefit schemes is to deal with the change in the obligation and asset in the following order.

Step	Item	Recognition
1	Record opening figure • Asset • Obligation	
2	Interest cost on obligation • Based on discount rate and PV obligation at start of period. • Should also reflect any changes in obligation during period.	DEBIT Interest cost (P/L) (x% x b/d obligation) CREDIT PV defined benefit obligation (SOFP)

3	Interest on plan assets • Based on discount rate and asset value at start of period. • Technically, this interest is also time apportioned on contributions less-benefits paid in the period.	DEBIT Plan assets (SOFP) CREDIT Interest cost (P/L) (x% x b/d assets)

4	Current service cost Increase in the present value of the obligation resulting from employee service in the current period.	DEBIT Current service cost (P/L) CREDIT PV defined benefit obligation (SOFP)
5	Contributions As advised by actuary	DEBIT Plan assets (SOFP) CREDIT Company cash
6	Benefits Actual pension payments made	DEBIT PV defined benefit obligation (SOFP) CREDIT Plan assets (SOFP)
7	Past service cost Increase/decrease in PV obligation as a result of introduction or improvement of benefits.	Positive (increase ii obligation): DEBIT Past service cost (P/L) CREDIT PV defined benefit obligation (SOFP) Negative (decrease in obligation: DEBIT PV defined benefit obligation (SOFP) CREDIT Past service cost (P/L)

8	Gains and losses on settlement - Difference between the value of the obligation being settled and the settlement price	Gain DEBIT PV defined benefit obligation (SOFP) CREDIT Service cost (P/L) Loss DEBIT Service cost (P/L) CREDIT PV defined benefit obligation (SOFP)
9	Re-measurements: actuarial gains and losses • Arising from annual valuations of obligation. • On obligation, differences between actuarial assumptions and actual experience during	Gain DEBIT PV defined benefit obligation (SOFP) CREDIT Other comprehensive income (P/L) Loss DEBIT Other comprehensive income
	the period, or changes in actuarial assumptions.	(P/L) CREDIT PV defined benefit obligation (SOFP)
10	Re-measurements: return on assets - Arising from annual valuations of plan assets	Gain DEBIT FV plan assets (SOFP) CREDIT Other comprehensive income (P/L) Loss DEBIT Other comprehensive income (P/L) CREDIT FV plan assets (SOFP)

Other Long Term Benefits

Other long-term employee benefits include, for example:

(a) Long-term compensated absences such as long-service or sabbatical leave;

(b) Jubilee or other long-service benefits;

(c) Long-term disability benefits;

(d) Profit-sharing and bonuses payable twelve months or more after the end of the period in which the employees render the related service; and
(e) Deferred compensation paid twelve months or more after the end of the period in which it is earned.

Recognition and Measurement: Other Long Term Benefits

There are many similarities between these types of benefits and defined benefit pensions. For example, in a long-term bonus scheme, the employees may provide service over a number of periods to earn their entitlement to a payment at a later date. In some case, the entity may put cash aside, or invest it in some way (perhaps by taking out an insurance policy) to meet the liabilities when they arise.

As there is normally far less uncertainty relating to the measurement of these benefits, IAS 19 requires a simpler method of accounting for them. Unlike the accounting method for postemployment benefits, this method does not recognize re-measurements in other comprehensive income.

The entity should recognise all of the following in profit or loss.
(a) Service cost
(b) Net interest on the defined benefit liability (asset)
(c) Re-measurement of the defined benefit liability (asset)

Employee benefits

Test your understanding 1 – Deller

Deller has a defined contribution pension scheme. However, during the year, it introduced a new post-employment plan (the Fund) for its employees as a way of enhancing the benefits they will receive when they retire. Deller makes monthly contributions into the Fund that are equal to a set percentage of the salary cost.

Upon retirement, employees will receive annual payments from the Fund based on their number of years of service and their final salary.

The Fund is voluntary and Deller can cancel it at any point.

Deller has a history of paying employees benefits that are substantially above the national average, with annual increases in excess of inflation. Deller has won many accolades as a 'top employer' and received positive coverage from the national press when the Fund was announced.
The leadership-team are well trusted by the employees.

Required:

Advice Deller on whether the Fund is a defined benefit plan or a defined contribution plan.

Answer:

Test your understanding 1 – Deller

It is possible that there will be insufficient assets in the Fund to pay the benefits due to retired employees, particularly if final salaries or life expectancy rise substantially. Deller therefore bears actuarial and investment risk because, if it continues with the Fund, it would need to make up for any shortfall.

Although the Fund is voluntary and can be cancelled, Deller has a history of remunerating its employees above the national average as well as a strong reputation as a good and honest employer. Deller therefore has a constructive obligation to continue with the Fund and to ensure that its level of assets is sufficient.

As a result of the above, the Fund should be accounted for as a defined benefit plan.

Test your understanding 2 – Defined contribution scheme

An entity makes contributions to the pension fund of employees at a rate of 5% of gross salaries. For convenience, the entity pays $10,000 per month into the pension scheme with any balance being paid in the first month of the following accounting year. The wages and salaries for 2006 are $2.7 million.

Required:

Calculate the pension expense for 2006, and the accrual/ prepayment at the end of the year.

Answer:

Test your understanding 2 – Defined contribution scheme This

appears to be a defined contribution scheme.

The charge to profit or loss should be:

$2.7m x 5% = $135,000

The statement of financial position will therefore show an accrual of $15,000, being the difference between the $135,000 expense and the $120,000 ($10,000 x 12 months) cash paid in the year.

Illustration 1 – Defined benefit plan – Celine

The following information is provided in relation to a defined benefit plan operated by Celine. At 1 January 2004, the present value of the obligation was $140 million and the fair value of the plan assets amounted to $80 million.

	2004	2005
Discount rate at start of year	4%	3%
Current and past service cost ($m)	30	32
Benefits paid ($m)	20	22
Contribution into plan ($m)	25	30
Present value of obligation at 31 December ($m)	200	230
Fair value of plan assets at 31 December ($m)	120	140

Required:

Determine the net plan obligation or asset at 31 December 2004 and 2005 and the amounts to be taken to profit or loss other comprehensive income for both financial years.

Solution

The statement of financial position

	2004	2005
	$m	$m
PV of plan obligation	200.0	230.0
FV of plan assets	(120.0)	(140.0)

Closing net liability	80.0	90.0

The statement of profit or loss and other comprehensive income

Both the service cost component and the net interest component are charged to profit or loss for the year. The re-measurement component, which comprises actuarial gains and losses, together with returns on plan assets to the extent that they are not included within the net interest component, is taken to other comprehensive income.

	2004	2005
Profit or loss	$m	$m
Service cost component	30.0	32.0
Net interest component	2.4	2.4

	32.4	34.4
Other comprehensive income		
Re-measurement component	12.6	5.6
Total comprehensive income charge for year	45.0	40.0

Reconciliation of the net obligation for 2004 and 2005

	2004 $m	2005 $m
Obligation bal b/fwd 1 January	140.0	200.0
Asset bal b/fwd at 1 January	(80.0)	(120.0)
Net obligation b/fwd at 1 January	60.0	80.0
Service cost component	30.0	32.0
Net interest component		
4% x $60m	2.4	
3% x $80m		2.4
Contribution into plan	(25.0)	(30.0)
Benefits paid	-	-
Re-measurement component (bal.fig.)	12.6	5.6
Net obligation c/fwd at 31 December	80.0	90.0

Illustration 2 – Past service costs

An entity operates a pension plan that provides a pension of 2% of final salary for each year of service. On 1 January 2005, the entity improves the pension to 2.5% of final salary for each year of service, including service before this date. Employees must have worked for the entity for at least

five years in order to obtain this increased benefit. At the date of the improvement, the present value of the additional benefits for service from 1 January 2001 to 1 January 2005 is as follows:

	$000
Employee with more than five years' service at 1.1.05	150
Employees with less than five years' service at 1.1.05	
(Average length of service: two years)	120
	270

Required:

Explain how the additional benefits are accounted for in the financial statement of the entity.

Solution

The entity recognises all $270,000 immediately as an increase in the defined benefit obligation following the amendment to the plan on 1 January 2005. This will form part of the service cost component. Whether or not the benefits have vested by the reporting date is not relevant to their recognition as an expense in the financial statements.

Illustration 3 – Curtailments

AB decides to close a business segment. The segment's employees will be made redundant and will earn no further pension benefits after being made redundant. Their plan assets will remain in the scheme so that the employees will be paid a pension when they reach retirement age (i.e. this is a curtailment without settlement).

Before the curtailment, the scheme assets had a fair value of $500,000, and the defined benefit obligation had a present value of $600,000. It is estimated that the curtailment will reduce the present value of the future obligation by 10%, which reflects the fact that employees will not benefit from future salary increases and therefore will be entitled to a smaller pension than previously estimated.

Required:

What is net gain or loss on curtailment and how will this be treated in the financial statements?

Solution

The obligation is to be reduced by 10% x $600,000 = $60,000, with no change in the fair value of the assets as they remain in the plan. The reduction in the obligation represents a gain on curtailment which should be included as part of the service cost component and taken to profit or loss for the year. The net position of the plan following curtailment will be:

	Before	On Curtailment	After
	$000	$000	$000
Present value of obligation	600	(60)	540
Fair value of plan assets	(500)	-	(500)
Net obligation in SOFP	100	(60)	40

The gain on curtailment is $60,000 and this will be included as part of the service cost component in profit or loss for the year.

Test your understanding 3 – Fraser

The following information relates to a defined benefit plan operated by Fraser. At 1 January 2001, the present value of the obligation was $1,000,000 and the fair value of the plan assets amounted to $900,000.

	2001	2002	2003
Discount rate at start of year	10%	9%	8%
Current and past service cost ($000)	125	130	138
Benefits paid ($000)	150	155	165
Contributions paid into plan ($000)	90	95	105
PV of obligation at 31 December ($000)	1,350	1,340	1,450

FV of plan assets at 31 December ($000)	1,200	1,150	1,300

Required:

Show how the defined benefit plan would be shown in the financial statements for each of the years ended 31 December 2001, 2003 and 2003 respectively.

Answer:

Test your understanding 3 – Fraser

Statement of financial position

	2001	2002	2003
	$000	$000	$000
Net pension (asset)/ liability	150	190	150

Profit or loss and other comprehensive income for the year

	2001	2002	2003
	$000	$000	$000
Profit or loss			
Service cost component	125	130	138
Net interest component	10	14	15
Charge to profit or loss	135	144	153
Other comprehensive income:			
Re-measurement component	5	(9)	(88)
Total charge to comprehensive income	140	135	65

The re-measurement component on the net obligation

	2001	2002	2003

Net obligation at end of the year	150	190	150

	$000	$000	$000
Net obligation at start of the year	100	150	190
Net interest component (10% x 1/9% x 2/8% x 3)	10	14	15
Service cost component	125	130	138
Contributions into plan	(90)	(95)	(105)
Re-measurement (gain)/loss (bal.fig)	5	(9)	(88)

Test your understanding 4 – TC

TC has a defined benefit pension plan and prepares financial statements to 31 March each year. The following information is relevant for the year ended 31 March 2003:

- The net pension obligation at 31 March 2003 was $55 million. At 31 March 2002, the net obligation was $48 million, comprising the present value of the plan obligation stated at $100 million, together with plan assets stated at fair value of $52 million.
- The discount rate relevant to the net obligation was 6.25% and the actual return on plan assets for the year was $4 million.
- The current service cost was $12 million.
- At 31 March 2003, TC granted additional benefits to those currently receiving benefits that are due to vest over the next four years and which have a present value of $4 million at that date. They were not allowed for in the original actuarial assumptions.
- During the year, TC made pension contributions of $8 million into the scheme and the scheme paid pension benefits in the year amounting to $3 million.

Required:

Explain the accounting treatment of the TC pension scheme for the year to 31 March 2003, together with supporting calculations.

Answer:

Test your understanding 4 – TC

		$m
Net obligation brought forward		48
Net interest component (6.25% x 48)		3
Service cost component:		
Current service cost	12	
Past service cost	4	
		16
Contributions into the plan		(8)

Benefits paid	-
Re-measurement component (bal fig)	(4)
Net obligation carried forward	55

Explanation:

- The discount rate is applied to the net obligation brought forward. The net interest component is $3m and this is charged to profit or loss.
- The current year service cost, together with the past service cost forms the service cost component. Past service cost is charged in full, usually when the scheme is amended, rather than when the additional benefits vest. The total service cost component is $16m and this is charged to profit or loss.
- To the extent that there has been a return on assets in excess of the amount identified by application of the discount rate to the fair value of plan assets, this is part of the remeasurement component (i.e.$4m - $3.25m ($52m x 6.25%) = $0.75m).
- Contributions paid into the plan during the year of $8m reduce the net obligation.
- Benefits paid of $3 million will reduce both the scheme assets and the scheme obligation, so have no impact on the net obligation.
- The statement of financial position as at 31 March 2003 will show a net deficit (a liability) of $55m.

Test your understanding 5 – Mickleover

On 1 January 2003 Mickleover stated a defined benefit pension scheme for its employees and immediately contributed $4m cash into the scheme. The actuary has stated that the net obligation was $0.4m as at 30 June 2004. The interest rate for good quality corporate bonds was 10% at 1 July 2003 but 12% by 30 June 2004. The actual return on the plan assets was 11%. The increased cost from the employee's service in the year was $4.2m which can be assumed to accrue at the year end.

On 30 June 2004 Mickleover paid $0.3m in settlement of a defined benefit obligation with a present value of $0.2m. This related to staff that were to be made redundant although, as at 30 June 2004, they still had an average remaining employment term of one month. The redundancies were not foreseen at the start of the year.

Required:

Discuss the correct accounting treatment of the above transaction in the financial statements of Mickleover for the year ended 30 June 2004.

Answer:

Test your understanding 5 – Mickleover

- The accounting treatment of a defined benefit plan is as follows:
- The amount recognised in the statement of financial position is the present value of the defined benefit obligation less the fair value of the plan assets as at the reporting date.
- The opening net position should be unwound using a discount rate that applies to good quality corporate bonds. This should be charged/credited to profit or loss.
- The increased cost from the employees' service during the past year is known as a current service cost. This should be expensed against profits as part of the service cost component and credited to the pension scheme obligation.
- Curtailments should be recognised at the earlier of when the curtailment occurs or when the related termination benefits are recognised.
- The remeasured component should be included in other comprehensive income and identified as an item which will not be reclassified to profit and loss in future periods.

In relation to Mickleover:

- The net liability on the statement of financial position as 30 June 2004 is $0.4m.
- Although this is first year of the scheme cash of $4m was introduced at the start of the year and so this should be unwound at 10%.
- The net interest component credited to profit and loss will therefore be $0.4m (10% x $4m).The service cost arises at the year end and so is not unwound.
- Although the employees have not yet been made redundant, the costs related to the redundancy will have been recognised during the current reporting period. Therefore, a loss on curtailment of $0.1m ($0.3m - $0.2m) should also be recognised in the currency year. As the curtailment was not foreseen and would not have been included within the actuarial assumptions, the $0.1m should be charged against profits within the service cost component.

- The re-measurement loss, which includes the difference between the actual returns on plan assets and the amount taken to profit or loss as part of the net interest component, $0.5m (W1).

(W1) re-measurement component

		$m
Net obligation brought forward		0
Contributions		(4)
Net interest component (10% x $4m)		(0.4)
Service cost component:		
Current service cost	4.2	
Loss on cutailment	0.1	
		4.3
Benefits paid		-
Remeasurement component (bal fig)		0.5
Net obligation carried forward		0.4

Illustration 4 – The asset ceiling

The following information relates to a defined benefit plan:	$000
Fair value of plan assets	950
Present value of pension liability	800
Present value of future refunds and reductions in future	70

Contributions Required:

What is the value of the asset that recognised in the financial statement?

Solution

The amount that can be recognised is the lower of:

	$000
Present value plan obligation	800
Fair value of plan assets	(950)
	(150)

	$000
PV of future refunds and / or reductions in future contributions	(70)

Therefore the asset that can be recognised is restricted to $70,000.

Test your understanding 6 – Arc

The following information relates to the defined benefit plan operated by Arc for the year ended 30 June 2004:

	$m
FV of plan assets b/fwd at 30 June 2003	2,600
PV of obligation b/fwd at 30 June 2003	2,000
Current service cost for the year	100
Benefits paid in the year	80
Contributions into plan	90
FV of plan assets at 30 June 2004	3,100
PV of plan obligation at 31 June 2004	2,400

Discount rate for the defined benefit obligation – 10%

Arc has identified that the asset ceiling at 30 June 2003 and 30 June 2004, based upon the present value of future refunds from the plan and/or reductions in future contributions amounts to $200m at 30 June 2003 and 30 June 2004.

Required:

Explain, with supporting calculations, the accounting treatment of the pension scheme for the year ended 30 June 2004.

Answer:

Test your understanding 6 – Arc

	Net plan asset before ceiling adj	Ceiling adj*	Net plan asset after ceiling adj	Note
	$m	$m	$m	
Balance b/fwd	(600)	400	(200)	1
Net interest component (10%)	(60)	40	(20)	2
Service cost component	100	-	100	3
Benefits paid	-	-	-	4
Contributions in	(90)	-	(90)	5
Sub-total:	(650)	440	(210)	
Remeasurement component:	(50)	60	10	6

Balance c/fwd	(700)	500	(200) *note

that this is effectively a balancing figure.

Explanation:

(1) The asset ceiling adjustment at the previous reporting date of 30 June 2003 measures the net defined benefit asset at the amount recoverable by refunds and/or reduced future contributions, stated at $200m. In effect, the value of the asset was reduced for reporting purposes at 30 June 2003.

(2) Interest charged on the obligation or earned on the plan assets is based upon the discount rate for the obligation, stated at 10%. This will then require adjustment to agree with the net return on the net plan asset at the beginning of the year. Net interest earned is taken to profit or loss for the year.

(3) The current year service cost increases the plan obligation, which therefore reduces the net plan asset. The current year service cost is taken to profit or loss for the year.

(4) Benefits paid in the year reduce both the plan obligation and the plan assets by the same amount.

(5) Contributions into the plan increase the fair value of plan assets, and also the net plan asset during the year.

(6) The re-measurement component, including actuarial gains and losses for the year, is identified to arrive at the present value of the plan obligation and the fair value of the plan assets at 30 June 2004. As there is a net asset of $700m ($3,100 - $2,400) for the defined benefit pension plan, the asset ceiling test is applied to restrict the reported asset to the expected future benefits in the form of refunds and/or reduced future contributions. This is stated in the question to be $200m. To the extent that an adjustment is required to the net asset at the reporting date, this is part of the net re-measurement component.

IFRS 2 - SHARE BASED PAYMENTS

INTRODUCTION

Share-based payment occurs when any entity purchases goods or services from another party such as a supplier or employee and rather than paying directly in cash, settles the amount owing in shares, share options or future cash amounts linked to the value of shares.

Prior to the publication of IFRS 2 there appeared to be an anomaly to the extent that if a company paid its employees in cash, an expense was recognised in profit or loss, but if the payment was in share options, no expense was recognised.

IFRS 2 requirements

IFRS 2 requires an expense to be recoginsed in profit or loss in relation to share-based payments.

- The argument against expensing share-based payments was that there is no true expense although expense is being recognised.
- The main argument for was the share-based payments are simply another form of compensation that should go into the calculation of earnings for the sake of transparency for investors and the business community.

OBJECTIVE

The objective of this IFRS is to specify the financial reporting by an entity when it undertakes a share based payment transaction.

SCOPE

A share-based payment transaction is one in which the entity transfers equity instruments, such as shares or share options, in exchange for goods and services supplied by employees or third parties. IFRS 2 applies to all share-based payment transactions. The Standard recognises and addresses three types of transactions according to the method of settlement.

- Equity-settled share-based payment transactions

The entity receives goods or services in exchange for equity instruments of the entity (including shares or share options).

- Cash-settled share-based payment transactions

The entity receives goods or services in exchange for amounts of cash that are based on the price (or value) of the entity's shares or other equity Instruments of the entity.

- Transactions with a choice of settlement

The entity receives goods or services and either the entity or the supplier has a choice as to whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments.

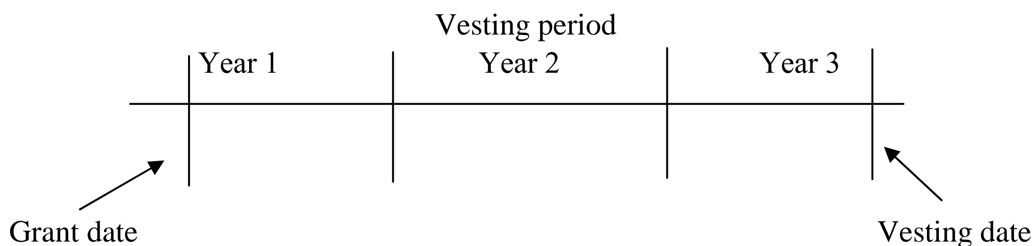
Transactions outside the scope of IFRS 2

The following are outside the scope of IFRS 2:

- Transactions with employees and others in their capacity as a holder of equity instruments of the entity
- The issue of equity instruments in exchange for control of another entity In a business combination
- Contracts that may or will be settled, net in company shares (IFRS 9)

DEFINITIONS

Before considering the accounting treatment of share-based payment transactions, it is important to understand the terminology used within the topic.



Share-based payment transaction A share-based payment transaction in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity.

Share-based payment arrangement an agreement between the entity and another party (including an employee) to enter into a share-based payment transaction, which thereby entitles the other party to receive cash or other assets of the entity for amounts that are based on the price of the entity's shares or other equity instruments of the entity, or to receive equity instruments of the entity, provided the specified vesting conditions, if any, are met.

Equity instrument A contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Equity instrument granted The right (conditional or unconditional) to an equity instrument of the entity conferred by the entity on another party, under a share-based payment arrangement.

Share option A contract that gives the holder the right, but not the obligation, to subscribe to the entity's shares at a fixed or determinable price for a specified period of time.

Grant date. The date at which the entity and another party (including an employee) agree to a share based payment arrangement, being when the entity and the other party have a shared understanding of the terms and conditions of the arrangement. At grant date the entity confers on the other party (the counterparty) the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained.

Intrinsic value The difference between the fair value of the shares to which the counterparty has the(conditional or unconditional) right to subscribe or which it has the right to receive, and the price (if any)the other party is (or will be) required to pay for those shares. For example, a share option with an exercise price of $15 on a share with a fair value of $20 has an intrinsic value of $5.

Measurement date The date at which the fair value of the equity instruments granted is measured. For transactions with employees and others providing similar services, the measurement date is grant date.
For transactions with parties other than employees (and those providing similar services), the measurement date is the date the entity obtains the goods or the counterparty renders service.

Vest To become an entitlement. Under a share-based payment arrangement, a counterparty‘s right to receive cash, other assets or equity instruments of the entity vests when the counterparty‘s entitlement is no longer conditional on the satisfaction of any vesting conditions.

Vesting conditions The conditions that must be satisfied for the counterparty to become entitled to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement. Vesting conditions include service conditions, which require the other party to complete a specified period of service, and performance conditions, which require specified

performance targets to be met (such as a specified increase in the entity's profit over a specified period of time).

Vesting period The period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied

General rules – A summary

RECOGNITION

- An entity shall recognize the goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received.
- When the goods or services received or acquired in a share-based payment transaction do not qualify for recognition as assets, they shall be recognized as expenses.
- Goods might be consumed over a period of time or, in the case of inventories, sold at a later date, in which case an expense is recognized when the goods are consumed or sold.
- The entity shall recognize a corresponding increase in equity if the goods or services were received in an equity-settled share-based payment transaction or a liability if the goods or services were acquired in a cash-settled share-based payment transaction.

MEASUREMENT

- For equity-settled share-based payment transactions, the entity shall measure the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably.
- If the entity cannot estimate reliably the fair value of the goods or services received, the entity shall measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted.

EQUITY-SETTLED SHARE-BASED PAYMENT TRANSACTIONS

Where payment for goods or services is in the form of shares or share options, the fair value of the transaction-is recognised in profit or loss, spread over the vesting period.

Introduction

If goods or services are received in exchange for shares or share options the transaction is accounted for by:

Dr. Expense/Asset

Cr. Equity

IFRS 2 does not stipulate which equity account the credit entry is made to. It is normal practice to credit a separate component of equity, mostly retained earnings are credited.

We must next consider:

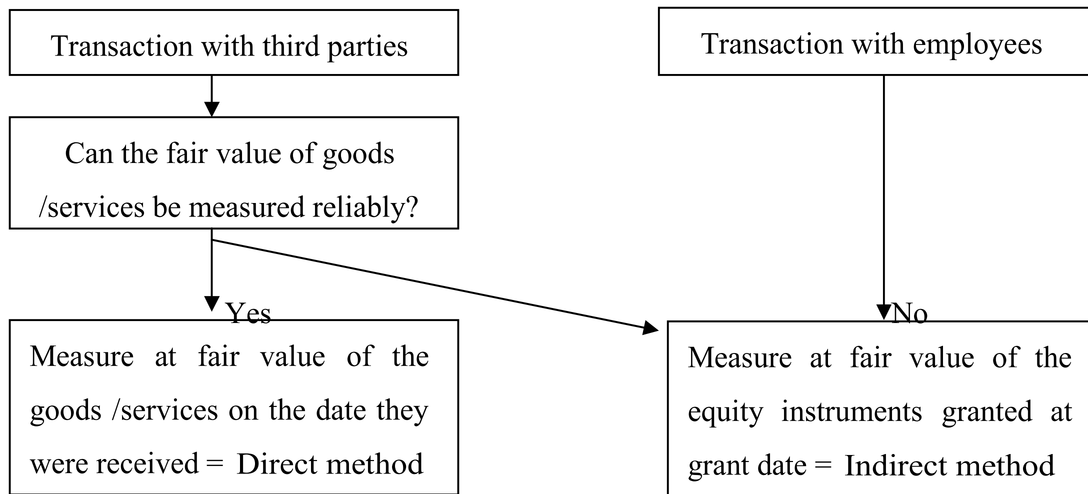
1 Measurement of the total expense taken to profit or loss 2
When this expense should be recorded.

Measurement

When considering the total expense to profit or loss, the basic principle is that equity-settled share-based transactions are measured at fair value.

Fair value will depend upon who the transaction is with:

- There is a rebuttable presumption that the fair value of goods / services received from a third party can be measured reliably.
- It is not normally possible to measure services received when the shares or share options form part of the remuneration package of employees.



Transactions in Which Services are Received

Allocation of expense to financial years

Immediate vesting

Where the instruments granted vest immediately, i.e. the recipient party becomes entitled to them immediately, and then the transaction is accounted for in full on the grant date.

Vesting period exists

Where entitlement to the instruments granted is conditional on vesting conditions, and these are to be met over a specified vesting period, the expense is spread over the vesting period.

Transactions with third parties (non-employees)

Applying the rules seen in the sections above, transactions with third parties are normally

- Measured at the fair value of goods / services received
- Recorded when the goods / services are received

Transactions with employees

Applying the rules seen in the sections above, transactions with employees are normally

- Measured at the fair value of equity instruments granted at grant date
- Spread over the vesting period (often a specified period of employment)

Immediate vesting

If the equity instruments granted vest immediately, the counterparty is not required to complete a specified period of service before becoming unconditionally entitled to those equity instruments. The entity shall presume that services rendered by the counterparty as consideration for the equity instruments have been received. In this case, on grant date the entity shall recognize the services received in full, with a corresponding increase in equity.

Vesting Period

If the equity instruments granted do not vest until the counterparty completes a specified period of service, the entity should account for those services as they are rendered by the counterparty during the vesting period.

Transactions Measured by Reference to the Fair Value of the Equity Instruments Granted

Determining the fair value of equity instruments granted

For transactions measured by reference to the fair value of the equity instruments granted, an entity shall measure the fair value of equity instruments granted at the measurement date, based on market prices if available.

If market prices are not available, the entity shall estimate the fair value of the equity instruments granted using a valuation technique to estimate what the price of those equity instruments would have been on the measurement date in an arm‘s length transaction between knowledgeable, willing parties.

Treatment of Vesting Conditions

The Impact of Different Types of Vesting Conditions Vesting conditions may be:

- Non-market based i.e. not relating to the market value of the entity's shares
- Market based i.e. linked to the market price of the entity's shares in some way

Non-market based vesting conditions

- These conditions are taken into account when determining the expense which must be taken to profit or loss in each year of the vesting period.
- Only the number of shares or share options expected to vest will be account for.

- At each period end (including interim periods), the number expected to vest should be revised as necessary
- On the vesting date, the entity should revise the estimate to equal the number of shares or share options that do actually vest.

Market Based Vesting Conditions

- These conditions are taken into account when calculating the fair value of the equity instruments at the grant date.
- They are not taken into account when estimating the number of shares or share options likely to vest at each period end.
- If the shares or share options do not vest, any amount recognised in the financial statements will remain.

Market and non-market based vesting conditions

Where equity instruments are granted with both, market and non-market vesting conditions, an entity should recognise an expense irrespective of whether market conditions are satisfied provided all other vesting conditions are satisfied.

In summary, where market and non-market conditions co-exist, it makes no difference whether the market conditions are achieved. The possibility that the target share price may not be achieved has already been taken into account when estimating the fair value of the options at grant date. Therefore, the amounts recognised as an expense in each year will be the same regardless of what share price has been achieved.

Other issues

Transactions during the year

Where the grant date arises mid-year, the calculation of the amount charged to profit or loss must be prorated to reflect that feet

Vested options not exercised

If, after the vesting date, options are not exercised or the equity instrument is forfeited, there will be no impact on the financial statements. This is because the holder of the equity instrument has effectively made that decision as an investor.

The services for which the equity instrument remunerated were received by the entity and the financial statements reflect the substance of this transaction. IFRS 2 does, however, permit a transfer to be made between reserves in such circumstances to avoid an amount remaining in a separate equity reserve where no equity instrument will be issued.

Variable vesting date

Where the vesting date is variable depending upon non-market based vesting conditions, the calculation of the amount expensed in profit or loss must be based upon the best estimate of when vesting will occur.

MODIFICATIONS AND RE-PRICING

Equity instruments may be modified before they vest.

E.g. A downturn in the equity market may mean that the original option exercise price set is no longer attractive. Therefore the exercise price is reduced (the option is 're-priced') to make it valuable again.

Such modifications will often affect the fair value of the instrument and therefore the amount recognized in profit or loss.

The accounting treatment of modifications and re-pricing is:

- Continue to recognise the original fair value of the instrument in the normal way (even where the modification has reduced the fair value).
- Recognise any increase in fair value at the modification date (or any increase in the number of instruments granted as a result of modification) spread over the period between the modification date and vesting date.
- If modification occurs after the vesting date, then the additional fair value must be recognized immediately unless there is, for example, an additional service period, in which case the difference is spread over this period.

CANCELLATIONS AND SETTLEMENTS

An entity may settle or cancel an equity instrument during the vesting period. Where this is the case, the correct accounting treatment is:

- To immediately charge any remaining fair value of the instrument that has not been recognised in profit or loss (the cancellation or settlement accelerates the charge and does not avoid it).
- Any amount paid to the employees by the entity on settlement should be treated as a buyback of shares and should be recognised as a deduction from equity. If the amount of any such payment is in excess of the fair value of the equity instrument granted, the excess should be recognised immediately in profit or loss.

Cancellation and reissuance

Where an entity has been through a capital restructuring or there has been a significant downturn in the equity market through external factors, an alternative to repricing the share options is to cancel them and issue new options based on revised terms. The end result is essentially the same as an entity modifying the original options and therefore should be recognised in the same way.

Repurchase after vesting

Where equity instruments are repurchased by an employing entity following vesting, this is similar to the entity providing the employee with cash remuneration in the first instance. The reporting therefore reflects this with the payment being recognised as a deduction from equity. The charge recognised in profit or loss will remain, as this reflects the services for which the employee has been remunerated. If the payment made is in excess of the fair value of the instruments granted, then this is recognized immediately in profit or loss reflecting that this is payment for additional services beyond what was originally agreed.

Determining the fair value of equity instruments granted

Where a transaction is measured by reference to the fair value of the equity instruments granted, fair value is based on market prices where available.

If marker price are not available the entity should estimate the fair value of the equity instruments granted

CASH SETTLED BASED TRANSACTIONS

- For cash-settled share-based payment transactions, the entity shall measure the goods or services acquired and the liability incurred at the fair value of the liability.

- Until the liability is settled, the entity shall remeasure the fair value of the liability at the end of each reporting period and at the date of settlement, with any changes in fair value recognised in profit or loss for the period.

If goods or services are received in exchange for cash amounts linked to the value of shares, the transactions is accounted for by:

Dr Expense/Asset

Cr Liability

TRANSACTION WITH A CHOICE OF SETTLEMENT

Counter party has the choice

For transactions with parties other than employees, the entity shall measure the equity component of the compound financial instrument as the difference between the fair value of the goods or services received and the fair value of the debt component, at the date when the goods or services are received.

Fair value of goods/services	$x
Less Liability (PV)	($x)
(R.V) Equity Option	$x

Double Entry:

Dr. Asset/ Expense $xxx

Cr. Liability $xxx Cr.

Equity Option $xxx

Liability will be re-measured

For transactions with employees, the entity shall measure the fair value of the compound financial instrument at the measurement date, taking into account the terms and conditions on which the rights to cash or equity instruments were granted.

Fair value of equity route/ alternative $xxx

Less liability (PV)	($xxx)
(R.V) Equity Option	$xxx

IFRS 2 requires that the value of the debt component is established first. The equity component is then measured as the residual between that amount and the value of the instrument as a whole. In this respect

IFRS 2 applies similar principles to IFRS 9 Financial Instruments, where the value of the debt components is established first. However, the method used to value the constituent parts of the compound instrument in IFRS 2 differs from that of IFRS 9.

Fair value of goods or service = Fair value of debt component + Equity component (residual)

For transactions in which the fair value of goods or services is measured directly (that is normally where the recipient is not an employee of the company), the fair value of the equity component is measured as the difference between the fair value of the goods or services required and the fair value of the debt component.

For other transactions including those with employees where the fair value of the goods or services is measured indirectly by reference to the fair value of the equity instruments granted, the fair value of the compound instrument is estimated as a whole.

The debt and equity components must then be valued separately. Normally transactions are structured in such a way that the fair value of each alternative settlement is the same.

Entity has the choice

When entity has the choice of settlement, the entity shall determine whether it has present obligation to deliver cash or not. Such circumstances arise where, for example, the entity is prohibited from issuing shares or where it has a stated policy, or past practice, of issuing cash rather than shares.

If the entity has a present obligation to settle in cash, the entity should record the transaction as if it is cash settled share based payment transaction.

If no present obligation exists, the entity should treat the transaction as if it was equity settled transaction.

On settlement, if the transaction was treated as an equity-settled transaction and cash was paid, the cash should be treated as if it was a repurchase of the equity instrument by a deduction against equity.

DEFERRED TAX IMPLICATIONS

Share based payments

Share-based transactions may be tax deductible in some jurisdictions. However, the amount deductible for tax purpose does not always correspond to the amount that is charged to profit or loss under IFRS 2.

In most cases it is not just the amount but also the timing of the expense allowable for tax purposes that will differ from that required by IFRS 2.

For example an entity recognises an expense for share options granted under IFRS 2, but does not receivea tax deduction until die options are exercised. The tax deduction will be based on the share price on the exercise date and will be measured on the basis of the options' intrinsic value
i.e. the difference between market price and exercise price at the exercise date.

In the case of share-based employee benefits under IFRS 2 the cost of the services as reflected in the financial statements is expensed and therefore the carrying amount is nil.

The difference between the carrying amount of nil and the tax base of share-based payment expense received to date is a deferred tax asset, provided the entity has sufficient future taxable profits to utilize this deferred tax asset.

The deferred tax asset temporary difference is measured as:

	$
Carrying amount of share-based payment expense	0
Less: tax base of share-based payment expense	<u>(X)</u>
(estimated amount tax authorities will permit as a deduction	

In future periods, based on year end information)

Temporary difference	(X)
Deferred tax asset at X%	X

If the amount of the tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction relates also to an equity item.

The excess is therefore recognised directly in equity. The examples below show the accounting for equity settled and cash-settled transactions.

DISCLOSURES

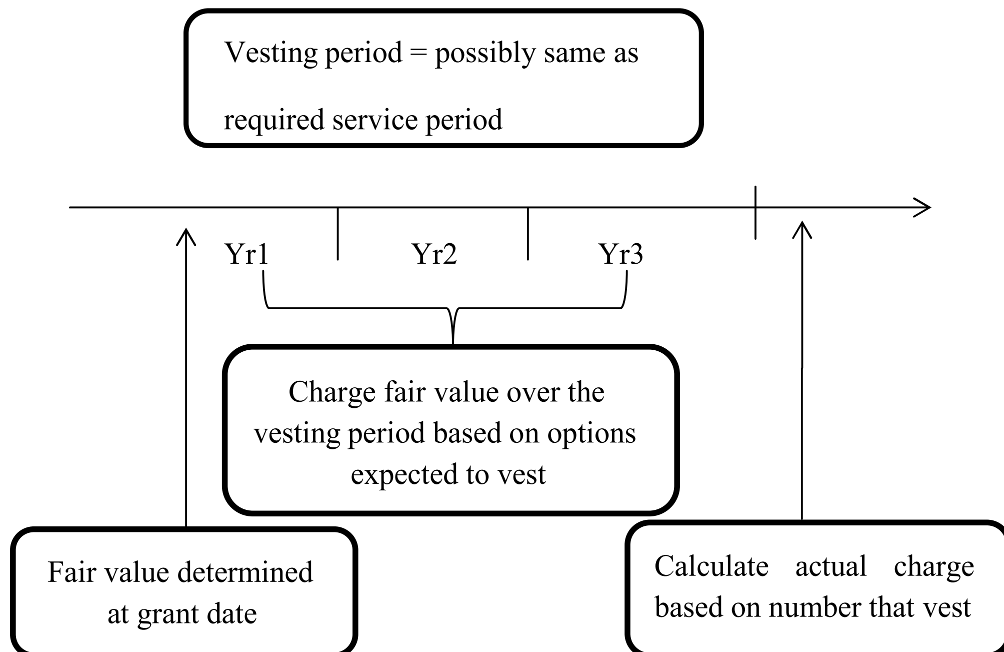
IFRS 2 requires extensive disclosures under three main headings:

- Information that enables users of financial statements to understand the nature and extent of the share-based payment transactions that existed during the period.
- Information that allows users of financial statements to understand how the fair value of the goods or services received, or the fair value of the equity instruments which have been granted during the period, was determined.
- Information that allows users of financial statements to understand the effect of expenses, which have arisen from share-based payment transactions, on the entity's profit or loss in the period.

Share-based payment

Illustration 1 – When to recognise the transaction

Grant date   Vesting date



Test your understanding 1 – Equity-settled share-based An entity has a reporting date of 31 December.

On 1 January 2001 it grants 100 share options to each or its 500 employees. Each grant is conditional upon the employee working for the entity until 31 December 2003. At the grant date the fair value of each share option is $15.

During 2001, 20 employees leaves and the entity estimates that a total of 20% of the 500 employees will leave during the three-year period.

During 2002, a further 20 employees leave and the entity now estimates that only 15% of the original 500 employees will leave during the three-year period.

During 2003, a further 10 employees leave.

Required:

Calculate the remuneration expense that will be recognised in each of the three year of the share-based payment scheme.

Answer:

Test your understanding 1 – Equity-settled share-based

The total expense recognised is based on the fair value of the share options granted at the grant date (1 January 2001). The entity recognises the remuneration expense as the employees' services are received during the three-year vesting period.

Year ended 31 December 2001

At 31 December 2001, the entity must estimate the number of options expected to vest by predicting how many employees will remain in employment until the vesting date. It believes that 80% of the employees will stay for the full three years and therefore calculates an expense based on this assumption:

(500 employees x 80%) x 100 options x $15 FV x 1/3 = $200,000

Therefore, an expense is recognised for $200,000 together with a corresponding increase in equity.
Year ended 31 December 2002

The estimate of the number of employees staying for the full three years is revised at each year end. At 31 December 2002, it is estimated that 85% of the 500 employees will stay for the full three years. The calculation of the share based payment expense is therefore as follows:

	$
(500 employees x 85%) x 100 options x $15 FV x 2/3	425,000
Less previously recognised expense	(200,000)
Expense in year ended 31 December 2002	225,000

Equity will be increased by $225,000 to $425,000 ($200,000 + $225,000).

Year ended 31 December 2003

A total of 50 (20 + 20 + 10) employees left during the vesting period. The expense recognised in the final year of the scheme is as follows:

$

(500 – 50 employees) x 100 options x $15 FV x 3/3	675,000
Less previously recognised expense	(425,000)
Expense in year ended 31 December 2003	250,000

The financial statements will include the following amounts:

Statement of profit or loss	2001	2002	2003
	$	$	$
Staff costs	200,000	225,000	250,000

Statement of financial position	2001	2002	2003
	$	$	$
Other components of equity	200,000	425,000	675,000

Test your understanding 2 – Market based conditions

On 1 January 2001, one hundred employees were given 50 share options each. These will vest if the employees still work for the entity on 31 December 2002 and if the share price on that date is more than $5.

On 1 January 2001, the fair value of the options was $1. The share price on 31 December 2001 was $3 and it was considered unlikely that the share price would rise to $5 by December 2002. Ten employees left during the year ended 31 December 2001 and a further ten are expected to leave in the following year.

Required:

How should the above transaction be accounted for in the year ended 31 December 2001?

Answer:

Test your understanding 2 – Market based conditions

Test expense recognised is based on the fair value of the options at the grant date. This should be spread over the vesting period.

There are two types of conditions attached to the share based payment scheme:

- A service condition (employees must complete a minimum service period)
- A market based performance condition (the share price must be $5 at 31 December 2002).

Although it looks unlikely that the share price target will be hit, this condition has already been factored into the fair value of the options at the grant dat. Therefore, this condition can be ignored when determining the charge to the statement of profit or loss.

The expense to be recognised should therefore be based on how many employees are expected to satisfy the service condition only.
The calculation is as follows:

(100 employees – 10 – 10) x 50 options x $1 FV x ½ = $2,000 The

entity to recognise this is:

Dr Profit or loss $2,000 Cr Equity $2,000

Test your understanding 3 – Blueberry

On 1 January 2004 an entity, Blueberry, granted share options to each of its 200 employees, subject to a three-year vesting period, provided that the volume of sales increases by a minimum of 5% per annum throughout the vesting period. A maximum of 300 share options per employee will vest, dependent upon the increase in the volume of sales throughout each year of the vesting period as follows:

- If the volume of sales increases by an average of between 5% and 10% per year, each eligible employee will receive 100 share options.
- If the volume of sales increases by an average of between 10% and 15% per year, each eligible employee will receive 200 share options.

- If the volume of sales increases by an average of over 15% per year, each eligible employee will receive 300 share options.

All the grant date, Blueberry estimated that the fair value of each option was $10 and that the increase in the volume of sales each year would be between 10% and 15%. It was also estimated that a total of 22% employees would leave prior to the end of the vesting period. At each reporting date within the vesting period, the situation was as follows:

Reporting date	Employees leaving in year	Further leavers expected prior to vesting date	Annual increase in sales volume	Expected sales volume increase over remaining vesting period	Average annual increase in sales volume to date
31 Dec x4	8	18	14%	14%	14%
31 Dec x5	6	4	18%	16%	16%
31 Dec x6	2		16%		16%

Required:

Calculate the impact of the above share-based payment scheme on Blueberry's financial statements in each reporting period.

Answer:

Test your understanding 3 – Blueberry

Rep. date	Calculation of equity	Equity	Expense	Note
		$000	$000	
31/12/04	(174 x 200 x $10) x 1/3	116	116	1
31/12/05	(182 x 300 x $10) x 2/3	364	248	2
31/12/06	(184 x 300 x $10) x 3/3	552	188	3

Note:

(1) At 31/12/04 a total of 26 employees (8 + 18) are expected to leave by the vesting date meaning that 174 are expected to remain. Blueberry estimates that average annual growth in sales volume will be 14%. Consequently, it is estimated that eligible employees would each receive 200 share options at the vesting date.
(2) At 31/12/05, a total of 18 employees (8 + 6 + 4) are expected to leave by the vesting date meaning that 182 are expected to remain. Blueberry estimates that the average growth in sales volume will be 16%. Consequently, it is estimated that eligible employees will each receive 300 share options at the vesting date.
(3) At 31/12/06, it is known that total of 16 employees (8 + 6 + 2) have left at some point during the vesting period, leaving 184 eligible employees. As average annual growth in sales volume over the vesting period was 16%, eligible employees are entitled to 300 share options each.

Testing your understanding 4 – Beginner

Beginner offered directors an option scheme conditional on a three-year period of service. The number of options granted to each of the ten directions at the inception of the scheme was 1 million. The options were exercisable shortly after the end of the third year. Upon exercise of the share options, those directors eligible would be required to pay $2 for each share of $1 nominal value.

The fair value of the options and the estimates of the number of options expected to vest at various points in time were as follows:

Year	Rights expected to vest	Fair value of the option
		$
State of Year One	8m	0.30
End of Year One	7m	0.33
End of Year Two	8m	0.37

At the end of year three, 9 million rights actually vested.

Required:

(a) Show how the option scheme will affect the financial statements for each of the three years of the vesting period.

(b) Show the accounting treatment at the vesting date for each of the following situations:

(i) The fair value of a share was $5 and eligible directions exercised their share options immediately.

(ii) The fair value of a share was $1.50 and all eligible directors allowed their share options to lapse.

Answer:

Testing your understanding 4 – Beginner

Year		Equity	Expense
		$000	$000
Year 1	(7m x $0.3 x 1/3)	700	700
Year 2	(8m x $0.3 x 2/3)	1,600	900
Year 3	(9m x $0.3)	2,700	1,100

Note: Equity-settled share-based payments are measured using the fair value of the instrument at the grant date (the start of year one).

(i) All eligible directors exercised their options:

The entity will post the following entry:

Dr Cash (9m x $2) $18,0m Dr Equity reserve $2.7m

Cr Share capital (9m x $1) $9.0m

Cr Share premium (bal. fig.) $11.7m

(ii) No options are exercised

The amount recognised in equity ($2.7m) remains. The entity can choose to transfer this to retained earnings.

Test your understanding 5 – Modifications

An entity grants 100 share options to each of its 500 employees, provided that they remain in service over the next three years. The fair value of each option is $20.

During year on, 50 employees leave. The entity estimates that a further 60 employees will leave during years two and three.

At the end of year one the entity reprices its share options because the share price has fallen. The other vesting conditions remain unchanged. At the date of repricing, the fair value of each of the original share options granted (before taking the repricing into account) was $10. The fair value of each repriced share option is $15.
During year two, a further 30 employees leave. The entity estimates that a further 30 employees will leave during year three.

During year three, a further 30 employees leave.

Required:

Calculate the amounts to be recognised in the financial statements for each of the three years of the scheme.

Answer:

Test your understanding 5 – Modifications

The repricing means that the total fair value of the arrangement has increased and this will benefit the employees. This in turn means that the entity must account for an increased remuneration expense. The increased cost is based upon the difference in the fair value of the option, immediately before and after the repricing. Under the original arrangement, the fair value of the repricing of the option at the date of repricing was $10, which increased to $15 following the reporting of the options, for each share estimated to vest. The additional cost is recognised over the remainder of the vesting period (years two and three).

The amounts recognised in the financial statements for each of the three years are as follows:

	Equity	Expwnse
	$	$
Year one original		

(500 – 50 – 6) x 100 x $20 x 1/3	260,000	260,000
Year two original		
(500 – 50 – 30 – 30) x 100 x $20 x 2/3		
Incremental	520,000	260,000
(500 – 50 – 30 – 30) x 100 x $5 x 1/3		
	97,500	97,500
	617,500	357,500
Year three original		
(500 – 50 – 30 – 30) x 100 x $20	780,000	260,000
Incremental		
(500 – 50 – 30 – 30) x 100 x $5	195,000	97,500
	975,000	357,500

Test your understanding 6 – Cancellations and settlements

An entity introduced an equity-settled share-based payment scheme on 1 January 2000 for its 5 directors. Under the terms of the scheme, the entity will grant 1,000 options to each director if they remain in employment for the next three years. All five directors are expected to stay for the full three years. The fair value of each option at the grant date was $8.

ON 30 June 2001, the entity decided to base its share-based payment schemes on profit targets instead. It therefore cancelled the existing scheme. On 30 June 2001, it paid compensation of $10 per option to each of the 5 directors. The fair value of the options at 30 June 2001 was $9.

Required:

Explain, with calculation, how the cancellation and settlement of the share-based payment scheme should be accounted for in the year ended 31 December 2001.

Answer:

Test your understanding 6 – Cancellations and settlements

The share option scheme has been cancelled. This means that all the expense not yet charged through profit or loss must now be recognised in the year ended 31 December 2001.

	$
Total expense	40,000
(5 directors x 1,000 options x $8)	
Less expense recognise in year ended 31 December 2000	(13,333)
Expense to be recognised	26,667

To recognise the remaining expense, the following entry must be posted:

Dr Profit or loss	$26,667
Cr Equity	$26,667

Any payment made in compensation for the cancellation that is up to the fair value of the options is recognised as a deduction to equity. Any payment in excess of the fair value is recognised as an expense.

The compensation paid to the director for each option exceeded the fair value by $1 ($10 - $9). Therefore, an expense of $1 per option should be recognised in profit or loss.

The following accounting entry is required:

Dr Equity (5 directors x 1,000 options x $9)	$45,000
Dr Profit or loss (5 directors x 1,000 options x $1)	$5,000
Cr Cash (5 directors x 1,000 options x $10)	$50,000

Illustration 2 – Cash settled share – based payment transactions An entity

has a reporting date of 31 December.

On 1 January 2001 the entity grants 100 share appreciation rights (SARs) to each of its 300 employees, on the condition that they continue to work for the entity until 31 December 2003.

During 2001, 20 employees leave. The entity estimates that a further 40 will leave during 2002 and 2003.

During 2002, 10 employees leave. The entity estimates that a further 20 will leave during 2003.

During 2003, 10 employees leave.

The fair value of a SAR at each reporting date is shown below:

	$
2001	10.00
2002	12.00
2003	15.00

Required:

Calculate the expense for each of the three years of the scheme, and the liability to be recognised in the statement of financial position as at 31 December for each of the three years.

Solution

Year	Liability at year-end	Expense for year
	$000	$000
2001 ((300 – 20 – 40) x 100 x $10 x 1/3)	80	80
2002 ((300 – 20 – 10 - 20) x 100 x $12 x 2/3)	200	120
2003 ((300 – 20 – 10 - 10) x 100 x $15)	390	190

Note that the fair value of the liability is remeasured at each reporting date. This is then spread over the vesting period.

Test your understanding 7 – Growler

On 1 January 2004 Growler granted 200 share appreciation rights (SARs) to each of its 500 employees on the condition that they continue to work for the entity for two years. At 1 January 2004, the entity expects that 25 of those employees will leave each year.

During 2004, 20 employees leave Growler. The entity expects that the same number will leave in the second year.

During 2005, 24 employees leave.

The SARs vest on 31 December 2005 and can be exercised during 2006 and 2007. On 31 December 2006, 257 of the eligible employees exercised their SARs in full. The remaining eligible employees exercised their SARs in full on 31 December 2007.

The fair value and intrinsic value of each SAR was as follows:

Reporting date	FV per SAR	Intrinsic value per SAR
31 December 2004	$5	
31 December 2005	$7	
31 December 2006	$8	$7
31 December 2007	$10	$10

Required:

(a) Calculate the amount to be recognised as a remuneration expense in the statement of profit or loss, together with the liability to be recognised in the statement of financial position, for each of the two years to the vesting date.

(b) Calculate the amount to be recognised as a remuneration expense and reported as liability in the financial statements for each of the two years ended 31 December 2006 and 2007.

Answer:

Test your understanding 7 – Growler

(a) The liability is remeasured at each reporting date, based upon the current information available relating to know and expected leavers, together with the fair value of the SAR at each date. The remuneration expense recognised is the movement in the liability from one reporting date to the next as summarized below:

Rep. date	Working	Liability Expense (SFP)	(P/L)
		$	$
31/12/04	(500 – 20 – 20) x 200 x $5 x 1/2	230,000	230,000
31/12/05	(500 – 20 – 24) x 200 x $7 x 2/2	638,400	408,400

(b) The number of employees eligible for a cash payment is 456 (500 – 20 -24). Of these, 257 exercise their SARs at 31/12/06 and the remaining 199 exercise their SARs at 31/12/07. The liability is measured at each reporting date, based upon the current information available at that date, together with the fair value intrinsic value at the date of exercise.

Year ended 31/12/06

	$
Liability b/fwd	638,400
Cash payment (257 x 200 x $7)	(359,800)
Profit or loss (bal. fig)	39,800
Liability c/fwd (199 x 200 x $8)	318,400

Year ended 31/12/07

	$
Liability b/fwd	318,400
Cash payment (199 x 200 x $10)	(398,000)
Profit or loss (bal. fig)	79,600
Liability c/fwd	nil

IAS 12 – INCOME TAXES

IAS 12, Income Taxes, deals with taxes on income, both current tax and deferred tax. Income tax accounting is complex, and preparers and users find some aspects difficult to understand and apply.

These difficulties arise from exceptions to the principles in the current standard, and from areas where the accounting does not reflect the economics of the transactions.

Objective

The objective of IAS 12 is to prescribe the accounting treatment for income taxes.

Definitions

Accounting profit

This is the net profit (or loss) for the reporting period before deducting tax expense.

Taxable Profit

This is the profit (or loss) for a period, determined in accordance with the local tax authority's rules, upon which income taxes are payable.

Tax Expense

Tax in the statement of profit or loss may consist of three elements:

- Current tax expense
- Adjustments to tax charges of prior periods (over/under provisions)
- Transfers to/from deferred tax.

CURRENT TAX

This is the amount of income tax payable (or recoverable) to tax authorities in relation to the current trading activities and the taxable profit (or loss) for the current period.

Measurement of Current Tax

The current tax expense for a period is based on the taxable and deductible amounts that will be shown on the tax return for the current year.

IAS 12 requires any unpaid tax in respect of the current or prior periods to be recognised as a liability. Conversely, any excess tax paid in respect of current or prior periods over what is due should be recognised as an asset to the extent it is probable that it will be recoverable.

The tax rate to be used in the calculation for determining a current tax asset or liability is the rate that is expected to apply when the asset is expected to be recovered, or the liability to be paid. These rates should be based upon tax laws that have already been enacted (are already part of law) or substantively enacted (have already passed through sufficient parts of the legal process that they are virtually certain to been acted) by the reporting date.

Accounting for Current Tax

In most jurisdictions, tax is paid several months after the end of the accounting period. At the period end, an estimated amount is accrued based on the year‘s profits:

Dr Income tax expense (P&L) estimated tax charge

Cr Tax payable (liability in SOFP) estimated tax charge

When the tax is actually paid some months later, it is recorded by:

Dr Tax payable (SFP) amount paid

Cr Cash amount paid.

Since the amount paid is likely to differ from the estimated tax charge originally accrued, a balance is left on the tax payable account:

Tax payable			
ash (tax paid)	X	Income tax (estimated tax charge)	X
verprovision c/f	X	Under provision c/f	X

An overprovision arises where the actual tax paid is less than the estimated tax charge. This reduces the following year‘s tax charge in the statement of profit or loss.

An under provision arises where the actual tax paid is more than the estimated charge. This increases the following year‘s tax charge in the statement of profit or loss.

Recognition of current tax

Normally, current tax is recognised as income or expense and included in the net profit or loss for the period. However, where tax arises from a transaction or event which is recognised as other comprehensive income recognised directly in equity (in the same or a different period) rather than in profit or loss, then the related tax should also be reported as other comprehensive income or reported directly in equity. An example of such a situation is where, under IAS 8, an adjustment is made to the opening balance of retained earnings due to either a change in accounting policy that is applied retrospectively, or to the correction of a material error. Any related tax is therefore also recognised directly in equity.

Presentation

Statement of financial position, tax assets and liabilities should be shown separately. Current tax assets and liabilities may be offset, only under the following conditions.

- The entity has a legally enforceable right to set off the recognised amounts.
- The entity intends to settle the amounts on a net basis, or to realise the asset and settle the liability at the same time.

The tax expense (income) related to the profit or loss from ordinary activities should be shown on the face of the statement of profit or loss and other comprehensive income as part of profit or loss for the period.

Summary: Accounting for Current Tax

- Current taxes include tax payable for current period and adjustment of under/over provision of prior periods
- Current taxes are to be treated as an expense
- If the tax expense and the provision at the end of the year are greater than the payment, the shortfall in the payment will be disclosed as a current tax liability and vice versa.

DEFERRED TAX

A mismatch can occur because International Financial Reporting Standards (IFRS) recognition criteria for items of income and expense are different from the treatment of items under tax law. Deferred taxation accounting attempts to deal with this mismatch. The IAS 12 standard is based on the temporary differences between the tax base of an asset or liability and its carrying amount in the financial statements.

Tax Base

This is the amount attributed to an asset or liability for tax purposes, based on the expected manner of recovery.

IAS 12 focuses on the future tax consequences of recovering an asset only to the extent of its carrying amount at the date of the financial statements. Future taxable amounts arising from recovery of the asset will be capped at the asset's carrying amount.

For example, a property may be revalued upwards but not sold, creating a temporary difference because the carrying amount of the asset in the financial statements is greater than the tax base of the asset. The tax consequence is a deferred tax liability.

Tax base-Asset

The tax base of an asset is the value of the asset in the current period for tax purposes. This is either;

- The amount that will be tax deductible in the future against taxable economic benefits when the carrying amount of the asset is recovered, or
- If those economic benefits are not taxable, the tax base is equal to the carrying amount of the asset.

Tax base-Liability

- The tax base of a liability is its carrying amount less any amount that will be tax deductible in the future.
- For revenue received in advance, the tax base of the resulting liability is its carrying amount less any amount of the revenue that will not be taxable in future periods.

Revenue received in advance.

The tax base of the recognised liability is its carrying amount, less revenue that will not be taxable in future periods

Un-recognised items

If items have a tax base but are not recognised in the statement of financial position, the carrying amount is nil

Tax bases not immediately apparent

If the tax base of an item is not immediately apparent, the tax base should effectively be determined in such as manner to ensure the future tax consequences of recovery or settlement of the item is recognised as a deferred tax amount.

Consolidated financial statements

In consolidated financial statements, the carrying amounts in the consolidated financial statements are used, and the tax bases determined by reference to any consolidated tax return (or otherwise from the tax returns of each entity in the group).

CASES OF NO DEFERRED TAX

IAS 12 states that in the following circumstances, the tax base of an asset or liability will be equal to its carrying amount:

- Accrued expenses that have already been deducted in determining an entity's tax liability for the current or earlier periods.
- A loan payable that is measured at the amount originally received and this amount is the same as the amount repayable on final maturity of the loan.
- Accrued income that will never be taxable.

ACCOUNTING FOR DEFERRED TAX

Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

In simple terms, deferred tax is tax that is payable in the future. However, to understand this definition more fully, it is necessary to explain the term = taxable temporary differences'.

Deferred tax assets are the amounts of income taxes recoverable in future periods in respect of:

- Deductible temporary differences
- The carry forward of unused tax losses
- The carry forward of unused tax credits

A deferred tax asset is recognised to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be used. This also applies to deferred tax assets for unused tax losses carried forward.

This is an application of prudence concept.

Reassessment of un-recognised deferred tax assets

For all un-recognised deferred tax assets, at each reporting date an entity should reassess the availability of future taxable profits and whether part or all of any un-recognised deferred tax assets should now be recognised. This may be due to an improvement in trading conditions which is expected to continue.

TEMPORARY DIFFERENCES

Temporary differences are differences between the carrying amount of an asset or liability in the SOFP and its tax base.

Temporary differences may be of two types:

i. Taxable temporary differences are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

IAS 12 requires that a deferred tax liability is recorded in respect of all taxable temporary differences that exist at the year-end – this is sometimes known as the full provision method.

Within financial statements, non-current assets with a limited economic life are subject to depreciation. However, within tax computations, non-current assets are subject to capital allowances (also known as tax depreciation) at rates set within the relevant tax legislation. Where at the year-end the cumulative depreciation charged and the cumulative capital allowances claimed are different, the carrying value of the asset (cost less accumulated depreciation) will then be different to its tax base (cost less accumulated capital allowances) and hence a taxable temporary difference arises.

Examples

A taxable temporary difference occurs when:

- Depreciation or amortisation is accelerated for tax purposes
- Development costs capitalised in the statement of financial position deducted against taxable profit when the expenditure was incurred
- Interest income is included in the statement of financial position when earned, but included in taxable profit when the cash is actually received.
- Prepayments in the statement of financial position deducted against taxable profits when the cash expense was incurred.
- Revaluation/Fair value adjustment of assets with no adjustment of the tax base.
- Deferred tax on impairment where these adjustments are ignored for tax purposes until the asset is sold.

ii. Deductible temporary differences are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

A deferred tax asset (DTA) shall be recognised for all deductible temporary differences to the extent it is probable that taxable profit will be available against which the deductible temporary difference can be utilised.

- Provisions, accrued product warranty costs for which the taxation laws do not permit the deduction until the company actually pays the claims. This is a deductible difference as its taxable profits for the current period will be higher than those in future, when they will be lower.

Calculation of Deferred taxes

Deferred tax assets and deferred tax liabilities can be calculated using the following formulae:

Temporary difference	=	Carrying amount	- Tax base
Deferred tax asset or liability	=	Temporary difference	x Tax rate

The following formula can be used in the calculation of deferred taxes arising from unused tax losses or unused tax credits:

Deferred tax asset = Unused tax loss or unused tax credits x Tax rate Measurement of deferred tax assets and liabilities

Deferred tax is provided in full for all temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements.

Tax rates

- Measurement shall be at the tax rates expected to apply to the period when the asset is realised or liability is settled.
- The rates used shall be those enacted or substantially enacted by the end of the reporting period.
- Measurement depends upon the expectations about the manner in which the recovery of tax asset or settlement of tax liability will take place.
- Deferred tax expense is recognized as an expense in statement of profit or loss. If the tax relates to items that are credited or charged directly to equity, then this current tax and deferred tax shall also be charged or credited directly to equity.

- A change in tax rates or tax laws, a reassessment of the recoverability of deferred tax assets or a change in the expected manner of recovery of an asset have tax consequences that are recognized in profit or loss, except to the extent that they relate to items previously charged or credited outside profit or loss.
- The measurement of deferred tax liabilities and deferred tax assets reflects the tax consequences of the manner in which the entity expects to recover or settle the carrying amount of its assets and liabilities. The expected manner of recovery for land with an unlimited life is always through sale, but for other assets the manner in which management expects to recover the asset, either through use or sale or both, should be considered at each date of the financial statements.
- Where the tax rate or tax base is impacted by the manner in which the entity recovers its assets or settles its liabilities (e.g. whether an asset is sold or used), the measurement of deferred taxes is consistent with the way in which an asset is recovered or liability settled
- Where deferred taxes arise from revalued non-depreciable assets (e.g. revalued land), deferred taxes reflect the tax consequences of selling the asset
- Deferred taxes arising from investment property measured at fair value under IAS 40 Investment
- Property reflect the rebuttable presumption that the investment property will be recovered through sale
- If dividends are paid to shareholders, and this causes income taxes to be payable at a higher or lower rate, or the entity pays additional taxes or receives a refund, deferred taxes are measured using the tax rate applicable to undistributed profits

Discounting

- In the case of deferred tax assets and liabilities, the values are not to be discounted. Deferred tax assets and liabilities should not be discounted because the complexities and difficulties involved will affect reliability and comparability would be affected.

However that where carrying amounts of assets or liabilities are discounted (e.g. a pension obligation), the temporary difference is determined based on a discounted value.

RECOGNITION OF DEFERRED TAX IN THE FINANCIAL

STATEMENTS

The deferred tax amount calculated is recorded as a deferred tax balance in the statement of financial position with a corresponding entry to the tax charge, other comprehensive income or goodwill.

Principles of recognition

As with current tax, deferred tax should normally be recognised as income or an expense amount within the tax charge, and included in the net profit or loss for the period. Only the movement in the deferred tax asset / liability on the statement of financial position is recorded:

Dr	Tax charge	X	
Cr	Deferred tax liability		X
Or			
Dr	Deferred tax asset	X	
Cr	Tax charge		X

Note that the recognition of a deferred tax asset may be restricted

Therefore, the movement in the deferred tax liability in the year is recorded in the statement of profit or loss where:

- An increase in the liability, increases the tax expense
- A decrease in the liability decreases the tax expense.

The closing figures are reported in the Statement of Financial Position as the deferred tax liability.

Exceptions to recognition in profit or loss

- Deferred tax relating to items dealt with as other comprehensive income (such as a revaluation) should be recognised as tax relating to other comprehensive income within the statement of comprehensive income.
- Deferred tax relating to items dealt with directly in equity (such as the correction of an error or retrospective application of a change in accounting policy) should also be recognised directly in equity.
- Deferred tax resulting from a business combination is included in the initial cost of goodwill (This is covered in more detail later in the chapter).

- Initial recognition of an asset or liability in a transaction that is not a business combination and that affects neither accounting profit nor taxable profit.
- Investments in subsidiaries, branches, associates and joint ventures where certain criteria apply.

Where it is not possible to determine the amount of current/deferred tax that relates to other comprehensive income and items credited/charged to equity, such tax amounts should be based on a reasonable pro rata allocation of the entity's current/deferred tax.

COMPONENTS OF DEFERRED TAX

Deferred tax charges will consist of two components:

(a) Deferred tax relating to temporary differences.

(b) Adjustments relating to changes in the carrying amount of deferred tax assets/ liabilities (where there is no change in temporary differences), e.g. changes in tax rates/ laws, reassessment of the recoverability of deferred tax assets, or a change in the expected recovery of an asset Common scenarios

There are a number of common examples which result in a taxable or deductible temporary difference. This list is not, however exhaustive.

TAXABLE TEMPORARY DIFFERENCES

Accelerated capital allowances

- These arise when capital allowances for tax purposes are received before deductions for accounting depreciation are recognised in the statement of financial position (accelerated capital allowances).
- The temporary difference is the difference between the carrying amount of the asset at the reporting date and its tax written down value (tax base).
- The resulting deferred tax is recognised in profit or loss.

Interest revenue

- In some jurisdictions interest revenue may be included in profit or loss on an accruals basis, but taxed when received.

- The temporary difference is equivalent to the income accrual at the reporting date as the tax base of the interest receivable is nil.
- The resulting deferred tax is recognised in profit or loss.

Development costs

- Development costs may be capitalised for accounting purposes in accordance with IAS 38 while being deducted from taxable profit in the period incurred (i.e. they receive immediate tax relief).
- The temporary difference is equivalent to the amount capitalised at the reporting date as the tax base of the costs is nil since they have already been deducted from taxable profits.
- The resulting deferred tax is recognised in profit or loss.

Revaluations to fair value-property, plant and equipment

IFRS permits or requires some assets to be revalued to fair value, e.g. property, plant and equipment under IAS 16.

Temporary difference

In some jurisdictions a revaluation will affect taxable profit in the current period. In this case, no temporary difference arises as both carrying value and the tax base are adjusted.

In other jurisdictions, including the UK, the revaluation does not affect taxable profits in the period of revaluation and consequently, the tax base of the asset is not adjusted. Hence a temporary difference arises.

This should be provided for in full based on the difference between carrying amount and tax base.

An upward revaluation will therefore give rise to a deferred tax liability, even if:

- The entity does not intend to dispose of the asset
- Tax due on any future gain can be deferred through rollover relief

This is because the revalued amount will be recovered through use which will generate taxable income in excess of the depreciation allowable for tax purposes in future periods.

Manner of recovery

The carrying amount of a revalued asset may be recovered

- Through sale, or
- Through continued use.

The manner of recovery may affect the tax rate applicable to the temporary difference, and / or the tax base of the asset.

Recording deferred tax

As the underlying revaluation is recognised as other comprehensive income, so the deferred tax thereon is also recognised as part of tax relating to other comprehensive income. The accounting entry is therefore:

Dr	Tax on other comprehensive income	X	
Cr	Deferred tax liability		X

Non-depreciated revalued assets

Recovery of Revalued Non-Depreciable Assets requires that deferred tax should be recognised even where non-current assets are not depreciated (e.g. land). This is because the carrying value will ultimately be recovered on disposal.

Revaluations to fair value - other assets

IFRS permit or require certain other assets to be revalued to fair value, for example:

- Certain financial instruments under IFRS 9
- Investment properties under IAS 40

Where the revaluation is recognised in profit or loss (e.g. fair value through profit or loss instruments, investment properties) and the amount is taxable / allowable for tax, and then no deferred tax arises as both the carrying value and the tax base are adjusted.

Where the revaluation is recognised as other comprehensive income (e.g. financial assets at fair value through other comprehensive income) and does not therefore impact taxable profits, then the

tax base of the asset is not adjusted and deferred tax arises. This deferred tax is also recognised as other comprehensive income.

Retirement benefit costs

In the financial statements, retirement benefit costs are deducted from accounting profit as the service is provided by the employee. They are not deducted in determining taxable profit until the entity pays either retirement benefits or contributions to a fund. Thus a temporary difference may arise.

- A deductible temporary difference arises between the carrying amount of the net defined benefit liability and its tax base. The tax base is usually nil.
- The deductible temporary difference will normally reverse.
- A deferred tax asset is recognised for this temporary difference to the extent that it is recoverable, that is sufficient profit will be available against which the deductible temporary difference can be utilised.
- If there is a net defined benefit asset for example when there is a surplus in the pension plan, a taxable temporary difference arises and a deferred tax liability is recognised.

Under IAS 12, both current and deferred tax must be recognised outside profit or loss if the tax relates to items that are recognised outside profit or loss. This could make things complicated as it interacts with IAS 19 Employee benefits.

IAS 19 allows a choice of accounting policy regarding recognition of actuarial gains and losses:
In profit or loss either in the period in which they occur or deferred on a systematic basis In other comprehensive income in the period in which they occur.

It may be difficult to determine the amount of current and deferred tax that relates to items recognised in profit or loss or in other comprehensive income. As an approximation, current and deferred taxes are allocated on an appropriate basis, often pro rata.

Deferred tax movement relating to the actuarial losses

IAS 12 Income Taxes requires deferred tax relating to items charged or credited to other comprehensive income to be recognised in other comprehensive income hence the amount of the

deferred tax move mentrelating to the actuarial losses charged directly to OCI must be split out and credited directly to OCI.

Dividends receivable from overseas companies

- Dividends received from UK companies are not taxable on other UK companies. Dividends received from overseas companies, however, are.
- Overseas dividends receivable may be included in profit or loss on an accruals basis, but taxed when received.
- The temporary difference is equal to the dividend receivable (asset) at the reporting date, as the tax base of the dividend receivable is nil.
- The calculation of deferred tax should take into account any double taxation relief which may be available.
- The deferred tax arising is recognised in profit or loss.

DEDUCTIBLE TEMPORARY DIFFERENCES

Tax losses

Where tax losses arise, the manner of recognition of these in the financial statements depends upon how they are expected to be utilised.

- If losses are carried back to crystallise a refund, then a receivable is recorded in the statement of financial position and the corresponding credit is to the current tax charge.
- If losses are carried forward to be used against future profits or gains, then they should be recognisedas deferred tax assets to the extent that it is probable that future taxable profit will be available against which the losses can be used.

Unused tax credits carried forward against taxable profits will also give rise to a deferred tax asset to the extent that profits will exist against which they can be utilised.

Recognition of deferred tax asset

The existence of unused tax losses is strong evidence that future taxable profit may not be available. The following should be considered before recognising any deferred tax asset:

- Whether an entity has sufficient taxable temporary differences against which the unused tax losses can be offset
- Whether it is probable that the entity will have taxable profits before the unused tax losses expire
- Whether the tax losses result from identifiable causes which are unlikely to recur
- Whether tax planning opportunities are available to create taxable profit

Group tax relief

Where the acquisition of a subsidiary means that tax losses which previously could not be utilised, can now be utilised against the profits of the subsidiary, a deferred tax asset may be recognised in the financial statements of the parent company. This amount is not taken into account in calculating goodwill arising on acquisition.

Provisions

- A provision is recognised for accounting purposes when there is a present obligation, but it is not deductible for tax purposes until the expenditure is incurred
- In this case, the temporary difference is equal to the amount of the provision, since the tax base is nil
- Deferred tax is recognised in profit or loss

Share based payments

Share-based transactions may be tax deductible in some jurisdictions. However, the amount deductible for tax purposes does not always correspond to the amount that is charged to profit or loss under IFRS 2.

In most cases it is not just the amount but also the timing of the expense allowable for tax purposes that will differ from that required by IFRS 2.

For example an entity recognises an expense for share options granted under IFRS 2, but does not receive a tax deduction until the options are exercised. The tax deduction will be based on the share price on the exercise date and will be measured on the basis of the options' intrinsic value i.e. the difference between market price and exercise price at the exercise date. In the case of share-based

employee benefits under IFRS 2 the cost of the services as reflected in the financial statements is expensed and therefore the carrying amount is nil.

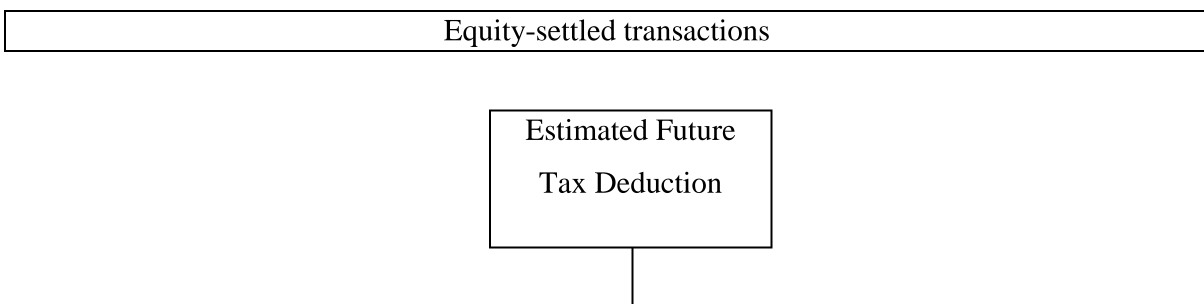
The difference between the carrying amount of nil and the tax base of share-based payment expense received to date is a deferred tax asset, provided the entity has sufficient future taxable profits to utilize this deferred tax asset

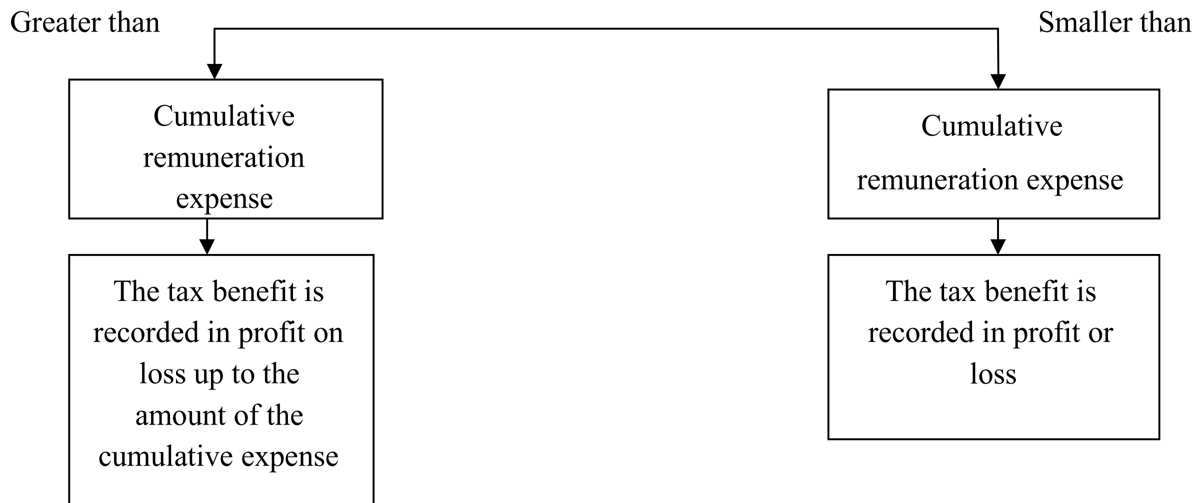
The deferred tax asset temporary difference is measured as:

	$
Carrying amount of share-based payment expense	0
Less: tax base of share-based payment expense	(X)
(estimated amount tax authorities will permit as a deduction in future periods, based on year end information)	
Temporary difference	(X)
Deferred tax asset at X%	X

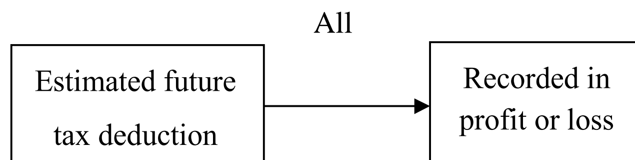
If the amount of the tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction relates also to an equity item.

The excess is therefore recognised directly in equity. The diagrams below show the accounting for equity settled and cash-settled transactions.





Cash-settled transactions



DEFERRED TAX ARISING FROM A BUSINESS COMBINATION

Fair value adjustments on consolidation

The tax benefit is recorded in profit or loss Recorded in profit or loss IFRS 3 requires assets acquired on acquisition of a subsidiary or associate to be recognized at their fair value rather than their carrying amount in the individual financial statements of the subsidiary. The fair value adjustment does not, however, have any impact on taxable profits or the tax base of the asset.

This is much like a revaluation in an individual company's accounts.

Therefore, an upwards fair value adjustment made to an asset will result in the carrying value of the asset exceeding the tax base and so a taxable temporary difference will arise.

The resulting deferred tax liability is recorded in the consolidated accounts by:

Dr Goodwill (group share)

Cr Deferred tax liability

Undistributed profited of subsidiaries, branches, associated and joint ventures

- The carrying amount of, for example, a subsidiary in consolidated financial statement is equal to the group share of the net assets of the subsidiary plus purchased goodwill.
- The tax base is usually equal to the cost of the investment.
- The difference between these two amounts is a temporary difference. It can be calculated as the parent‘s share of the subsidiary‘s post acquisition profits which have not been distributed.

Recognition of deferred tax

A deferred tax liability should be recognized on the temporary difference unless:

- The parent / investor / venture is able to control the timing of the reversal of the temporary difference, and
- It is probable that the temporary difference will not reverse (i.e. the profits will not be paid out) in the foreseeable future.

This can be applied to different levels of investment as follows:

- Subsidiary

As a parent company can control the dividend policy of a subsidiary, deferred tax will not arise in relation to undistributed profits.

- Associate

An investor in an associate does not control that entity and so cannot determine its dividend policy. Without an agreement requiring that the profits of the associate should not be distributed in the foreseeable future, therefore, an investor should recognize a deferred tax liability arising from taxable temporary differences associated with its investment in the associate. Where an investor cannot determine the exact amount of tax, but only a minimum amount, then the deferred tax liability should be that amount.

- Joint venture

In a joint venture, the agreement between the parties usually deals with profit sharing. When a venture can control the sharing of profits and it is probable that the profits will not be distributed in the foreseeable future, a deferred liability is not recognized.

Changes in foreign exchange rates

Where a foreign operation's taxable profit or tax loss (and therefore the tax base of its nonmonetary assets and liabilities) is determined in a foreign currency, changes in the exchange rate give rise to taxable or deductible temporary differences.

These relate to the foreign entity's own assets and liabilities, rather than to the reporting entity's investment in that foreign operation, and so the reporting entity should recognize the resulting deferred tax liability or asset, both these are probable:

a) That the temporary difference will reverse in the foreseeable future, and
b) That taxable profit will be available against which the temporary difference can be utilized.

DEDUCTIBLE TEMPORARY DIFFERENCES

Un-realised profits on intra-group trading

- From a tax perspective, one group company selling goods to another group company is taxed on the resulting profit in the period that the sale is made.
- From an accounting perspective no profit is realized until the recipient group company sells the goods to a third party outside the group. This may occur in a different accounting period from that in which the initial group sale is made.
- A temporary difference therefore arises equal to the amount of unrealized intra-group profit. This is the difference between:
  - Tax base, being cost to the recipient company (i.e. cost to selling company plus unrealized intra-group profit on sale to the recipient company)
  - Carrying value to the group, being the original cost to the selling company, since the intra-group profit is eliminated on consolidation
- Deferred tax is provided on consolidation

Fair value adjustments

IFRS 3 requires assets and liabilities acquired on acquisition of a subsidiary or associate to be brought in at their fair value rather than the carrying amount. The fair value adjustment does not, however, have any impact on taxable profits or the tax base of the asset.

Therefore a fair value adjustment which increases a recognized liability or creates a new liability will result in the tax base of the liability exceeding the carrying value and so deductible temporary difference will arise.

A deductible temporary difference also arises where an asset�something carrying amount is reduced to a fair value less than its tax base.

The resulting deferred tax asset is recorded in the consolidated accounts by:

Dr	Deferred tax asset	X	
Cr	Goodwill		X

Deferred tax assets of an acquired subsidiary

Deferred tax assets of a subsidiary may not satisfy the criteria for recognition when a business combination is initially accounted for but may be realized subsequently.
These should be recognized as follows:

- If recognized within 12 months of the acquisition date and resulting from new information about circumstances existing at the acquisition date, the credit entry should be made to goodwill. If the carrying amount of goodwill reduced to zero, any further amounts should be recognized in profit or loss.
- If recognized outside the 12 months measurement period ‘or not resulting from new information about circumstances existing at the acquisition date, the credit entry should be made to profit or loss.

PRESENTATION AND DISCLOSURE

Presentation

Current tax assets and current tax liabilities can only be offset in the statement of financial position if the entity has the legal right and the intention to settle on a net basis.

Deferred tax assets and deferred tax liabilities can only be offset in the statement of financial position if the entity has the legal right to settle current tax amounts on a net basis and the deferred tax amounts are levied by the same taxing authority on the same entity or different entities that intend to realise the asset and settle the liability at the same time.

The amount of tax expense (or income) related to profit or loss is required to be presented in the statement(s) of profit or loss and other comprehensive income.

The tax effects of items included in other comprehensive income can either be shown net for each item, or the items can be shown before tax effects with an aggregate amount of income tax for groups of items (allocated between items that will and will not be reclassified to profit or loss in subsequent periods).

Disclosure

IAS 12 requires the following disclosures:

- Major components of tax expense (tax income). Examples include:

o Current tax expense (income) o Any adjustments of taxes of prior periods

o Amount of deferred tax expense (income) relating to the origination and reversal of o temporary differences

o Amount of deferred tax expense (income) relating to changes in tax rates or the o imposition of new taxes

o Amount of the benefit arising from a previously unrecognised tax loss, tax credit or o temporary difference of a prior period

o Write down, or reversal of a previous write down, of a deferred tax asset

o Amount of tax expense (income) relating to changes in accounting policies and corrections of errors.

IAS 12 further requires the following disclosures:

- Aggregate current and deferred tax relating to items recognised directly in equity
- Tax relating to each component of other comprehensive income

- Explanation of the relationship between tax expense (income) and the tax that would be expected by applying the current tax rate to accounting profit or loss (this can be presented as are conciliation of amounts of tax or a reconciliation of the rate of tax)
- Changes in tax rates
- Amounts and other details of deductible temporary differences, unused tax losses, and unused tax credits
- Temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements
- For each type of temporary difference and unused tax loss and credit, the amount of deferred tax assets or liabilities recognised in the statement of financial position and the amount of deferred tax income or expense recognised in profit or loss
- Tax relating to discontinued operations
- Tax consequences of dividends declared after the end of the reporting period
- Information about the impacts of business combinations on an acquirer's deferred tax assets
- Recognition of deferred tax assets of an acquiree after the acquisition date.

Other required disclosures:

- Details of deferred tax assets
- Tax consequences of future dividend payments.

In addition to the disclosures required by IAS 12, some disclosures relating to income taxes are required by IAS 1 Presentation of Financial Statements, as follows:

- Disclosure on the face of the statement of financial position about current tax assets, current tax liabilities, deferred tax assets, and deferred tax liabilities
- Disclosure of tax expense (tax income) in the profit or loss section of the statement of profit or loss and other comprehensive income (or separate statement if presented).

Deferred tax and the framework

As we have seen, IAS 12 considers deferred tax by taking a balance sheet approach to the accounting problem by considering temporary differences in terms of the difference between the carrying values and the tax values of assets and liabilities – also known as the valuation approach. This can be said

to be consistent with the IASB Framework‘s approach to recognition within financial statements. However, the valuation approach is applied regardless of whether the resulting deferred tax will meet the definition of an asset or liability in its own right.

Thus, IAS 12 considers the overriding accounting issue behind deferred tax to be the application of matching – ensuring that the tax consequences of an item reported within the financial statements are reported in the same accounting period as the item itself.

For example, in the case of a revaluation surplus, since the gain has been recognised in the financial statements, the tax consequences of this gain should also be recognised – that is to say, a tax charge. In order to recognise a tax charge, it is necessary to complete the double entry by also recording a corresponding deferred tax liability.

However, part of the Framework‘s definition of a liability is that there is a =present obligation‘. Therefore, the deferred tax liability arising on the revaluation gain should represent the current obligation to pay tax in the future when the asset is sold. However, since there is no present obligation to sell the asset, there is no present obligation to pay the tax.

Therefore, it is also acknowledged that IAS 12 is inconsistent with the Framework to the extent that a deferred tax asset or liability does not necessarily meet the definition of an asset or liability.

Illustration 1 – Basic principle of deferred tax

Prudent prepares financial statements to 31 December each year. On 1 January 2000, the entity purchased a non-current asset for $1.6 million that had an anticipated useful life of four years.

This asset quantified for immediate tax relief of 100% of the cost of the asset.

For the year ending 31 December 2000, the draft accounts showed a profit before tax of $2 million. The directors anticipate that this level of profit will be maintained for the foreseeable future.

Prudent pays tax at a rate of 30%. Apart from the difference caused by the purchase of the noncurrent asset in 2000, there are no other differences between accounting profit and taxable profit or the tax base and carrying amount of net assets.

Required:

Compute the pre, and post-tax profits for Prudent for each of the four years ending 31 December 2000-2003 inclusive and for the period as a whole assuming:

(a) That no deferred tax is recognised
(b) That deferred tax is recognised

Solution

(a) No deferred tax

First of all, it is necessary to compute the taxable profits of Prudent for each period and the current tax payable:

	Year ended 31 December				Total
	2000	2001	2002	2003	
	$000	$000	$000	$000	$000
Accounting profit	2,000	2,000	2,000	2,000	8,000 Add back
Depreciation	400	400	400	400	1,600
Deduct Capital Allowances	(1,600)	-	-	-	(1,600)
Taxable profits	800	2,400	2,400	2,400	8,000
Current tax at 30%	240	720	720	720	2,400

The differences between the accounting profit and the taxable profit that occur from one year to another, cancel out over the four years as a whole.

The statements of profit or loss for each period and for the four years as a whole are given below:

	Year ended 31 December				Total
	2000	2001	2002	2003	
	$000	$000	$000	$000	$000
Profit before tax	2,000	2,000	2,000	2,000	8,000
Current tax	(240)	(720)	(720)	(720)	(2,400)

Profit after tax	1,760	1,280	1,280	1,280	5,600

Ignoring deferred tax produces a performance profit that suggests a declining performance between 2000 and 2001.

In fact the decline in profits is caused by the timing of the current tax charge on them. In 2000, some of the accounting profit escapes tax, but the tax is only postponed until 2001, 2002 and 2003, when the taxable profit is more than the accounting profit.

(b) Deferred tax is recognised

The deferred tax figures that are required in the statement of financial position are given below:

	Year ended 31 December			
	2000	2001	2002	2003
	$000	$000	$000	$000
Carrying amount	1,200	800	400	Nil
Tax base	Nil	Nil	Nil	Nil
Temporary difference at year end	1,200	800	400	Nil
Closing deferred tax liability (30%)	360	240	120	Nil
Opening deferred tax liability	Nil	(360)	(240)	(120)
So charge/ (credit) to P/L	360	(120)	(120)	(120)

The statements of profit or loss for the four year period including deferred tax are shown below:

	Year ended 31 December				Total
	2000	2001	2002	2003	
	$000	$000	$000	$000	$000
Profit before tax	2,000	2,000	2,000	2,000	8,000
Current tax	(240)	(720)	(720)	(720)	(2,400)
Deferred tax	(360)	120	120	120	Nil
Profit after tax	1,400	1,400	1,400	1,400	5,600

A more meaningful performance profile is presented.

Test your understanding 1 – Dive (temporary differences)

An entity, Dive, provides the following information regarding its assets and liabilities as at 31 December 2001.

	Carrying Amount	Tax base	Temporary difference
Assets			
A machine cost $100,000. Depreciation of $18,000 has been charged to date. Tax allowances of $30,000 have been claimed.			
Interest received in the statement of financial position is $1,000. The interest will be taxed when received.			
Trade receivables have a carrying amount of $10,000. The revenue has already been included in taxable profit.			
Inventory has been written down by $500 to $4,500 in the financial statements. The reduction is ignored for tax purpose until the inventory is sold.			

Liabilities

Current liabilities include accrued expenses of $1.000. This is deductible for tax on a-cash paid basis.

Accrued expenses have a carrying amount of $5,000. The related expense has been deducted for tax purposes.

Required:

Complete the table with carrying amount, tax base and temporary difference for each of the assets and liabilities.

Answer:

Test your understanding 1 – Dive (temporary differences)

	Carrying amount	Tax base	Temp-differences
	$	$	$
Non-current asset	82,000	70,000	12,000
Interest receivable	1,000	Nil	1,000
Receivables	10,000	10,000	Nil
Inventory	4,500	5,000	(500)
Accrual (cash basis for tax)	(1,000)	Nil	(1,000)
Accrual (already had tax relief)	(5,000)	(5,000)	Nil

Test your understanding 2 – Dive (deferred tax calculation) Required:

Using the information in ‘test your understanding 1’, calculate Dive’s deferred tax balance as at 31 December 2001. The applicable tax rate is 30%.

Answer:

Test your understanding 2 – Dive (deferred tax calculation)

The net temporary difference as at the reporting date is as follow:

			$
Non-current assets			12,000
Interest receivable			1,000
Receivables	- Inventory	(500)	
Accrual (cash basis for tax)			(1,000)
Accrual (already had tax relief)			-
			11,500

There will be a deferred tax liability because the carrying value of the net assets and liabilities exceeds their net tax base. The deferred tax liability is calculated by applying the relevant tax rate to the temporary difference.

The deferred tax liability is therefore $3,450 ($11,500 x 30%).

Assuming that there is no opening deferred tax liability, the following accounting entry is required:

Dr Tax expense (P/L)	$3,450
Cr Deferred tax liability (SEP)	$3,450

Test your understanding 3 – Brick

Brick is a company with a reporting date of 30 April 2004. The company obtains tax relief for research and development expenditure on a cash paid basis. The recognition of a material development asset during the year, in accordance with IAS 38, created a significant taxable temporary difference as at 30 April 2004.

The tax rate for companies as at the reporting period was 22%. On 6 June 2004, the government passed legislation to lower the company tax rate to 20% from 1 January 2005.

Required:

Explain which tax rate should have been used to calculated the deferred tax liability for inclusion in the financial statements for the year ended 30 April 2004.

Answer:

Test your understanding 3 – Brick

Deferred tax liabilities and assets should be measured using the tax rates expected to apply when the asset is realised. The tax rate must have been enacted or substantively enacted by the end of the reporting period.

The government enacted the 20% tax rate after the period end. Therefore, it should not be used when calculating the deferred tax liability for the year ended 30 April 2004. The current 22% rate should be used instead.

Per IAS 10, changes in tax rates after the end of the reporting period are a non-adjusting event. However, if the change in the tax rate is deemed to be material then Brick should disclose this rate change and an estimate of the financial impact.

Test your understanding 4 – Dodge

An entity, Dodge, owns property, plant and equipment that cost $100,000 when purchased. Depreciation of $40,000 has been charged up to the reporting date of 31 March 2001. The entity has claimed total tax allowances on the asset of $50,000. On 31 March 2001, the asset is revalued to $90,000. The tax rate is 30%.

Required:

Explain the deferred tax implications of this situation.

Answer:

Test your understanding 4 – Dodge

The carrying amount of the asset is $90,000 and the tax base is $50,000 ($100,000 - $50,000).
The carrying amount exceeds the tax base by $40,000 ($90,000 - $50,000).

This temporary difference will give rise to a deferred tax liability of $12,000 ($40,000 x 30%).

Prior to the revaluation, the carrying amount of the asset was $60,000. The asset was then revalued to $90,000. Therefore, $30,000 ($90,000 - $60,000) of the temporary difference relates to the revaluation. Revaluation gains are recorded in other comprehensive income and so the deferred tax charge relating to this gain should also be recorded in other comprehensive income.
This means that the tax charged to other comprehensive income is $9,000 ($30,000 x 30%).

The following accounting entry is required:

Dr Other comprehensive income	$9,000
Dr Profit or loss (bal. fig.)	$3,000
Cr Deferred tax liability	$12,000

The balance on the revaluation reserve within other components of equity will be $21,000 (30,000 revaluation gain - $9,000 deferred tax).

Test your understanding 5 – Splash

An entity, Splash, established a share option scheme for its four directors. This scheme commenced on 1 July 2008. Each director will be entitled to 25,000 share options on condition that they remain with Splash for four years, from the date the scheme was introduced.

Information regarding the share options is provided below:

Fair value of option at grant date	$10
Exercise price of option	$5

The fair value of the shares at 30 June 2009 was $17 per share.

A tax deduction is only given for the share options when they are exercised. The allowable deduction will be based on the intrinsic value of the options. Assume a tax rate of 30%.

Required:

Calculate and explain the amounts to be included in the financial statements of Splash for the year ended 30 June 2009, including explanation and calculation of any deferred tax implications.

Answer:

Test your understanding 5 – Splash

The expense reognised for an equity-settled share-based payment scheme is calculated based on the fair value of the options at the grant date. This expense is spread over the vesting period. At each reporting date, the entity should reassess the number of options expected to vest.

The expense for the scheme in the year ended 30 June 2009 is $250,000 (4 x 25,000 x $10 x 1/4).

For tax reporting date, the shares have a market value of $17 but the options at the date they are exercised.

At the reporting date, the shares have a market value of $17 but the options allow the holders to purchase these shares for $5. The options therefore have an intrinsic value of $12 ($17 -$5).

The deferred tax asset is calculated as follows:

	$	$
Carrying value of share-based payment	Nil	
Tax base of the share-based payment	(300,000)	
(4 x 25,000 x ($17 - $5) x 1/4)		
X Tax rate 30%	(300,000)	
Deferred tax asset		90,000

Where the amount of the estimated future tax deduction exceeds the accumulated remuneration expense, this indicates that the tax deduction relates party to the remuneration expense and partly to equity.

In this case, the estimated future tax deduction is $300,000 whereas the accumulated remuneration expense is $250,000. Therefore, $50,000 of the temporary difference is deemed to relate to an equity item, and the deferred tax relating to this should be credited to equity.

The following entry is required;

Dr Deferred tax asset	$90,000

Cr Equity ($50,000 x 30%)	$15,000	Cr
Profit or loss ($250,000 x 30%)		$75,000

If the deferred tax asset is to be recognised, it must be capable of reliable measurement and also be regarded as recoverable.

Test your understanding 6 – Red

As at 31 December 2001, Red has tax adjusted losses of $4m which arose from a one-off restructuring exercise. Under tax law, these losses may be carried forward to relieve taxable profits in the future. Red has produced forecasts that predict total future taxable profits over the next three years of $2.5m. However, the accountant of Red is not able to reliably forecast profits beyond that date. The tax rate for profits earned during the year ended 31 December 2001 is 30%. However, the government passed legislation during the reporting period that lowered the tax rate to 28% from 1 January 2002.

Required;

Explain the deferred tax implications of the above.

Answer:

Test your understanding 6 – Red

A deferred tax asset can be recognised if it is deemed probable that future taxable profits will be available against which the unused losses can be utilized.

The tax losses have arisen from an exceptional event, suggesting that the entity will return to profitability. Forecasts produced by the accountant confirm this.
Red is only able to reliably forecast future profits of $2.5m. This limits the deferred tax asset that can be recognised.

Deferred tax should be calculated using the tax rate that is expected to be in force when the temporary difference reverses based on the rates enacted by the reporting date. This means that the 28% rate should be used.

The deferred tax asset that can be recognised is therefore $700,000 ($2.5m x 28%). There will be a corresponding credit to the tax expense in the statement of profit or loss.

Test your understanding 7 – Tom

On 30 June 2001 Tom acquired 100% of the shares of Jones for $300,000. At this date, the carrying amount of the next assets of Jones were $250,000. Included in this net asset figure is inventory which cost $50,000 but which had a replacement cost of $55,000. The applicable tax rate is 30%.

Required:

Explain the deferred tax implications of the above in the consolidated financial statements of the Tom group.

Answer:

Test your understanding 7 – Tom

According to IFRS 3, the net assets of the subsidiary at the acquisition date must be consolidated at fair value. The carrying amount of the inventory in the group financial statements will be $55,000. The tax base of the inventory is based on its carrying amount of $50,000 in the individual financial statements. Therefore, there is a temporary difference of $5,000 that arises on consolidation.

A deferred tax liability must be recognised in the consolidated financial statements for $1,500 ($5,000 x 30%). This is treated as a reduction in the subsidiary's net assets at the acquisition date, which will increase the goodwill arising on acquisition.

	$	$
Consideration		300,000
Net assets:		
Carrying amount	250,000	
Fair value uplift	5,000	
Deferred tax liability	(1,500)	
		(253,500)
Goodwill at acquisition		46,500

Test your understanding 8 – Mug

Mug has owned 80% of the ordinary shares of Glass for many years. During the current year, Mug sold inventory to Glass for $250,000 making a gross profit margin of 40%. One quarter of this inventory remains unsold by Glass at the reporting date.

The tax rate is 20%.

Required:

Discuss the deferred tax implications of the above transaction.

Answer:

Test your understanding 8 – Mug

There has been an intra-group sale and some of the inventory remains within the group at the reporting date. The profits held within this unsold inventory must therefore be removed from the consolidated statements.

The profit on the sale was $100,000 ($250,000 x 40%). Of this, $25,000 ($100,000 x 25%) remains within the inventory of the group.

The adjustment required to eliminate the unrealized profits is:

Dr Cost of sales	$25,000
Cr Inventory	$25,000

The carrying amount of inventory in the consolidated financial statements is now $25,000 lower than its tax base, creating a deductible temporary difference of $25,000. This gives rise to a deferred tax asset of $5,000 ($25,000 x 20%) in the consolidated statement of financial position as well as a corresponding reduction to the tax expense in the consolidated statement of profit or loss.

The adjustment required to account for the deferred tax is:

Dr Deferred tax asset	$5,000
Cr Tax expense	$5,000

IFRS 8 – OPERATING SEGMENTS

Large entities produce a wide range of products and services, often in several different countries. Further information on how the overall results of entities are made up from each of these product or geographical areas will help the users of the financial statements. Following are the reasons for segment reporting (By product, region or operation).

- The entity's past performance will be better understood
- The entity's risks and returns may be better assessed

- More informed judgments may be made about the entity as a whole

OBJECTIVE

An entity shall 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.

SCOPE

This IFRS shall apply to the separate and consolidated financial statements of an entity: (i) Whose debt or equity instruments are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets), or
(ii) That files, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation.

OPERATING SEGMENTS

An operating segment is a component of an entity:
(a) That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity),
(b) 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
(c) For which discrete financial information is available.
An operating segment may engage in business activities for which it has yet to earn revenues, for example, start-up operations may be operating segments before earning revenues.

The term =chief operating decision maker' identifies a function, not necessarily a manager with a specific title. That function is to allocate resources to and assess the performance of the operating segments of an entity.

This definition means that not every part of an entity is necessarily an operating segment. IFRS 8 quotes the example of a corporate headquarters that may earn no or incidental revenues and so would not be an operating segment.

Aggregation criteria

Two or more operating segments may be aggregated into a single operating segment if aggregation is consistent with the core principle of this IFRS, the segments have similar economic characteristics, and the segments are similar in each of the following respects:

(a) The nature of the products and services;
(b) The nature of the production processes;
(c) The type or class of customer for their products and services;
(d) The methods used to distribute their products or provide their services; and
(e) If applicable, the nature of the regulatory environment, for example, banking, insurance or public utilities.

DETERMINING REPORTABLE SEGMENTS

An entity shall report separately information about an operating segment that meets

I) the definition of an operating segment, and
II) Any of the following quantitative thresholds:

(a) Its reported revenue, including both sales to external customers and intersegment sales or transfers, is 10 per cent or more of the combined revenue, internal and external, of all operating segments.

(b) The absolute amount of its reported profit or loss is 10 per cent 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.

(c) Its assets are 10 per cent or more of the combined assets of all operating segments.

If the total external revenue reported by operating segments constitutes less than 75 per cent of the entity‘s revenue, additional operating segments shall be identified as reportable segments until at least 75 per cent of the entity‘s revenue is included in reportable segments.

Operating segments that do not meet any of the quantitative thresholds may be considered reportable, and separately disclosed, if management believes that information about the segment would be useful to users of the financial statements.

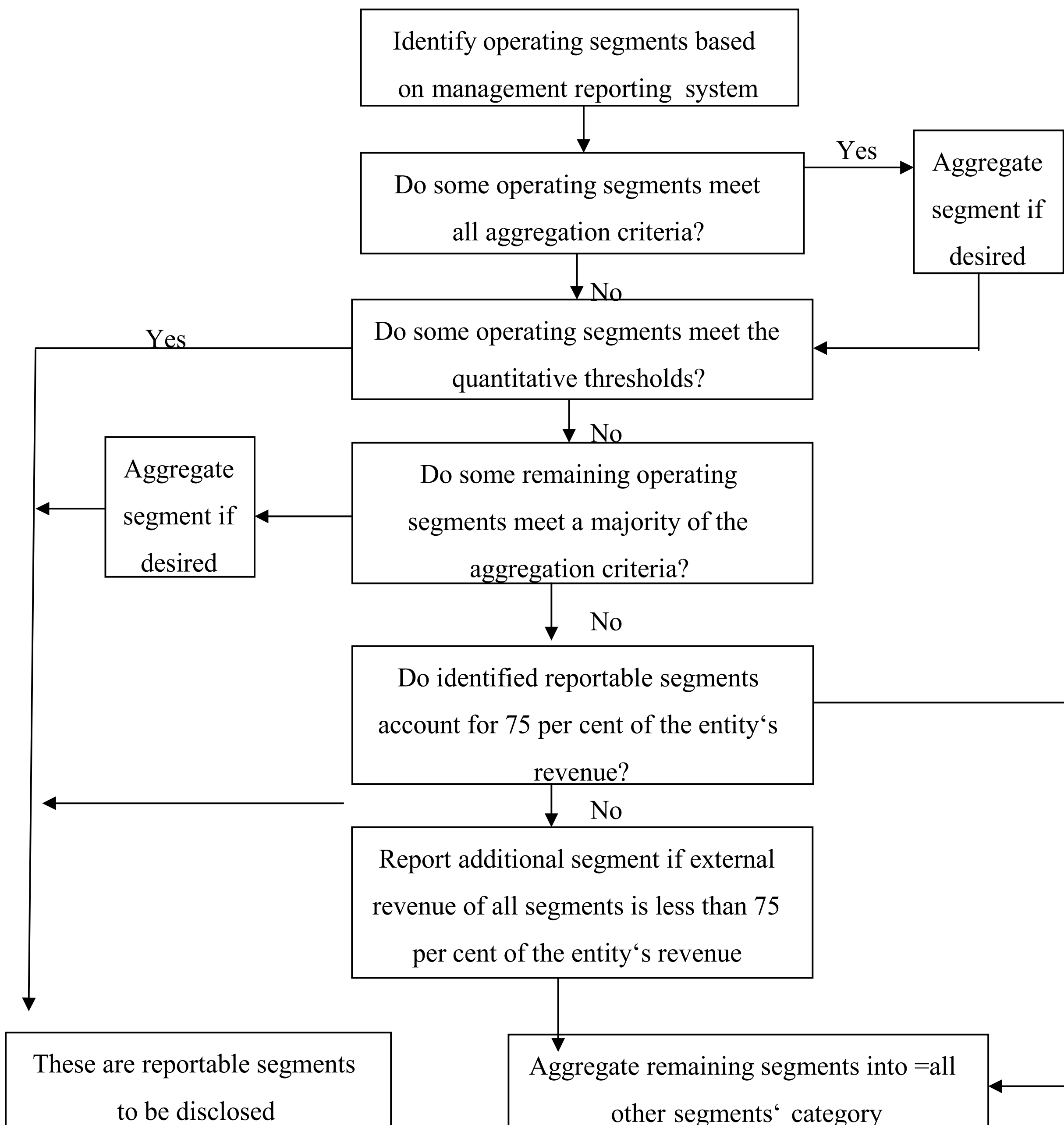
Aggregating segments

Two or more operating segments below the thresholds may be aggregated to produce a reportable segment if the segments have similar economic characteristics, and the segments are similar in a majority of the aggregation criteria above

Non reportable segments

An entity may combine information about operating segments that do not meet the quantitative thresholds to produce a reportable segment only if the operating segments have similar economic characteristics and share a majority of the aggregation criteria.

DECISION TREE TO ASSIST IN IDENTIFYING REPORTABLE SEGMENTS



Measurement

The amount of each segment item reported shall be the measure reported to the chief operating decision maker for the purposes of making decisions about allocating resources to the segment and assessing its performance.

2.7.2 Suggested proforma

Information about profit or loss, assets and liabilities

	Segment A	*Segment B*	*Segment C*	*All other segments*	*Inter segment*	*Entity total*
Revenue – external customers	X	X	X	X	–	X
Revenue – inter segment	X	X	X	X	X	–
	X	X	X	X	(X)	X
Interest revenue	X	X	X	X	(X)	X
Interest expense	(X)	(X)	(X)	(X)	X	(X)
Depreciation and amortisation	(X)	(X)	(X)	(X)	–	(X)
Other material non-cash items	X/(X)	X/(X)	X/(X)	X/(X)	X/(X)	X/(X)
Material income/expense (IAS 1)	X/(X)	X/(X)	X/(X)	X/(X)	X/(X)	X/(X)
Share of profit of associate/JVs	X	X	X	X	–	X
Segment profit before tax	X	X	X	X	(X)	X
Income tax expense	(X)	(X)	(X)	(X)	–	(X)
Unallocated items						X/(X)
Profit for the year						X
Segment assets	X	X	X	X	(X)	X
Investments in associate/JVs	X	X	X	X	–	X
Unallocated assets						X
Entity's assets						X
Expenditures for reportable assets	X	X	X	X	(X)	X
Segment liabilities	X	X	X	X	(X)	X
Unallocated liabilities						X
Entity's liabilities						X

Information about geographical areas

	Country of domicile	*Foreign countries*	*Total*
Revenue – external customers	X	X	X
Non-current assets	X	X	X

DISCLOSURES BY REPORTABLE OPERATING SEGMENTS

IFRS 8 provides a framework on which to base the reported disclosures.

1. Entities are required to provide general information on such matters as how the reportable segments are identified and the types of products or services from which each reportable segment derives its revenue.
2. Entities are required to report a measure of profit or loss and total assets for each reportable segment. Both should be based on the information provided to the chief operating decision maker. If the chief operating decision maker is regularly provided with information on liabilities for its operating segments then these liabilities should also be reported on a segment basis. IFRS 8 specifies disclosures that are needed regarding profit or loss and assets where the amounts are included in the measure of profit or loss and total assets:
   - Revenues - internal and external.
   - Interest revenues and interest expense. These must not be netted off unless the majority of a segment's revenues are from interest and the chief operating decision maker assesses the performance of the segment based on net interest revenue.
   - Depreciation and amortization.
   - Material items of income and expense disclosed separately.
   - Share of profit after tax of, and carrying value of investment in, entities accounted for under the equity method.
   - Material non-cash items other than depreciation and amortization.
   - The amount of additions to non-current assets other than financial instruments, deferred tax assets, post-employment benefit assets and rights arising under insurance contracts. The measurement basis for each item separately reported should be the one used in the information provided to the chief operating decision maker. The internal reporting system may use more than one measure of an operating segment's profit or loss, or assets or liabilities. In such circumstances the measure used in the segment report should be the one that management believes is most consistent with those used to measure the corresponding amounts in the entity's financial statements.

Entities are required to provide a number of reconciliations:

- The total of the reportable segments' revenues to the entity's revenue
- The total of the reportable segments' profit or loss to the entity's profit or loss
- The total of the reportable segments' assets to the entity's assets
- Where separately identified, the total of the reportable segments' liabilities to the entity's liabilities and
- The total of the reportable segments' amounts for every other material item disclosed to the corresponding amount for the entity.

Entity-wide disclosures

Unless otherwise provided in the segment report IFRS 8 requires entities to provide information about its revenue on a geographical and 'class of business' basis. Entities also need to provide information on noncurrent assets on a geographical basis, but not on a 'class of business' basis.

If revenues from single external customer amount to 10% or more of the total revenue of the entity then the entity needs to disclose that fact plus:

- The total revenue from each customer (although the name is not needed) and
- The segment or segment reporting the revenues.

The 'entity-wide disclosures' are needed even where the entity has only a single operating segment, and therefore does not effectively segment report

Criticisms of IFRS 8

(a) Some commentators have criticized the 'management approach' as leaving segment identification too much to the discretion of the entity.
(b) The management approach may mean that financial statements of different entities are not comparable.
(c) Segment determination is the responsibility of directors and is subjective.
(d) Management may report segments which are not consistent for internal reporting and control purposes, making its usefulness questionable.
(e) For accounting periods beginning on or after 1 January 2005 listed entities within the EU are required to use adopted international standards in their consolidated financial statements. The EU has not yet adopted IFRS 8 and until it does IAS 14 will continue to apply here. Some stake holders believe the standard to be flawed due to the amount of discretion it gives to management.

(f) Geographical information has been downgraded. It could be argued that this breaks the link between a company and its stakeholders.
(g) There is no defined measure of segment profit or loss.

Segment reporting

Test your understanding 1 – E-Games

E-Games is a UK based company that sells computer games and hardware. Sales are made through the E-Games website as well as through high street stores. The products sold online and in the stores are the same. E-Games sells new releases for $40 in its stores, but for $30 online.

Internal reports used by the chief operating decision maker show the results of the online business separately from the stores. However, they will be aggregated together for disclosure in the financial statements.

Required:

Should the online business and the high street stores be aggregated into a single segment in the operating segments disclosure?

Answer:

Test your understanding 1 – E-Games

IFRS 8 says that two or more operating segments may be aggregated into a single segment if they have similar economic characteristics and the segments are similar in the following respects:

- The nature of products or services.
- The types of customer.
- Distribution methods.

The standard says that segments with similar economic characteristics would have similar longterm gross margins.
The E-Games stores and online business sell the same types of product, and there are likely to be no major differences in the types of customer (individual consumers). Therefore, in these respects, the segments are similar.

However, customers will collect their goods from the stores, but E-Games will deliver the products sold online. This means that distribution methods are different.

Moreover, there are different sales prices between the stores and the online business, giving rise to significant differences in gross margin. This suggests dissimilarity in terms of economic characteristics. This means that it might be more appropriate to disclose these two segments separately.

Note:
There is no 'right' or 'Wrong' answer here. There are numerous retailers who do not disclose their online operations as a separate segment. However, the International Accounting Standards Board notes in its post-implementation review of IFRS 8 that many companies are overaggregating segments. For exam purpose, it is important to state the relevant recognition criteria and then to apply these to the information given in the question.

Test your understanding 2 – Identifying reportable segments

The management of a company have identified operating segments based on geographical location. Information for these segments is provided below:

Segment	Total revenue	External revenue	Internal revenue	Profit/ (loss)	Assets
	$000	$000	$000	$000	$000
Europe	260	140	120	98	3,400
Middle East	78	33	45	(26)	345
Asia	150	150	-	47	995
North America	330	195	135	121	3,800
Central Smerica	85	40	45	(15)	580
South America	97	54	43	12	880
	1,000	612	388	237	10,000

Required:

According to IFRS 8, which segments must be reported?

Answer:

Test your understanding 2 – Identifying reportable segments

The 10% tests

Segment	10% total revenue (W1)	10% results test (W2)	10% assets (W3)	Report?
Europe	Y	Y	Y	Y
Middle East	N	N	N	N
Asia	Y	Y	N	Y
North America	Y	Y	Y	Y
Central America	N	N	N	N
South America	N	N	N	N

Based on the 10% tests, Europe, Asia and North America are reportable. However, we must check whether they comprise at least 75% of the company's external revenue.

The 75% test
External revenue

	$000
Europe 140 Asia 150	
North America	195
Total	485

The external revenue of reportable segments is 79% ($485,000/ $612,000) of total external revenue. The 75% test is met and no other segments need to be reported.
Conclusion

The reportable segments are Europe, Asia and North America.

(W1) 10% of total sales

10% x $1m = $100,000.

All segments whose total sales exceed $100,000 are reportable.

(W2) 10% of results

10% of profit making segments:

10% x ($98,000 + $47,000 + $121,000 + $12,000) = $27,800

10% of loss making segments:

10% x ($26,000 + $15,000) = $4,100

Therefore, all segments which make a profit or a loss of greater than $27,800 are reportable.

(W3) 10% of total assets

10% x $10m = $1m

All segments whose assets exceed $1m are reportable.

IAS 33 – EARNINGS PER SHARE

INTRODUCTION

Earnings Per Share (EPS) is an unusual accounting ratio in that it has a whole standard devoted to its calculation and presentation. The importance attached to this ratio derives from the fact that it is used as basis for a number of significant statistics used by investors.

USES OF EPS

The uses of EPS as a financial indicator include:

- The assessment of management performance over time.
- Trend analysis of EPS to give an indication of earnings performance.
- An indicator of dividend payouts. The higher the EPS the greater the expectation of an increased dividend compared to previous periods.
- An important component in determining the entity's price/earnings (P/E) ratio.

Scope and Objective

The objective of the standard is to prescribe principles for the determination and presentation of earning per share in order to improve performance comparisons between different entities in the same period and over time for the same entity.

IAS 33 only applies to entities whose securities are publicly traded or that are in the process of issuing securities to the public. This is because entities, whose securities are not traded, do not have a readily observable market price which would make it difficult to calculate a P/E ratio.

DEFINITIONS

Ordinary shares: an equity instrument that is subordinate to all other classes of equity shares.
Potential ordinary shares: a financial instrument or other contract that may entitle its holder to ordinary shares.

Examples of potential ordinary shares include:

- Convertible debt
- Convertible preference shares
- Share warrants
- Share options

Warrants or options: financial instruments that give the holder the right to purchase ordinary shares.

Dilution: a reduction in EPS or an increase in loss per share resulting from the assumption that convertible instruments are converted, the options or warranties are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

Antidilution: an increase in EPS or a reduction in loss per share resulting from the assumption that convertible instruments are converted, the options or warranties are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

BASIC EPS

The basic EPS should be calculated by dividing the net profit or loss attributable to ordinary equity shareholders by the weighted average number of ordinary shares outstanding during the period. The net profit is profit after tax and preference dividends.

CHANGES IN THE CAPITAL STRUCTURE

Most of the complications in the computation of EPS arise from changes in the share capital. The underlying principle is that EPS should be comparable from period to period.

Thus in arriving at the denominator in the EPS calculation, the shares in issue at the beginning of the period may need to be adjusted for shares bought back or issued during the period multiplied by a time weighting factor.

It is necessary to time apportion and come up with a weighted average number of shares outstanding; because where capital has been invested through the issue of shares part-way through the year, additional earnings will only have been generated from the date at which the investment took place. If earnings for the year were apportioned over shares in issue at the year end the resultant EPS would not fairly reflect performance for the current period in comparison to a previous period when there may have been no such change in equity. Similar logic applies where shares have been bought back in the year.

The four most common reasons for adjusting shares in issue at the beginning of the period are:

- Issue of new shares during the period (fully or partly paid)
- Bonus issues
- Rights issues;
- Potential ordinary shares (resulting in calculation of diluted EPS)

Issue of new shares during the period (Fully paid)
Shares should be included in the weighted average calculation from the date consideration is receivable

Issue of new shares during the period (Partly paid)
The general principle under IAS 33 that shares should be included in the weighted average calculation from the date consideration is receivable does not apply to shares that are issued in partly paid form.

Partly paid shares are treated as fractions of shares; based on payments received to date as a proportion of the total subscription price. These shares are included in the averaging calculation only to the extent that they participate in dividends for the period. Dividend entitlement of such shareholders is usually restricted to an amount based on this fraction.

The weighted average number of shares should be restricted based on this fraction. If the actual receipts to date were only applied to the issue of fully paid shares, then the number of fully paid shares would be smaller than was actually the case for partly paid shares being issued.

Bonus issue, share split and share consolidation
Where a company issues new share's by way of a capital is action of reserves (a bonus issue) during the period, the effect is to increase only the number of shares outstanding after the issue.
There is no effect on earnings as there is no inflow of funds as a result of the issue.

As shareholders rights are not affected; each individual will hold the same proportion of outstanding shares as before the issue. IAS 33 requires that the bonus shares are treated as if they had occurred at the beginning of the period. The EPS from the previous period should also be recalculated using the new number of shares in issue to allow comparison with the current year's EPS, as if the issue had taken place at the beginning of that period as well.
When calculating the prior period EPS comparator then multiply last year's EPS by the factor:

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

When calculating the weighted average number of shares then the bonus factor to apply is the inverse of the above, i.e.

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

Similar considerations apply where ordinary shares are split into shares of smaller nominal value (a share of $1 is split into four share of 25c each) or consolidated into shares of higher nominal value (four shares of 25c each are consolidated into one share of $1). In both these situations, the number of shares outstanding before the event is adjusted for the proportionate change in the number of shares outstanding after the event.

RIGHTS ISSUE

With a rights issue additional capital is raised by the issue of the shares. Existing shareholders are offered the right to purchase new shares from the company, usually at a discount to the current market price.

Then when dealing with a rights issue at a discount, calculation of EPS should mark adjustment for the two elements:

- A bonus issue (reflecting the fact that the cash received would not pay for all the/shares issued if based on fair values, rather than being discounted).
- An assumed issue at full price (reflecting the fact that new shares are issued in return for cash);

Consequently the number of shares outstanding at the beginning of the year should be adjusted for the bonus factor to give a deemed number of shares in issue before the rights issue. This should be weighted for the period up to the date of the rights issue.

The bonus factor is equal to: $\frac{\text{Fair Value before rights issue}}{\text{Theoretical ex - rights Price after rights issue}}$

Additionally the number of shares actually in issue after the rights issue is weighted for the period after the rights issue.

As in the section on bonus issues, the prior period EPS should be adjusted for the bonus factor. This is achieved by taking the reciprocal of the bonus factor (turn fraction Upside down) and multiplying by last year's EPS.

DILUTED EARNINGS PER SHARE

An entity may have in issue at the reporting date a number of financial instruments that give rights to ordinary shares at a future date. IAS 33 refers to these as potential ordinary shares.

Examples of potential ordinary shares include:

- Convertible debt;
- Convertible preference shares;
- Share warrants
- Share options

Where these rights are exercised they will increase the number of shares. Earnings may also be affected. The overall effect will tend towards lowering (or diluting) the EPS.

This will tend to be the case because holders of these rights will only take them if it is to their benefit which tends to be prejudicial to existing shareholders.

So that existing shareholders can see the potential dilution of their present earnings, IAS 33 requires that a diluted EPS is calculated.

The calculation is performed as if the potential ordinary shares had been in issue throughout the period. If the rights were granted during the reporting the period, then time apportion.

The diluted EPS is:

$$\frac{\text{Earnings as per basic eps + Adjustment for dilutive potential ordinary shares}}{\text{Weighted Average number of shares per basic EPS + Adjustment for dilutive potential ordinal}}$$

CONVERTIBLE FINANCIAL INSTRUMENTS

CALCULATION OF EARNINGS

The basic earnings figure should be adjusted to reflect any changes in profit that would arise when the potential ordinary shares outstanding are actually issued. Adjust:

1. Profits

There will be a saving of interest. Interest is a tax-deductible expense and so the post- tax effects will be brought into the adjusted profits.

There will be a saving of preference dividend. There is no associated tax effect.

Therefore, the numerator should be adjusted for the after-tax effects of dividends and interest charged in relation to dilutive potential ordinary shares and for any other changes in income that would result from the conversion of the potential ordinary shares.

2. The number of shares

The denominator should include shares that would be issued on the conversion.

The potential ordinary shares are deemed to be converted to ordinary shares at the start of the period unless they were issued during the reporting period.

SHARE WARRANTS AND OPTIONS

A share option or warrant gives the holder the right to purchase or subscribe for ordinary shares. IAS 33 requires that the assumed proceeds from these shares should be considered to have been received from the issue of shares at fair value. These would have no effect on EPS.

The difference between the number of shares that would have been issued at fair value and the number of shares actually issued is treated as an issue of ordinary shares for no consideration.

This bonus element has a dilutive effect with regard to existing shareholders.

Analysis and interpretation

Illustration 1 – Basic earnings per share

An entity issued 200,000 shares at full market price on 1 July 2008.

Relevant information is provided below:

	2008	2007
Profit attributable to the ordinary		

Share holders for the year ending 31 Dec	$550,000	$460,000
Number of ordinary shares in issue at 31 Dec	1,000,000	800,000 Required:

Calculate the basic EPS for the years ended 31 December 2007 and 2008.

Solution

Calculate of earnings per share

2007 = $460,000/800,000 = 57.5c

(W1) Weighted average number of shares in 2008

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

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

Illustration 2 – Bonus issues

An entity made a bonus issue of one new share for every five existing shares held on 1 July 2008.

Relevant information	2008	2007
Profit attributable to the ordinary		
Share holders for the year ending 31 Dec	$550,000	$460,000
	1,200,000	1,000,000
Number of ordinary shares in issue at 31 Dec		

Required:

(a) Calculate basic EPS for the year ended 31 December 2008.

(b) Calculate the prior year comparative EPS figure as it would appear in the financial statements for the year ended 31 December 2008.

Solution

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

(W1) Weighted average number of shares

1,000,000 x 6/12 x 6/5 (W2) 600,000 1,200,000 x 6/12

600,000

Weighted average number of shares 1,200,000

(W2) Bonus fraction

It was a one for five-bonus issue

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

The bonus fraction is therefore 6/5.

(b) EPS in the financial statements for the year ended 31 December 2007 would have been 46.0c ($460,000/1,000,000).

This is re-started in the financial statements for the year ended 31 December 2008 by multiplying it by the inverse of the bonus fraction. The restarted comparative is therefore

38.3c (46.0c x 5/6).

Illustration 3 – Rights issues

An entity issued one new share for every two existing shares at $1.50 per share on 1 July 2008. The pre-issue market price was $3.00 per share.

Relevant information	2008	2007
Profit attributable to the ordinary		
Share holders for the year ending 31 Dec	$550,000	$460,000
Number of ordinary shares in issue at 31 Dec	1,200,000	800,000

Required:

(a) Calculate basic EPS for the year ended 31 December 2008.

(b) Calculate the prior year comparative EPS figure as it would appear in the financial statements for the year ended 31 December 2008.

Solution

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

(W1) Weighted average number of shares

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

(W2) Bonus fraction

The bonus fraction is calculated as:

Share price before rights issue/ Theoretical share price after rights issue.

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

(W3) Theoretical share price after rights issue

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

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

(b) EPS in the financial statements for the year ended 31 December 2007 would have been 57.5c ($60,000/800,000).

This is restated in the financial statements for the year ended 31 December 2008 by multiplying it by the inverse of the bonus fraction.

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

Test your understanding 1 – Coe

Coe, a public limited company, is preparing its consolidated financial statements for the year ended 31 December 2001. Coe has owned 75% of the equity shares of Crace for a number of years. The following accounting issues have yet to be finalized:

(1) On 1 January 2001, 1,000 of Coe's managers were granted 500 share options each. These will vest on 31 December 2003 if the managers are still employed by Coe. The fair value of one share option at the grant date was $6. By 31 December 2001, 50 of these managers had left the business and another 80 were expected to leave by the vesting date. The exercise price of the options is $3. The average price of one Coe's equity shares over the year is $10. No entries have been posted in relation to this share option scheme.

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

(3) On 31 December 2001, Crace made an interest-free loan of $3 million charity and recognised this amount as a financial asset. The charity will repay the money on 31 December 2004. Market rates of interest are 5%.

Required:

(i) Explain, with calculations, how the above events should be corrected in the consolidated financial statements for the year ended 31 December 2001.

(ii) Discuss the impact of these corrections on basic and diluted earnings per share. Non calculations are required. Answer:

Test your understanding 1 – Coe

Share Options

This is an equity-settled share-based payment. A remuneration expense should be recognised in profit or loss over the three year vesting period. This should be based on the fair value of the options at the grant date ($6) and the number of options expected to vest. The other side of the accounting entry is recognised in equity.

The expense is calculated as follows:

(1,000 – 50 – 80) x 500 x $6 x 1/3 = $0.9 million.

The adjusting entry is:

Dr Profit or loss	$0.9m
Cr Equity	$0.9m

This adjustment reduces the profit attributable to the equity shareholders of the group by $0.9 million and so will reduce basic earnings per share and diluted earnings per share.

The share options represent a commitment to issue equity shares in the future at an amount that is below the average share price. These are therefore a dilutive instrument, which will cause a further reduction in diluted earnings per share.

Land

In accordance with IFRS 13 Fair Value Measurement, the selling price of similar plots of land would constitute a level 2 input to the fair value hierarchy. It is unlikely that level 1 in-puts exist. However, Coe should assess whether adjustments are required to the $5 million price to take into account the location and condition of its specific asset.

Assuming no adjustments are required to the valuation, the land should be revalued to its fair value of $5 million with a gain of $1 million recognised in other comprehensive income.

Dr Property, plant and equipment	$1m
Cr Other comprehensive income	$1m

In the statement of other comprehensive income, this gain will be presented as an item that will not be reclassified to profit or loss in the future.

This adjustment has no impact on profit. As such, it has no impact on basic and diluted earnings per share.

Financial asset

The loan is a financial asset because it gives Crace a contractual right to receive cash.

The financial asset should have been initially measured at fair value. Because the loan is interestfree, the $3million price does not represent the asset's fair value. The fair value should be determined by discounting the future cash flows to present value using a market rate of interest:

$3m x 1/1.05^3 = $2.6 million.

The financial asset must be written down to $2.6 million. The $0.4 million loss is expensed to profit or loss:

Dr Profit or loss	$0.4m
Cr Financial asset	$0.4m

This adjustment reduces consolidated profit by $0.4 million. Of this, $0.3 million ($0.4m x 75%) is attributable to the equity shareholders of the group and the remaining $0.1 million is attributable to the non-controlling interest.

Basic and diluted earnings per share are calculated based on profit attributable to the equity shareholders of the group. As such, these ratios will deteriorate once the error is corrected.

Test your understanding 2 – Impact of policy choices

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

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

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

Statement of profit or loss (extracts)

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

Statements of financial position (extracts)

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

Required:

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

Answer:

Test your understanding 2 – Impact of policy choices

	Entity A	Entity B

Operating profit margin 18.2% 4.5% Return on

capital employed 16.7% 2.4%

Gearing (debt/debt + equity) 41.7% 23.8%

As a result of it's upwards revaluation, Entity B has charged more depreciation to profit or loss than Entity A. This means that Entity B has lower profits and a lower operating profit margin.

Entity B's upwards revaluation has increased equity in the statement of financial position. This reduces its ROCE, making Entity B appear less efficient than entity A. However it also means that Entity B's gearing is lower than Entity A's, making it seem like a less risky investment.

Test your understanding 3 – Tuyet

Tuyet is a public limited company that prepares its financial statements in accordance with International Financial Reporting Standards and has a year end of 31 December 2001. It manufactures furniture that is sold to a range of retail outlets. As at the yearend Tuyet has loans outstanding, with repayments of $7 million due annually in each of the nest four years.

You are a potential investor in Tuyet. You are analyzing its statement of cash flows for the year ended 31 December 2001, which is presented below:

Statement of cash flows for year ended 31 December 2001

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

		3
Cash flows from investing activities		
Proceeds from sale of PPE	20	
Purchases of PPE	(30)	
		(10)
Cash flows from financing activities		
Proceeds from shares	15	
Repayment of loans	(7)	
Dividends paid	-	
		8
Increase in cash and cash equivalents		1
Opening cash and cash equivalents		(5)
Closing cash and cash equivalents		(4)

Required:

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

Answer:

Test your understanding 3 – Tuyet

High level analysis

Tuyet has generated a cash surplus during the year. However, this is relatively small compared to the size of its outgoings. Moreover, Tuyet is in a negative overall cash position (i.e. it has overdrafts).

This will lead to increased interest payments. There is also a risk that overdraft could be withdrawn, placing Tuyet at considerable risk.

Operating cash flows

Tuyet has made an operating profit of $40 million ($35 + $5m) but it has only generated cash from operations of $18 million. This suggests that Tuyet's profits are relatively low quality and are not backed up by cash.

There have been substantial increases in the level of inventories year-on-year. This is having a negative impact on Tuyet's cash flows. This might be a response to bulk orders. Alternatively, it could be due to inefficient inventory management, exposing Tuyet to the risk of inventory obsolescence.

The increase in receivables suggests that customers are paying Tuyet more slowly. It would seem that Tuyet is compensation for this by taking longer to pay its own suppliers. This could cause Tuyet problems – particularly if its suppliers tighten or remove credit terms.

After making mandatory and tax payments, there is only a small cash surplus of $3 million from operating activities. Tuyet's trading operations are not generating enough cash to invest in PPE or to repay loans and so funds have been obtained from other less-sustainable sources.

Investing cash flows

Tuyet has invested in PPE during the year. This suggests that productive capacity can be maintained or improved.

However, it should be noted that substantial receipts have been generated by selling PPE – these cash flows will not recur year-after-year. Without these receipts, Tuyet would have recorded an overall decrease in cash and cash equivalents.

The high level of PPE disposals raises concerns: does Tuyet have idle assets (which may require impairment), or it being forced into disposing of key assets in order to raise cash?

Financing cash flows

Tuyet has repaid some of its loan this yea. As a result interest payments should reduce in the future, freeing up operating cash flows.

However, the loan repayment was only possible as a result of a share issue. Tuyet cannot perform share issues indefinitely. Therefore, higher operating cash flows are required if Tuyet is to meet its future loan repayments.

Tuyet has not paid a dividend this year, no doubt due to its poor cash position. This may deter potential and current investors from providing further resources.

Test your understanding 4 – Hutton

Hutton include an additional performance measure (APM) called 'underlying profit' in its financial statements. The followings is and extract of information to be found in the financial statements for the year ended 31 December 2001:

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

Hutton also presents comparable information for the prior period.

Required:

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

Answer:

Test your understanding 4 – Hutton

Depreciation and amortization are judgemental, non-cash expense. However, excluding them from underlying profit ignores the fact that the entity's non-current assets will need to be replaced or enhanced in the future.

The impairment of a brand suggests that the business outlook may be weaker than expected. It also indicates that management over-paid for the brand. Adding back this expense when calculating underlying profit diminishes its significance when assessing the past decisions of management and also when predicting Hutton's future performance.

Foreign exchange differences on monetary items can be volatile, and potentially distort an entity's performance profile. However, many monetary items, such as receivables and payables, are shout-term in nature and so represent gains and losses that will be realized in the near future. It would seems that Hutton will be receiving less units of its functional currency (or paying more units) than originally expected when the overseas transactions are settled and so it seems odd to exclude these losses from underlying profit.

Fair value gains on financial assets measured at fair value through profit or loss are volatile and may make it difficult to compare an entity's performance year-on-year. However, these financial assets are likely to be sold in the short-term and so the gains (or losses) will be realized shortly. They are also unlikely to be one-off items – entities that trade material quantities of financial assets will probably enter into similar transactions on a regular basis.

Overall, it looks like Hutton is trying to disguise a weak performance – particularly as the APM has turned a loss before tax into a profit. This could be misleading, particularly if the APM is presented with prominence.

However, to Hutton's credit, it discloses the calculation behind the APM, thus allowing users to reconcile it to the figures in the financial statements. This will enable them to draw their own conclusions about the adequacy and usefulness of this APM.

Test your understanding 5 – Lorenzo

Lorenzo develops and manufactures desktop and laptop computers. Profit after tax for the yearended 31 December 2001 is 5% lower than the prior period. Lorenzo discloses the following non-financial performance measures in its Integrated Report for the year ended 31 December 2001.

	2001	2000
Faults per 1,000 sales	2.1	3.2
Customer service helpline waiting time (minutes)	1.5	4.2
Staff turnover* (%)	6.5	13.2

*(leavers/ average number of employees x 100)
Required:

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

Solution

Test your understanding 5 – Lorenzo

Profits

Lorenzo's profit decline year-on-year will be concerning to investors. However, the nonfinancial information presented in the integrated report paints a more optimistic picture of the entity's future prospects.

Faults

A decline in the number of faults in Lorenzo's products will reduce future repair costs, increasing profits. Fewer faults will improve customer satisfaction. This may generate stronger brand loyalty, making it more likely that customers will make repeat purchases.

Helpline

The reduction in helpline waiting times may be due to the reduction in the number of product faults or, potentially, to investment in the customer services department. Whatever the reason, this is likely to have a positive impact on customer perception which may, once again, improve brand loyalty.

Staff turnover

Reduced staff turnover means that staff experience is being retained in the business. This might help to reduce recruitment and training costs in the future. Moreover, experienced staff will probably perform at a higher level than inexperienced staff. In facts this may partly explain the improvement in fault level and customer helpline waiting times. Reduced staff turnover could also have other benefits – more experienced staff might develop more innovative products.

Summary and further information

In conclusion, the non-financial information in the Integrated Report provides an important insight into Lorenzo's future prospects. Nonetheless, it would be useful to compare these performance measures to other entities in the same sector. Furthermore, some investors may question the reliability of these disclosures unless assurance is provided by an assurance practitioner.

Test your understanding 6 – AA

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

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

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

AA has also been criticized in the press for the quality of its products. Some customers have complained that the shoes are not well-made and that they must be regularly replaced. A major consumer magazine has strongly argued that AA products are a 'false economy' and that expensive but better quality shoes.

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

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

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

Required:

Why would an integrated report provide useful information about AA?

Answer:

Test your understanding 6 – AA

An integrated report might highlight a number of positive issues about AA:

- AA's financial capital has increased as a result of its profitable current business activities.
- Financial capital has increased due to the receipt of government grants and this will help AA to repay its debts in the short and also, potentially, the medium term.
- AA's has a positive impact on social capital by helping low income families to buy essential items of clothing. This is likely to foster brand loyalty from these customers, as well as generating good publicity. This may lead to a further increase in financial capital in the future.

However, it could be argued that the AA business model will not create value in the long-term. An integrated report might refer to the following issues:

- The government grants may not continue indefinitely. This could be due to government budget cuts, increasing competition or, perhaps, as a result of ongoing quality issues with AA products.
- AA does not invest highly in human capital. Unskilled and untrained staff are unlikely to foster brand loyalty and could lead to a loss of custom over time.
- AA uses cheap labour from overseas. Although this is likely to increase financial capital, it may lead to a net decrease in other capitals

  - AA may be criticized for not investing in local communities, or for exploiting overseas workers. By not investing in human capital there may also be a negative impact on social and relationship capital.
  - AA's recognition of the need to increasingly monitor its suppliers indicated that current economic benefits may not be sustainable in the longer-term.
- Purchasing goods from overseas will increase AA's carbon footprint. Moreover, AA does not widely recycle. Its activities thus place an overall drain on natural capital and this may deter some investors and consumers.
- A focus on high street expansion may leave AA vulnerable to online competitors, who will be able to offer the same products more cheaply. AA's lack of investment in staff may compound this because the retail stores are unlikely to offer a greater experience or level of service than can be obtained online. The current business model may therefore not be resilient in the medium or long term.

Summary

AA's business model is currently profitable. Such information could be obtained from the historical financial statements. However, an integrated report that looks at value creation and stability in the medium and longer term may offer a more pessimistic outlook. Banks are more likely to invest in companies who have sustainable business models and therefore integrated reports will help them to make stronger investment decisions. Other investors, such as potential or currency shareholders, would also be able to make more informed decisions.

Producing an Integrated report is not mandatory. Businesses which have a detrimental net impact on capitals (particularly non-financial capitals) are unlikely to voluntarily produce an integrated report. In contrast, companies who create value in sustainable ways are more likely to want to disclose this to users. However, if the production of an integrated report was mandatory, then it might motivate a company like AA to shift its focus from increasing short term financial capital to the generation of an array of capitals over the medium and long-term.

IFRS 5 – NON-CURRENT ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS

OBJECTIVE

The objective of this standard is to specify the accounting for Non-current assets held for sale, and presentation and disclosure of discontinued operations.

NON-CURRENT ASSETS HELD FOR SALE

HELD FOR SALE

This term refers to a non-current asset whose carrying amount will be recovered principally through a sale transaction rather than through continuing use.

DISCONTINUED OPERATION

A discontinued operation includes the following criteria (Discussed in detail after measurement):

- is a separately identifiable component
- must represent a major line of the entity's business
- is part of a plan to dispose of a major line of business or a geographical area is a subsidiary acquired with a view to resell

DISPOSAL GROUP

This is a group of assets and possibly some liabilities that an entity intends to dispose of in a single transaction.

CLASSIFICATION OF NON-CURRENT ASSETS AS HELD FOR SALE

For an asset to be classified as held for sale:

a) It must be available for immediate sale in its present condition allowing for terms that are usual or customary;
b) Its sale must be highly probable {expected within 1 year of reclassification);
c) It must be genuinely sold, not abandoned.

Immediate sale

The application of the phrase does make allowance for conditions considered 'usual and customary' in selling the asset, e.g. allowance would be made for searches and surveys when selling property. No allowance is made for conditions imposed by the seller of the asset or disposal group.

Highly probable

For a sale to be highly probable it must be significantly more likely than probable. In addition the standard sets out the following criteria to be satisfied:

- Management, at a level that has the authority to sell the assets or disposal group, is committed to a plan to sell;
- An active program to locate a buyer and complete the sale must have begun. This will include making it known to those that might be interested that the asset or disposal group is available for sale;
- The asset or disposal group must be actively marketed at a price that is reasonable compared to its current fair value.

This should take account of local conditions in the market. Thus if it is customary to price above fair value in the expectation of low bids or vice versa this is acceptable. The term actively marketed requires that the entity is making positive efforts to sell, not just to locate a buyer, e.g. by engaging a selling agent.

- The sale of the asset is expected to be recorded as completed within time, ear from the date of classification.

(If the sale is not completed within one year and this is due to events beyond entity's control, it is still possible for the asset to be continued to be classified as held for sale provided the entity is still committed to selling the asset).

- The actions required to complete the plan should indicate that it is not likely that there will be significant changes made to the plan or that the plan will be withdrawn.

MEASUREMENT

Non-current assets or disposal groups that meet the criteria to be classified as held for sale are measured at the lower of:

- Fair value less costs to sell; and
- Carrying amount (in accordance with the relevant Standard).

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Costs to sell are "the incremental costs directly attributable to the disposal of an asset (or disposal group)". Examples would include lawyer's or estate agent's fees.

The costs must be incremental; internal costs cannot be included in costs to sell.

Measurement on initial classification as held for sale

IFRS 5 requires that immediately before the initial classification of an asset (or disposal group) as held for sale, the carrying amount of the asset (or all the assets and liabilities in a disposal group) should be measured in accordance with the relevant IFRS.

Initial classification as held for sale may lead to a write down to fair value less costs to sell.

Note:

- Any impairment loss on initial or subsequent write-down of the asset or disposal group to fair value less cost to sell is to be recognised in the statement of profit or loss.
- Any subsequent increase in fair value less cost to sell can be recognised in the statement of profit or loss to the extent that it is not in excess of the cumulative impairment loss that has been recognised in accordance with the IFRS 5 or previously in accordance with IAS 36.
- Any impairment loss recognised for disposal group should be applied in the order set out in IAS 36.

The standard sets out how to allocate the impairment loss among the constituent parts of the disposal group (or cash generating unit). The loss itself is still charged to the statement of profit or loss.

SUBSEQUENT REMEASUREMENT

- Whilst a non-current asset/disposal group is classified as held for sale it should not be depreciated or amortised.
- At each reporting date where a non-current asset or disposal group continues to be classified as held for sale it should be re-measured at fair value less costs to sell at that date.
- This may give rise to further impairments or a reversal of previous impairment losses. In either case recognise in the statement of profit or loss.

DISCONTINUED OPERATIONS – Detailed explanation

As mentioned earlier, discontinued operation is a component of an entity that:

i.) Either has been disposed of, or
ii.) Is classified as held for sale, and that component

a) Represents a separate major line of business or geographical area of operations, or
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) It is a subsidiary acquired exclusively with a view to resale.

Component:

The standard defines this term as "operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity".

A component will have been a single Cash Generating Unit (CGU) or a collection of CGUs while held for use in the business.

A component can be distinguished operationally and for financial reporting purposes if:

- Its operating assets and liabilities can be directly attributed to it;
- Its income (gross revenue) can be directly attributed to it;
- At least a majority of its operating expenses can be directly attributed to it.

Classification as discontinued operation

A component of the reporting entity is classified as discontinued at:

- The date of its disposal (sale/termination); or
- Or when the operation meets the IFRS criteria to be classified as held for sale.

In order to have been classified as a discontinued operation by the reporting date the disposal or reclassification as 'held for sale' must have taken place by that reporting period end.

If an operation is to be terminated, but it is not actually closed by the reporting date then it will not be classified as discontinued at the year end.

Major line of business or geographical segment

A separate business segment or geographical segment as defined in IFRS 8 – Operating Segments, would normally meet this condition.

Single plan

If a component is not itself a separate major line of business or geographical area of operations then it must be "part of a single co-ordinated plan" to dispose of such a line of business or geographical area of operations. The single plan might relate to a disposal in one transaction or piecemeal.

PRESENTATION

- Non-current assets that meet the criteria are presented separately on the Statement of Financial Position within current assets.
- If the held for sale item is a disposal group then related liabilities are also reported separately within current liabilities.
- Discontinued operations and operations held for sale must be disclosed separately in the statement of financial position at the lower of their carrying value less costs to sell.

Performance Reporting

Test your understanding 1 – Discontinued operations

The Portugal group of companies has a financial year-end of 30 June 2004. The financial statements were authorized three months later. The group is disposing of many of its subsidiaries, each of which is a separate major line of business or geographical area.

- A subsidiary, England, was sold on 1 January 2004.

- On 1 January 2004, an announcement was made that there were advanced negotiations to sell subsidiary Switzerland and that, subject to regulatory approval, this was expected to be completed by 31 October 2004.
- The board has also decided to sell a subsidiary called France. Agents have been appointed to find a suitable buyer but none have yet emerged. The agent's advice is that potential buyers are yet emerged. The agent's advice is that potential buyers are deterred by the expected price that Portugal hopes to achieve.
- On 10 July, an announcement was made that another subsidiary, Croatia, was for sale. It was sold on 10 September 2004.

Required:

Explain whether each of these subsidiaries meets the definition of a 'discontinued operation' as defined by IFRS 5.

Answer:

Test your understanding 1 – Discontinued operations

England has been sold during the year. It is a discontinued operation per IFRS 5.

Switzerland is a discontinued operation per IFRS 5. There is clear intention to sell, and the sale is highly probable within 12 months.

France is not a discontinued operation per IFRS 5. It does not seem that France is being offered for sale at a reasonable price in relation to its current fair value. The sale does not seem to be highly probable within 12 months.

Croatia is not a discontinued operation per IFRS 5. The conditions for classification as held for sale were not meet until after the year end.

FINANCIAL INSTRUMENTS

Introduction to Financial Instruments

1. IAS 32 Financial Instruments: Presentation
2. IFRS 7 Financial Instruments: Disclosures
3. IFRS 9 Financial Instruments

IAS 32 FINANCIAL INSTRUMENTS: PRESENTATION

OBJECTIVE

The stated objective of IAS 32 is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and liabilities.

IAS 32 addresses this in a number of ways:

- clarifying the classification of a financial instrument issued by an entity as a liability or as equity
- prescribing the accounting for treasury shares (an entity's own repurchased shares)
- prescribing strict conditions under which assets and liabilities may be offset in the balance sheet

SCOPE

- IAS 32 applies in presenting and disclosing information about all types of financial instruments

with the exceptions of items under IAS 27, IAS 28, IFRS 11, IAS 19 and IFRS 2 and nonfinancial items which will be settled through physical delivery.

However, IAS 32 applies to:

- The contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument

DEFINITIONS

The following terms are used in this Standard with the meanings specified:

A Financial Instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

A Financial Asset is any asset that is:

(a) Cash;

(b) An equity instrument of another entity; (c) A contractual right:

(i) To receive cash or another financial asset from another entity; or

(ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

(d) A contract that will or may be settled in the entity's own equity instruments and is:

(i) A non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or

(ii) A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

A Financial Liability is any liability that is:

(a) A contractual obligation:

(i) To deliver cash or another financial asset to another entity; or

(ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially un-favourable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments and is:

(i) A non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

(ii) A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

An Equity Instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

A Put table Instrument is a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.
Examples of financial assets include Trade receivables, Options, Shares (when used as an investment).

Examples of financial liabilities include Trade payables, Debenture loans payable, Redeemable preference (non-equity) shares and Forward contracts standing at a loss.

Financial instruments include both of the following.

(a) Primary instruments: e.g. receivables, payables and equity securities

(b) Derivative instruments: e.g. financial options, futures and forwards, interest rate swaps and currency swaps, whether recognized or unrecognized

IAS 32 makes it clear that the following items are not financial instruments.

- Physical assets, e.g. inventories, property, plant and equipment, leased assets and intangible assets (patents, trademarks etc).
- Prepaid Expenses deferred revenue and most warranty obligations.
- Liabilities or assets that is not contractual in nature
- Contractual rights/obligations that do not involve transfer of a financial asset, e.g. commodity futures contracts, operating leases

Compound Financial Instruments

The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components shall be classified separately as financial liabilities, financial assets or equity instruments.

An entity recognises separately the components of a financial instrument that:

(a) Creates a financial liability of the entity and

(b) Grants an option to the holder of the instrument to convert it into an equity instrument of the entity.

Treasury Shares

If an entity reacquires its own equity instruments, those instruments (treasury shares‘) shall be deducted from equity. No gain or loss shall be recognized in profit or loss on the purchase, sale, issue or cancellation of an entity‘s own equity instruments. Consideration paid or received shall be recognized directly in equity.

Interest, Dividends, Losses and Gains

Interest, dividends, gains, and losses relating to an instrument classified as a liability should be reported in profit or loss. This means that dividend payments on preferred shares classified as liabilities are treated as expenses. On the other hand, distributions (such as dividends) to holders of a financial instrument classified as equity should be charged directly against equity, not against earnings.

Transaction costs of an equity transaction are deducted from equity. Transaction costs related to an issue of a compound financial instrument are allocated to the liability and equity components in proportion to the allocation of proceeds.

OFFSETTING FINANCIAL ASSETS AND LIABILITIES

IAS 32 also prescribes rules for the offsetting of financial assets and financial liabilities. It specifies that a financial asset and a financial liability should be offset and the net amount reported when and only when, an entity:

- Has a legally enforceable right to set off the amounts; and
- Intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

Disclosures
Financial instruments disclosures are in IFRS 7 Financial Instruments: Disclosures, and no longer in IAS 32.

IFRS 9 FINANCIAL INSTRUMENTS (REPLACEMENT OF IAS 39)

OBJECTIVE
The objective of this IFRS is to establish principles for the financial reporting of financial assets and financial liabilities that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity‘s future cash flows.

RECOGNITION AND DERECOGNITION

Initial Recognition

Financial asset or financial liability should be recognized by an entity in its statement of financial position when the entity becomes party to the contractual provisions of the financial asset or financial liability, even at nil cost.

Effective interest rate method

Total finance cost:	$
Interest paid	xx
Issuance cost	xx
Discount	xx
Premium	xx
Total finance cost	xx

(Allocate over loan term using effective interest rate)

Years	Opening balance	Finance cost charged	Interest paid	Rollover	Closing balance
Y1	xx	Issue cost, discount & premium	Nominal value x Par value	Discount, issue cost & premium	xx

Calculation of fair value of financial instrument

- Fair value = Present value of future cash flows at current market interest for similar financial instruments
- Use market rate of relevant year or date
- Future cash flows will be used.

CLASSIFICATION OF FINANCIAL ASSETS

An entity shall classify financial assets as subsequently measured at:

- A mortised cost or
- Fair value through profit or loss (FVTPL)
- Fair value through other comprehensive income (FVTOCI)

A financial asset (debt instrument only) shall be measured at a mortised cost if both of the following conditions are met:

The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows (Solely principal amount and interest).

The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. Interest is compensation for time value of money and credit risk.

Important points

- Assess business management model on portfolio level not on individual investment
- Irregular sales of investments do not impact business management model
- Businesses may have different business management models for different investments

Fair Value Designation of Financial Assets

Even if an instrument meets the two a mortised cost tests, IFRS 9 contains an option to designate a financial asset as measured at Fair Value Through Profit and Loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency.

Fair value through other comprehensive income The criteria are as follows:

For investments in equity	For investment in debt
Investment in equity not held for trading	Business management model is to hold investment for collection of contractual cash flows and to sell
Entity has made an irrevocable election to recognize gain/ (loss) in other comprehensive income	Investment can generate contractual cash flow at specified time, Principal and Interest, where interest is compensation of time value of money & credit risk

Fair value through profit or loss The criteria are as follows:

- It is the default category (After not meeting any other category's criteria)
- Investments not categorized at amortized cost and FVTOCI will be classified here

MEASUREMENT OF FINANCIAL ASSETS

1) At Amortised cost:

Initial measurement: Fair value (Cash paid) + Transaction cost

Subsequent measurement: At amortised cost using effective interest rate method

2) At FVTOCI:

Initial measurement: Fair value (Cash paid) + Transaction cost

Subsequent measurement: At fair value and gain/loss will be charged to OCI

3) At FVTPL:

Initial measurement: Fair value (Cash paid)

Transaction cost is charged to P&L

Subsequent measurement: At fair value and gain/loss will be charged to P&L

DERECOGNITION OF FINANCIAL ASSETS

Derecognition is the removal of a previously recognised financial instrument from an entity‘s statement of financial position.

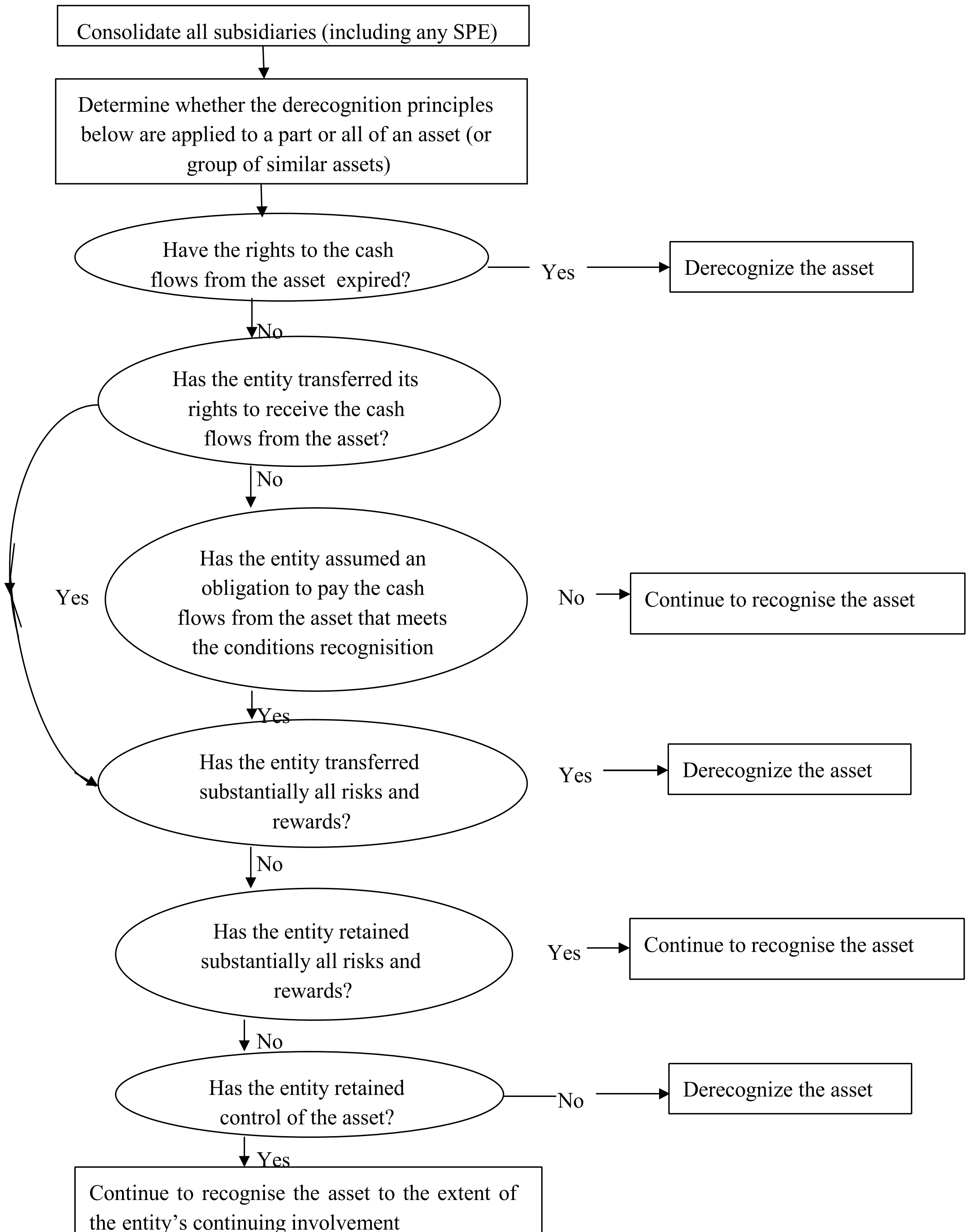
An entity should derecognize a financial asset when:

(a) The contractual rights to the cash flows from the financial asset expire e.g., cash received from receivable, Option exercised, option expired etc. , OR

(b) The entity transfers substantially all the risks and rewards of ownership of the financial asset to another party.

Accounting Treatment

On derecognition the difference between the carrying amount and consideration received should be recognised in P&L. Reclassify in P&L any accumulated gains or losses already recognised in OCI.


Consolidate all subsidiaries (including any SPE)
Determine whether the derecognition principles below are applied to a part or all of an asset (or group of similar assets)
Have the rights to the cash flows from the asset expired?
Yes
Derecognize the asset
No
Has the entity transferred its rights to receive the cash flows from the asset?
No
Yes
Has the entity assumed an obligation to pay the cash flows from the asset that meets the conditions recognisition
No
Continue to recognise the asset
Yes
Has the entity transferred substantially all risks and rewards?
Yes
Derecognize the asset
No
Has the entity retained substantially all risks and rewards?
Yes
Continue to recognise the asset
No
Has the entity retained control of the asset?
No
Derecognize the asset
Yes
Continue to recognise the asset to the extent of the entity's continuing involvement

Assess risk and rewards of financial asset immediately before and after transfer a) Substantial risk and rewards transferred

Derecognize:

Dr. Cash/Asset xx

Dr/Cr. (loss)/Profit xx

Cr. Financial asset xx Examples:

- Unconditional sale of financial asset
- Factoring of receivables (without recourse)
- Sales of asset on repurchase terms where repurchase will be at market price
- Sale of asset with call or put option and option is deep out of money

b) Substantial risks and rewards retained Continue to recognize the asset
Any cash received would be secured loan

Dr. Cash xx

Cr. Loan xx

Examples:

- Factoring of receivables with recourse
- Sales of asset on repurchase term where repurchase price is already decided
- Sale of asset with call or put option and option is deep in the money Sale of asset with return swap contract

Remember always to apply the principle of substance over form.

Classification of Financial Liabilities Financial liabilities are either classified as:

- Financial liabilities at amortised cost; or
- Financial liabilities as at fair value through profit or loss (FVTPL).

Financial liabilities are measured at amortised cost unless either:

- The financial liability is held for trading and is therefore required to be measured at FVTPL (e.g. derivatives not designated in a hedging relationship), or
- The entity elects to measure the financial liability at FVTPL (using the fair value option).

Measurement of Financial Liabilities

1) At Amortised cost:
Initial measurement: Fair value (Cash received) - Issue cost

Subsequent measurement: At amortised cost using effective interest rate method
Examples of items at amortised cost are

- Trade payables
- Loan payables
- Bank borrowings

2) At Fair value option:
Fair value Gain/Loss will be split

- Gain/Loss due to own credit risk will be charged to OCI
- Gain/Loss due to other credit risk will be charged to P&L

3) At FVTPL:

Initial measurement:

Fair value (Cash received)
Transaction cost is charged to P&L

Subsequent measurement:

- Fair value will be calculated by PV(FCF) by using current market interest rate
- Any Gain or loss will be charged to P&L
  Examples of items at FVTPL are Held for trading liability, Derivatives standing at loss, Contingent liability arising at business combination

RECLASSIFICATION OF FINANCIAL INSTRUMENTS

For financial assets, reclassification is required between FVTPL and amortised cost, or vice versa, if and only if the entity's business model objective for its financial assets changes so its previous model assessment would no longer apply.

If reclassification is appropriate, it must be done prospectively from the reclassification date. An entity does not restate any previously recognised gains, losses, or interest.

IFRS 9 does not allow reclassification where:

- Financial assets have been classified as equity instruments, or
- The fair value option has been exercised in any circumstance for a financial assets or financial liability.

DERECOGNITION OF FINANCIAL LIABILITIES

An entity shall remove a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished - i.e. when the obligation specified in the contract is discharged or cancelled or expires.

The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss.

IMPAIRMENT OF FINANCIAL INSTRUMENTS

Scope

The impairment requirements are applied to:

- Financial assets measured at amortised cost (incl. trade receivables)
- Financial assets measured at fair value through OCI
- Loan commitments and financial guarantees contracts where losses are currently accounted for under IAS 37 Provisions, Contingent Liabilities and Contingent Assets
- Lease receivables.

The impairment model follows a three-stage approach based on changes in expected credit losses of a financial instrument that determine Therecognition of impairment, and

- The recognition of interest revenue.

Initial recognition

At initial recognition of the financial asset an entity recognises a loss allowance equal to 12 months expected credit losses which consist of expected credit losses from default events possible within 12 months from the entity‘s reporting date. An exception is purchased or originated credit impaired financial assets.

Subsequent measurement

Stage	1	2	3
Impairment	12 month expected credit loss	Lifetime expected credit loss	
Interest	Effective interest on the gross carrying amount (before deducting expected losses)		fective interest on the net (carrying) amount

THREE STAGE APPROACH

Stage 1

12 month expected credit losses (gross interest)

- Applicable when no significant increase in credit risk
- Entities continue to recognise 12 month expected losses that are updated at each reporting date
- Presentation of interest on gross basis

Stage 2

Lifetime expected credit losses (gross interest)

- Applicable in case of significant increase in credit risk
- Recognition of lifetime expected losses
- Presentation of interest on gross basis

Stage 3

Lifetime expected credit losses (net interest)

- Applicable in case of credit impairment
- Recognition of lifetime expected losses
- Presentation of interest on a net basis

PRACTICAL EXPEDIENTS

30 days past due rebuttable presumption

- Rebuttable presumption that credit risk has increased significantly when contractual payments are more than 30 days past due
- When payments are 30 days past due, a financial asset is considered to be in stage 2 and lifetime expected credit losses would be recognised
- An entity can rebut this presumption when it has reasonable and supportable information available that demonstrates that even if payments are 30 days or more past due, it does not represent a significant increase in the credit risk of a financial instrument.

Low credit risk instruments

- Instruments that have a low risk of default and the counterparties have a strong capacity to repay (e.g. financial instruments that are of investment grade)
- Instruments would remain in stage 1, and only 12 month expected credit losses would be provided.

SIMPLIFIED APPROACH

Short term trade receivables

- Recognition of only =lifetime expected credit losses‘(i.e. stage 2)
- Expected credit losses on trade receivables can be calculated using provision matrix (e.g. geographical region, product type, customer rating, collateral or trade credit insurance, or type of customer)
- Entities will need to adjust the historical provision rates to reflect relevant information about current conditions and reasonable and supportable forecasts about future expectations.

Long term trade receivables and lease receivables Entities have
a choice to either apply:

- The three-stage expected credit loss model; or
- The simplified approach ‘where only lifetime expected credit losses are recognised.

LOAN COMMITMENTS AND FINANCIAL GUARANTEES

- The three-stage expected credit loss model also applies to these off balance sheet financial commitments

- An entity considers the expected portion of a loan commitment that will be drawn down within the next 12 months when estimating 12 month expected credit losses (stage 1), and the expected portion of the loan commitment that will be drawn down over the remaining life the loan commitment (stage 2)
- For loan commitments that are managed on a collective basis an entity estimates expected credit losses over the period until the entity has the practical ability to withdraw the loan commitment.

Purchased or originated credit-impaired financial assets

Purchased or originated credit-impaired financial assets are treated differently because the asset is credit impairedat initial recognition. For these assets, an entity would recognise changes in lifetime expected losses since initial recognition as a loss allowance with any changes recognised in profit or loss. Under the requirements, any favourable changes for such assets are an impairment gain even if the resulting expected cash flows of a financial asset exceed the estimated cash flows on initial recognition.

HEDGING

Hedging for accounting purposes, means designating one or more hedging instruments so that their change in fair value is an off-set, in whole or in part, to the change in fair value or cash flows of a hedged item.

Hedging instruments: A hedging instrument is a designated derivative or (in limited circumstances) another financial asset or liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item.

Hedged item

A hedged item is an asset, liability, firm commitment, or forecasted future transaction that:
(a) Exposes the entity to risk of changes in fair value or changes in future cash flows, and that (b) Is designated as being hedged

Hedge accounting

Hedge accounting recognises the offsetting effects on profit or loss of changes in the fair values of the hedging instrument and the hedged item.

Hedging relationships are of three types:

(a) Fair value hedge: a hedge of the exposure to changes in fair value of a recognised asset or liability or an un-recognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss.

(b) Cash flow hedge: a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss.

(c) Hedge of a net investment in a foreign operation as defined in IAS 21.

Designation and Documentation

Must be for malised at the inception of the hedging relationship:

- The hedging relationship
- Risk management strategy and objective for undertaking the hedge
- The hedged item and hedging instrument
- How hedge effectiveness will be assessed.

All three hedge effectiveness requirements met

(a) An economic relationship exists between the hedged item and hedging instrument

(b) Credit risk does not dominate changes in value (c) The hedge ratio is the same for both the:

- Hedging relationship
- Quantity of the hedged item actually hedged, and the quantity of the hedging instrument used to hedge it.

Types of Hedging

1. Fair value hedge

It is the exposure to changes in fair value of recognized asset or liabilities

Accounting treatment

- Hedge Instrument:

Hedge instrument gain/loss will be charged to P&L (unless hedge item is equity instrument measured at FVTOCI).

- Hedge Item:

Hedge item gain/loss will be charged to P&L (unless hedge item is equity instrument at FVTOCI, then recognize in OCI)

2. Cash flow hedge

It is a hedge of the exposure to variability in cash flows that:

- Attributable to particular risk associated with recognized asset or liability or a high probable forecast transaction
- Could affect profit or loss

Accounting treatment Hedge Instrument:

- Gain or loss on hedge instrument that's determined to be an effective hedge must be recognized in OCI (will become spate reserve in SOCIE) and ineffective portion will be charged to P&L , and effective portion (separate reserve) will be reclassified to P&L when cash flows expected to effect P&L
- If non-financial asset recognized due to hedge item then reserve can be adjusted in initial cost of non-financial asset.

DERIVATIVES

Definition:

Any contract, that have three features:

1. Its initial cost is zero or nominal as compared to other contracts that has similar response to changes in market value
2. It will be settled in future
3. Its value is dependent on certain underlying item

Derivative contracts

Types of derivative contract are as follows:

- Future contract
- Forward contract
- Options
- Swap contract

Accounting treatment:

- Fair value through profit and loss
- Initial measurement: Fair Value
- Subsequent measurement: Fair value and gain/(loss) will be charged to P&L
- Derivative Standing at gain; Financial Asset
- Derivative Standing at loss; Financial Liability

Embedded Derivatives

An embedded derivative is a component of a hybrid contract that also includes a non-derivative host— with the effect that some of the cash flows of the combined instrument vary in a way similar to a standalone derivative.

Host contracts are the contracts in which derivative contracts are embedded.

Examples include:

(a) A lease
(b) A debt or equity instrument
(c) An insurance contract
(d) A sale or purchase contract
(e) A construction contract

A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty, is not an embedded derivative, but a separate financial instrument.

Measurement

Hybrid contracts with financial asset hosts

If a hybrid contract contains a host that is an asset within the scope of this IFRS, an entity shall apply the measurement rules to the entire hybrid contract (recognized at FVTPL). E.g.
Investment in convertible loan, Investment in bond where interest rate vary with gold prices

Other hybrid contracts
If host contact is a financial liability or non-financial contracts E.g. Issue of convertible loan, lease/construction contract in foreign currency
Criteria: (if met separation required)

- Economic characteristic should be different (host contract and derivative)
- Host contract should not be measured at FVTPL
- Embedded derivatives should meet the definition of stand - alone derivative

Financial instruments

Test your understanding 1 – Ashes' financial assets A
shes' holds the following financial assets:

1. Investments in ordinary shares that are held for short-term speculation.
2. Investments in ordinary shares that, from the purchase date, are intended to be held for the long term.

Required:
How should Ashes classify and account for its financial assets?
Answer:
Test your understanding 1 – Ashes' financial assets
(1) Investments in equity held for short-term speculative purposes must be classified and accounted for as fair value through profit or loss. Such assets are initially recognised at fair value. Any transaction costs are expensed to profit or loss. The assets are remeasured to fair value at the reporting date with the gains and losses on remeasurement recognised in profit or loss.
(2) Investments in equity that, from the outset, are going to be held indefinitely may be irrevocably designated upon initial recognition as fair value through other comprehensive income. Such assets are initially recognised at fair value plus transaction costs. They are

remeasured to fair value at the reporting date and gains and losses on remeasurement are recognised in other comprehensive income. If no such election on purchase is made then the investment must be classified and accounted for as fair value through profit or loss (see (1) above.

Test your understanding 2 – Paloma

Paloma purchased a new financial asset on 31 December 2003. The asset is a bond that will mature in three years. Paloma buys debt investments with the intention of holding them to maturity although has, on occasion, sold some investments if cash flow deteriorated beyond acceptable levels. The bond pays a market rate of interest. The Finance Director is unsure as to whether this financial asset can be measured at amortised cost.

Required:

Advise the Finance Director on how the bond will be measured.

Answer:

Test your understanding 2 – Paloma

A debt instrument can be held at amortised cost if

- The entity intends to hold the financial assets to collect contractual cash flows, rather than selling it to realize fair value changes.
- The contractual cash flows of the asset are solely payments of principal and interest based upon the principal amount outstanding.

Paloma's objective is to hold the financial assets and collect the contractual cash flows. Making some sales when cash flow deteriorates does not contradict that objective.

The bond pays a market level of interest, and therefore the interest payments received provide adequate compensation for the time value of money or the credit risk associated with the principal amount outstanding.

This means that the asset can be measured at amortised cost.

Test your understanding 3 – Tokyo

On 1 January 2001, Tokyo bought a $ 100,000 5% bond for $95,000, incurring issue costs of $2,000. Interest is received in arrears. The bond will be redeemed at a premium of $5,960 over nominal value on 31 December 2003. The effective rate of interest is 8%.

The fair value of the bond was as follows:

31/12/X1 $110,000

31/12/X2 $104,000

Required:

Explain, with calculations, how the bond will have been accounted for over all relevant years if:

(a) Tokyo's business model is to hold bonds until the redemption date.

(b) Tokyo's business model is to hold bonds until redemption but also to sell them if investments with higher returns become available.

(c) Tokyo's business model is to trade bonds in the short-term. Assume that Tokyo sold this bond for its fair value on 1 January 2002.

The requirement to recognise a loss allowance on debt instruments held at amortised cost or fair value through other comprehensive income should be ignored.

Answer:

Test your understanding 3 – Tokyo

(a) The business model is to hold the asset until redemption. Therefore, the debt instrument will be measured at amortised cost.

The asset is initially recognised at its fair value plus transaction costs of $97,000 ($95,000 + $2,000).

Interest income will be recognised in profit or loss using the effective rate of interest.

	Bfd	Interest (8%)	Receipt	Cfd
	$	$	$	$
y/e 31/12/X1	97,000	7,760	(5,000)	99,760
y/e 31/12/X2	99.760	7,981	(5,000)	102,741
y/e 31/12/X3	102.741	8,219	(5,000)	nil

(105,960)

In the year ended 31 December 2001, interest income of $7,760 will be recognised in profit or loss and the asset will be held at $99,760 on the statement of financial position.

In the year ended 31 December 2002, interest income of $7,981 will be recognised in profit or loss and the asset will be held at $102,741 on the statement of financial position.

In the year ended 31 December 2003, interest income of $8,219 will be recognised in profit or loss.

(b) The business model is to hold the asset until redemption, but sales may be made to invest in other assets will higher returns. Therefore, the debt instrument will be measured at fair value through other comprehensive income.

The asset is initially recognised at its fair value plus transaction costs of $97,000 ($95,000 + $2,000).

Interest income will be recognised in profit or loss using the effective rate of interest. The asset must be revalued to fair value at the year end. The gain will be recorded in other comprehensive income.

	Bid	Interest (per (a))	Receipt	Total	Gain/ (loss)	Cfd
	$	$	$	$	$	$
y/e 31/12/X1	97,000	7,760	(5,000)	99,760	10,240	110,000
y/e 31/12/X2	110,000	7,981	(5,000)	112,981	(8,981)	104,000
y/e 31/12/X3	104,000	8,219	(5,000) (105,960)	1,259	(1,259	nil

Note that the amounts recognised in profit or loss as interest income must be the same as if the asset was simply held at amortised cost. Therefore, the interest income figures are the same as in part (a).

In the year ended 31 December 2001, interest income of $7,760 will be recognised in profit or loss and a revaluation gain of $10,240 will be recognised in other comprehensive income. The asset will be held at $110,000 on the statement of financial position.

In the year ended 31 December 2002, interest income of $7,981 will be recognised in profit or loss and a revaluation loss of $8,981 will be recognised in other comprehensive income. The asset will be held at $104,000 on the statement of financial position.

In the year ended 31 December 2003, interest income of $8,219 will be recognised in profit or loss and a revaluation loss of $1,259 will be recognised in other comprehensive income. (c) The bond would be classified as fair value through profit or loss. The asset is initially recognised at its fair value of $95,000. The transaction costs of $2,000 would be expensed to profit or loss.

In the year ended 31/12/X1, interest income of $5,000 ($100,000 x5%) would be recognised in profit or loss. The asset would be revalued to $110,000 with a gain of $15,000 ($110,000 - $95,000) recognised in profit or loss.

On 1/1/X2, the cash proceeds of $110,000 would be recognised and the financial asset would be derecognized.

Test your understanding 4 – Magpie

On 1 January 2001, Magpie lends $2 million to an important supplier. The loan, which is interest-free, will be repaid in two years' time. The asset is classified to be measured at amortised cost. There are no transaction fees.

Market rates of interest are 8%. The loss allowance is highly immaterial and can be ignored.

Required:

Explain the accounting entries that Magpie needs to post in the year ended 31 December 2001 to account for the above.

Answer:

Test your understanding 4 – Magpie

The loan is a financial asset because Magpie has a contractual right to receive cash in two years' time.

Financial assets are initially recognised at fair value. Fair value is the price paid in an orderly transaction between market participants at the measurement date.

Market participants would receive 8% interest on loans of this type, whereas the loan made to the supplier is interest-free. It would seem that the transaction has not occurred on fair value terms.

The financial asset will not be recognised at the price paid of $2 million as this is not the fair value. Instead, the fair value must be determined. This can be achieved by calculating the present value of the future cash flows from the loan (discounted using a market rate of interest).

The financial asset will therefore be initially recognised at $1.71 million ($2m x $1/1.08^2$). The entry required to record this is as follows:

Dr Financial asset	$1.71m
Dr Profit or loss	$0.29m
Cr Cash	$2.00m

The financial asset is subsequently measured at amortised cost:

	1 Jan X1	Interest (8%)	Receipt	31 DecX1
	$m	$m	$m	$m
y/e 31/12/X1	1.71	0.14	-	1.85
y/e 31/12/X1				

Interest income of $0.14 million is recorded by posting the following:

Dr Financial asset	$0.14m
Cr Profit or loss	$0.14m

The loan is interest-free, so no cash is received during the period.

The financial asset will have a carrying amount of $1.85 million as at 31 December 2001.

By 31 December 2002, the financial asset will have a carrying amount of $2 million. This amount will then be repaid by the supplier.

Test your understanding 5 – Tahoe

San Fran is a company that has issued a public bond. It reports to its shareholders on a bi-annual basis.

Tahoe, a company which holds financial assets until maturity, is one of many investors in San Fran's bond. On purchase, Tahoe deemed the bond to have a low credit risk due to San Fran's strong capacity to fulfill its short-term obligations. It was perceived, however, that adverse changes in the economic environment could have a detrimental impact on San Fran's liquidity.
At Tahoe's reporting date, it has access to the following information about San Fran:

- Sales have declined 15% over the past 6 months
- External agencies are reviewing its credit rating, but no changes have yet been made
- Although market bond prices have remained static, San Fran's bond price has fallen dramatically.

Required:

Discuss the accounting treatment of the bond in Tahoe's financial statements at the reporting date.

Answer:

Test your understanding 5 – Tahoe

Using available information, Tahoe needs to assess whether the credit risk on the bond has increased significantly since inception.

It would seem that San Fran's performance has declined and this may have an impact on its liquidity.

The review of San Fran's credit rating by external agencies is suggestive of wider concerns about the performance and position of San Fran.

The fact that market bond prices are static suggests that the decline in San Fran's bond price is entity specific. This is likely to be a response to San Fran's increased credit risk.

Based on the above, it would seem that the credit risk of the bond is no longer low. As a result, it can be concluded that credit risk has increased significantly since inception.

This means that Tahoe must recognise a loss allowance equal to lifetime expected credit losses on the bond.

Test your understanding 6 – Napa

On 1 January 2001, Napa purchased a bond for $1m which is measured at amortised cost. Interest of 10% is payable in arrears. Repayment is due on 31 December 2003. The effective rate of interest is 10%.

On 31 December 2001, Napa received interest of $100,000. It estimated that the probability of default on the bond within the next 12 months would be 0.5%. If default occurs within the next 12 months then Napa estimated that no further interest will be received and that only 50% of the capital will be repaid on 31 December 2003.

The asset's credit risk at 31 December 2001 is low.

Required:

Discuss the accounting treatment of the financial asset at 31 December 2001.

Answer:

Test your understanding 6 – Napa

The credit risk on the financial asset has not significantly increased. Therefore, a loss allowance should be made equal to 12-month expected credit losses. The loss allowance should factor in a range of possible outcomes, as well as the time value of money.

The credit loss on the asset is $586,777 (W1). This represents the present value of the difference between the contractual cash flows and the expected receipts if a default occurs.

The expected credit loss is $2,934 ($586,777 credit loss x 0.5% probability of occurrence). A loss allowance of $2,934 will be created and an impairment loss of $2,934 will be charged to profit or loss in the year ended 31 December 2001.

The net carrying amount of the financial asset on the statement of financial position is $997,066 ($1,000,000 - $2,934).

Note: Interest in future periods will continue to be charged on the asset's gross carrying amount of $1,000,000.

Date of receipt	Expected cash shortfall	Discount rate	Present value
	$		$
31/12/X2	100,000	1/1.1	90,909
31/12/X3	100,000	$1/1.1^2$	82,645
31/12/X3	500,000	$1/1.1^2$	413,223
			586,777

Test your understanding 7 – Eve

On 1 February 2006, Eve made a four – year loan of $10,000 to Fern. The coupon rate on the loan is 6%, the same as the effective rate of interest. Interest is received at the end of each year.

On 1 February 2009, Fern tells Eve that it is in significant financial difficulties. At this time the current market interest rate is 8%.

Eve estimates that it will receive no more interest from Fern. It also estimates that only $6,000 of the capital will be repaid on the redemption date. Eve has already recognised a loss allowance of $1,000 in respect of its loan to Fern.

Required:

How should this be accounted for?

Answer:

Test your understanding 7 – Eve

Evidence about the significant financial difficulties of Fern mean that the asset is now credit impaired

Expected losses on credit impaired assets are calculated as the difference between the asset's gross carrying amount and the present value of the expected future cash flows discounted using the original effective rate of interest.

Because the coupon and the effective interest rate are the same, the carrying amount of the asset will remain constant at $10,000.
The present value of the future cash flows discounted using the original effective rate is ($5,660 x 1/1.06).

The expected losses are therefore $4,340 ($10,000 - $5,660) and so a loss allowed should be recognised for this amount. Therefore, the existing loss allowance must be increased by $3,340 ($4,340 - $1,000) with an expense charged to profit or loss.

The asset is credit impaired and so interest income will now be calculated on the net carrying amount of $5,660 (the gross amount of $10,000 less the loss allowance of $4,340). Consequently, in the last year of the loan, interest of $340 (5,660 x 6%) will be recognised in profit or loss.

Test your understanding 8 – FVOCI and expected losses

An entity purchases a debt instrument for $1,000 on 1 January 2001. The interest rate on the bond is the same as the effectively rate. After accounting for interest for the year to 31 December 2001, the carrying amount of the bond is still $1,000.

At the reporting date of 31 December 2001, the fair value of the instrument has fallen to $950. There has not been a significant increase in credit risk since inception so expected credit losses should be measured at 12-month expected credit losses. This is deemed to amount to $30.

Required:

Explain how the revaluation and impairment of the financial asset should be accounted for.

Answer:

Test your understanding 8-FVOCI and expected losses

A loss of $50 ($1,000 - $950) arising on the revaluation of the asset to fair value will be recognised in other comprehensive income.

Dr OCI	$50
Cr Financial asset	$50

The 12-month expected credit losses of $30 will be debited to profit or loss. The credit entry is not recorded against the carrying amount of the asset but rather against other comprehensive income:

Dr Impairment loss (P/L)	$30
Cr OCI	$30

There is therefore a cumulative loss in OCI of $20 (the fair value change of $50 offset by the impairment amount of $30).

Test your understanding 9 – Ming

Ming has two receivables that it has factored to a bank in return for immediate cash proceeds. Both receivables are due from long standing customers who are expected to pay in full and on time. Ming had agreed a three-month credit period with both customers.

The first receivable is for $200,000. In return for assigning the receivable, Ming has received $180,000 from the factor. Under the terms of the factoring arrangement, Ming will not have to repay this money, even if the customer does not settle the debt (the factoring arrangement is said to be 'without recourse').

The second receivable is for $100,000. In return for assigning the receivable, Ming has received $70,000 from the factor. The terms of this factoring arrangement state that Ming will receive a further $5,000 if the customer settles the account on time.

If the customer does not settle the account in accordance with the agreed terms then the receivable will be reassigned back to Ming who will then be obligated to refund the factor with the original $70,000 (this factoring arrangement is said to be 'with recourse').

Required:

Discuss the accounting treatment of the two factoring arrangements.

Answer:

Test your understanding 9 – Ming

The principle at stake with derecognition or otherwise of receivables is whether, under the factoring arrangement, the risks and rewards of ownership pass from Ming to the factor. The key risk with regard to receivables is the risk of bad debt.

In the first arrangement the $180,000 has been received as a one-off, non-refundable sum. This is factoring without recourse for bad debts. The risk of bad debt has clearly passed from Ming to the factoring bank. Accordingly Ming should derecognize the receivable and there will be an expense of $20,000 recognised.

In the second arrangement the $70,000 is simply a payment on account. More may be received by Ming implying that Ming retains an element of reward. The monies received are refundable in the event of default and as such represent an obligation. This means that the risk of slow payment and bad debt remains with Ming who is liable to repay the monies so far received. Despite the passage of legal title the receivable should remain recognised in the accounts of Ming. In substance Ming has borrowed $70,000 and this loan should be recognised immediately. This will increase the gearing of Ming.

Test your understanding 10 – Case

Case holds equity investments at fair value through profit or loss. Due to short-term cash flow shortages, Case sold some equity investments for $5 million when the carrying amount was $4 million. The terms of the disposal state that Case has the right to repurchase the shares at any point cover the next two years at their fair value on the repurchase dat. Case has not derecognized the investment because its directors believe that a repurchase is highly likely.

Required:

Advise the directors of Case as to the acceptability of the above accounting treatment.

Answer:

Test your understanding 10 – Case

An entity has transferred a financial asset if it has transferred the contractual rights to receive the cash flows of the asset.

IFRS 9 says that if an entity has transferred a financial asset, it must evaluate the extent to which it has retained the significant risks and rewards of ownership. If the entity transfers substantially all the risks and rewards of ownership, the entity must derecognize the financial asset.

Gains and losses on the disposal of a financial asset are recognised in the statement of profit or loss. Case is under no obligation to buy back the shares and is therefore protected from future share price declines. Moreover, if Case does repurchase the shares, this will be at fair value rather than a pre-fixed price and therefore Case does not retain the risks and rewards related to price fluctuations.

The risks and rewards of ownership have been transferred and, as such, Case should derecognize the financial asset. A profit of $1m ($5m - $4m) should be recognised in profit or loss.

Test your understanding 11 – Jones

Jones bought an investment in equity shares for $40 million plus associated transaction costs of $1 million. The asset was designated upon initial recognition as fair value through other comprehensive income. At the reporting date the fair value of the financial asset had risen to $60 million. Shortly after the reporting date the financial asset was sold for $70 million.

Required:

(a) How should the investment be accounted for?

(b) How would the answer have been different if the investment had been classified to be measured at fair value through profit and loss?

Answer:

Test your understanding 11 – Jones

(a) On purchases the investment is recorded at the consideration paid. The asset is classified as fair value through other comprehensive income and, as such, transaction costs are included in the initial value:

Dr Asset 41m Cr Cash 41m

At the reporting date the asset remeasured to fair value and the gain of $19m ($60m - $41m) is recognised in other comprehensive income and taken to equity:

Dr Asset 19m

Cr Other components of equity 19m

On disposal the asset is derecognized. The profit or loss on disposal, recorded in the statement of profit loss, is determined by comparing disposal proceeds with the carrying value of the asset:

Dr Cash 70m Cr Asset 60m

Cr Profit or loss 10m

Note that the gains or losses previously taken to equity are not recycled upon derecognition, although they may be reclassified within equity.

(b) If Jones had designated the investment as fair value through profit and loss, the transaction costs would have been recognised as an expense in profit or loss. The entry posted on the purchase date would have been:

Dr Asset 40m Cr Cash 40m

Dr Profit or loss 1m

Cr Cash 1m

At the reporting date, the asset is remeasured to fair value and the gain of $20m ($60m - $40m) is recognised in the statement of profit or loss:

Dr Asset 20m

Cr Profit or loss 20m

On disposal the asset is derecognized and the profit on disposal is recorded in the statement of profit or loss:

Dr Cash 70m Cr Asset 60m

Cr profit or loss 10m

Note that the reported profit on derecognition of $10 million is the same whether the asset was designated as fair value through profit or loss or fair value through other comprehensive income.

Test your understanding 12 – Hoggard

Hoggard buys 100 options on 1 January 2006 for $5 per option. Each option gives Hoggard the right to buy a share in Rowling on 31 December 2006 for $10 per shre.

Required:

How should this be accounted for, give the following outcomes?

(a) The options are sold on 1 July 2006 for $15 each.

(b) On 31 December 2006, Rewling's share price is $8 and Hoggard lets the option lapse unexercised.

(c) The option is exercised on 31 December when Rowling's share price is $25. The shares are classified as held for trading.

Answer:

Test your understanding 12 – Hoggard

In all scenarios the cost of the derivative on 1 January 2006 is $500 ($5 x 100) and an asset is recognised in the statement of financial position.

Dr Asset – option $500

Cr Cash $500

Outcome A

If the option is sold for $1,500 (100 x $15) before the exercise date, it is derecognized at a profit of $1,000.

Dr Cash $1,500

Cr Asset – option $500

Cr Profit or loss $1,000

Outcome B

If the option lapses unexercised, then it is derecognized and there is a loss to be taken to profit or loss:

Dr Profit or loss $500

Cr Asset – option $500

Outcome C

If the option is exercised then the option is derecognized, the entity records the cash paid upon exercise, and the investment in shares is recognised at fair value. An immediate profit is recognised:

Dr	Asset – investment (100 x $25)	$2,500	
Cr	Cash (100 x $10)		$1,000
Cr	Asset – option		$500
Cr	Profit or loss	$1,000	

Test your understanding 13 – Fair value hedge

On 1 January 2008 an entity purchased equity instruments for their fair value of $900,000. They were designated upon initial recognition to be classified as fair value through other comprehensive income.

At 30 September 2008, the equity instrument was still worth $900,000 but the entity became worried about the risk of a decline in value. It therefore entered into a futures contract to sell the shares for $900,000 in six months' time. It identified the futures contract as a hedging instrument as part of a fair value hedging arrangement. The fair value hedge was correctly documented and designated upon initial recognition. All effectiveness criteria have been complied with.

By the reporting date of 31 December 2008, the fair value of the equity instrument had fallen to $800,000, and the fair value of the futures contract had risen by $90,000.

Required:

Explain the accounting treatment of the fair value hedge arrangement based upon the available information.

Answer:

Test your understanding 13 – Fair value hedge

The hedged item is an investment in equity that is measured at fair value through other comprehensive income (OCI). Therefore, the increase in the fair value of the derivative of $90,000 and the fall in fair value of the equity interest of $100,000 since the inception of the hedge are taken to OCI.

Dr Derivative $90,000

Cr OCI	$90,000
Dr OCI	$100,000
Cr Equity investment	$100,000

The net result is a small loss of $10,000 in OCI.

Test your understanding 14 – Firm commitments

Chive has a firm commitment to buy an item of machinery for CU2m on 31 March 2002. The Directors are worried about the risk exchange rate fluctuations.

On 1 October 20001, when the exchange rate is CU2: $1, Chive enters into a futures contract to buy CU2m for $1m on 31 March 2002.

At 31 December 2001, CU2m would cost $1,100,000. The fair value of the futures contract has risen to $95,000. All effectiveness criteria have been complied with.

Required:

Explain the accounting treatment of the above in the financial statements for the year ended 31 December 2001 if:

(a) Hedge accounting was not used.

(b) On 1 October 2001, the futures contract was designated as a fair value hedge of the movements in the fair value of the firm commitment to purchase the machine.

Answer:

Test your understanding 14 – Firm commitments

(a) The futures contract is a derivative and is measured at fair value with all movements being accounted for through profit or loss.

The fair value of the futures control at 1 October 2001 was nil. By the year end, it had risen to $95,000. Therefore, at 31 December 2001, Chive will recognise an asset at $95,000 and a gain of $95,000 will be recorded in profit or loss.

(b) If the relationship had been designated as a fair value hedge then the movement in the fair value of the hedging instrument (the future) and the fair value of the hedged item (the firm commitment) since inception of the hedge are accounted for through profit or loss.

The derivative has increased in fair value from $nil at 1 October 2001 to $95,000 at 31 December 2001. Purchasing CU2 million at 31 December 2001 would cost Chive $100,000 more than it would have done at 1 October 2001. Therefore the fair value of the firm commitment has fallen by $100,000.

At year end, the derivative will be held at its fair value of $95,000, and the gain of $95,000 will be recorded in profit or loss.

The $100,000 fall in the fair value of the commitment will also be accounted for, with an expense recognised in profit or loss.

In summary, the double entries are as follows:

Dr Derivative	$95,000
Cr Profit or loss	$95,000
Dr Profit or loss	$100,000
Cr Firm commitment	$100,000

The gain on the derivative and the loss on the firm commitment largely net off. There is a residual $5,000 (100,000 - $95,000) net expense in profit or loss due to hedge ineffectiveness. Nonetheless, financial statement volatility is far less than if hedge accounting had not been used.

Test your understanding 15 – Cash flow hedge

A company enters into a derivative contract in order to protect its future cash inflows relating to a recognised financial asset. At inception, when the fair value of the hedging instrument was nil, the relationship was documented as a cash flow hedge.

By the reporting date, the loss in respect of the future cash flows amounted to $9,100 in fair value terms. It has been determined that the hedging relationship meets all effectiveness criteria.

Required:

Explain the accounting treatment of the cash flow hedge if the fair value of the hedging instrument at the reporting date is:

(a) $8,500 (b)

$10,000

Answer:

Test your understanding 15 – Cash flow hedge

(a) The movement on the hedging instrument is less than the movement on the hedged item. Therefore, the instrument is remeasured to fair value and the gain is recognised in other comprehensive income.

Dr Derivative	$8,500
Cr OCI	$8,500

(b) The movement on the hedging instrument is more than the movement on the hedged item. The excess movement of $900 ($10,000 - $9,100) is recognised in the statement of profit or loss.

Dr Derivative	$10,000
Cr Profit or loss	$900
Cr OCI $	9,100

Test your understanding 16 – Bling

On 31 October 2001, Bling had inventories of gold which cost $6.4m to buy and which could be sold for $7.7m. The management of Bling are concerned about the risk of fluctuations in future cash inflows from the sale of this gold.

To mitigate this risk, Bling entered into a futures contract on 31 October 2001 to sell the gold for $7.7m. The contracts mature on 31 March 2002. The hedging relationship was designated and documented at inception as a cash flow hedge. All effectiveness criteria are complied with.
On 31 December 2001, the fair value of the gold was $8.6m. The fair value of the futures contract had fallen by $0.9m.

There is no change in fair value of the gold and the futures contract between 31 December 200` and 31 March 2002. On 31 March 2002, the inventory is sold for its fair value and the futures contract is settled net with the bank.

Required:

(a) Discuss the accounting treatment of the hedge in the year ended 31 December 2001.

(b) Outline the accounting treatment of the inventory sale and the futures contract settlement on 31 March 2002.

Answer:

Test your understanding 16 – Bling

(a) Between 1 October 2001 and 31 December 2001, the fair value of the futures contract had fallen by $0.9m. Over the same time period, the hedge item (the estimated cash receipts from the sale of the inventory) had increased by $0.9m ($8.6m - $7.7m).

Under a cash flow hedge, the movement in the fair value of the hedging instrument is accounted for through other comprehensive

Dr Other comprehensive income	$0.9m
Cr Derivative	$0.9m

The loss recorded in order comprehensive income will be held within equity.

(b) The following entries are required:

Dr Cash	$8.6m
Cr Revenue	$8.6m

Dr Cost of sales	$6.4m
Cr Inventory	$6.4m

To record the sale of the inventory at fair value

Dr Derivative	$0.9m
Cr Cash	$0.9m

To record the settlement of the futures contract

Dr Profit or loss	$0.9m
Cr OCI	$0.9m

To recycle the losses held in equity through profit or loss in the same period as the hedged item affects profit or loss.

Test your understanding 17 – Grayton

In January, Grayton, whose function currency is the dollar ($), decided that it was highly probable that it would buy an item of plant in one year's time for KR 200,000. As a result of being risk averse, it wished to hedge the risk that the cost of buying KRs would rise and so entered into a forward rate agreement to buy KR 200,000 in one year's time for the fixed it was designated as a hedging instrument.

At Grayton's reporting date of 31 July, the KR had depreciated and the value of KR 200,000 was $90,000. The fair value of the derivative had declined by $10,000. These values remained unchanged until the plant was purchased.

Required:

How should this be accounted for?

Answer:

Test your understanding 17 – Grayton

The forward rate agreement has no fair value at its inception so is initially recorded at $nil.

This is a cash flow hedge. The derivative has fallen in value by $10,000 but the cash flows have increased in value by $10,000 (it is now $10,000 cheaper to buy the asset).
Because it has been designated a cash flow hedge, the movement in the value of the hedging instrument is recognised in other comprehensive income:

Dr	Other comprehensive income	$10,000
Cr	Derivative	$10,000

(Had this not been designated a hedging instrument, the loss would have been recognised immediately in profit or loss.)

The forward contract will be settled and closed when the asset is purchased.

Property, plant and equipment is a non-financial item. The loss on the hedging instrument held within equity is adjusted against the carrying amount of the plant.

The following entries would be posted:

Dr	Liability – derivative	$10,000
Dr	Plant	$90,000
Cr	Cash	$100,000

Being the settlement of the derivative and the purchase of the plant.

Dr	Plant	$10,000
Cr	Cash flow hedge reserve	$10,000

Being the recycling of the losses held within equity against the carrying amount of the plant.
Notice that the plant will be held at $100,000 ($90,000 + $10,000) and the cash spent in total was $100,000. This was the position that the derivative guaranteed.

IFRS 7 FINANCIAL INSTRUMENT DISCLOSURES

Objective

IFRS 7 requires entities to provide disclosures in their financial statements that enable users to evaluate:

- The significance of financial instruments for the entity's financial position and performance; and
- The nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

Classes of financial instruments and level of disclosures

IFRS 7 requires that certain disclosures should be given by class of financial instruments. The classes of financial instruments that will be disclosed should be appropriate to the nature of the information disclosed and should take into account the characteristics of those financial instruments. An entity should provide sufficient information to permit reconciliation to the line items presented in the statement of financial position.

Statement of financial position:

- Financial assets measured at fair value through profit and loss, showing separately those held for trading and those designated at initial recognition
- Special disclosures about financial assets and financial liabilities designated to be measured at fair value through profit and loss, including disclosures about credit risk and market risk, changes in fair values attributable to these risks and the methods of measurement.
- Reclassifications of financial instruments from one category to another (e.g. from fair value to amortised cost or vice versa) information about financial assets pledged as collateral and about financial or non- financial assets held as collateral
- Reconciliation of the allowance account for credit losses (bad debts) by class of financial assets.
- Information about compound financial instruments with multiple embedded derivatives Breaches of terms of loan agreements

Statement of profit or loss and other comprehensive income

- Items of income, expense, gains, and losses, with separate disclosure of gains and losses from financial assets measured at fair value through profit and loss, showing separately those held for trading and those designated at initial recognition total interest income and total interest expense for those financial instruments that are not measured at fair value through profit and loss fee income and expense amount of impairment losses by class of financial assets interest income on impaired financial assets

Test your understanding 1 – Lizzer

Lizzer is a debt issuer whose business is the security sation of a portfolio of underlying investments and financing their purchase through the issuing of listed, limited recourse debt. The repayment of the debt is dependent upon the performance of the underlying investments. Debtholders bear the ultimate risks and rewards of ownership of the underlying investments. Given the dent specific nature of the underlying investments, the risk profit of individual debt may differ.

Lizzer does not consider its debt-holders as being amongst the primary users of the financial statements and, accordingly, does not wishes to provide disclosure of the debt-holders' exposure to risks in the financial statements, as distinct from the risks faced by the company's shareholders, in accordance with IFRS 7 Financial Instruments:

Required:

Discuss the directors' view that no further information regarding the above should be disclosed in the financial statements because it would be 'excessive'.

Answer:

Test your understanding 1 – Lizzer

Lizzer's perception of who could reasonably be considered to be among the users of its financial statements is too narrow, being limited to the company's shareholders rather than including debtholders.

IAS 1 states that the objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. The standard also states that omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements.

The objective of IFRS 7 is to require entities to provide disclosures in their financial statements that enable users to evaluate the significance of financial instruments for the entity's financial position and performance. IFRS 7 state that, amongst other matters, for each type of risk arising from financial instruments, an entity shall disclose:

- The exposures to risk and how they arise
- Its objectives, policies and processes for managing the risk and the methods used to measure the risk.

Thus the risks attached to the debt should be disclosed.

IFRS 10 – CONSOLIDATED FINANCIAL STATEMENTS

A group is formed when one company, known as the parent, acquires control over another company, known as its subsidiary.

The subsidiary and the holding company are considered separate legal entities. Group accounts are presented as if the parent company and its subsidiary were one single entity – an application of the substance over form concept.

DEFINITIONS

Group of Companies arises when one company (Parent) takes control of another company (subsidiary).

Subsidiary is a company controlled by another company.

Parent is a company that controls one or more subsidiaries.

Non-Controlling Interest is a collective representation of the shareholders that normally own 49% or less of equity.

Consolidated Financial Statements means F/S of whole Group presented as a single set of accounts.

CONTROL

According to IFRS 10 Consolidated

Financial Statements an investor controls investee when it 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.

Existence of parent subsidiary relationship Parent subsidiary relationship exists when:

- The parent holds more than one half of the voting power of the entity
- The parent has power over more than one half of the voting rights by virtue of an agreement with other investors (common control)
- The parent has the power to govern the financial and operating policies of the entity under the articles of association of the entity
- The parent has the power to appoint or remove a majority of the board of directors
- The parent has the power to cast the majority of votes at meetings of the board

EXEMPTION FROM PREPARING GROUP ACCOUNTS

A parent need not present consolidated financial statements if the following stipulations hold:

- The parent itself is a wholly-owned subsidiary or it is a partially owned subsidiary of another entity Its securities are not publicly traded
- The parent's debt or equity instruments are not traded in a public market
- The parent did not file its financial statements with a securities commission or other regulatory organisation.
- The ultimate parent publishes consolidated financial statements that comply with International Financial Reporting Standards.

CONDITIONS - DIRECTORS MAY NOT WISH TO CONSOLIDATE A SUBSIDIARY

The directors of a parent company may not wish to consolidate some subsidiaries due to:

- Control is temporary as the subsidiary was purchased for re-sale
- Unsatisfactory performance and weak financial position of the subsidiary
- Differing activities (nature) of the subsidiary from the rest of the group
- Reduction of apparent gearing by avoiding consolidation of subsidiary's loan
- Legal conditions restricting the parent's ability to run the subsidiary.

Apart from legal restriction, these reasons are not permitted according to IFRSs and consolidated financial statements should be prepared including all these subsidiaries.

IFRS 3 requires exclusion from consolidation only if the parent has lost control over its investment. This could occur in cases where control over a subsidiary is lost because of a restriction from government, a regulator, a court of law, or as a result of a contractual agreement.

GENERAL RULES

- Same accounting policies should be used for both the holding company and the subsidiaries. Adjustments must be made where there is a difference
- The reporting dates of parent and subsidiary will be the same in most cases. In case of difference, the subsidiary will be allowed to prepare another set of accounts for consolidation purposes (if the difference is of more than three months).

Accounting for subsidiaries in separate financial statements of the holding company

The holding company will usually produce its own separate financial statements. Investments in subsidiaries and associates have to be accounted for at cost or in accordance with IFRS 9. Where subsidiaries are classified as held for sale then the provisions of IFRS 5 have to be complied with.

Acquisition costs

In accordance with IFRS 3, because acquisition-related costs are not part of the exchange transaction between the acquirer and the acquiree (or its former owners), they are not considered part of the business combination.

Costs of issuing debt or equity instruments are accounted for under IAS 32 Financial Instruments: Presentation and IFRS 9 Financial Instruments. All other costs associated with an acquisition must be expensed, including reimbursements to the acquiree for bearing some of the acquisition costs. Therefore, transaction costs no longer form a part of the acquisition price; they are expensed as incurred.

Transaction costs are not deemed to be part of what is paid to the seller of a business. They are also not deemed to be assets of the purchased business that should be recognised on acquisition.

The standard requires entities to disclose the amount of transaction costs that have been incurred. Examples of costs to be expensed include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; and general administrative costs, including the costs of maintaining an internal acquisitions department.

ACQUIRED ASSETS AND LIABILITIES

IFRS 3 establishes the following principles in relation to the recognition and measurement of items arising in a business combination:

- Recognition principle. Identifiable assets acquired, liabilities assumed, and noncontrolling
- interests in the acquiree, are recognised separately from goodwill
- Measurement principle. All assets acquired and liabilities assumed in a business combination are measured at acquisition-date fair value.
- IFRS 3 (Revised) has introduced some changes to the assets and liabilities recognised in the acquisition statement of financial position. The existing requirement to recognise all of the identifiable assets and liabilities of the acquiree is retained. Most assets are recognised at fair value, with exceptions for certain items such as deferred tax and pension obligations.

Intangible assets

Acquired intangible assets must be recognised and measured at fair value in accordance with the principles if it is separable or arises from other contractual rights, irrespective of whether the acquiree had recognised the asset prior to the business combination occurring. This is because there is always sufficient information to reliably measure the fair value of these assets. Acquirers are required to recognise brands, licences and customer relationships, and other intangible assets.

Contingent amounts

Contingent assets are not recognised, and contingent liabilities are measured at fair value. Until a contingent liability is settled, cancelled or expired, a contingent liability that was recognised in the initial accounting for a business combination is measured at the higher of the amount the liability would be recognised under IAS 37 Provisions, Contingent Liabilities and Contingent Assets, and the amount less accumulated amortization (amount under the relevant standard).

The acquirer can seldom recognise a reorganisation provision at the date of the business combination.

There is no change from the previous guidance in the new standard: the ability of an acquirer to recognisea liability for terminating or reducing the activities of the acquiree is severely restricted. A restructuring provision can be recognised in a business combination only when the acquiree has, at

the acquisition date, an existing liability for which there are detailed conditions in IAS 37, but these conditions are unlikely to exist at the acquisition date in most business combinations.

Timeline for acquisition accounting

An acquirer has a maximum period of 12 months from the date of acquisition to finalise the acquisition accounting. The adjustment period ends when the acquirer has gathered all the necessary information, subject to the 12-month maximum. There is no exemption from the 12month rule for deferred tax assets or changes in the amount of contingent consideration. The revised standard will only allow adjustments against goodwill within this one-year period.

Group accounting – basic groups

Illustration 1 – Consolidated statement of financial position

Summarised financial statements for three entities for the year ended 30 June 2008 are as follows:

Statements of financial position

	Borough	High	Street
Assets	$	$	$
Property, plant and equipment	100,000	80,000	60,000
Investments	121,000	-	-
Inventories	22,000	30,000	15,000
Receivables	70,000	10,000	2,000
Cash and cash equivalents	47,000	25,000	3,000
	360,000	145,000	80,000

Equity and liabilities

Equity capital ($1 shares)	100,000	75,000	35,000
Retained earnings	200,000	50,000	40,000
Other components of equity	10,000	5,000	-
Liabilities	50,000	15,000	5,000
	360,000	145,000	80,000

On 1 July 2007, Borough purchased 45,000 shares in High for $100,000. At that date. High had retained earnings of $30,000 and no other components of equity. High's net assets had a fair value of $120,000 and the fair value of the non-controlling interest was $55,000. It is group policy to value the non-controlling interest at acquisition at fair value.

The excess of the fair value of High's net assets over their carrying amounts at the acquisition date relates to property, plant and equipment. This had a remaining estimated useful life of five years at the acquisition date. Goodwill has been subject to an impairment review and it was determined to be impaired by $7,000.

On 1 July 2007, Borough purchased 10,500 equity shares in Street for $21,000. At that date, Street had retained earnings of $25,000 and no other components of equity.

During the year Borough sold goods too High for $10,000 at a margin of 50%. By the reporting date, High had only sold 80% of these goods. Included in the receivables of Borough and the liabilities of High are intra-group balance of $5,000.

On 5 July 2008, Borough received notification that an employee was claiming damages against them as a result of a work-place accident that took place on 30 April 2008. Lawyers have advised that there is a 60% chance that Borough will lose the case and will be required to pay damage of $30,000.

Required:

Prepare the consolidated statement of financial position as at 30 June 2008.

Solution

Borough Group statement of financial position as at 30 June 2008

Non-Current Assets	$
Goodwill (W3)	28,000
Property, plant and equipment ($100,000 + $80,000 + $15,000 (W2) - $3,000 (W2))	192,000
Investment in Associate (W7)	25,500
Current Assets	
Inventories ($22,000 + $30,000 - $1,000 (W6))	51,000
Receivables ($70,000 + $10,000 - $5,000 inter.co)	75,000
Cash and cash equivalents ($47,000 + $25,000)	72,000
	443,500
Equity capital	100,000
Retained earnings (W5)	179,500
Other components of equity (W5)	13,000
Non-controlling interest (W4)	61,000
Total equity	353,500
Liabilities ($50,000 + 15,000 - $5,000 inter.co + $30,000 (W8))	90,000
	443,500

(W1) Group structure

Borough is the parent

High is a 60% subsidiary (45/75)
Street is a 30% associate (10.5/35)

Both acquisitions took place a year ago

	Acq	Rep date
	$	$
Equity capital	75,000	75,000
Other components of equity	-	5,000
Retained earnings	30,000	50,000
Fair value adjustment (FVB)	15,000*	15,000
Depreciation on FVA (15,000/5)	-	(3,000)
*bal fig		
	120,000	142,000

(W3) Goodwill

	$
Consideration	100,000
FV of NCL at acquisition	55,000

	155,000
FV of net assets at acquisition (W2)	(120,000)
Goodwill at acquisition	35,000
Impairment	(7,000)
Goodwill at the reporting date	

(W2) Net assets of High

28,000

(W4) Non-controlling interest

	$
Fair value of NCL at acquisition (given)	55,000
NCL % of post-acquisition net assets	8,800
(40% x (142,000 - $120,000) (W2))	
NCL share of goodwill impairment	
(40% x $7,000)	(2,800)
	61,000

(W5) Group reserves

Group retained earnings

	$
Parent	200,000
Provision (W8)	(30,000)
Share of post-acquisition retained earnings:	
High: 60% x (($50,000 - $3,000) - $30,000) (W2)	10,200
Street: 30% x ($40,000 - $25,000)	4,500
Group share of goodwill impairment	(4,200)
(60% x $7,000)	
PURP (W6)	(1,000)
	179,500

Other components of equity

	$
Parent	10,000
Share of post-acquisition other components of equity:	
High: 60% x ($5,000 - $nil) (W2)	3,000
	13,000

(W6) Provision for unrealized profit

The profit on the intra-group sale was $5,000 (50% x $10,000).

The unrealised profit still in inventory is $1,000 (20% x $5,000).

The parent was the seller, so retained earnings is adjusted in (W5)

Dr Retained earnings	$1,000
Cr Inventories	$1,000

(W7) Investment in the associate

	$
Cost	21,000
Share of increase in retained earnings (30% x ($40,000 - $25,000))	4,500
	25,500

(W8) Provision

The obligation event, the accident, happened during the reporting period. This means that there is an obligation from a past event, and a probable outflow of resources that can be

measured reliably. A provision is therefore required for the best estimate of the amount payable, which is $30,000. This is charged to the statement of profit or loss so will reduce retained earnings in (W5).

Dr Retained earnings	$30,000
Cr Provision	$30,000

Illustration 2 – Consolidated statement of profit or loss

H has owned 80% of the ordinary shares or S and 30% of the ordinary shares of A for many years. The information below is required to prepare the consolidated statement of profit or loss for the year ended 30 June 2008.

Statement of profit or loss for the year ended 30 June 2008

	H	S	A
	$	$	$
Revenue	500,000	200,000	100,000
Cost of sales	(100,000)	(80,000)	(40,000)
Gross profit	400,000	120,000	60,000
Distribution costs	(160,000)	(20,000)	(10,000)
Administrative expenses	(140,000)	(40,000)	(10,000)
Profit from operations	100,000	60,000	40,000
Tax	(23,000)	(21,000)	(14,000)
Profit after tax	77,000	39,000	26,000

Note: There were no items of other comprehensive income in the year.

At the date of acquisition, the fair value of S's plant and machinery, which at that time had a remaining useful life of ten years, exceeded the book value by $ 10,000.

During the year S sold goods to H for $10,000 at a margin of 25%. By the year-end H had sold 60% of these goods.

The group accounting policy is to measure non-controlling interests using the proportion of net assets method. The current year goodwill impairment loss was $1,200, and this should be charged to administrative expenses.

By 30 June 2008 the investment in A had been impaired by $450, of which the current year loss was $150.

On 1 January 2008, H signed a contract to provide a customer with support services for the following twelve months. H received the full fee of $30,000 in advance and recognised this as revenue.

Required:

Prepare the consolidated statement of profit or loss for the year ended 30 June 2008.

Solution

Group statement of profit or loss for the year ended 30 June 2008

	$
Revenue	675,000
($500,000 + $200,000 - $10,000 (W3) - $15,000 (W4)	
Cost of sales	(172,000)
($100,000 + $80,000 + $1,000 (W2) - $10,000 (W3) + $1,000 (W3)	
Gross profit	503,000
Distribution costs ($160,000 + $20,000)	(180,000)
Administrative expense	(181,200)

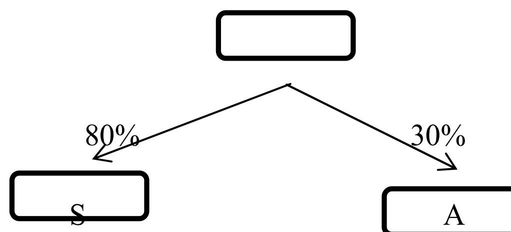
($140,000 + $40,000 + $1,200 GW imp)

Profit from operations	141,800
Share of profit of associate	7,650
((30% x $26,000) - $150 impairment)	
Profit before tax	149,450
Tax ($23,000 + $150 impairment)	(44,000)
Profit for the period	105,450
Attributable to:	
Equity holders of the parent (bal. fig)	98,050
Non-controlling interest (W5)	7,400
Profit for the period	105,450

Workings

(W1) Group structure

H



(W2) Excess depreciation $

10,000/10 years = $1,000.

The adjusting entry is:

Dr Cost of sales	$1,000
Cr PPE $	$1,000

(W3) Intra-Group trading

The $10,000 trading between S and H must be eliminated:

Dr Revenue	$10,000
Cr Cost of sales	$10,000

The profit on the sale was $2,500 (25% x $10,000). Of this, $1,000 ($2,500 x 40%) remains within the inventories of the group. The PURP adjustment is therefore:

Dr Cost of sales	$1,000
Cr Inventories	$1,000

(W4) Revenue

The performance obligation is satisfied over time. Based on the passage of time, the contract is 50% (6/12) complete so only 50% of the revenue should be recognised by the reporting date. Therefore $15,000 ($30,000 x 50%) should be removed from revenue and held as a liability on the SFP.

Dr Revenue	$15,000
Cr Contract liability	$15,000

(W5) Profit attributable to NCL

	$	$
S's profit for the year	39,000	
PURO (W3)	(1,000)	
Excess depreciation (W2)	(1,000)	
	37,000	

X 20%

Profit attributable to NCL	7,400

Note: If the parent had sold goods to the subsidiary then the PURP adjustment would not be included when calculating the profit attributable to the NCL.

Goodwill has been calculated using the share of net assets method. Therefore, none of the impairment loss is attributable to the NCL.

Illustration 3 – Associates

Paint has several investments in subsidiary companies. On 1 July 2001, it acquires 30% of the ordinary shares of Animate for $2m. This holding gives Paint significant influence over Animate. At the acquisition date, the fair value of Animate's net assets approximate to their carrying values with the exception of a building. This building, with a remaining useful life of 10 years, had a carrying value of $1m but a fair value of $1.8m.

Between 1 July 2001 and 31 December 2001, Animate sold goods to Paint for $1 million making a profit of $100,000. All of these goods remain in the inventory of Paint. This sale was made on credit and the invoice has not yet been settled.

Animate made a profit after tax of $800,000 for the year ended 31 December 2001. At 31 December 2001, the directors of Paint believe that the investment in the associate needs impairing by $50,000.

Required:

Prepare extracts from the consolidated statement of financial position and the consolidated statement of profit or loss showing the treatment of the associate for the year ended 31 December 2001.

Solution

Consolidated statement of financial position	$
Investment in associate (W1)	2,058,000

Consolidated statement of profit or loss

Share of profit of associate (W2)	28,000

Note: No adjustment is required for receivable and payables held between Paint and Animate. (W1)

Investment in associate

	$
Cost	2,000,000
Share of post-acquisition profit	120,000
(30% x $800,000 x 6/12)	
Share of excess depreciation ((\$1.8m - \$1m)/ 10 years) x 6/12	(12,000) (30% x
Impairment	(50,000)
Investment in associate	2,058,000

The inventory is held within the group so the parent's share of the PURP is credited against inventory rather than the investment in the associate.

(W2) Share of associate's profit

	$
P's share of A's profit after tax	120,000
(30% x $800,000 x 6/12)	
Impairment	(50,000)
P's share of excess depreciation	(12,000)
(30% x ((\$1.8m - \$1m)/ 10 years) x 6/12)	
P's share of PURP	(30,000)

(30% x $100,000)	
	_________
Share of profit of associate	28,000
	_________

Test your understanding 1 – Control

Parsley has a 40% holding in the ordinary shares of Oregano. Another investor has a 10% shareholding in Oregano whilst the remaining voting rights are held by thousands of shareholders, none of whom individually hold more than 1 per cent of the voting rights. Parsley also holds debt instruments that, as at 30 April 2004, are convertible into ordinary shares of Oregano at a price of $4 per share. At 30 April 2004, the shares of Oregano trade at $3.80 per share. If the debt was converted into ordinary shares, Parsley would hold 60% of the voting rights in Oregano. Parsley and Oregano undertake similar activities and would benefit from synergies.

Required:

Discuss how Parsley's investment in the ordinary shares of Oregano should be treated in the consolidated financial statements for the year ended 30 April 2004.

Solution

Test your understanding 1 – Control

An investor controls an investee if the investor has:

- 'Power over the investee
- Exposure, or rights, to variable returns from its involvement with the investee
- The ability to use its power over the investee to affect the amount of the investor's returns' (IFRS 10, para7).

When assessing control, an investor considers its potential voting rights. Potential voting rights are rights to obtain voting rights of an investee, such as those arising from convertible instruments or options.

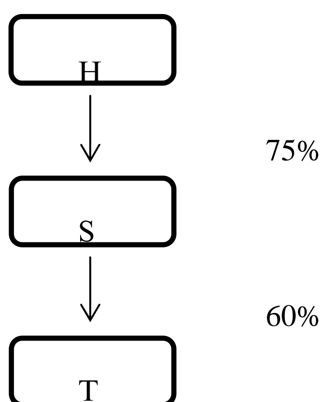
Potential voting rights are considered if the rights are substantive. This would mean that the rights need to be currently exercisable. Other factors that should be considered in determining whether potential voting rights are substantive, according to IFRS 10, include:

- Whether the exercise price creates a financial barrier that would prevent (or deter) the holder from exercising its rights
- Whether the party or parties that hold the rights would benefit from the exercise of those rights.

Parsley has voting rights that are currently exercisable and these should be factored into an assessment of whether control exists. The fact that the exercise price on the convertible instrument is out the money (i.e. the exercise price is higher than the current market price.) could potentially deter Parsley from taking up these voting rights. However, these options are not deeply out of the money. This may also be compensated by the fact that synergies would arise on the acquisition. This would suggest that it is likely that Parsley will exercise the options. The potential voting rights should therefore be considered substantive.
Based on the above, Parsley has control over Oregano. Oregano should be treated as a subsidiary and consolidated.

Test your understanding 2 – Vertical group Look at

the group structure below:



75%

60%

Required:

Does Company H control Company T?

Answer:

Test your understanding 2 – Vertical group

H'controls S because the size of its shareholding gives it the ability to affect variable returns through the power it exercises.

S controls T for the same reasons as above.

H is therefore also able to exert control over T by virtue of its ability to control S.

All three companies form a group. H is a parent company and S and T are its subsidiaries.

Test your understanding 3 – Identifying the acquirer

Abacus and Calculator are two public limited companies. The fair values of the net assets of these two companies are $100 million and $60 million respectively.
On 31 October 2001, Abacus incorporates a new company, Phone, in order to effect the combination of Abacus and Calculator. Phone issues its shares to the shareholders of Abacus and Calculator in return for their equity interests.

After this, Phone is 60% owned by the former shareholders of Abacus and 40% owned by the former shareholder of Calculator. On the board of Phone are 4 of the former directors of Abacus and 2 of the former directors of Calculator.

Required:

With regards to the above business combination, identify the acquirer.

Answer:

Test your understanding 3 – Identifying the acquirer

If the business combination has not involved the transfer of cash or other assets, the acquirer is usually the entity that issues its equity interests. This might point towards Phone being the acquirer, since Phone has issued shares in exchange for the shares of Abacus and Calculator.

However, other circumstances must be considered:

- The acquirer is usually the entity whose (former) management dominates the management of the combined entity.
- The acquirer is usually the entities whose owners retain or receives the largest portion of the voting rights in the combined entity.
- The acquirer is normally the entity whose size is greater than the other entities.

All three of these circumstances would point towards Abacus being the acquirer. This would appear to reflect the substance of the transaction since Phone has been incorporated by Abacus as a way of enabling a business combination with Calculator.

Test your understanding 4 – Fair value of identifiable net assets

P purchased 60% of the shares of S on 1 January 2001. At the acquisition date, S had share capital of $10,000 and retained earnings of $190,000.

The property, plant and equipment of S includes land with a carrying value of $10,000 but a fair value of $50,000.
Included within the intangible assets of S is goodwill of $20,000 which arose on the purchase of the trade and assets of a sole-trader business. S has an internally generated brand that is not recognised (in accordance with IAS 38). The directors of P believe that this brand has a fair value of $150,000.

In accordance with IAS 37, the financial statements of S disclose the fact that a customer has initiated legal proceedings against them. If the customer wins, which lawyers have advised is unlikely, estimated damages would be $1 million. The fair value of this contingent liability has been assessed as $100,000 at the acquisition date.

The directors of P wish to close one of the divisions of S. They estimate that this will cost $200,000 in redundancy payments.

Required:

What is the fair value of S's identifiable net assets at the acquisition date?

Answer:

Test your understanding 4 – Fair value of identifiable net assets

$

Share capital		10,000
Retained earnings		190,000
Fair value uplift	($50,000 - $10,000)	40,000
Goodwill		(20,000)
Brand		150,000
Contingent liability		(100,000)
		270,000

Goodwill in the subsidiary's own financial statements is not an identifiable asset because it cannot be disposed of separately from the rest of the business.
No adjustment is made to the fair value of the net assets for the estimated redundancy provision. This is because no obligation exists at the acquisition date.

Test your understanding 5 – Purchase consideration

Following on from TYU 4, the purchase consideration transferred by P in exchange for the shares in S was as follows:

- Cash paid of $300,000
- Cash to be paid in one year's time of $200,000
- 10,000 shares in P. These had a nominal value of $1 and a fair value at 1 January 2001 of $3 each
- $250,000 to be paid in one year's time if S makes a profit before tax of more than $2m. There is a 50% chance of this happening. The fair value of this contingent consideration can be measured as the present value of the expected value.

Legal fees associated with the acquisition were $10,000.

Where required, a discount rate of 10% should be used.

Required:

Per IFRS 3, what is the fair value of the consideration transferred to acquire control of S?

Answer:

Test your understanding 5 – Purchase consideration

	$
Cash paid	300,000
Deferred cash ($200,000 x (1/1.1))	181,818
Shares (10,000 x $3)	30,000
Contingent consideration ($250,000 x 50% x (1/1.1)	113,636
Fair value of consideration	625,454

The legal fees are expensed to the statement of profit or loss
Test your understanding 6 – Goodwill

Following on from 'Test your understandings' 4 and 5, the fair value of the non-controlling interest at the acquisition date is $160,000 Required:

Calculate the goodwill arising on the acquisition of S if the non-controlling interest at the acquisition date is valued at:

(a) Fair value
(b) Its proportion of the fair value of the subsidiary's identifiable net assets.

Answer:

Test your understanding 6 – Goodwill

	Fair value method	Net assets method
	$	$
Consideration (TYU 4)	625,454	625,454
Add: NCL at acquisition	160,000	108,000

(part b = 40% x $270,000)		
	785,454	733,454
FV of identifiable net assets at Acquisition (TYU 3)	(270,000)	(270,000)
	515,454	463,454

The fair value method calculates both the group's goodwill and the goodwill attributable to the non-controlling interest. Therefore, goodwill is higher under this method.
The proportion of net assets method only calculates the goodwill attributable to the group. Goodwill is lower under this method.

Illustration 4 – Impairment of goodwill

A owns 80% of B. At 31 October 2006 the carrying amount of B's net assets is $60 million, excluding goodwill of $8 million that arose on the original acquisition.

The recoverable amount of the net assets of B is $64 million.

Calculate the impairment loss if:

(a) The NCL at acquisition was measured at fair value
(b) The NCL at acquisition was measured at its proportion of the fair value of the subsidiary's identifiable net assets.

Solution

(a) Full goodwill method

	$m
Goodwill	8
Net assets	60

Carrying amount	68 Recoverable amount	64
Impairment		4

The impairment loss will be allocated against goodwill, reducing it from $8m to $4m.

The $4m impairment expense will be charged to profit or loss. Of this, $3.2m ($4m x 80%) is attributable to the group and $0.8m ($4m x 20%) is attributable to the NCL.

(b) Proportionate method

	$m	$m
Goodwill	8	
Unrecognised NCL (20/80 x $8m)	2	
Total notional goodwill		10
Net assets		60

Carrying amount	70 Recoverable amount	64
Impairment		6

The impairment loss is allocated against the total notional goodwill. Only the group's shares of good will has been recognised in the financial statements and so only the group's share (80%) of the impairment is recognised. The impairment charged to profit or loss is therefore $4.8m and goodwill will be reduced to $3.2m ($8m - $4.8m).

Test your understanding 7 – Happy

On 1 January 2005, Lucky group purchased 80% of Happy for $500,000. The fair value of the identifiable net assets of Happy at the date of acquisition amounted to $590,000.

The carrying amount of Happy's net assets at 31 December is $520,000 (excluding goodwill). Happy is a cash-generating until.

At 31 December 2005 the recoverable amount of Happy's net assets is $530,000.

Required:

Calculate the impairment loss and explain how would be dealt with in the financial statements of the Lucky group. If:

(a) The NCL at acquisition was measured at its fair value of $130,000.
(b) The NCL at acquisition was measured at its share of the fair value of Happy's identifiable net assets.
(c) Answer:

Test your understanding 7 – Happy

(a) Full goodwill method

Goodwill arising on acquisition:

	$000
Fair value of consideration paid	500
NCL at acquisition	130
	630
Less: fair value of net assets at acquisition	(590)
	40

Impairment review:

	$000
Goodwill	40
Net assets	520
Carrying amount	560
Recoverable amount	(530)
Impairment	30

The impairment loss is allocated against goodwill, reducing it from $40,000 to $10,000.

The $30,000 impairment expense will be charged to the statement of profit or loss. Of this, $24,000 (80% x $30,000) is attributable to the group and $6,000 (20% x $30,000) is attributable to the NCL.

(b) Proportionate method

Goodwill arising on acquisition:

	$000
Fair value of consideration paid	500
NCL share of net assets at acquisition (20% x $590,000)	118
	618
Less: fair value of net asset at acquisition	(590)
Goodwill	28

Impairment review:

	$000	$000
Goodwill	28	
Unrecognised NCL (20/80 x $28,000)	7	
Total notional goodwill		35
Net assets		520
Carrying amount		555
Recoverable amount		(530)
Impairment		25

The impairment loss is firstly allocated to the notional goodwill. However, only the group's share of the goodwill was recognised in the financial statements and so only the group's share of the impairment is recognised.

The total impairment recognised is therefore $20,000 (80% x $25,000). This will be charged to the statement of profit or loss and is all attributable to the group.

Test your understanding 8 – Pauline

On 1 April 2007 Pauline acquired the following non-current investments:

- 6 million equity shares in Sonia by an exchange of two shares in Pauline for every four shares in Sonia plus $1.25 per acquired Sonia share in cash. The market price of each Pauline share at the date of acquisition was $6 and the market price of each Sonia share at the date of acquisition was $3.25.
- 30% of the equity shares of Arthur at a cost of $7,50 per share in cash.

Only the cash consideration of the above investments has been recorded by Pauline. In addition $1,000,000 of professional costs relating to the acquisition of Sonia is included in the cost of the investment.

The summarised draft statements of financial position of the three companies at 31 March 2008 are presented below:

	Pauline	Sonia	Arthur
	$000	$000	$000
Assets			
Non-current assets			
Property, plant and equipment	36,800	20,800	36,000
Investment in Sonia and Arthur	26,500	-	-
Financial assets	13,000	-	-

Current assets			36,000
Inventories	76,300	20,800	
Trade receivables			7,200
Total assets	13,800	12,400	4,800
Equity and liabilities	6,400 96,500	~~3,000 36~~,200	48,000
Equity shares of $1 each		8,000	
Retained earnings	20,000		8,000
		12,000	
	32,000	5,800	
- at 31 March 2007	18,500		22,000
- for year ended 31			10,000
March 2008	70,500	25,800 2,000 8,400	
			40,000
Non-current liabilities			
	10,000 16,000		
7% Loan notes			2,000
Current liabilities			
Trade payables			6,000
	96,500	36,200	48,000

The following information is relevant to the preparation of the consolidated statement of financial position:

(i) At the date of acquisition Sonia had an internally generated brand name. The directors of Pauline estimate that this brand name has a fair value of $2 million, an indefinite life and has not suffered any impairment.

(ii) On 1 April 2007, Pauline sold an item of plant to Sonia at its agreed fair value of $5 million. Its carrying amount prior to the sale was $4 million. The estimated remaining life of the plant at the date of sale was five years.

(iii) During the year ended 31 March 2008 Sonia sold goods to Pauline for $5.4 million. Sonia had marked up these goods by 50% on cost. Pauline had a third of the goods still in its inventory at 31 March 2008. There were no intra-group payables or receivables at 31 March 2008.

(iv) Pauline has a policy of valuing non-controlling interests at fair value at the date of acquisition. For this purpose the shares price of Sonia at this date should be used. Impairment tests on 31 March 2008 concluded that the recoverable amount of the net assets of Sonia were $34 million.

(v) The financial assets in Pauline's statement of financial position are classified as fair value through profit or loss. In the draft financial statements, they are held at their fair value as at 1 April 2007. They have a fair value of $18 million as at 31 March 2008.

Required:

Prepare the consolidated statement of financial position for the Pauline group as at 31 March 2008.

Answer:

Test your understanding 8 – Pauline

Consolidated statement of financial position as at 31 March 2008

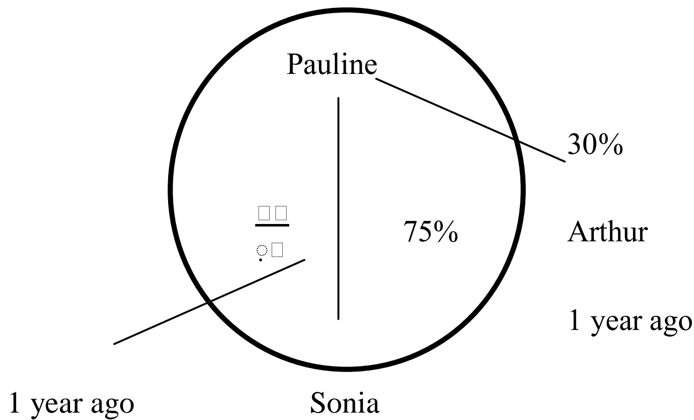
	$000
Assets	
Non-current assets	
Property, plant and equipment	56,800
($36,800 + $20,800 - $800 (W8))	
Goodwill (W3)	6,800
Intangible assets (W2)	2,000

Investment in associate (W6)	21,000
Financial assets (W9)	18,000
	104,600
Current assets	
Inventories ($13,800 + $12,400 - $600 (W7))	25,600
Trade receivables ($6,400 + $3,000)	9,400
Total assets	139,600
Equity and liabilities	
Equity attributable to equity holders of the parent	
Equity shares of $1 each ($20,000 + $3,000 (W3))	23,000
Share premium (W3)	15,000
Retained earnings (W5)	58,200
	96,200
Non-controlling interest (W4)	7,000
Total equity	103,200
Non-current liabilities	
7% Loan notes ($10,000 + $2,000)	12,000
Current liabilities	
Trade payables ($16,000 + $8,400)	24,400

Total equity and liabilities	139,600

Workings

(W1) Group structure



	At acquisition date	At reporting date
	$000	$000
Equity capital	8,000	8,000
Retained earnings Fair value adj:	12,000	17,800
Brand	2,000	2,000
PURP (W7)		(600)
		27,200
	22,000	

(W3) Goodwill

	Sonia
Fair value of consideration	
	$000
	18,000
Share exchange (6m x 2/4 x $6)	

(W2) Net assets – Sonia

	$000
Cash paid (6m x $1.25)	7,500
	25,500
FV of NCL at acquisition (2m x $3.25)	6,500
	32,000
Less FV of net assets at acquisition (W2)	(22,000)
Goodwill at acquisition	10,000
Impairment (W10)	(3,200)
Goodwill at reporting date	6,800

The 3 million shares issued by Pauline in the share exchange at a value of $6 each would be recorded as $1 per share in equity capital and $5 per share in share premium. This gives an increase in equity capital of $3 million and a share premium of $15 million.

(W4) NCL

	$000
Fair value of NCL at acquisition (W3)	6,500
NCL share of post-acquisition net asset movement (25% x ($27,200 - $22,000)) (W2)	1,300
NCL share of goodwill impairment (25% x $3,200) (W10)	(800)

		7,000

(W5) Group retained earnings

		$000
100% of Pauline's retained earnings ($32,000 + $18,500)		50,500
Professional costs written off	(1,000)	
Gain on financial assets (W9)		5,000
P% of Sonia's post-acquisition retained earnings**		
(75% x ((17,800 - $600) - $12,000) (W2))		3,900
P% of Arthur's post-acquisition retained earnings		
(30% x $10,000)		3,000
PPE PURP (W8)		(800)
P% of goodwill impairment		(2,400)
(75% x $3,200) (W10)		
		58,200

** It is worth noting that, if the subsidiary has no other components of equity', then you could simply take P's share of the subsidiary's post-acquisition net assets movement:

75% x ($27,200 - $22,000 (W2)) = $3,900

(W6) Investment in associates

	$000
Cost (8,000 x 30% x $7,50)	18,000
P's share post-acquisition reserves ($10,000 x 30%)	3,000

21,000

(W7) PURP in inventory

Intra-group sales are $5.4 million on which Sonia made a profit of $1,800,000 ($5,400,000 x 50/150).

The unrealised profit still in inventory is therefore $600,000 ($1,800,000 x 1/3).

Sonia is the seller so the profit must be removed from Sonia's retained earnings in W2. The adjusting entry is:

Dr Retained earnings (W2)	$600,000
Cr Inventories	$600,000

(W8) PURP in PPE

The carrying amount of the PPE is $4m ($5m – ($5m/5 years)).

If no group transfer had happened, then the carrying amount would have been $3.2m ($4m – ($4m/5 years).

PPE must therefore be reduced by $800,000 ($4m - $3.2m). Pauline is the seller so the profit impact must be adjusted against Pauline's retained earnings in W5. The adjusting entry is:

Dr Retained earnings (W5)	$800,000
Cr PPE	$800,000

(W9) Financial assets

The financial assets must be remeasured to fair value and the gain recorded through profit or loss.

The gain on revaluation to fair value is $5m ($18m - $13m). This will be recorded in profit or loss and will increase group retained earnings in W5.

(W10) Impairment

$000

Goodwill (W3)	10,000
Net assets (W2)	27,200
Carrying amount	37,200
Recoverable amount	(34,000)
Impairment	3,200

The impairment loss will be charged against goodwill.

Full goodwill has been calculated so the impairment expense must be allocated between the NCL (W4) and retained earnings (W5).

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

At the date of acquisition, the investment by the parent company in the subsidiary company is cancelled of against the equity (share capital, state premium, retained earnings of subsidiary company. Any excess remaining is known as goodwill.

All assets and liabilities of subsidiary company are than added on a line by line basis with the assets and liabilities of the parent company.

In the consolidated statement of financial position, the share capital and share premium will ALWAYS be of Parent Co. only.

If the parent contacts less than 100% of a subsidiary, the remaining investment is known as Non - controlling interest and apportion of equity shall now be attributable to NCI.

Types of consideration

There are five different ways in which consideration may be paid at the acquisition of subsidiary co. A sum of all of these is called the COST OF INVESTMENT.

Consideration might be paid in the following ways:

- By cash
- By share for share exchange
- By deferred consideration
- By contingent consideration

- By loan notes

By Cash

The consideration is calculated by multiplying the number of shares acquired with per share cash paid i.e.

Total no. of shares of subsidiary co. x % holding x cash paid per share.

By Share for share exchange

The consideration is calculated by multiplying the number of shares issued by Parent Co. with per share price of Parent Co. at the date of acquisition. i.e. No. of shares issued by Parent co. x Parent co. per share price

By Deferred consideration: Deferred consideration is recorded at present value at the date of acquisition.

<u>Initial recognition:</u>

Dr. Cost of investment

Cr. Provision for deferred consideration

<u>Subsequent recognition</u>: Un-winding of discount

Dr. Consolidates retained earnings

Cr. Provision for deferred consideration

Contingent consideration: At times, the parent Co. agrees to pay the consideration only if some specified conditions are met such conditions are contingent events and IFRS 3 requires to measure such consideration at fair value.

<u>Initial recognition:</u>

Dr. Cost of investment

Cr. Provision for contingent consideration

<u>Subsequent recognition:</u>

Fair value of contingent considered is re-assessed at every subsequent reporting date. Increase/ Decrease in fair value is charged to consolidated retained earnings.

In case of increase in fair value, following double entry will be passed.

Dr. Consolidates retained earnings
Cr. Provision for contingent consideration

By loan notes

The consideration is calculated by recording the loan notes issued to shareholders of subsidiary co. at the date of acquisition.

The loan notes are issued to shareholders of subsidiary co. so these are NOT subsequently adjusted as inter-company loan.

Fair Value Adjustment

All items in subsidiary co. financial statements are brought at their fair value at the date of acquisition for a valid calculation of goodwill. Gain or loss on fair value adjustment is included in the calculation of goodwill.

Additional depreciation due to fair value adjustment is deducted from retained earnings.

Goodwill in consolidated Statement of Financial Position:

Acquisition-date fair value of consideration transferred by parent		X
Plus: Fair (or full) value of the N-CI at date of acquisition	X	
Less: Fair value of subsidiary's identifiable net assets at date of acquisition	(X)	
Equals: Total Goodwill		X

Format for detailed working of Full Goodwill calculation

Cost of investment by Parent Co.	X	

Fair value of NCI at the date of acquisition	X	XX
Fair value of net assets of subsidiary co.		
Share capital	X	
Share premium	X	
Pre-acquisition retained earnings	X	
Pre-acquisition revaluation reserve	X	
Fair value adjustment	X/(X)	(XX)
GOODWILL		XX/(XX)

Negative goodwill is called Bargain Purchase Gain. It is charged to current year statement of profit or loss as income.

Impairment of Goodwill

Under this approach the goodwill appearing in the consolidated Statement of Financial Position is the total goodwill. The accounting treatment will be:

Dr Group retained Earnings X Dr Non-controlling interest X

Cr Goodwill X

INTRA-GROUP BALANCES:

Intra-group balances shall be removed from consolidated statement of financial position (CSOFP) only if the balances reconcile.

Dr. Payables

Cr. Receivables

If balances do not reconcile then there can be two possible reasons for it. It is either due to cash in transit or goods in transit.

Make the adjustments for in transit items to bring their values at the same level in parent and subsidiary co.

• Cash in transit DR Cash
CR Receivables

• Goods in transit
DR Inventories
CR Payables

Intra-Group unrealized profits
These are the profits on inventory arising as a result of inter company/intra group sale and the goods are still unsold at the year end.
Downstream transactions: If P Co has sold goods to S Co and these goods remain the in inventory at the year end, the profit recognized by the parent Co. Shall be eliminated (No impact on NCI)

Dr. Consolidated Reserves
Cr. Inventory

Upstream transaction: If the S Co. has sold goods to the P Co. The profits have been earned by the S Co and shall be eliminated not only from group reserve but also from NCI

Dr. Consolidated Reserves
Dr. NCI
Cr. Inventories

Intra-group loans: The portion of loan given by the P Co to its subsidiary is an intra-group receivable, payable and shall be eliminated as such.

Dr. Loan liability
Cr. Loan Asset

Any interest receivable payable on such loans shall also be eliminated but only to the extent related to the parent

Dr. Interest payable

Cr. Interest receivable

If the P Co has not recorded interest receivable on loans given to the sub Co. the first treatment is to record the interest receivable.

Dr. Interest receivable

Cr. Consolidated reserves

After this an intra-group interest receivable payables exists which shall be eliminated
Dr. Interest payable

Cr. Interest receivable

If P Co. has recorded the receivable but subsidiary company has not included a payable in its own financial statements, first treatment is to record the interest payable.

After this an intra-group interest receivable, payable asset which shall be eliminated.

Intra-group dividends: If the parent Co has not recorded the dividend recoverable the first treatment is to record the receivables.

Dr. Dividend receivable

Cr. Consolidated reserve

After this an intra - group, dividends receivable/payable exists which shall be eliminated:

Dr. Consolidated reserves

Dr. NCI

Cr. Dividend payable

Redeemable Preference Shares:

Treat like any other long-term loans i.e. eliminate as an intercompany loan and adjust for any interest accrual.

Full or fair value of NCI: IFRS-3, allows/requires goodwill to be stated at full value i.e. a part of goodwill shall now be attributable to NCI.

Now goodwill impairment shall be charged not only to be parent company but also to NCI

Dr. NCI
Dr. Consolidated Reserves
Cr. Goodwill

FORMAT FOR CALCULATION OF NCI

Fair value of NCI at the date of acquisition* X

Subsidiary Co. share of post-acquisition retained earnings X Share of post-acquisition revaluation reserve X

Unrealised profit (Upstream transaction) (X) Impairment of Goodwill (Share) (X)

Additional depreciation on fair value adjustment (X)

Non- controlling Interest XX

*If fair value of NCI is not available in question, it can be calculated by multiplying NCI no. of shares with Subsidiary Co. per share price at the date of acquisition

CONSOLIDATD RETAINED EARNINGS

Format for calculation of consolidated retained earnings

Parent Co. total retained earnings	X
Subsidiary Co. share of post-acquisition retained earnings	X
Unrealised profit	(X)
Impairment of Goodwill (Share)	(X)
Additional depreciation on fair value adjustment	(X)

Unwinding of present value of deferred consideration	(X)
Increase/ Decrease in fair value of contingent consideration	(X)/X
Any other adjustment as per question	(X)/X
Consolidated Retained Earnings	XX

CONSOLIDATED STATEMENT PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

The basic idea of preparing consolidated statement of profit or loss is to show the results of the group as if it were a single entity.

The majority of figures are simple aggregations of the results of the parent and all the subsidiaries (line by line) down to profit after tax.

In aggregating the results of the parent and subsidiaries, intra-group transactions such as dividend income, interest income and unrealised profits are eliminated.

Any non-controlling interest is ignored until profit after tax. Their interest in profits after tax is then subtracted as a one-liner to leave profits attributable to members of the parent.

P group plc - Pro-forma Consolidated statement of profit or loss

For year ended 30 November 20X6

	$'m
Sales revenue (P+S less intra-group sales)	X
Cost of Sales (P+S less intra-group purchases plus unrealised profit in inventory)	(X)
Gross Profit	X
Distribution Costs (P+S)	(X)
Administrative Expenses (P+S)	(X)
Group operating Profit	X
Interest and similar income receivable (P+S less intra group interest income)	X
Interest expenses (P+S less intra-group interest expense)	(X)
	X

Share of Profits of Associate (PAT)	X
Profit before tax	X
Income tax expense (P+S)	(X)
Profit for the period	X
Profit attributable to:	
Owners of the parent	X
Non-controlling interest	X
	X

OTHER ADJUSTMENTS

- If the subsidiary is acquired during the current accounting period it is necessary to apportion the profit for the period between its pre-acquisition and post-acquisition elements. This is dealt with by determining on a line-by-line basis the post-acquisition figures of the subsidiary.
- After profit after tax in consolidated statement of profit or loss, total profits are divided between profits attributable to group and profit attributable to NCI
- Any dividends receivable by the parent must be cancelled against dividends paid from the subsidiary undertaking.
- Where group companies trade with each other one will record a sale and the other an equal amount as a purchase. These items must be removed from the consolidated statement of profit or loss by cancelling from both sales and cost of sales.
- The unrealized profit adjustment is to increase cost of sales. In case of upstream transaction, the unrealized profit is deducted from profit attributable to NCI also.
- Investment in loans means an intra-group finance cost as well as inter-group dividends.
- These will cancel out in basically the same way as for dividends.
- Impairment of goodwill is treated as an administration expense unless otherwise stated
- There is no impact of fair value adjustment on acquisition at the statement of profit or loss.
- However, any additional depreciation related to such fair value adjustment must be charged by adding to cost of sales and deducting from profit after tax of subsidiary while calculating profit attributable to NCI

IAS 28 – INVESTMENTS IN ASSOCIATES

SCOPE

This Standard shall be applied in accounting for investments in associates.

DEFINITIONS

The following terms are used in this Standard with the meanings specified:-

- An associate is an entity, including an unincorporated entity such as a partnership, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture.
- The equity method is a method of accounting whereby the investment is initially recognized at cost and adjusted thereafter for the post-acquisition change in the investor‘s share of net assets of the investee. The profit or loss of the investor includes the investor‘s share of the profit or loss of the investee.
- Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies. Investments of 20% to 50% in voting power of companies lead to existence of significant influence. Significant influence by an investor is usually evidenced in one or more of the following ways:-

a. Representation on the board of directors or equivalent governing body of the investee.
b. Participating in policy making process, including participation in decisions about dividends or other distributions.
c. Material transactions between the investor and the investee
d. Interchange of managerial personnel; or
e. Provision of essential technical information.

ACCOUNTING OF ASSOCIATE

Associate should be accounted for in consolidated financial statement using equity method; i.e. investment is

- Initially recorded at cost;
- Adjusted for post-acquisition change in net assets (investor share); Or post acquisition profits/losses (investor share);

- The profit or loss of the investor includes the investor‘s share of the profit or loss of the investee.
- Dividend paid or distributions made will reduce the investment.
- On acquisition any difference between the cost of investment and investor‘s share of net fair value of
- associate‘s identifiable assets, liabilities and contingent liabilities is accounted for in accordance with IFRS-3.
- Goodwill relating to an associate is included in the carrying value of investment
- Any excess of the investor‘s share of net fair value of the associate‘s assets, liabilities and contingent liabilities over the cost of investment is excluded from the carrying value of investment and is included in the income statement of the year of acquisition.
- Adjustments in investor‘s share of profit and loss after acquisition are made in respect of depreciation based on Fair Value.
- If different reporting dates, adjust the effect of significant events between reporting dates;
- The investor‘s financial statements shall be prepared using uniform accounting policies for like transactions and events in similar circumstances.
- If the investor‘s share of losses exceeds or equals its interest in associate, the investor will discontinue the recognition of further losses. Additional losses can only be recognized if there exist any legal or constructive obligation
- Impairment test will be applied on the entire amount of investment under IAS -36 and the impairment loss will be recognized.
- No netting-off is done between receivables and payables

EXCEPTIONS TO THE EQUITY METHOD

An investment in an associate shall be accounted for using the equity method except when: 1) There is an evidence that the investment is acquired and held exclusively with a view to its disposal within twelve months from acquisition date (Then apply IFRS -5).

2) All of the following apply:

a. The investor is a wholly-owned subsidiary its other owners do not object if the investor does not apply the equity method;
b. The investor‘s debt or equity instruments are not traded in a public market
c. The investor did not file its financial statements with securities commission, and

d. The ultimate parent of the investor produces consolidated financial statements.

Some noteworthy points include:

- Investment described in 1 above shall be classified as held for trading and accounted for in accordance with IFRS-5.

EQUITY METHOD

STATEMENT OF PROFIT OR LOSS

- Dividend income from associates (reported in the investor's books) is replaced by the profit after tax of the associate.

STATEMENT OF FINANCIAL POSITION

Initially the Investments in Associates is shown at cost (same as in the individual accounts), identifying any goodwill included in the cost.

In subsequent years the Investor's accounts will show:

- The investment at cost
- Plus group share of associate's post acquisition reserves.
- Less any impairment of investment to date.

On the bottom of the balance sheet consolidated reserves will reflect the other side of these adjustments.

Method	$
Cost of Investment	X
Plus group share of post-acquisition reserves	X
Less impairment of investment	(X)
INVESTMENT IN ASSOCIATES	X

Transactions between a Group and Associate

Profits and losses resulting from upstream ‘and downstream ‘transactions between an investor (including its consolidated subsidiaries) and an associate are recognised in the investor ‘s financial statements only to the extent of unrelated investors‘ interests in the associate. Upstream ‘transactions are, for example, sales of assets from an associate to the investor.

Downstream ‘transactions are, for example, sales of assets from the investor to an associate.

The investor‘s share in the associate‘s profits and losses resulting from these transactions is eliminated.

The double entry is as follows, where a% is the parent's holding in the associate, and PUP is the provision for unrealised profit.

DEBIT Retained earnings of parent PUP × A%

CREDIT Group inventories PUP × A%

For upstream transactions (associate sells to parent/subsidiary) where the parent holds the inventories.

OR

DEBIT Retained earnings of parent /subsidiary PUP × A%

CREDIT Investment in associate PUP × A%

For downstream transactions, (parent/subsidiary sells to associate) where the associate holds the inventory.

DISCLOSURES

There are no disclosures specified in IAS 28. Instead, IFRS 12 Disclosure of Interests in Other Entities outlines the disclosures required for entities with joint control of, or significant influence over, an investee.

IFRS 11 – JOINT ARRANGEMENTS

OBJECTIVE

The objective of this IFRS is to establish principles for financial reporting by entities that have an interest in arrangements that are controlled jointly (i.e. joint arrangements).

SCOPE

This IFRS shall be applied by all entities that are a party to a joint arrangement.

DEFINITIONS

Joint arrangement: An arrangement of which two or more parties have joint control.

Joint control: The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

Joint operation A joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.
Separate vehicle A separately identifiable financial structure, including separate legal entities or entities recognised by statute, regardless of whether those entities have a legal personality.

JOINT ARRANGEMENTS

A joint arrangement has the following characteristics:
(a) The parties are bound by a contractual arrangement.
(b) The contractual arrangement gives two or more of those parties joint control of the arrangement.

Contractual Arrangements

The contractual arrangement sets out the terms upon which the parties participate in the activity that is the subject of the arrangement.

The contractual arrangement generally deals with such matters as:
(a) The purpose, activity and duration of the joint arrangement.
(b) How the members of the board of directors, or equivalent governing body, of the joint arrangement, are appointed.

(c) The decision-making process: the matters requiring decisions from the parties, the voting rights of the parties and the required level of support for those matters. The decision-making process reflected in the contractual arrangement establishes joint control of the arrangement.

(d) The capital or other contributions required of the parties.

(e) How the parties share assets, liabilities, revenues, expenses or profit or loss relating to the joint arrangement.

Classification of a Joint Arrangement

The classification of joint arrangements requires the parties to assess their rights and obligations arising from the arrangement. When making that assessment, an entity shall consider the following:

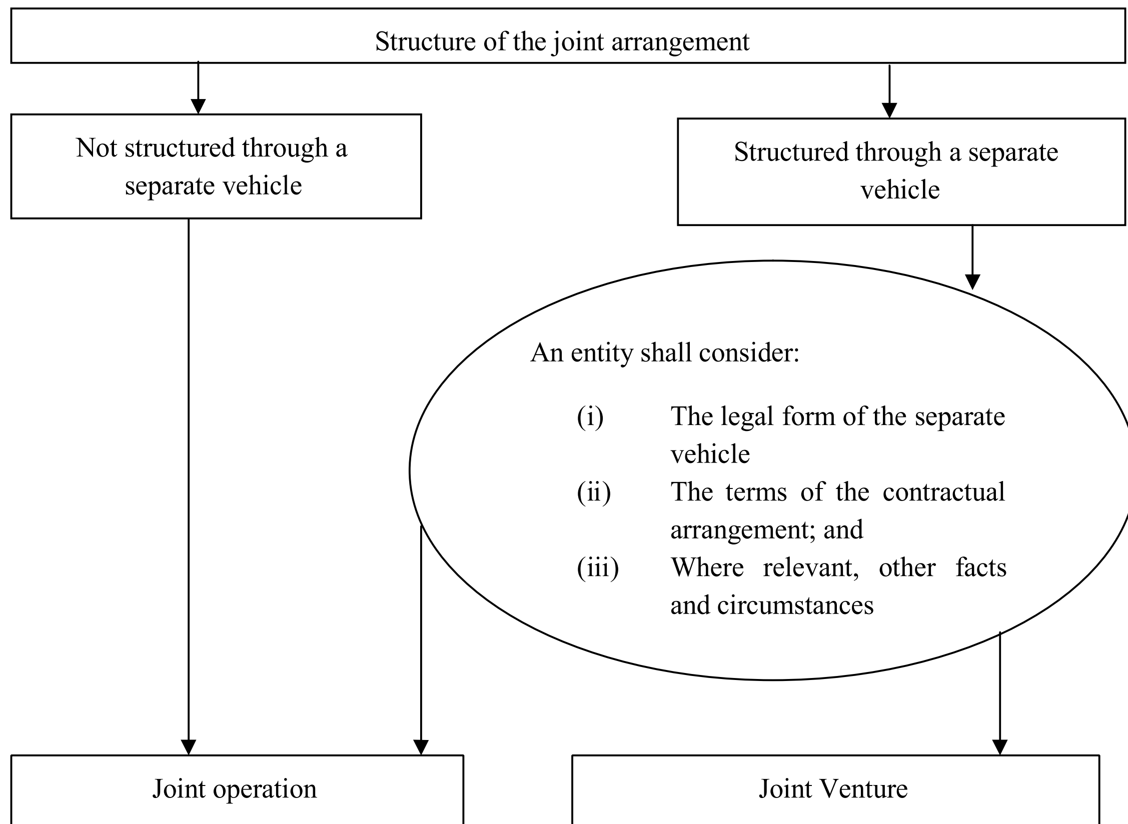
(a) The structure of the joint arrangement.

(b) When the joint arrangement is structured through a separate vehicle:

(i) The legal form of the separate vehicle; (ii) The terms of the contractual arrangement and

(iii) When relevant, other facts and circumstances.

A joint arrangement is either a joint operation or a joint venture.



The following table compares common terms in contractual arrangements of parties to a joint operation and common terms in contractual arrangements of parties to a joint venture. The examples of the contractual terms provided in the following table are not exhaustive.

	Joint operation	Joint venture
The terms of the Contractual Arrangement	The parties to the joint arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.	The parties to the joint arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.
Rights to assets	The parties to the joint arrangement share all interests (eg rights, title or ownership) in the assets relating to the arrangement in a specified proportion (eg in proportion to the parties' ownership interest in the arrangement or in proportion to the activity carried out through the arrangement that is directly attributed to them).	The assets brought into the arrangement or subsequently acquired by the joint arrangement are the arrangement's assets. The parties have no interests (ie no rights, title or ownership in the assets of the arrangement.
Obligations for liabilities	The parties share all liabilities, obligations, costs and expenses in a specified proportion (e.g. in proportion to their ownership interest in the arrangement or in proportion to the activity carried out through the arrangement that is directly attributed to them).	The joint arrangement is liable for the debts and obligations of the arrangement. The parties are liable to the arrangement only to the extent of Their respective: - Investments in the arrangement, or - Obligations to contribute any unpaid or additional capital to the arrangement, or - Both

	The parties to the joint arrangement liable for claims by third parties.	Creditors of the joint arrangement do are not have rights of recourse against any party.
Revenues, expenses, profit or loss	The contractual arrangement establishes the allocation of revenues and expenses on thebasis of the relative performance of each party to the joint arrangement. For example, the contractual arrangement might establish that revenues and expenses are allocated on the basis of the capacity that each party uses in a plant operated jointly.	The contractual arrangement establishes each party's share in the profit or loss relating to the activities of the arrangement.

Guarantees The provision of guarantees to third parties, or the commitment by the parties to provide them, does not, by itself, determine that the joint arrangement is a joint operation.

Financial Statements of Parties to Joint Arrangements

Joint Operations

A joint operator shall recognise in relation to its interest in a joint operation:

(a) its assets, including its share of any assets held jointly;

(b) its liabilities, including its share of any liabilities incurred jointly;

(c) its revenue from the sale of its share of the output arising from the joint operation;

(d) its share of the revenue from the sale of the output by the joint operation; and (e) Its expenses, including its share of any expenses incurred jointly.

Joint Ventures

A joint venture shall recognise its interest in a joint venture as an investment and shall account for that investment using the equity method in accordance with IAS 28 Investments in Associates and Joint Ventures unless the entity is exempted from applying the equity method as specified in that standard.

Application of IAS 28 (2011) To Joint Ventures

The consolidated statement of financial position is prepared by:

- Including the interest in the joint venture at cost plus share of post-acquisition total comprehensive income

- Including the group share of the post-acquisition total comprehensive income in group reserves

The consolidated statement of profit or loss and other comprehensive income will include:

- The group share of the joint venture's profit or loss
- The group share of the joint venture's other comprehensive income.

The use of the equity method should be discontinued from the date on which the joint venture ceases to have joint control over, or have significant influence on, a joint venture.

Transactions between a Joint Venture and a Joint Venture

Upstream transactions: A joint venture may sell or contribute assets to a joint venture so making a profit or loss. Any such gain or loss should, however, only be recognised to the extent that it reflects the substance of the transaction.

Therefore:

- Only the gain attributable to the interest of the other joint ventures should be recognised in the financial statements.

The full amount of any loss should be recognised when the transaction shows evidence that the net realisable value of current assets is less than cost, or that there is an impairment loss.

Downstream transactions: When a joint venture purchases assets from a joint venture, the joint venture should not recognise its share of the profit made by the joint venture on the transaction in question until it resells the assets to an independent third party, i.e. until the profit is realised.

Losses should be treated in the same way, except losses should berecognised immediately if they represent a reduction in the net realisable value of current assets, or a permanent decline in the carrying amount of non-current assets. te major line of business or geographical area of operations then it must be "part of a single co-ordinated plan" to dispose of such a line of business or geographical area of operations. The single plan might relate to a disposal in one transaction or piecemeal.

PRESENTATION

- Non-current assets that meet the criteria are presented separately on the Statement of Financial Position within current assets.
- If the held for sale item is a disposal group then related liabilities are also reported separately within current liabilities.
- Discontinued operations and operations held for sale must be disclosed separately in the statement of financial position at the lower of their carrying value less costs to sell.

Test your understanding 1 – A, B, C and D

A, B and C establish a new entity, which is called D, A has 50 per cent of the voting rights in the new entity, B has 30 per cent and C has 20 per cent. The contractual arrangement between A, B and C specifies that at least 75 per cent of the voting rights are required to make decisions about the activities of entity D.

Required:

How should A account for its investment in D in its consolidated financial statements?

Answer:

Test your understanding 1 – A, B, C and D

A does not control the arrangement because it needs the agreement of B when making decisions. This would imply that A and B have joint control of the arrangement because decisions about the activities of the entity cannot be made without both A and B agreeing.

In the consolidated financial statements of the A Group, D should be treated as a joint venture. This is because it is a separate entity over which A has joint control. The joint venture will be accounted for using the equity method.

Illustration 1 – Joint operation – Blast

Blast has a 30% share in a joint operation. The assets, liabilities, revenues and costs of the joint operation are apportioned on the basis of shareholders. The following information relates to the joint arrangement activity for the year ended 30 November 2002:

- The manufacturing facility cost $30m to contract and was completed on 1 December 2001 and is to dismantled at the end of its estimated useful life of 10 years. The present value of this dismantling cost to the joint arrangement at 1 December 2001, using a discount rate of 8%, was $3m.
- During the year ended 30 November 2002, the joint operation entered into the following transactions:
  - Goods with a production cost of $36m were sold for $50m - Other operating costs incurred amounted to $1m.
  - Administration expenses incurred amounted to $2m.

Blest has only accounted for its share of the cost of the manufacturing facility, amounting to $9m. The revenue and costs are receivable and payable by the two other joint operation partners who will settle amounts outstanding with Blast after each reporting date.

Required:

Show how Blast will account for the joint operation within its financial statements for the year ended 30 November 2002.

Solution – Blast

Profit or loss impact:	$m
Revenue ($50m x 30%)	15,000
Cost of sales ($36m x 39%)	(10,800)
Operating costs ($1m x 30%)	(0.300)
Depreciation (($30m + 3m) x 1/10 x 30%)	(0.990)
Administration expenses ($2m x 30%)	(0.600)
Finance cost ($3m x 8% x 30%)	(0.072)
Share of net profit re joint operation (include in retained earnings within SOFP)	2,238

Statement of financial position impact:	$m
Property, plant and equipment (amount paid = share of cost)	9,000
Dismantling cost ($3m x 30%)	0.900
Depreciation ($33m x 1/10 x 30%)	(0.990)
	8.910
Trade receivable (i.e. share of revenue due)	15,000
Non-current liabilities:	
Dismantling provision (($3m x 30%) + $0.072)	0.972
Current liabilities:	
Trade payables ($10.8m + $0.3m + $0.6m) (i.e. share of expenses to pay)	11,700

The amounts calculated above should be classified under the appropriate headings within the statement of profit or loss for the year or statement of financial position as appropriate.

Note also that where there are amounts owed to and from a joint operating partner, it may be acceptable show just a net amount due to or from each partner.

IFRS 12 DISCLOSURE OF INTERESTS IN OTHER ENTITIES

OBJECTIVE

The objective of IFRS 12 is to require the disclosure of information that enables users of financial statements to evaluate:

- The nature of, and risks associated with, its interests in other entities
- The effects of those interests on its financial position, financial performance and cash flows

DEFINITIONS

Structured entity An entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements

The standard requires disclosure of:

(a) Significant judgements and assumptions.

(b) Information about interests in subsidiaries, associates, joint arrangements and structured entities that are not controlled by an investor.

Significant judgements and assumptions

An entity discloses information about significant judgements and assumptions it has made (and changes in those judgements and assumptions) in determining:

- That it controls another entity
- That it has joint control of an arrangement or significant influence over another entity
- The type of joint arrangement (i.e. joint operation or joint venture) when the arrangement has been structured through a separate vehicle

Interests in subsidiaries

An entity shall disclose information that enables users of its consolidated financial statements to:

- Understand the composition of the group
- Understand the interest that non-controlling interests have in the group's activities and cash flows
- Evaluate the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group
- Evaluate the nature of, and changes in, the risks associated with its interests in consolidated structured entities
- Evaluate the consequences of changes in its ownership interest in a subsidiary that do not result in a loss of control
- Evaluate the consequences of losing control of a subsidiary during the reporting period.

Interests in joint arrangements and associates

An entity shall disclose information that enables users of its financial statements to evaluate:

- The nature, extent and financial effects of its interests in joint arrangements and associates, including the nature and effects of its contractual relationship with the other investors with joint control of, or significant influence over, joint arrangements and associates
- The nature of, and changes in, the risks associated with its interests in joint ventures and associates.

Interests in unconsolidated structured entities (not controlled by an investor)

An entity shall disclose information that enables users of its financial statements to:

- Understand the nature and extent of its interests in unconsolidated structured entities

- Evaluate the nature of, and changes in, the risks associated with its interests in unconsolidated structured entities.

Test your understanding 1 – Fish

On 1 January 2001, Fish acquired 80% of the ordinary shares of Lobster. The group accountant has calculated that the goodwill arising on acquisition was $40 million. However, the financial controller has uncovered a number of errors and requires advice about how to resolve them:

- No entries have been posted in respect of contingent cash consideration that will be paid in 2005 if Lobster meets profit targets. The contingent consideration had a fair value of $4 million at acquisition and was calculated using a discount rate of 10%.
- No fair value adjustment has been recorded in respect of Lobster's non-depreciable land. This land had a carrying amount of $2 million at acquisition and a fair value of $3 million.
- Lobster's brand is internally generated and has not been recognised in the consolidated financial statements. At acquisition it had a fair value of $5 million and a remaining estimated useful life of 5 years.

Fish's policy is to value the non-controlling interest (NCL) at acquisition at fair value. The fair value of the NCL at acquisition was correctly calculated and included in the goodwill calculation.

Required:

Explain to the financial controller how the above three issues should have been accounted for in the consolidated financial statements for the year ended 31 December 2001. Provide the journals required to correct any errors. Ignore deferred tax.

Answer:

Test your understanding 1 – Fish

Contingent consideration

Contingent consideration should be included in the goodwill calculation at its fair value at the acquisition date. This will increase the value of goodwill by $4 million. A non-current liability should also be recognised. The entry to correct this is:

Dr Goodwill $4m Cr

liabilities $4m

The discount on the contingent consideration should be unwoung over the year. This gives rise to a financial cost of $0.4 million ($4m x 10%) in the statement of profit or loss and increases the carrying amount of the liability to $4.4 million. The entry to correct this is:

Dr Finance costs $0.4m

Cr liabilities $0.4m

Land

IFRS 3 says that the identifiable net assets of the subsidiary should be consolidated at fair value. The property, plant and equipment balance therefore needs uplifting by $1 million. This will reduce the goodwill arising on acquisition by $1 million. The entry to correct this is:

Dr Property, plant and equipment $1m

Cr Goodwill $1m

Brand

The brand is an identifiable asset and so should have been consolidated at its fair value of $5 million as at the acquisition date. This reduces the goodwill balance by $5 million:

Dr Intangible assets $5m

Cr Goodwill $5m

The fair value adjustment should be amortised over its remaining useful life. This will give rise to an amortization charge of $1 million ($5m/5 years) in the statement of profit or loss, reducing the carrying amount of

Dr Profit or loss $1m Cr Intangible assets $1m

Of the total $1 million expense, $0.8 million is attributable to the owners of the parent company and $0.2 million is attributable to the non-controlling interest.

Goodwill

The total goodwill arising on the acquisition of Fish is $38 million ($40m + $4m - $1m - $5m). This should be subject to annual impairment review.

CHANGES IN GROUP STRUCTURES

STEP ACQUISITIONS AND DISPOSALS

STEP ACQUISITIONS

What is a step acquisition?

A step acquisitions 'is a business combination achieved in stages, where the acquirer (parent company) gains control of an acquiree (subsidiary) in stages over a period of time.

When control is achieved

- Any previously held equity shareholding should be treated as if it had been disposal of and then reacquired at fair value at the acquisition date.
- Any gain or loss on remeasurement to fair value should be recognised in profit or loss in the period.

Goodwill is calculated as:

	$
Fair value of consideration paid to acquire control	X
Non-controlling interest (valued using either fair value or the proportion of net assets method)	X
Fair value of previously held equity interest at acquisition date	X
	X
Fair value of net assets of acquire	(X)

Goodwill	X

Increasing or reducing a shareholding whilst retaining control

After a parent company has acquired a subsidiary, it might increase or reduce its shareholding, whilst still retaining control.

IAS 27 (revised) states that when an entity changes the percentage size of its ownership in a subsidiary without losing control, the transaction should be accounted for as an equity transaction.

- A group of companies is viewed as a single economic entity, and the equity ownership of this entity consists of equity shareholders in the parent and non-controlling interests in subsidiaries.
- The sale of shares between the parent company and non-controlling interests is therefore a transaction between equity owners of the group.
- Since the sale of the shares is a transaction between equity owners in their capacity as owners of the group, no profit or loss arises on the transaction, and there is no gain or loss to report either as 'other comprehensive income'.
- The transaction should simply result in an adjustment to equity. The carrying amounts of the parent's interests and the non-controlling interests in the equity of the group are adjusted to record the change in their ownership interests.

The rules summarised

When shares in a subsidiary are bought from or sold to non-controlling interests, but the parent entity retains control over the subsidiary, the transaction should be recorded directly in equity for the purpose of preparing consolidated accounts.

When shares are purchased from NCI, the difference between the price paid for the shares and the carrying value of the NCI shares purchased should be recorded as a debit or credit to the parent entity's equity interest in the group.

If the price paid for the shares exceeds their carrying value, there will be a reduction in the parent entity's equity interest in the group, and so the excess price paid should be debited to the parent entity's interest.

Similarly when shares in a subsidiary are sold to NCI but the parent retains control over the subsidiary the difference between the price paid for the shares and the carrying value of the NCI shares purchased should be recorded as a debit or credit to the parent entity's equity interest in the group.

A 'gain' on the sale will be recorded as a credit to the parent entity's equity interest in the group.
It follows that no additional goodwill or reduction in goodwill occurs as a result of these transactions.

There is also no recognition of any gain or loss on the transaction in the consolidated statement of comprehensive income (either profit or loss, or other comprehensive, income).
The calculation is as follows:

	$
Fair value of consideration paid	(X)
Decrease in NCI in net assets at date of transaction	X
Decrease in NCI in goodwill at date of transaction	X
Adjustment to parent's equity	(X)

Full and partial disposals of shares in a subsidiary
Four possible situations following a disposal

- Disposals of shares in subsidiaries without loss of control
- Disposals of shares in subsidiaries and loss of control: the general accounting rules
- Full disposal of shares in a subsidiary
- Partial disposal of shares: subsidiary becomes an associate after the disposal
- Partial disposal of shares: the remaining shares become an ordinary investment

Full and partial disposals of shares in a subsidiary
Whenever you cross the 50% boundary, you revalue, and a gain or loss is reported in profit or loss for the year. If you do not cross the 50% boundary, no gain or loss is reported: instead there is an adjustment to the parent‘s equity.

Disposal of Shares in Subsidiaries without Loss of Control

The previous section explained the accounting rules for an increase or reduction in the shareholding of a parent entity in a subsidiary, without any change in control. The transaction is accounted for within equity, as a transaction between owners of equity in the group.

The same rules apply to the disposal of some shares without losing control as to the purchase of additional shares when control already exists.

Disposals where control is lost: accounting treatment For a full disposal, apply the following treatment.

(a) Statement of profit or loss and other comprehensive income

(i) Consolidate results and non-controlling interest to the date of disposal.

(ii) Show the group profit or loss on disposal.

(b) Statement of financial position

There will be no non-controlling interest and no consolidation as there is no subsidiary at the date the statement of financial position is being prepared.

Disposal of a whole subsidiary or associate - revision

Parent company's accounts

In the parent's Individual financial statements the profit or loss on disposal of a subsidiary or associate holding will be calculated as:

	$
Sales proceeds	X
Less: Carrying amount (cost in P's own statement of financial position)	(X)
Profit (loss) on disposal	X/(X)

Group accounts — disposal of subsidiary

Gain or loss on disposal

In the group financial statements the profit or loss on disposal will be calculated as:

	$	$
Proceeds		X
Less: Amounts recognised prior to disposal:		
Net assets of subsidiary	X	
Goodwill	X	
Non-controlling interest	(X)	(X)
Profit / loss		X/(X)

Remember:

- If the disposal is midyear:
- A working will be required to calculate both net assets and the non-controlling interest at the disposal date.
- Any dividends declared or paid in the year of disposal and prior to the disposal date must be deducted from the net assets of the subsidiary if they have not already been accounted for.
- Goodwill recognised prior to disposal is original goodwill arising less any impairments to date.

For partial disposals, use the following treatments.

(a) Subsidiary to associate

(i) Statement of profit or loss and other comprehensive income

(1) Treat the undertaking as a subsidiary up to the date of disposal, i.e. consolidate for the correct number of months and show the non-controlling interest in that amount.

(2) Show the profit or loss on disposal.

(3) Treat as an associate thereafter.

(ii) Statement of financial position

(1) The investment remaining is at its fair value at the date of disposal (to calculate the gain)

(2) Equity account (as an associate) thereafter, using the fair value as the new 'cost'. (Post 'acquisition' retained earnings are added to this cost in future years to arrive at the carryingvalue of the investment in the associate in the statement of financial position.)

GAIN OR LOSS ON DISPOSAL

In this case there is a loss of control, and so a gain or loss on disposal is calculated as:

	$	$
Proceeds		X
Fair value of interest retained		X
		X
Less: net assets of subsidiary recognised prior to disposal:		
Net assets	X	
Goodwill	X	
Non-controlling interest	X	
		X
Profit / loss		X/(X)

(b) Subsidiary to trade investment/IEI

(i) Statement of profit or loss and other comprehensive income

(1) Treat the undertaking as a subsidiary up to the date of disposal, i.e. consolidate.

(2) Show profit or loss on disposal.

(3) Show dividend income only thereafter.

(ii) Statement of financial position

(1) The investment remaining is at its fair value at the date of disposal (to calculate the gain).

(2) Thereafter, treat as an investment in equity instruments under IFRS 9.

GROUP REORGANISATIONS AND RESTRUCTURING

Changes in direct ownership (i.e. internal group reorganisations) can take many forms. Apart from division alisation, all other internal reorganisations will not affect the consolidated financial statements, but they will affect the accounts of individual companies within the group.

Groups will reorganise on occasions for a variety of reasons.

(a) A group may want to float a business to reduce the gearing of the group. The holding company will initially transfer the business into a separate company.

(b) Companies may be transferred to another business during a division alisation process.

(c) The group may 'reverse' into another company to obtain a stock exchange quotation.

(d) Internal reorganisations may create efficiencies of group structure for tax purposes.

GROUP REORGANISATIONS AND RESTRUCTURING

Methods of reorganising/ restructuring

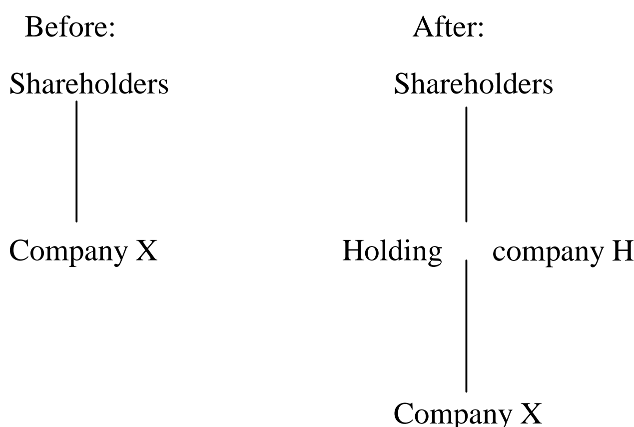
Groups may sometimes be restructured or reorganised. There are various reasons why a restructuring might be considered necessary or desirable. These are explained later. Examples of reorganisations or restructuring include the following:

- Creating a new holding company for the group
- A change in ownership between companies in the group
- Divisionalisation
- A demerger

Creating a new holding company

A new holding company may be created for the group. The reason for this may be to improve the structure of the group, possibly with a view to making more changes later, such as adding new subsidiaries.

The effect of creating a new holding company is typically as follows:



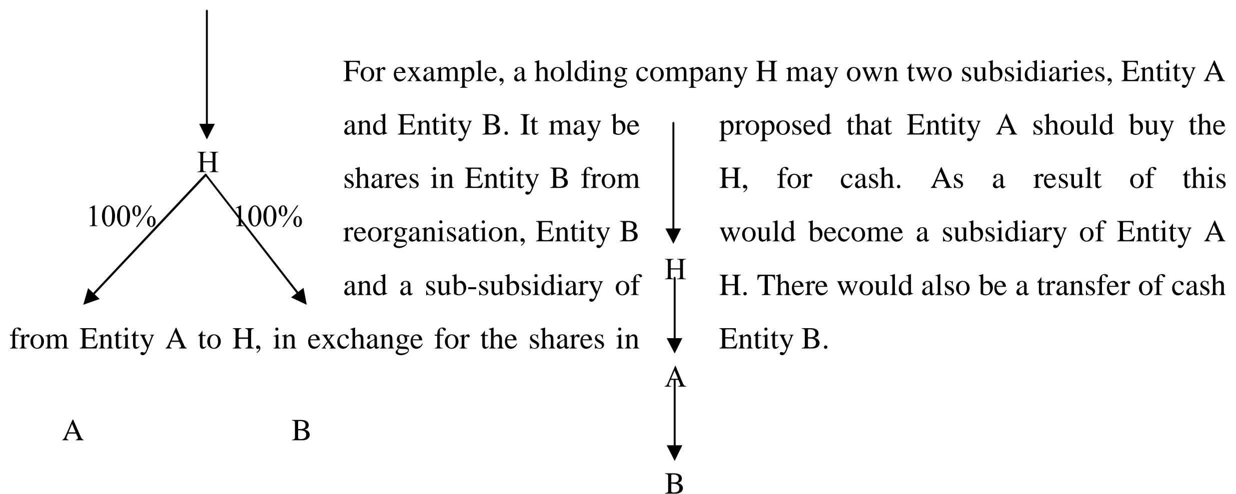
To create the new holding company, the former shareholders of Company X may exchange their shares in Company X for shares in the new holding company H. They become the owners of H, and

H is the 100% owner of Company X. In these arrangements, there is usually just a share-forshare exchange, with shares in X exchanged for shares in H, and no cash transactions are involved.

A change in ownership of companies within a group

When companies in a group are 100%-owned, it may be decided to reorganise the group and transfer ownership of subsidiaries from one group Company to another.

For example, a holding company H may own two subsidiaries, Entity A and Entity B. It may be proposed that Entity A should buy the shares in Entity B from H, for cash. As a result of this reorganisation, Entity B would become a subsidiary of Entity A and a sub-subsidiary of H. There would also be a transfer of cash from Entity A to H, in exchange for the shares in Entity B.



Company A buys the equity capital of B from H for cash.
All companies continue to operate.

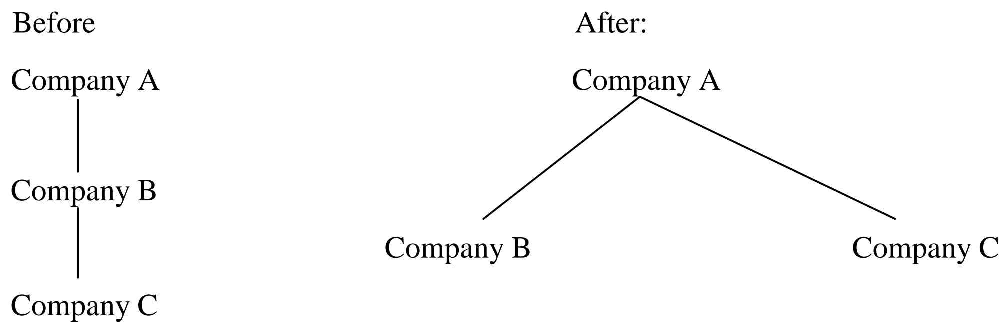
In the proposed structure, there is a change in the ownership of Entity B, as it has been transferred so that it is directly owned by Entity A, not H.

The accounting implications are as follows:

- There organisation has not changed the assets of the group and so will not affect the group financial statements.
- In the individual accounts of H, there is a gain or loss in disposal of the shares in Entity B. In H's own financial statements, the cost of the investment in Entity B is removed and replaced with the cash received, together with the resulting gain or loss (in H's reserves).

ALTERNATIVE CHANGE IN OWNERSHIP

An alternative situation is where a subsidiary becomes directly owned by the parent, as can be seen in the diagram below.



This type of group reorganisation is often done when the parent company wishes to sell Company B, but to retain company C. This reorganisation will have no effect on the consolidated accounts because the group remains the same. It is the individual companies whose accounts will change.

This transaction cannot normally be effected by a share-for-share exchange, because the law in some countries does not allow a subsidiary to hold shares in a parent company. Instead, Company B pays a special dividend called a 'dividend in specie' to the parent, which is effectively the cost of investment in Company C. Company B must have sufficient distributable profits to do this.

Alternatively, Company A can pay cash to Company B in return for the investment in Company C.

- There is no effect on the group financial statements as the assets of the group are unchanged.
- There has not been a disposal of shares in Entity B by H, so the investment must remain in the accounts of H.
- The investment in Entity B in the individual H's accounts will certainly have suffered impairment, given that the trade of Entity B has been transferred to Entity A.
- If any goodwill arose when H acquired B, this will also be impaired, because the business to which the goodwill relates has now been transferred.
- Entity A has not bought the shares of Entity B. It has bought the net assets of B in exchange for cash. Entity A will therefore include all of B's net assets into its own statement of financial position, as B's business operations have now been merged with A's own.

DIVISIONALISATION WITHIN A GROUP

Within a group, there may be operating divisions, and each division may be established as a subsidiary company within the group. Each division may own several sub-subsidiaries, each responsible for a different aspect of the division's overall operations.

When there is division alisation of operations within the group, it may be decided from time to time to switch assets from one division to another. For example, it may be decided to close down one division and transfer its operations to another division.

Accounting for a Divisional Reorganisation

This is a divisionalisation restructuring or reorganisation. It does not affect the ownership of Entity B. Entity B is still owned by H and the investment remains in the statement of financial position of H. Entity B has simply transferred its assets, liabilities and all business operations to Entity A, in exchange for cash. As a result, Entity B is now a 'shell' company, containing just share capital and the cash from the sale.

SUBSIDIARY ACQUIRED EXCLUSIVELY WITH A VIEW TO SUBSEQUENT DISPOSAL

Subsidiaries acquired exclusively with a view to resell are classified as Discontinued Operations under IFRS 5. n entity that is committed to a sale involving loss of control of a subsidiary that qualifies for held-for-sale classification under IFRS 5 classifies all of the assets and liabilities of that subsidiary as held for sale, even if the entity will retain a non-controlling interest in its former subsidiary after the sale.

IAS 21 – THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

OBJECTIVE

The objective of this Standard is to prescribe how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency.

SCOPE

This Standard shall be applied:

(a) In accounting for transactions and balances in foreign currencies, except for those derivative transactions and balances that are within the scope of IFRS 9 Financial Instruments;

(b) In translating the results and financial position of foreign operations that are included in the financial statements of the entity by consolidation, proportionate consolidation or the equity method; and

(c) In translating an entity‘s results and financial position into a presentation currency.

DEFINITIONS

The following terms are used in this Standard with the meanings specified:

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

Exchange difference is the difference resulting from translating a given number of units of one currency into another currency at different exchange rates. Exchange rate is the ratio of exchange for two currencies.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Foreign currency is a currency other than the functional currency of the entity.

Foreign operation is an entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.

Functional currency is the currency of the primary economic environment in which the entity operates.

A group is a parent and all its subsidiaries.

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.

Net investment in a foreign operation is the amount of the reporting entity's interest in the net assets of that operation.

Presentation currency is the currency in which the financial statements are presented.

Spot exchange rate is the exchange rate for immediate delivery.

INDICATORS OF FUNCTIONAL CURRENCY

Primary economic indicators

The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. An entity considers the following factors in determining its functional currency:

(a) The currency:

(i) That mainly influences sales prices for goods and services and

(ii) Of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.

(b) The currency that mainly influences labour material and other costs of providing goods or services

Secondary Indicators

The following factors may also provide evidence of an entity's functional currency (judgements from management if functional currency is not immediately):

(a) The currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated.

(b) The currency in which receipts from operating activities are usually retained.

Functional Currency of Foreign Operations

The following additional factors are considered in determining the functional currency of a foreign operation:

(a) Whether the activities of the foreign operation are carried out as an extension of the reporting entity, rather than being carried out with a significant degree of autonomy.

(b) Whether transactions with the reporting entity are a high or a low proportion of the foreign operation‘s activities.

(c) Whether cash flows from the activities of the foreign operation directly affect the cash flows of the reporting entity and are readily available for remittance to it.

(d) Whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligations without funds being made available by the reporting entity

Change in Functional Currency

Once determined, the functional currency is not changed unless there is a change in those underlying transactions, events and conditions.

Currency of Hyperinflationary Economies

If the functional currency is the currency of a hyperinflationary economy, the entity‘s financial statements are restated in accordance with IAS 29 Financial Reporting in Hyperinflationary Economies.

REPORTING FOREIGN CURRENCY TRANSACTIONS IN THE FUNCTIONAL CURRENCY

INITIAL RECOGNITION

A foreign currency transaction is a transaction that is denominated or requires settlement in a foreign currency, including transactions arising when an entity:

(a) Buys or sells goods or services whose price is denominated in a foreign currency;
(b) Borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency; or
(c) Otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

A foreign currency transaction shall be recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction.

SUBSEQUENT MEASUREMENT

A foreign currency transaction may give rise to assets or liabilities that are denominated in a foreign currency. These assets and liabilities will need to be translated into the entity's functional currency at each reporting date. How they will be translated depends on whether the assets or liabilities are monetary or non-monetary items.

Monetary items

The essential feature of a monetary item, as the definition implies, is the right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Examples of monetary assets include:

- Cash and bank balances
- Trade receivables and payables
- Loan receivables and payables
- Foreign currency bonds held as available for sale
- Foreign currency bonds held to maturity
- Pensions and other employee benefits to be paid in cash
- Provisions that are to be settled in cash
- Cash dividends that are recognised as a liability
- A contract to receive (or deliver) a variable number of the entity's own equity instruments or a variable amount of assets in which the fair value to be received (or delivered) equals a fixed or determinable number of units of currency

Foreign currency monetary items outstanding at the end of the reporting date shall be translated using the closing rate. The difference between this amount and the previous carrying amount in functional currency is an exchange gain or loss.

Non-monetary items

A non-monetary item does not give the right to receive or create the obligation to deliver a fixed or determinable number of units of currency. Examples of non-monetary items include:

- Amounts prepaid for goods and services (e.g. prepaid rent)
- Goodwill
- Intangible assets
- Inventories
- Property, plant and equipment
- Provisions to be settled by the delivery of a non-monetary asset
- Equity instruments that are held as available for sale financial assets
- Equity investments in subsidiaries, associates or joint ventures

Non-monetary items carried at historic cost are translated using the exchange rate at the date of the transaction when the asset arose (historical rate). They are not subsequently retranslated in the individual financial statements of the entity.

Issues in the measurement of non-monetary assets

- Subsequent depreciation should be translated on the same basis as the asset to which it relates, so the rate at the date of acquisition for assets carried at cost and at the rate at the last valuation date for assets carried at revalued amounts. Application of the depreciation method to the translated amount will achieve this.
- The carrying amount of inventories is the lower of cost and net realisable value in accordance with IAS 2 Inventories. The carrying amount in the functional currency is determined by comparing:
- The cost, translated at the exchange rate at the date when that amount was determined.
- The net realisable value, translated at the exchange rate at the date when that value was determined (e.g. the closing date at the reporting date).

Impairment testing of foreign currency non-monetary assets

Similarly in accordance with IAS 36 Impairment 0/ Assets, the carrying amount of an asset for which there is an indication of impairment, is the lower of:

- The carrying amount, translated at the exchange rate at the date when that amount was determined.

- The recoverable amount, translated at the exchange rate at the date when that value was determined (e.g. the closing rate at the reporting date).

The effect of this comparison may be that an impairment loss is recognised in the functional currency but would not be recognised in the foreign currency or vice versa.

The Rules

The rules in IAS 21 for reporting assets and liabilities at the end of a subsequent reporting period make a distinction between:

- Monetary items, such as trade payables and trade receivables, and
- Non-monetary items, such as non-current assets and inventory.

The rules are as follows, for entities preparing their individual financial statements:

Asset or liability	Accounting treatment for the statement of financial position:
Monetary items	Re-translate at the closing rate.
Non-monetary items carried at cost	No re-translation. The transaction is left at the original spot rate.
Non-monetary items carried at fair value	Re-translate at the exchange rate ruling at the fair value date of the adjustment.

Recognition of Exchange Differences

Exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements shall be recognised in profit or loss in the period in which they arise, except as described below

There are two situations to consider.

(a) The transaction is settled in the same period as that in which it occurred: all the exchange difference is recognised in that period.

(b) The transaction is settled in a subsequent accounting period: the exchange difference recognised in each intervening period up to the period of settlement is determined by the change in exchange rates during that period.

When a gain or loss on a non-monetary item is recognised in other comprehensive income, any exchange component of that gain or loss shall be recognised in other comprehensive income. Conversely, when a gain or loss on a non-monetary item is recognised in profit or loss, any exchange component of that gain or loss shall be recognised in profit or loss.

Exchange differences arising on a monetary item that forms part of a reporting entity‘s net investment in a foreign operation shall be recognised in profit or loss in the separate financial statements of the reporting entity or the individual financial statements of the foreign operation, as appropriate.

In the financial statements that include the foreign operation and the reporting entity (e.g. consolidated financial statements when the foreign operation is a subsidiary), such exchange differences shall be recognised initially in other comprehensive income and reclassified from equity to profit or loss on disposal of the net investment.

Change in functional currency
When there is a change in an entity‘s functional currency, the entity shall apply the translation procedures applicable to the new functional currency prospectively from the date of the change.

The foreign operation: accounting rules Three stages in the consolidation process:

- The translation stage
- The consolidation stage

The Foreign Operation: Accounting Rules
Three stages in the consolidation process
If a company has a foreign operation (such as a foreign subsidiary) that prepares its accounts in a functional currency that is different from the group's presentation currency, there are three stages in the accounting process, for the purpose of preparing consolidated financial statements (or including the foreign associate or joint venture in the financial statements of the reporting entity).

Stage	Description
Adjust and update	• Ensure that the individual financial statements of the foreign entity is correct and up-to-date. • If any adjustments are required to correct the financial statements of the foreign entity, these should be made in the statements of the foreign entity and in its own functional currency.
Translate	• The assets and liabilities of the foreign entity should be translated into the presentation currency of the parent company. (As explained earlier, the presentation currency of the parent company might be the same or might be different from its functional currency.) • The rules for translation are explained below.
Consolidate	After translation, all the financial statements are now in the same currency. Normal group accounting principles are now used to prepare the consolidated accounts of the group.

The translation stage

The rules set out below apply where the functional currency of the foreign entity is not a currency suffering from hyperinflation.

The normal rules for translation, contained in IAS 21, are as follows:

(1) The statement of financial position

- The assets and liabilities of the foreign operation, for inclusion in the consolidated statement of financial position, are translated at the closing rate. (Comparative figures for the previous year are translated at the same rate.)
- For foreign subsidiaries, this rule also applies to purchased goodwill arising on the acquisition of the subsidiary.

(2) The statement of profit or loss and other comprehensive income

- Income and expenses for inclusion in the consolidated statement of profit or loss and other comprehensive income are translated at the spot rates at the dates of each of the transactions.
- For practical reasons, average rates for a period may be used, if they provide a reasonable approximation of the spot rates when the transactions took place.

(3) Exchange differences

- All resulting exchange differences are recognised in other comprehensive income for the period and are credited (gain) or debited (loss) to a separate reserve within the equity section of the consolidated statement of financial position, and this reserve is maintained within equity until the foreign operation is eventually disposed of.
- Gains or losses are therefore reported as gains or losses in other comprehensive income and movements in the separate reserve, and not as a gain or loss in profit or loss and an increase or reduction in retained earnings.

The gain or loss on translation

The exchange differences on translation result in a gain or loss. These gains or losses arise from a combination of two factors:

- Income and expense items are translated at the exchange rates ruling during the period, but assets and liabilities are translated at closing rates. The profit is therefore calculated at the actual exchange rates, but the accumulated profit in the consolidated statement of financial position is re-translated at the closing rate.
- The net assets of the subsidiary were translated at last year's closing rate at the end of the previous financial year. These net assets have now been retranslated and included in this year's statement of financial position at this year's closing rate.

IAS 21 states that these differences on translation are not recognised in profit or loss because changes in the exchange rates for these items have little or no effect on cash flows from operations. It would therefore be misleading to include them in profit or loss. However the actual treatment is that the exchange loss should be recognised in other comprehensive income for the year and taken to a separate reserve within equity in the consolidated statement of financial position.

The consolidation stage

After the translation stage, the financial statements of the overseas entity are in the presentation currency of the parent company.

The basic rule is that normal consolidation techniques can now be used. However, foreign exchange reserve must be included in the consolidated statement of financial position for the cumulative exchange differences.

It is also necessary to comply with the requirements of IAS 21 for purchased goodwill and foreign subsidiaries.

Purchased goodwill and foreign subsidiaries

IAS 21 requires that goodwill and any fair value adjustments arising on the acquisition of a foreign subsidiary are to be treated as part of the assets and liabilities of the foreign subsidiary.
The rules already described apply to these items.

This means that:

- Goodwill arising on the purchase of the foreign subsidiary (and also any fair value adjustments to the value of assets of the subsidiary) should be stated in the functional currency of the foreign subsidiary.
- The goodwill and fair value adjustments will therefore be translated each year at the closing exchange rate.

A gain or loss on translation will therefore arise (as described above for other assets and liabilities).

The effect of this rule is that goodwill and the acquisition of a foreign operation is re-stated over time because it is re-translated every year at the new closing exchange rate.

Exchange differences in other comprehensive income

Using the method of creating the consolidated statement of financial position shown in the previous example, you do not need to worry about exchange differences. By translating every balance in the

subsidiary's statement of financial position at the closing rate, the exchange differences are automatically included in reserves.

However, you may be asked to calculate exchange differences arising for reporting in other comprehensive income and a separate equity reserve.

The easiest way to work out the exchange differences (excluding the gain or loss on retranslation of goodwill) is to create the accounting equation for the foreign subsidiary in its own currency. Once this is translated into the parent's currency it will not balance, and the exchange differences are the balancing figure. These are the exchange differences arising from: Re-translating the opening net assets of the subsidiary at the closing rate, and

- Re-translating the subsidiary's post-acquisition profit at the closing rate.

DISPOSAL OF A FOREIGN SUBSIDIARY

Most of the accounting rules for the disposal of a foreign subsidiary, or for the partial disposal of a foreign subsidiary, are set out in IAS 27 (revised). Disposals are explained in another chapter. However IAS 27 does not deal with the accounting treatment of the balance on the separate equity reserve account when a foreign subsidiary is disposed of. This matter is dealt with by IAS 21.

- When the entire investment in a foreign subsidiary is disposed of, the cumulative balance in the separate equity reserve (which represents amounts previously recognised in other comprehensive income) should now be reclassified from equity to profit and loss.
- If there was a non-controlling interest in the subsidiary, the NCI is derecognised in the consolidated statement of financial position. Amounts previously recognised in other comprehensive income and attributed to NCI must not be reclassified and recognised in profit or loss of the reporting entity.
- When a proportion of an investment in a foreign subsidiary is disposed of, a proportionate share of the amounts previously recognised in other comprehensive income (the cumulative balance in the separate equity reserve) should now be reclassified from equity to profit or loss.

When income previously recognised as other comprehensive income is reclassified as a gain or loss to profit or loss as a re-classification adjustment, there must be an offsetting loss or gain in other comprehensive income, to avoid double-counting of the gain (or loss).

In other comprehensive income, negative income of $2 million should be recognised, to avoid double counting of the income previously recognised as other comprehensive income but now reclassified in profit or loss.

Disclosure

- The amount of exchange differences recognised in profit or loss (excluding differences arising on financial instruments measured at fair value through profit or loss in accordance with IAS 39).
- Net exchange differences recognised in other comprehensive income and accumulated in a separate component of equity and a reconciliation of the amount of such exchange differences at the beginning and end of the period.
- When the presentation currency is different from the functional currency, disclose that fact together with the functional currency and the reason for using a different presentation currency.
- A change in the functional currency of either the reporting entity or a significant foreign operation and the reason therefore.

When an entity presents its financial statements in a currency that is different from its functional currency, it may describe those financial statements as complying with IFRS only if they comply with all the requirements of each applicable Standard (including IAS 21) and each applicable interpretation.

Foreign currency in individual financial statements

Test your understanding 1 – Chive

Chive is an entity located in a country whose currency is dollars ($).

Seventy per cent of Chive's sales are denominated in dollars and 30% of them are denominated in sterling (£). Chive does not convert receipts from customers into other currencies. Chive buys most of its inventories, and pays for a large proportion of operating costs, in sterling.
Chive has two bank loans outstanding. Both of these loans are denominated in dollars.

Required:
What is the functional currency of Chive?
Answer:
Test your understanding 1 – Chive

Firstly, the primary indicators of functional currency should be applied. Most of Chive's sales are denominated in dollars and so this would suggest that the dollar is its functional currency. However, since a lot of the costs of the business are denominated in sterling, it could be argued that is functional currency is sterling.
Since the primary indicators of functional currency are not clear out, it is important to look at the secondary indicators. Receipts are retained in both dollars and sterling. However, funding is generated in the form of dollar loans, which further suggests that dollar might be Chive's functional currency.
All things considered, it would seem that the functional currency of Chive is dollars. This means that any business transactions that are denominated in sterling must be translated into dollars in order to record them.

Test your understanding 2 – Butler, Waiter and Attendant

(a) An entity, Butler, has a reporting date of 31 December and a functional currency of dollars ($).
On 27 November 2006 Butler plc buys goods from a Swedish supplier for SwK 324,000.
On 19 December 2006 Butler plc pays the Swedish supplier in full.
Exchange rates were as follows:
27 November 2006 – Sw K 11.15: $1
19 December 2006 – Sw K 10.93: $1

Required:
Describe how the above transaction should be accounted for in the financial statements of Butler for the year ended 31 December 2006.

(b) An entity, Waiter, has a reporting date of 31 December and the dollar ($) as its functional currency. Waiter borrows in the foreign currency of the Kram (K). The loan of K 120,000 was taken out on 1 January 2007. A repayment of K 40,000 was made on 1 March 2007.

Exchange rates were as follows

1 January 2007 – K1: $2

1 March 2007 – K1: $3

31 December 2007 – K1: $3.5

Required

Describe how the above should be accounted for in the financial statements of Waiter for the year ended 31 December 2007.

(c) An entity, Attendant, has a reporting date of 31 December and has the dollar ($) as its functional currency. Attendant purchased a plot of land overseas on 1 March 2000. The entity paid for the land in the currency of the Rylands (R). The purchase cost of the land at 1 March 2000 was R 60,000. The value of the land at the reporting date was R 80,000.

Exchange rates were as follows:

1 March 2000 – R8: $1

31 December 2000 – R10: $1

Required:

Describe how the above transaction should be accounted for in the financial statements of Attendant for the year ended 31 December 2000 if the land is measured at:

- Cost
- Fair value.

Answer:

Test your understanding 2 – Butler, Waiter and Attendant

(a) The transaction on 27 November 2006 must be translated using the exchange rate on the transaction date.

The transaction is recorded at $29,058 (SwK 324,000/11.15).

Dr Purchase $29,058 Cr Payables $29,058

The cash settlement on 19 December 2006 must be translated using the exchange rate on the settlement date.

The cash settlement is recorded at $29,643 (SwK 324,000/10.93).

Dr Payables $29,058 Dr Profit or loss $585

Cr Cash $29,643

An exchange loss of $585 has arisen and this is recorded in the statement of profit or loss.

(b) On 1 January 2007, money was borrowed in Krams. This must be translated into the functional currency using the exchange rate on the transaction date.

The transaction is recorded at $240,000 (K 120,000 x 2).

Dr Cash $240,000 Cr Loans $240,000 The cash settlement on 1 March 2007 must be translated into the functional currency using the exchange rate on the settlement date.

The cash settlement is recorded at $120,000 (K 40,000 x 3).

Dr Loans $120,000 Cr Cash $120,000

Loans are a monetary liability. At the reporting date, the remaining loan of K80,000 (K120,000 – K40,000) must be translated at the yearend exchange rate. This gives a closing liability of $280,000 (K 80,000 x 3.5).

The exchange loss on retranslation is calculated as follows:

	K	Rate	$
1 January 2007	120,000	2.0	240,000
1 March 2007	(40,000)	3.0	(120,000)
Exchange loss (bal. fig)			160,000
31 December 2007	80,000	3.5	280,000

The double entry to record this loss:

Dr Profit or loss $160,000

Cr Loans $160,000

(c) The asset is initially recognised at cost. This should be translated into the functional currency using the exchange rate on the purchase date. The land is therefore initially recorde at $7,500 ($60,000/8).

Land is not a monetary item so is therefore not retranslated. If held under the cost model, it will remain at $7,500.

If the land is held at fair value, then the valuation must be translated into dollars using the exchange rate in place when determined. Therefore, the land will be revalued to $8,000 (R 80,000/10).

The carrying value of the land must be increased by $500 ($8,000 - $7,500).

If the land is held under IAS 40 Investment Property, then the gain will be recorded in profit or loss.

If the land is held under IAS 16 Property, Plant and Equipment, then the gain will be recorded in other comprehensive income.

Test your understanding 3 – Highlight

(a) Highlight is an entity whose functional currency is the dollar ($) and has an annual reporting date of 31 December.

On 1 July 2003, Highlight purchased an item of plant and equipment on credit for Dn 400,000. On 1 November 2003, Highlight made a payment of Dn 180,000 to the supplier. The balance of the invoice remains outstanding.

Highlight has a policy of applying historical cost accounting and depreciating plant equipment at the rate of 20% per annum. The item of plant and equipment is not expected to have any residual value at the end of its useful life.

Relevant exchange rates to $1 are as follows:

	Dn
1 July 2003	10.0
1 November 2003	7.2
1 December 2003	9.0
31 December 2003	8.0

Required:

Prepare relevant extracts from Highlight's financial statements for the year ended 31 December 2003 to illustrate the impact of the above transactions.

(b) During 2003, Highlight entered into a number of transactions with Eraser, an overseas customer. On 1 November 2003, Highlight made credit sales to Eraser on 3 months credit for Dn 360,000. On 1 December 2003, Highlight made further credit sales to Eraser on 3 months credit for Dn 540,000.

By 31 December 2003, Highlight had received no payment from Eraser. As the receivables were still within their credit period, they were not regarded as being impaired.

Relevant exchange rates to $1 are as follow:

	Dn
1 July 2003	10.0
1 November 2003	7.2
1 December 2003	9.0
31 December 2003	8.0

Required:

Prepare relevant extracts from Highlight's financial statements for the year ended 31 December 2003 to illustrate the impact of the above transactions.

Answer:

Test your understanding 3 – Highlight

(a) Both the purchase of plant and equipment and the associated payable are recorded using the rate ruling at the date of the transaction (Dn 10 = $1), giving a value of $40,000. The partpayment made on 1 November is recorded using the rate applicable on that date, with the remaining dinar liability being restated in dollars at the closing rate at the reporting date. The exchange difference, in this case a loss of $12,500 (see calculation below), is taken to profit or loss as an operating expense.

	Dn	Rate	$
1/7/03 Payable recorded	400,000	10.0	40,000
1/1/03 Part-payment made	(180,000)	7.2	(25,000)
Exchange loss (bal. fig.)			12,500
31/12/03 Payable outstanding	220,000	8.0	27,500

Plant and equipment, as a non-monetary item, is accounted for at historic cost and is therefore no retranslated. The depreciation charge is $4,000 ($40,000 x 1/5 x 6/12).

Extracts of the financial statements for the year ended 31 December 2003 are as follows:

Statement of profit or loss:	$
Cost of sales (depreciation)	(4,000)
Operating expenses (exchange loss)	(12,500)
Statement of financial position:	
Property, plant and equipment ($40,000 - $4,000)	36,000
Current liabilities	27,500

(b) Each of the sales invoices denominated in Dn must be translated into $ using the spot rate on the date of each transaction. Each transaction will result in recognition of revenue and a trade receivable at the following amounts:

1 November 2003: Dn 360,000/7.2 = $50,000

1 December 2003: Dn 540,000/9.0 = $60,000

Both amounts remain outstanding at the reporting date and must be restated into dollars using the closing rate of Dn8 = $1. The exchange difference, in this case a gain of $2,500 (see calculation below), is taken to profit or loss as an item of other operating income.

		Dn	Rate	$
1/11/03	Receivable recorded	360,000	7.2	50,000
	Receivable recorded	540,000	9.0	60,000
	Exchange gain (bal. fig.)			2,500
31/12/03	Receivable outstanding	900,000	8.0	112,500

Extracts of the financial statements for the year ended 31 December 2003 are as follows:

Statement of profit or loss:	$
Revenue ($50,000 + $60,000	110,000
Other operating income (exchange gain)	2,500
Statement of financial position:	
Receivables	112,500

IAS 7-STATEMENT OF CASH FLOWS

OBJECTIVE

Group: Statement of Cash Flows

The objective of this Standard is to require the provision of information about the historical changes in cash and cash equivalents of an entity by means of a statement of cash flows which classifies cash flows during the period from operating, investing and financing activities.

Benefits of Cash Flow Information

- Cash flow information is useful in assessing the ability of the entity to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different entities
- It also enhances the comparability of the reporting of operating performance by different entities
- It is also useful in checking the accuracy of past assessments of future cash flows and in examining the relationship between profitability and net cash flow and the impact of changing prices.

DEFINITIONS

The following terms are used in this Standard with the meanings specified:

Cash comprises cash on hand and demand deposits.

Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Cash flows are inflows and outflows of cash and cash equivalents.

Operating activities are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

Cash and Cash Equivalents

Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value.

PRESENTATION OF A STATEMENT OF CASH FLOWS

The statement of cash flows shall report cash flows during the period classified by

- Operating,
- Investing and
- Financing activities.

Operating Activities

Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. Examples of cash flows from operating activities are:

(a) Cash receipts from the sale of goods and the rendering of services;

(b) Cash receipts from royalties, fees, commissions and other revenue;

(c) Cash payments to suppliers for goods and services;

(d) Cash payments to and on behalf of employees;

(e) Cash receipts and cash payments of an insurance entity for premiums and claims, annuities and other policy benefits;

(f) Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and

(g) Cash receipts and payments from contracts held for dealing or trading purposes.

Investing Activities

Examples of cash flows arising from investing activities are:

(a) Cash payments to acquire property, plant and equipment, intangibles and other long-term assets.

(b) Cash receipts from sales of property, plant and equipment, intangibles and other long-term assets;

(c) Cash payments to acquire equity or debt instruments of other entities and interests in joint ventures.

(d) Cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures.

Financing Activities

Examples of cash flows arising from financing activities are:

(a) Cash proceeds from issuing shares or other equity instruments;

(b) Cash payments to owners to acquire or redeem the entity's shares;

(c) Cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short-term or long-term borrowings;

(d) Cash repayments of amounts borrowed; and

(e) Cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease.

REPORTING CASH FLOWS FROM OPERATING ACTIVITIES

An entity shall report cash flows from operating activities using either:

(a) The direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or

(b) The indirect method, whereby profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

Under the indirect method, the net cash flow from operating activities is determined by adjusting profit or loss for the effects of:

(a) Changes during the period in inventories and operating receivables and payables;

(b) Non-cash items such as depreciation, provisions, deferred taxes, unrealized foreign currency gains and losses, and undistributed profits of associates; and all other items for which the cash effects are investing or financing cash flows.

A proforma of such a calculation is as follows and this method may be more common in the exam.

			$
Profit before taxation (statement of profit or loss and other comprehensive income)			X
Add depreciation			X
Loss (profit) on sale of non-current assets			X
(Increase)/decrease in inventories			(X)/X
(Increase)/decrease in receivables			(X)/X
Increase/(decrease) in payables			X/(X)
Cash generated from operations			X
Interest (paid)/received	(X) Income taxes paid	(X)	
Net cash flows from operating activities			X

It is important to understand why certain items are added and others subtracted. Note the following points.

(a) Depreciation is not a cash expense, but is deducted in arriving at the profit figure in the statement of comprehensive income. It makes sense, therefore, to eliminate it by adding it back. (b) By the same logic, a loss on a disposal of a non-current asset (arising through under provision of depreciation) needs to be added back and a profit deducted.

(c) An increase in inventories means less cash – you have spent cash on buying inventory. (d) An increase in receivables means the company's credit customers have not paid as much, and therefore there is less cash.

(e) If we pay off payables, causing the figure to decrease, again we have less cash.

Indirect versus direct

The direct method is encouraged where the necessary information is not too costly to obtain, but IAS 7does not require it, and favours the indirect method. In practice, therefore, the direct method is rarely used. It is not obvious that IAS 7 is right in favouring the indirect method. It could be argued that companies ought to monitor their cash flows carefully enough on an ongoing basis to be able to use the direct method at minimal extra cost.

Reporting cash flows from investing and financing activities

An entity shall report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities, except to the extent that cash flows described below are reported on ante basis.

Cash flows arising from the following operating, investing or financing activities may be reported on a net basis:

(a) Cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the entity; and

(b) Cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.

Foreign currency cash flows

Cash flows arising from transactions in a foreign currency shall be recorded in an entity‘s functional currency by applying to the foreign currency amount the exchange rate between the functional currency and the foreign currency at the date of the cash flow. The cash flows of a foreign subsidiary shall be translated at the exchange rates between the functional currency and the foreign currency at the dates of the cash flows.

Interest and dividends

Cash flows from interest and dividends received and paid shall each be disclosed separately. Each shall be classified in a consistent manner from period to period as either-operating, investing or financing activities.

Interest paid and interest and dividends received may be classified as operating cash flows because they enter into the determination of profit or loss. Alternatively, interest paid and interest and

dividend sreceived may be classified as financing cash flows and investing cash flows respectively, because they are costs of obtaining financial resources or returns on investments.

Dividends paid may be classified as a financing cash flow because they are a cost of obtaining financial resources. Alternatively, dividends paid may be classified as a component of cash flows from operating activities in order to assist users to determine the ability of an entity to pay dividends out of operating cash flows.

Taxes on income

Cash flows arising from taxes on income shall be separately disclosed and shall be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

Other disclosures

All entities should disclose, together with a commentary by management, any other information likely to be of importance.

(a) Restrictions on the use of or access to any part of cash equivalents.
(b) The amount of undrawn borrowing facilities which are available.
(c) Cash flows which increased operating capacity compared to cash flows which merely maintained operating capacity.

CONSOLIDATED STATEMENT OF CASH FLOWS

The special features of a consolidated statement of cash flows

A consolidated statement of cash flows is prepared largely from the consolidated statement of financial position, statement of comprehensive income (or income statement) and statement of changes in equity.

The rules for preparing a group statement of cash flows are similar to the rules for a statement of cash flows for an individual entity.

However, there are additional items in a consolidated statement of cash flows that are not found in the statement of cash flows of an individual company. The most significant of these are cash flows (or adjustments to profit before tax) relating to:

- Non-controlling interests
- Associates
- And acquiring or disposing of subsidiaries during the year.

Illustrative format

It might be useful to look at the format of a consolidated statement of cash flows, to see where these item sap pear. The indirect method is used here to present the cash flows from operating activities.

Entity XYZ

Statement of cash flows for the year ended 31 December 20X7

	$000	$000
Cash flows from operating activities		
Profit before tax	440	
Adjustments for:		
Depreciation and amortisation charges	450	
Loss on disposal of plant and machinery	50	
Share of profit of associates and joint ventures	(100)	
Foreign exchange loss	40	
Investment income	(25)	
Interest expense	25 880	
Increase in trade and other receivables	(80)	
Increase in inventories	(60)	
Increase in trade payables	40	
Cash generated from operations	780	
Interest paid	(30)	
Income taxes paid	(200)	

Net cash from operating activities		550
Cash flows from investing activities		
Acquisition of subsidiary, net of cash acquired (note 1)	(450)	
Purchase of property, plant and equipment (note 2)	(220)	
Proceeds from the sale of equipment	30	
Interest received	25	
Dividends received from associates	45	
Net cash used in investing activities		(570)
Cash flows from financing activities		
Proceeds from the issue of share capital	500	
Proceeds from long-term loan	100	
Redemption of debt securities	(150)	
Payment of finance lease liabilities	(80)	
Dividends paid to non-controlling interests (NCI)	(70)	
Dividends paid to parent company shareholders	(200)	
Net cash inflow from financing activities		100
Net increase in cash and cash equivalents		80
Cash and cash equivalents at the beginning of the period (note 3)		150
Cash and cash equivalents at the end of the period (note 3)		230

Exchange rate differences

A gain or loss arising from exchange rate differences is not a cash flow item. When the indirect method is used to present cash flows from operating activities, it is therefore necessary to make an adjustment to get from 'profit' to 'cash flow'.

- A loss arising from exchange rate differences (shown in the example above as a 'foreign exchange loss') must be added back.
- A gain arising from exchange rate differences must be subtracted.

Cash flows to the non-controlling interest

The non-controlling interest represents a third party so dividends paid to the non-controlling interest are reflected as a cash outflow. This payment should be presented separately and classified as =Cash flows from financing activities‘

	$
Non-controlling interest in group net assets at the beginning of the year	X
Non-controlling interest in profits after tax for the year	X
	X
Non-controlling interest in group net assets at the end of the year	(X)
Dividends paid to non-controlling interests (balancing figure)	X

The dividend paid of $120,000 will be disclosed as a cash flow from financing activities.

Associates and the group statement of cash flows

When a group has an interest in an associate entity, the consolidated statement of cash flows must show the cash flows that occur between the associate and the group. The consolidated statement of cash flows shows the effect on the group's cash position of transactions between the group and its associate.

Share of profit (or loss) of an associate

In the consolidated statement of comprehensive income or the income statement, the group profit includes the group's share of the profits of associates.

These profits are not a cash flow item. When the indirect method is used to present the cash flows from operating activities, an adjustment is therefore needed to get from 'profit' to 'cash flow'.

- The group's share of the profit of an associate must be deducted from profit.
- The group's share of the loss of an associate must be added to profit.

Cash flows involving associates

The cash flows that might occur between a group and an associate, for inclusion in the consolidated statement of cash flows are as follows:

- Investing activities
  - Cash paid to acquire shares in an associate during the year
  - Cash received from the disposal of shares in an associate during the year - Dividends received from an associate during the year.

- Financing activities
  - Cash paid as a new loan to or from an associate during the year
  - Cash received as a repayment of a loan to or from an associate during the year.

Note that dividends received from an associate are shown as cash flows from investing activities; whereas dividends paid to non-controlling interests in subsidiaries are (usually) shown as cash flows from financing activities.

Dividends received from the associate must be disclosed as a separate cash flow classified as Cash flows from investing activities‘.

The cash receipt can be calculated as follows:

	$
Group investment in net assets of associate at the beginning of the Year	X
Group share of associate's profits before tax	X
Group's share of associate's tax on profits	(X)
	X
Group investment in net assets of associate at the end of the year	(X)
Dividends received from associate in the year	X

Acquisitions and disposals of subsidiaries in the statement of cash flows
Acquisition of a subsidiary in the statement of cash flows When a subsidiary is acquired:

- The group gains control of the assets and liabilities of the subsidiary, which might include some cash and cash equivalents, and
- The group pays for its share of the subsidiary, and the purchase consideration might consist partly or entirely of cash.

If the subsidiary is acquired or disposed of during the accounting period the net cash effect of the purchase or sale transaction should be shown separately under Cash flows from investing activities‘.

The net cash effect will be the cash purchase price/cash disposal proceeds net of any cash or cash equivalents acquired or disposed of.

Inventory, trade receivables, trade payables

When a subsidiary has been acquired, the working capital brought into the group (receivables plus inventory minus trade payables of the acquired subsidiary) is paid for in the purchase price to acquire the subsidiary. As we have seen, this is treated as a separate item in the investing activities section of the statement of cash flows.

To avoid double counting of the effects of the working capital in the subsidiary at the acquisition date, we need to deduct from the value in the closing statement of financial position, or add to the value in the opening statement of financial position:

- The receivables in the net assets of the subsidiary acquired, as at the acquisition date
- The inventory in the net assets of the subsidiary acquired, as at the acquisition date, and
- The trade payables in the net assets of the subsidiary acquired, as at the acquisition date

Purchases of Non-Current Assets

When non-current assets are at carrying amount (net book value)

When non-current assets are shown at their carrying amount (net book value) and a subsidiary has been acquired during the year, purchases of non-current assets (assumed to be cash payments) are calculated as follows. (Figures have been included in the table for illustrative purposes.)

	$
Non-current assets at carrying amount, at the end of the year	290,000
Minus: Non-current assets acquired on acquisition of the subsidiary	(65,000)
	225,000
Net book value of disposals of non-current assets during the year	30,000
Depreciation charge for the year	40,000
	295,000
Non-current assets at carrying amount, at the beginning of the year	240,000
Cash paid to acquire non-current assets during the year	55,000

When non-current assets are at cost

When non-current assets are shown at cost and a subsidiary has been acquired during the year, purchases of non-current assets (assumed to be cash payments) are calculated as follows. (Again, figures have been included in the table for illustrative purposes.)

	$
Non-current assets at cost, at the end of the year	485,000
Non-current assets acquired on acquisition of the subsidiary	(90,000)
	395,000
Cost of disposals of non-current assets during the year	60,000
	455,000
Non-current assets at cost, at the beginning of the year	(400,000)
Cash paid to acquire non-current assets during the year	55,000

Disposal of a Subsidiary in the Statement of Cash Flows

The procedures for reporting the cash effect of disposals of subsidiaries in a group statement of cash flows are similar to those used for acquisitions, except that the process applies in reverse. In the group statement of cash flows, the cash received from the disposal is the cash actually received from the disposal, minus any cash in the subsidiary at the disposal date.

A note to the statement of cash flows should show the details of the disposal, including the cash received from the sale minus the cash in the subsidiary at the disposal date.

Note:

You should remember the assets and liabilities disposed of, and the non-controlling interest that leaves the group on the disposal, to avoid double counting the other cash flow items in the statement of cash flows.

Group statement of cash flows

Test your understanding 1 – Cash and cash equivalents

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

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

Required:

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

Answer:

Test your understanding 1 – Cash and cash equivalents: To qualify as a cash equivalent, an item must be readily convertible to cash and have an insignificant risk of a change in value. Furthermore, it should be held for the purpose of meeting short-term cash commitments.
Bank overdrafts are an integral part of most company's cash management. They are therefore generally treated as a component of cash.

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

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

Test your understanding 2 – Extracts

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

(1)	2001	2000
Property, plant and equipment (PPE)	250	100

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

Required:

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

(2)	2001	2000
	$	$
Deferred tax liability	100	50
Income tax liability	120	100

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

Required:

How much tax was paid in the period?

(3)

	2001	2000
	$	$
Retained earnings	300	200

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

How much was the cash dividend paid during the period?

Answer:

Test your understanding 2 – Extracts

(1) Property, plant and equipment

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

(2) Tax

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

(3) Retained earnings

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

Illustration 1 – Single entities

Below are the financial statements of Single for the year ended 30 September 2002:

Statement of financial position as at 30 September 2002 (including comparatives)

	2002	2001
	$m	$m
Non-current assets		
Property, plant and equipment	90	60
Current assets		
Inventories	32	20
Trade receivables	20	27
Cash and cash equivalents	8	12
	150	119
Equity and liabilities		
Share capital ($1 shares)	30	35
Retained earnings	60	35
	90	40
Non-current liabilities:		
Loans	10	29
Deferred tax	15	14
Current liabilities:		
Trade payables	23	25
Trade payable	12	11

150 119

Statement of profit or loss for the year ended 30 September 2002

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

Notes

(1) Property, plant and equipment with a carrying amount of $9 million was disposed of for cash proceeds of $13 million. Depreciation for the year was $17 million.
(2) Trade payables as at 30 September 2002 includes accruals for interest payable of $4 million (2001: $5 million).

Required:

Prepare the statement of cash flows single for the year ended 30 September 2002.

Solution

Statement of cash flows

Cash flows from operating activities	$m	$m
Profit before tax	46	
Finance cost	3	
Depreciation	17	
Profit on disposal of PPE ($13 - $9)	(4)	
Increase in inventories ($32 - $20)	(12)	
Decrease in receivables ($20 - $27)	7	
Decrease in payables	(1)	
(($23 - $4) – ($25 - $5))		

	56	
Interest paid (W1)	(4)	
Tax paid (W2)	(10)	
		42
Cash flows from investing activities		
Proceeds from sale of PPE	13	
Purchases of PPE (W3)	(56)	
		(43)
Cash flows from financing activities		
Proceeds from shares ($30 - $5)	25	
Repayment of loans ($10 - $29)	(19)	
Dividends paid (W4)	(9)	
Decrease in cash and cash equivalents		(4)
Opening cash and cash equivalents		12
Closing cash and cash equivalents		

Workings

(W1) Interest

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

(W2) Tax

	$m
Balance b/fwd ($14 + $11)	25

Profit or loss		12
		(3)
Cash paid (bal. fig.)	(10)	8
Balance c/fwd ($15 + $12)	27	

(W3) PPE

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

(W4) Retained earnings

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

Illustration 2 – Acquisitions and disposals

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

	2008	2007
	$000	$000
Inventories	74,666	53,019
Trade receivables	58,246	62,043
Trade payables	93,678	86,247

During 2008, Subsidiary A was acquired and all shares in Subsidiary B were disposed of.

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

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

Required:

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

Solution

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

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

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

	Inventories	Trade receivable	Trade payables
	$000	$000	$000
Bal c/fwd	74,666	58,246	93,678
Bal b/fwd	(53,019)	(62,043)	(86,247)
	21,647	(3,797)	7.431
Less: Sub acquired in year	(4,500)	(7,900)	(8,250)
Add: Sub disposed in year	6,800	6,700	5,740
	Inc 23,947	dec (4,997)	inc 4,921

Impact on cash flow	Outflow	Inflow	Inflow

Illustration 3 – Cash paid to NCI

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

	2007	2006
	$000	$000
Statement of financial position		
Equity:		
Non-controlling interest	780	690
Statement of profit or loss		
Profit for the period attributable to the non-controlling interest	120	230

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

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

Required:

What is the dividend paid to non-controlling interest in the year ended 31 December 2007? Solution

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

(W1) NCI at date of TT disposal

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

Alternatively, a T account can be used:
Non-controlling interests

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

Illustration 4 – Associates

The following information is from the consolidated statement of profit or loss for year ended 31 December 2001

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

Extract from consolidated statement of financial position as at 31 December 2001 (with comparations)

	2001	2000
	$000	$000
Non-current assets		
Investment in associate	466	456
Loan to associate	380	300

Required:

Calculate the relevant figure to be included in the group statement of cash flows for the year ended 31 December 2001.

Solution

Extracts from statement of cash flows

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

(W1) Dividend received from associate

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

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

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

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

Associate

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

504	504

Test your understanding 3 – The Z group

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

Extract from consolidated statement of profit or loss for year ended 31 December 2001

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

Extracts from consolidated statement of financial position as at 31 December 2001 (with comparatives)

	2001	2000
	$000	$000
Non-current assets		
Investment in associate	600	580

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

Required:

Based on the above information, prepare extracts showing relevant figures to be included in the group statement of cash flows for the year ended 31 December 2001.

Answer:

Test your understanding 3 – The Z group

Extracts from statement of cash flows

$000 Cash flows from operating activities

Profit before tax	915
Share of profit of associate	(15)

Cash flows from investing activities

Dividend received from associate	5
Cash paid to acquire associate (W1)	(10)

(W1) Associate

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

Test your understanding 4 – Consolidated extracts

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

(1)

	2001	2000
	$	$
Non-controlling interest	840	440

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

Required:

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

(2)

	2001	2000
	$	$
Non-controlling interest	850	500

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

Required:

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

(3) 2001 2000

	$	$
Investment in associate	500	200

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

Required:

How much was the cash dividend received by the group?

(4)

	2001	2000
	$	$
Investment in associate	3,200	600

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

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

Required:

How much was the cash dividend received by the grop?

(5)

	2001	2000
	$	$
Property, plant and equipment (PPE)	500	150

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

Required:

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

Answer:

Test your understanding 4 – Consolidated extracts

(1) Non-controlling interest

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

(2) Non-controlling interest

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

(3) Associate

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

(4) Associate

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

(5) Property, plant and equipment

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

Test your understanding 5 – AH Group

Extract from the consolidated financial statements of the AH Group for the year ended 30 June 2005 are given below:

Consolidated statement of profit or loss for the year ended 30 June 2005

$000

Revenue	85,000
Cost of sales	(60,750)
Gross profit	24,250
Operating expenses	(5,650)
Profit from operations	18,600
Finance cost	(1,400)
Profit before disposal of property	17,200
Disposal of property (note 2)	1,250
Profit before tax	18,450
Tax	(6,250)
Profit for the period	12,200
Attributable to:	
Non-controlling interest	405
Owners of the parent	11,795
	12,200

Note: There were no items of other comprehensive income.

Statement of financial position, with comparative, at 30 June 2005

	2005		2004	
Non-current assets	$000	$000	$000	$000
Property, plant and equipment	50,600		44,050	
Goodwill (note 3)	5,910		4,160	

		56,510		48,210
Current assets				
Inventories	33,500		28,750	
Trade receivables	27,130		26,300	
Cash and cash equivalents	1,870		3,900	
		62,500		58,950
		119,010		107,160
Equity and liabilities	$000	$000	$000	$000
Equity shares	20,000		10,000	
Share premium	12,000		18,000	
Retained earnings	24,135		18,340	
		56,135		46,340
Non-controlling interest		3,875		1,920
Total equity		60,010		48,260
Non-current liabilities				
Interest-nearing borrowings		18,200		19,200
Current liabilities				
Trade payables	33,340		32,810	
Interest payables	1,360		1,440	
Tax	6,100		5,450	
		40,800		39,700
		119,010		107,160

Notes:

(1) Several years ago, AH acquired 80% of the issued equity shares of its subsidiary, Bl. The NCI at the acquisition date was valued using the proportion of net assets method.

On 1 January 2005, AH acquired 75% of the issued equity shares of CJ in exchange for a fresh issue of 2 million of its own $1 equity shares (issued at a premium of $1 each) and $2 million in cash. The net assets of CJ at the date of acquisition were assessed as having the following fair values:

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

Goodwill relating to the acquisition of entity CJ during the year was calculated on the full goodwill basis. On 1 January 2005 when CJ was acquired, the fair value of the noncontrolling interest was $1,750,000.

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

(2) During the year, AH disposed of property, plant and equipment for proceeds of $2,250,000. The carrying value of the asset at the date of disposal was $1,000,000. There were no other disposals of property, plant and equipment. Depreciation of $7,950,000 was charged to the consolidated statement of profit or loss in the year.

Required:

Prepare the consolidated statement of cash flows of the AH Group for the year ended 30 June 2005 using the indirect method.

Answer:

Test your understanding 5 – AH Group

Consolidated statement of cash flows for the year ended 30 June 2005

	$000	$000
Cash flows from operating activities		
Profit before tax	18,450	
Less: profit on disposal of property	(1,250)	
(2,250 – 1,000)		

Add: finance cost	1,400	
Adjustment for non-cash items dealt with in arriving at operating profit:		
Depreciation	7,950	
Decrease in trade receivables (27,130 – 26,300 – 1,300)	470	
Increase in inventories (33,500 – 28,750 – 1,650)	(3,100)	
Decrease in trade payables (33,340 – 32,810 – 1,950)	(1,420)	
Goodwill impaired (W5)	1,000	
Cash generated from operations	23,500	
Interest paid (W1)	(1,480)	
Income taxes paid (W2)	(5,850)	
Net cash from operating activities		16,170
Cash flows from investing activities		
Acquisition of subsidiary net of cash acquired (2,000 – 50)	(1,950)	
Purchase of property, plant, and equipment (W3)	(11,300)	
Proceeds from sale of property	2,250	
Net cash used in investing activities		(11,000)
Cash flows from financing activities		

Repayment of long-term borrowings (18,200 – 19,200)	(1,000)	
Dividend paid by parent (W7)	(6,000)	
Dividends paid to NCI (W6)	(200)	
Net cash used in financing activities		(7,200)
Net decrease in cash and cash equivalents		(2,030)
Cash and cash equivalent at 1 July 2004		3,900
Cash and cash equivalents at 30 June 2005		1,870

(W1) Interest paid

	$000
Bal b/fwd	1,440
Profit or loss	1,400
Interest paid (bal. fig.)	(1,480)
Bal c/fwd	1,360

(W2) Income taxes paid

	$000
Bal b/fwd	5,450
Profit or loss	6,250
New subsidiary	250
Tax paid (bal.fig.)	(5,850)
Bal c/fwd	6,100

(W3) Property, plant and equipment

	$000
Bal b/fwd	44,050
New subsidiary	4,200
Depreciation	(7,950)
Disposals	(1,000)
Additions (bal. fig.)	11,300
Bal c/fwd	50,600

(W4) Goodwill arising on acquisition of subsidiary

	$000
Fair value of shares issued (2m x $2)	4,000
Cash consideration	2,000
	6,000
Fair value of NCI at acquisition	1,750
	7,750
Fair value of net assets at acquisition	(5,000)
Goodwill at acquisition	2,750

(W5) Goodwill

	$000
Bal b/fwd	4,160

Goodwill on sub acquired (W4)	2,750
Impairment in year (bal. fig.)	(1,000)
Bal c/fwd	5,910

(W6) Non-controlling interest

	$000
Bal b/fwd	1,920
NCI arising on subsidiary acquired	1,750
Profit or loss	405
Dividend paid (bal. fig.)	(200)
Bal c/fwd	3,875

(W7) Retained earnings

	$000
Bal b/fwd	18,340
Profit or loss	11,795
Dividend paid (bal. fig.)	(6,000)
Bal c/fwd	24,135

Test your understanding 6 – Pearl

Below are the consolidated financial statements of the Pearl Group for the year ended 30 September 2002:

Consolidated statements of financial position

	2002	2001

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

Current liabilities:

Trade payables	800	725
Tax payable	400	360
	6,165	4,920

Consolidated statement of profit or loss and other comprehensive income for the year ended 30 September 2002

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

	890
Total comprehensive income for the year attributable to:	
Owners of the parent	
Non-controlling interests	1,020
	120
	1,140

Consolidated statement of changes in equity

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

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

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

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

	1,490

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

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

Required:

Prepare the consolidated statement of cash flows for the Pearl group for the year ended 30 September 2002.

Answer:

Test your understanding 6 – Pearl

Consolidated statement of cash flows

	$000	$000
Cash flows from operating activities		
Profit before tax	1,115	
Finance cost	35	
Profit on sale of subsidiary	(100)	
Income from associates	(115)	
Depreciation	385	
Impairment (W1)	80	

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

Workings

(W1) Goodwill

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

(W2) Goodwill on acquisition of subsidiary

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

(W3) Goodwill at disposal date

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

(W4) Tax

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

Balance c/f ($400 + $150)	550

(W5) PPE

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

(W6) Dividend from associate

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

Test your understanding 7 – Boardres

Set out below is a summary of the accounts of Boardres, a public limited company, for the year ended 31 December 2007.

Consolidated statement of profit or loss and other comprehensive income for the year ended 31 December 2007

$000

Revenue	44,754
Cost of sales and other expenses	(39,613)
Profit from operations	5,141
Income from associates	30
Finance cost	(305)
Profit before tax	4,866
Tax:	(2,038)
Profit for the period	2,828
Other comprehensive income: Items that may be reclassified to profit or loss in future periods	
Total exchange difference on retranslation of foreign operations (note 5)	302
Total comprehensive income	3,130
Profit for the year attributable to:	
Owners of the parent	2,805
Non-controlling interests	23
	2,828
Total comprehensive income for the attributable to:	
Owners of the parent (2,805 + 302)	3,107
Non-controlling interests	23

	$000
Equity b/f	14,164

Profit for year	2,805
Dividends paid	(445)
Exchange differences	302
Equity c/f	16,826

Consolidated statement of financial position at 31 December

	Note	2007	2006
		$000	$000
Non-current assets			
Goodwill	(1)	500	-
Property, plant and equipment		11,157	8,985
Investment in associate		300	280
		11,957	9,265
Current assets			
Inventories		9,749	7,624
Receivables	(2)	5,354	4,420
Short-term investments		1,543	741
Cash		1,013	394
		29,616	22,444
Equity share capital		1,997	1,997
Share premium		5,808	5.808
Retained earnings		9,021	6,359
		16,826	14,164
		170	17

Non-controlling interest			
			3,130

Summary of changes in equity attributable to the owners of the parent for the year

Total equity		16,996	14,181	
Non-current liabilities				
Loans		2, 102		1,682
Provisions	(4)	1,290	935	
Current liabilities	(3)	9,228	5,646	
		29,616	22,444	

Notes to the accounts

(1) Property, plant and equipment

Property, plant and equipment movements include the followings:

	$000
Carrying amount of disposals	305
Proceeds from disposals	854
Depreciation charge for the year	907

(2) Short-term investments

The short-term investments are readily convertible into cash and there is an insignificant risk their value will change.

(3) Current liabilities

	2007	2006

	$000	$000
Bank overdrafts	1,228	91
Trade payables	4,278	2,989
Tax	3,722	2,566
	9,228	5,646

(4) Provisions

	Legal provision	Deferred taxation	Total
	$000	$000	$000
At 31 December 2006	246	689	935
Exchange rate adjustment	29	-	29
Increase in provision	460	-	460
Decrease in provision	-	(134)	(134)
At 31 December 2007	735	555	1,290

(5) Liberated

During the year, the company acquired 82% of the issued equity capital of Liberated for a cash consideration of $1,268,000. The fair values of the assets of Liberated were follows:

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

(6) Exchange gains

The net exchange gain on translating the financial statements of a wholly-owned subsidiary has been recorded in other comprehensive income and is held within retained earnings. The gain comprises difference on the retranslation of the following:

$000

Property, plant and equipment	138
Legal provision	(29)
Inventories	116
Trade receivables	286
Trade payables	(209)
Net exchange gain	302

(7) Non-controlling interest
The non-controlling interest is valued using the proportion of net assets method.

Required:

Prepare a statement of cash flows for the year ended 31 December 2007.

Test your understanding 7 – Boardres

Statement of cash flows for the year ended 31 December 2007

	$000	$000
Cash flows from operating activities		
Profit before tax	4,866	
Finance cost	305	
Income from associates	(30)	
Depreciation	907	
Goodwill (W7)	85	
Profit on disposal of PPE (W1)	(549)	
Increase in legal provision	460	
	6,044	
Change in working capital		
Increase in inventory		

(9,749 – 7,624 – 612 acq – 116 ex diff)	(1,397)	
Increase in receivables		
(5,354 – 4,420 – 500 acq – 286 ex diff)	(148)	
Increase in payables		
(4,278 – 2,989 – 407 acq – 209 ex diff)	673	
	5,172	
Interest paid	(305)	
Tax paid (W2)	(1,016)	
		3,851
Cash flows from investing activities		
Purchase of non-current assets (W3)	(3,038)	
Proceeds on disposal	854	
Cash consideration paid on acquisition of subsidiary, net of cash acquired		
(1,268 – 232)	(1,036)	
Dividend received from associate (W4)	10	
		(3,210)
Cash flows from financing activities		
Dividends paid	(445)	
Dividends paid to NCI (W6)	(20)	
Proceeds from debt issue (W5)	108	
		(357)

Change in cash and cash equivalents	284
Opening cash and cash equivalents	
(394 + 741 – 91)	1,044
Closing cash and cash equivalents	1,328
(1,013 + 1,543 – 1,228)	

Workings

(W1) Profit on disposal of property, plant and equipment

	$000
Sales proceeds	854
Carrying amount	(305)
Profit on disposal	549

(W2) Tax paid

	$000
Bal b/fwd (2,566 + 689)	3,255
Profit or loss	2,038
Tax paid (bal. fig.)	(1,016)
Bal c/fwd (3,722 + 555)	4,277

(W3) Property, plant and equipment

	$000
Bal b/fwd	8,985
Exchange gain	138
Acquisition of subsidiary	208
Depreciation	(907)
Disposal	(305)
Additions (bal. fig.)	3.038
Bal c/fwd	11,157

(W4) Dividends from associates

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

(W5) Debentures

	$000
Bal b/fwd	1,682
Acquisition of subsidiary	312
Cash received (bal. fig.)	108
Bal c/fwd	2,102

(W6) Non-controlling interest

	$000
Bal b/fwd	17
Total comprehensive income	23
Acquisition of subsidiary (18% x 833)	150
Dividend paid (bal. fig.)	(20)
Bal c/fwd	170 (W7)

Goodwill

	$000
Cost of investment	1,268
NCI acquisition (18 % x 833)	150
	1,418
FV of net assets at acquisition	(833)

Goodwill at acquisition	585

	$000
Goodwill b/fwd	nil
Goodwill acquired (above)	585
Goodwill impairment (bal. fig)	(85)
Goodwill c/fwd	500

IAS 24 – RELATED PARTY TRANSACTIONS

OBJECTIVE

The objective of this Standard is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances, including commitments, with such parties.

SCOPE

This Standard shall be applied in:

(a) Identifying related party relationships and transactions;

(b) Identifying outstanding balances, including commitments, between an entity and its related parties;

(c) Identifying the circumstances in which disclosure of the items in (a) and (b) is required; and (d) Determining the disclosures to be made about those items.

DEFINITIONS

The following terms are used in this Standard with the meanings specified:

A related party is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the =reporting entity‘).

(a) A person or a close member of that person‘s family is related to a reporting entity if that person:

(i) Has control or joint control over the reporting entity;

(ii) Has significant influence over the reporting entity; or

(iii) Is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

(b) An entity is related to a reporting entity if any of the following conditions applies:

(i) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).

(ii) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).

(iii) Both entities are joint ventures of the same third party.

(iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.

(v) The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.

(vi) The entity is controlled or jointly controlled by a person identified in (a).

(vii) A person identified in (a) (i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

A related party transaction is a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.

Close members of the family of a person are those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity and include:
(a) That person‘s children and spouse or domestic partner;
(b) Children of that person‘s spouse or domestic partner; and
(c) Dependants of that person or that person‘s spouse or domestic partner.

Compensation includes all employee benefits (as defined in IAS 19 Employee Benefits) including employee benefits to which IFRS 2 Share-based Payment applies.

Employee benefits are all forms of consideration paid, payable or provided by the entity, or on behalf of the entity, in exchange for services rendered to the entity.

It also includes such consideration paid on behalf of a parent of the entity in respect of the entity.

Compensation includes:
(a) Short-term employee benefits, such as wages, salaries and social security contributions, paid annual leave and paid sick leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and non-monetary benefits (such as medical care, housing, cars and free or subsidized goods or services) for current employees;
(b) Post-employment benefits such as pensions, other retirement benefits, post-employment life insurance and post-employment medical care;
(c) Other long-term employee benefits, including long-service leave or sabbatical leave, jubilee or other long-service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation;
(d) Termination benefits; and
(e) Share-based payment.

Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

Joint control is the contractually agreed sharing of control over an economic activity.
Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

Significant influence is the power to participate in the financial and operating policy decisions of an entity, but is not control over those policies. Significant influence may be gained by share ownership, statute or agreement.

Government refers to government, government agencies and similar bodies whether local, national or international.

A government-related entity is an entity that is controlled, jointly controlled or significantly influenced by a government.

DISCLOSURE

Relationships between parents and subsidiaries: Regardless of whether there have been transactions between a parent and a subsidiary, an entity must disclose the name of its parent and, if different, the ultimate controlling party.

Management compensation: Disclose key management personnel compensation in total and for each of the following categories:

- Short-term employee benefits
- Post-employment benefits
- Other long-term benefits
- Termination benefits
- Share-based payment benefits

Key management personnel are those persons having authority and responsibility for planning, directing, and controlling the activities of the entity, directly or indirectly, including any directors (whether executive or otherwise) of the entity.

Related party transactions: If there have been transactions between related parties, disclose the nature of the related party relationship as well as information about the transactions and outstanding balances necessary for an understanding of the potential effect of the relationship on the financial statements. These disclosures would be made separately for each category of related parties and would include:

- The amount of the transactions
- The amount of outstanding balances, including terms and conditions and guarantees Provisions for doubtful debts related to the amount of outstanding balances
- Expense recognised during the period in respect of bad or doubtful debts due from related parties

The disclosures shall be made separately for each of the following categories:
(a) The parent;
(b) Entities with joint control or significant influence over the entity;
(c) Subsidiaries;
(d) Associates;
(e) Joint ventures in which the entity is a venture;
(f) Key management personnel of the entity or its parent; and (g) Other related parties.
Items of a similar nature may be disclosed in aggregate except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the entity

A reporting entity is exempt from the disclosure requirements in relation to related party transactions and outstanding balances, including commitments, with:
(a) A government that has control, joint control or significant influence over the reporting entity; and
(b) Another entity that is a related party because the same government has control, joint control or significant influence over both the reporting entity and the other entity.

If a reporting entity applies the exemption, it shall disclose the following about the transactions and related outstanding balances:

(a) The name of the government and the nature of its relationship with the reporting entity (i.e. control, joint control or significant influence);

(b) The following information in sufficient detail to enable users of the entity's financial statements to understand the effect of related party transactions on its financial statements:

(i) The nature and amount of each individually significant transaction; and

(ii) For other transactions that are collectively, but not individually, significant, a qualitative or quantitative indication of their extent.

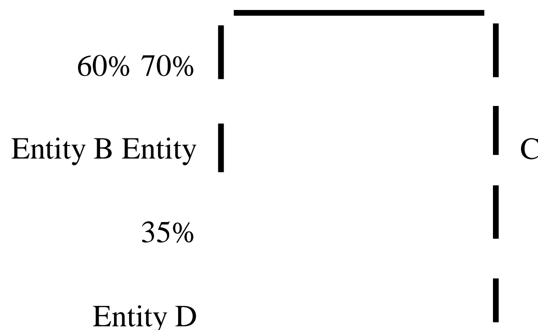
NOTE: This topic is very important for Ethics based questions.

Related parties

Test your understanding 1 – Group structures

Consider the following structures:

Entity A



Required:

Identify the related party relationships within the above structure.

Answer:

Test your understanding 1 – Group structures Entity A:

Entities that are within the same group are related to one another. Entities B and C are therefore related parties of A.

D is an associate of C. C is a member of A's group. This means that D is a related party of A.

Entity B:

Entities that are within the same group are related to one another. Entities A and C are therefore related parties of B.

D is an associate of C. C is a member of the same group as B. This means that D is related party of B.

Entity C:

Entities that are within the same group are related to one another. Entities A and B are therefore related parties of C.

Entities are related if one is an associate of another. C and D are therefore related parties.

Entity D:

Entities are related if one is an associated of another. D and C are therefore related parties.

Entities are related if one is an associate of a member of a group of which the other entity is also a member. D is an associate of C. Companies A and B are in the same group as C. This means that D is also a related party of A and B.

Test your understanding 2 – Individual shareholdings

Consider each of the following situations:
(a)

Mr P

Mr P controls entity A and is able to exert significant influence over entity B. (b)

Mr P

Entity A Entity B

Mr P is able exert significant influence over entity A and B.

Required:

For each situation explain whether or not entity A and entity B are related parties.

Answer:

Test your understanding 2 – Individual shareholdings Situation A:

Mr P is a related party of both entity A and B as he is able to exercise either control or significant influence over each entity.

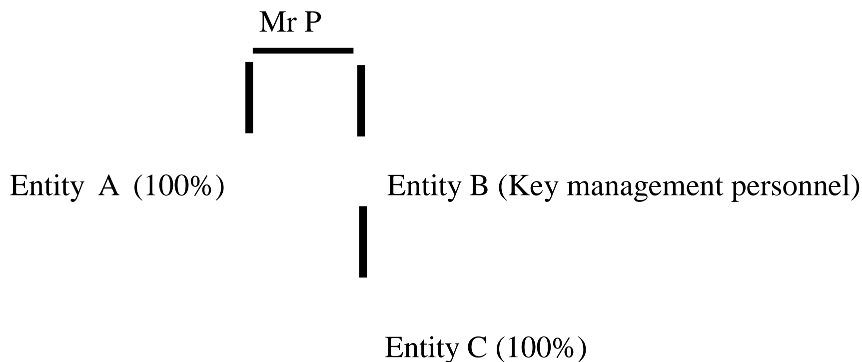
Mr P controls entity A and has significant influence over entity B. Therefore, A and B are related parties.

Situation B:

Mr P is a related party of both entity A and entity B as he is able to exercise significant influence over each entity.

Mr P does not control either entity A or entity B. Therefore, A and B are not related parties.
Test your understanding 3 – Key management personal Consider the

following situation:



Mr P owns all of the issued share capital of entity A. He also is a member of the key management personal of entity B which, in turn, owns all of the issued share capital of entity C.

Required:

Discuss the related party relationships arising from the above structure.

Answer:

Test your understanding 3 – Key management personal

Mr P has control over entity A, meaning that Mr P is a related party of A.

Mr P is a member of key management personal of B, so is a related party of B.

A and B are related parties, because Mr P controls A and is a member of key management personal of B.

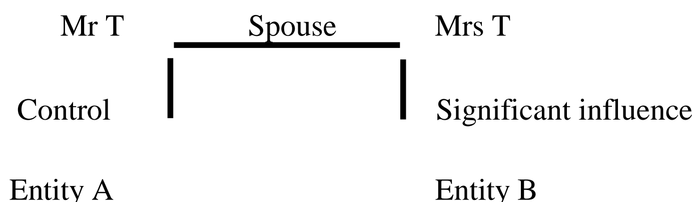
Entity B controls entity C so B and C are related parties.

Mr P is a member of key management personal of the parent of C, so Mr P and C are related parties.

This means that entities A and C are also related parties (Mr P controls A and is a member of key management personal of the parent company of C).

Test your understanding 4 – Family members Consider the

following situations:



Mr T controls entity A. His spouse, Mrs t, exercises significant influence over entity B.

Required:

Discuss the related party relationships arising from the above.

Answer:

Test your understanding 4 – Family members Mr T

and Mrs T are close family.

Mr T controls entity A. Mr T and Mrs T are related parties of entity A.

Mrs T has significant influence over entity B. Mrs T and Mr T are related parties of entity B.

Mr and Mrs T control entity A and have significant influence over entity B. A and B are related parties.

Test your understanding 5 – Picture and Frame

Joanne Smith has owned 60% of the equity shares of Picture and 70% of the equity shares of Frame for many years. On 1 January 2004, Picture entered into a lease agreement with Frame. Under the terms of the lease, Picture would lease one of its unused warehouses, with a remaining useful life of 20 years, to Frame for five years. Consideration payable by Frame would be $10,000 a year in arrears. Market rentals for similar sixed warehouses tend to be around $100,000 per year.

Required:

Discuss the correct treatment of the above transaction in Picture's financial statements for the year ended 30 June 2004.

Answer:

Test your understanding 5 – Picture and Frame

According to IFRS 16 Leases, a finance lease is a lease where the risks and rewards of ownership transfer to the lessee. The lease between Picture and Frame is only for a fraction of the asset's remaining useful life and the lease payments are insignificant. The lease is therefore an operating lease. Picture should recognise lease income on a straight line basis over the lease term. Therefore, $5,000 ($10,000 x 6/12) should be recognised in the current year's statement of profit or loss, as well as a corresponding entry to accrued income on the statement of financial position.

Picture and Frame are under joint control of Joanne Smith, so this means that they are related parties. Disclosure is required of all transactions between Picture and Frame during the financial period. Picture must disclose details of the leasing transaction and the income of $5,000 from Frame during the year.

Disclosures that related party transactions were made on terms equivalent to an arm's length transaction can only be made if they can be substantiated. The lease rentals are only 10% of normal market rate meaning that this disclosure cannot be made.

IAS 34-INTERIM FINANCIAL REPORTING

OBJECTIVE

The objective of this Standard is to prescribe the minimum content of an interim financial report and to prescribe the principles for recognition and measurement in complete or condensed financial statements for an interim period.

SCOPE

This Standard does not mandate which entities should be required to publish interim financial reports, how frequently, or how soon after the end of an interim period.

Publicly traded entities are encouraged:

(a) To provide interim financial reports at least as of the end of the first half of their financial year; and

(b) To make their interim financial reports available not later than 60 days after the end of the interim period.

DEFINITIONS

Interim period is a financial reporting period shorter than a full financial year.

Interim financial report means a financial report containing either a complete set of financial statements (as described in IAS 1 Presentation of Financial Statements (as revised in 2007)) or a set of condensed financial statements (as described in this Standard) for an interim period.

Minimum components of an interim financial report

An interim financial report shall include, at a minimum, the following components:

(a) A condensed statement of financial position;

(b) A condensed statement of profit or loss and other comprehensive income, presented as either;

(c) A condensed statement of changes in equity;

(d) A condensed statement of cash flows; and (e) Selected explanatory notes.

FORM AND CONTENT OF INTERIM FINANCIAL STATEMENTS

The condensed statement of financial position should include, as a minimum, each of the major components of assets, liabilities and equity as were in the statement of financial position at the end of the previous financial year, thus providing a summary of the economic resources of the entity and its financial structure.

The condensed statement of profit or loss and other comprehensive income should include, as a minimum, each of the component items of income and expense as are shown in profit or loss for the previous financial year, together with the earnings per share and diluted earnings per share.

The condensed statement of cash flows should show, as a minimum, the three major sub-totals of cash flow as required in statements of cash flows by IAS 7, namely: cash flows from operating activities, cash flows from investing activities and cash flow from financing activities.

The condensed statement of changes in equity should include, as a minimum, each of the major components of equity as were contained in the statement of changes in equity for the previous financial year of the entity.

Significant events and transactions

An entity shall include in its interim financial report an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period. Information disclosed in relation to those events and transactions shall update the relevant information presented in the most recent annual financial report.

The following is a list of events and transactions for which disclosures would be required if they are significant: the list is not exhaustive.

- Accounting policy changes
- Seasonality or cyclicality of operations
- Unusual and significant items
- Changes in estimates
- Issuances, repurchases, and repayments of debt and equity securities
- Dividends paid
- A few items of segment information (for those entities required by IFRS 8 to report segment information annually)
- Significant events after the end of the interim period
- Business combinations
- Long-term investments
- Restructurings and reversals of restructuring provisions
- Discontinued operations
- Changes in contingent liabilities and contingent assets
- Corrections of prior period errors
- Write-down of inventory to net realisable value
- Impairment loss on property, plant, and equipment; intangibles; or other assets, and reversal of such impairment loss

- Litigation settlements
- Any debt default or any breach of a debt covenant that has not been corrected subsequently
- Related party transactions
- Acquisitions and disposals of property, plant, and equipment
- Commitments to purchase property, plant, and equipment

Periods for which interim financial statements are required to be presented

Interim reports shall include interim financial statements (condensed or complete) for periods as follows:

(a) Statement of financial position as of the end of the current interim period and a comparative statement of financial position as of the end of the immediately preceding financial year.

(b) Statement of profit or loss and comprehensive income for the current interim period and cumulatively for the current financial year to date, with comparative statements of comprehensive income for the comparable interim periods (current and year-to-date) of the immediately preceding financial year.

(c) Statement of changes in equity cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

(d) Statement of cash flows cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

If the company's business is highly seasonal, IAS 34 encourages disclosure of financial information for the latest 12 months, and comparative information for the prior 12-month period, in addition to the interim period financial statements.

Materiality

In deciding how to recognise, measure, classify, or disclose an item for interim financial reporting urposes, materiality shall be assessed in relation to the interim period financial data. In making assessments of materiality, it shall be recognised that interim measurements may rely on estimates to a greater extent than measurements of annual financial data.

RECOGNITION AND MEASUREMENT

Accounting Policies

The same accounting policies should be applied for interim reporting as are applied in the entity's annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements.

Measurement

Measurements for interim reporting purposes should be made on a year-to-date basis, so that the frequency of the entity's reporting does not affect the measurement of its annual results.

- Revenues received seasonally, cyclically, or occasionally within a financial year shall not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the entity‘s financial year.
  Some entities consistently earn more revenues in certain interim periods of a financial year than in other interim periods, for example, seasonal revenues of retailers. Such revenues are recognised when they occur.
- Costs incurred unevenly during the financial year shall be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year.
- Employer payroll taxes and insurance contributions on an annual basis
- Major planned periodic maintenance or overhaul expected to occur late in the year is not anticipated
- Year-end bonuses are anticipated for interim reporting purposes if, and only if:
- The bonus is a legal obligation, or past practice would make the bonus a constructive
- obligation and the
- Entity has no realistic alternative but to make the payments; and
- A reliable estimate of the obligation can be made.
- Holiday pay: If an enforceable obligation on the employer, then any unpaid accumulated holiday pay may be accrued in the interim financial report.
- Intangible assets: Entities are required to apply the definition and recognition criteria for an intangible asset in the same way in an interim period as in an annual period.

- Other planned but irregularly occurring costs are generally are discretionary, even though they are planned and tend to recur from year to year.
- Depreciation and amortization are based only on assets owned during that interim period. They should not take into account asset acquisitions or disposals planned for later in the financial year.
- Use of estimates: All material relevant financial information being appropriately disclosed.

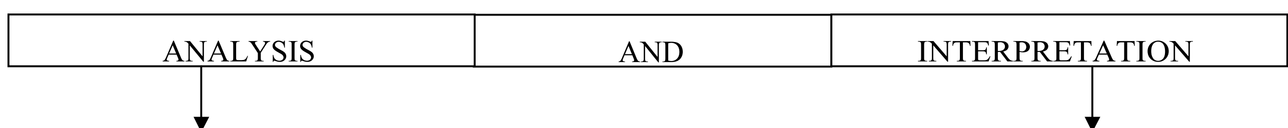
DISCLOSURE IN ANNUAL FINANCIAL STATEMENTS

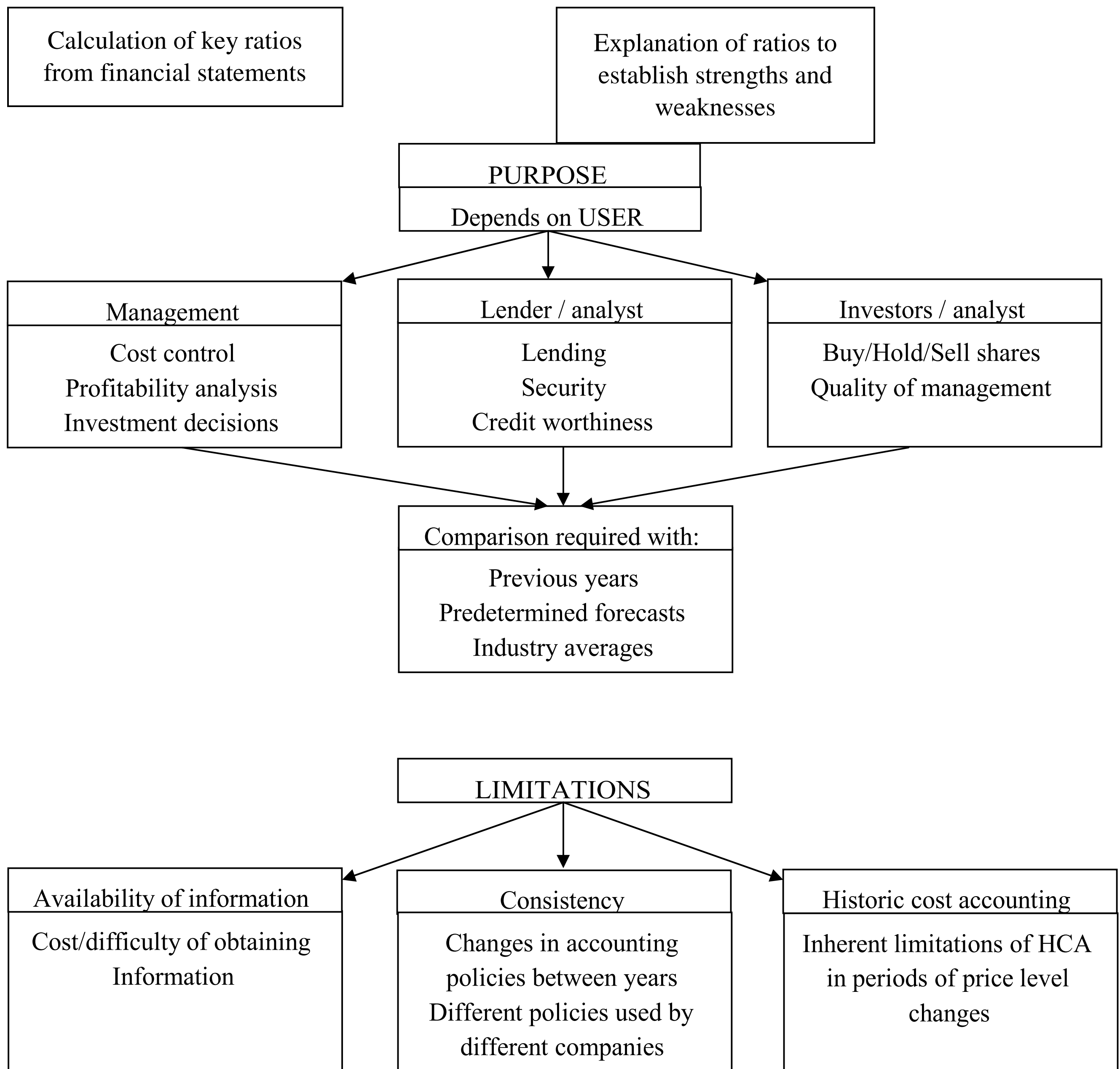
If an estimate of an amount reported in an interim period is changed significantly during the financial interim period in the financial year but a separate financial report is not published for that period, the nature and amount of that change must be disclosed in the notes to the annual financial statements.

INTERPRETATION OF FINANCIAL STATEMENTS AND RATIO ANALYSIS

Ratio analysis is a technique whereby complicated information is summarised to a common denominator so that a meaningful comparison of the company's performance and financial position can be made.

Financial statements provide important financial information for people who do not have access to the internal accounts. For example, current and potential shareholders can see how much profit a company has made, the value of its assets, and the level of its cash reserves. Although these figures are useful they do not mean a great deal by themselves. If the user is to make any real sense of the figures in the financial statements, they need to be properly an alysed using accounting ratios and then compared with either the previous year‘s ratios, or measured against averages for the industry.





The scenario of a performance appraisal question can take many forms.

Vertical or trend analysis

A company's performance may be compared to its previous period's performance. Past results may be adjusted for the effects of price changes. This is referred to as trend or vertical analysis. A

weakness of this type of comparison is that there are no independent benchmarks to determine whether the chosen company's current year results are good or bad. Just because a company's results are better than its results in the previous financial period - it does not mean the results are good. It may be that its results in the prior year were particularly poor.

Horizontal analysis

To try to overcome the problem of vertical analysis, it is common to compare a company's performance for a particular period with the performance of an equivalent company for the same period. This introduces an independent yardstick to the comparison. However, it is important to pick a similar sized company that operates in the same industry. Again, this type of analysis is not without criticism - it may be that the company selected as a comparator may have performed particularly well or particularly poorly.

Industry average comparison

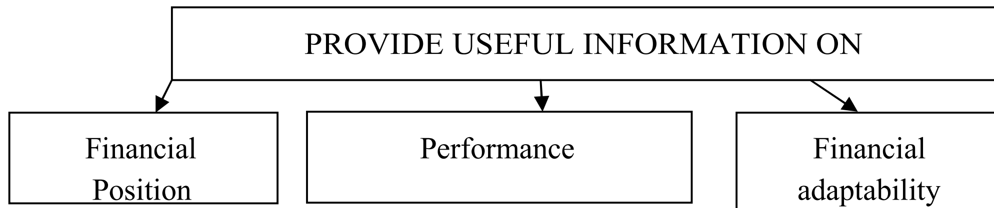
This type of analysis compares a company's results (ratios) to a compilation of the average of many other similar types of company. Such schemes are often operated on a subscription basis whereby subscribing companies calculate specified ratios and submit them to the scheme. In return they receive the average of the same ratios from all equivalent companies in the scheme.
This has the advantage of anonymity and avoids the bias of selecting a single company.

The context of the analysis needs to be kept in mind. A student may be asked to compare two companies as a basis for selecting one (presumably the better performing one) for an acquisition.

Alternatively, a shareholder may be asking for advice on how their investment in a company has performed. A bank may be considering offering a loan to a company and requires advice. It may be that the chief executive asks for the chief accountant‘s opinion on your company's results

WHAT IS THE OBJECTIVE OF FINANCIAL STATEMENTS?

To provide information about the financial position, performance and financial adaptability of an enterprise that is useful to a wide range of users for assessing the stewardship of management and for making economic decisions



Statement of Financial Position

- Statement of profit or loss
- Statement of Changes in equity
- Statement of Cash flows

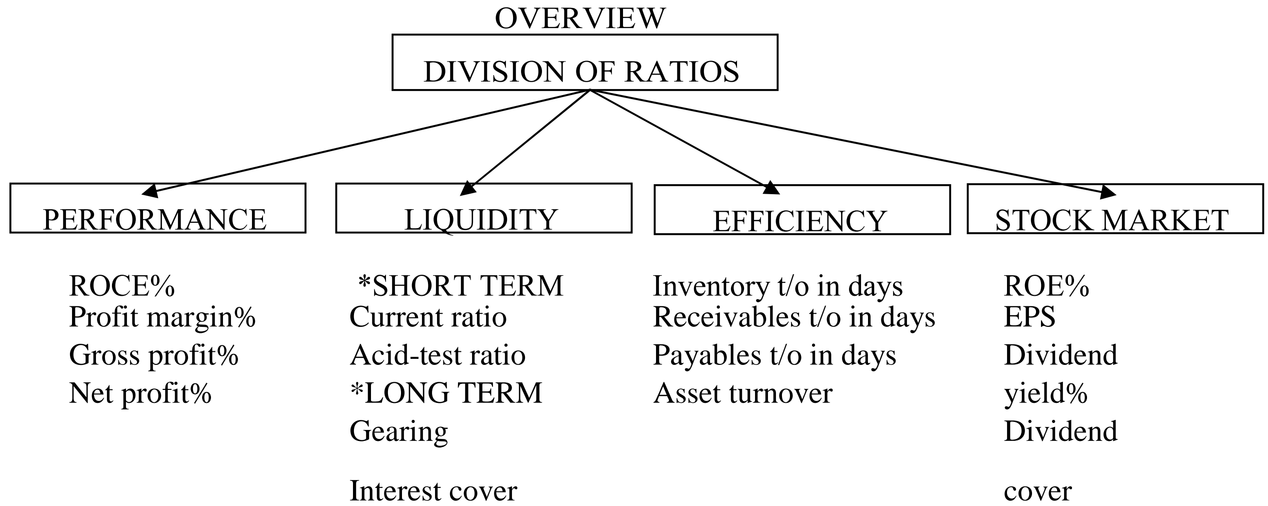
Statement of Financial Position	Resources, solvency & financial structure
Statement of profit or loss	Performance & Distributions
Statement of changes equity in	Realised gains/losses & unrealized gains losses (reserve movements)
Statement of cash flows	Amounts of cash flow Timings of cash flow Quality of profits

<u>Who are these users and what information do they want?</u>

Shareholders (investment decisions)	Profit and dividend prospects
Loan creditors (lending decisions)	Creditworthiness and liquidity
Employees (safety of employment)	Wage bargaining and future prospects
Suppliers (credit decisions)	Ability to pay on time and short term liquidity

Note that most users will be interested in what has happened in the past, and what may happen in the future!

PROVIDE USEFUL INFORMATION ON



Calculating a ratio is easy, and usually is little more than dividing one number by another. Indeed, the calculations are so basic that they can be programmed into a spreadsheet. The real skill comes in interpreting the results and using that information. Saying

That a ratio has increased because the top line in the calculation has increased (or the bottom line decreased) is rather pointless: this is simply translating the calculation into words. Use the mnemonic

RATIO to remind yourself to keep asking the following questions:

¤ Reason – why has this change occurred?

¤ Accident – is the change real or simply an accident of timing?

¤ Test – what can be done to test our conclusions? What other work should we do?

¤ Implications – what does this change mean? Liquidity crisis? Poor management etc?

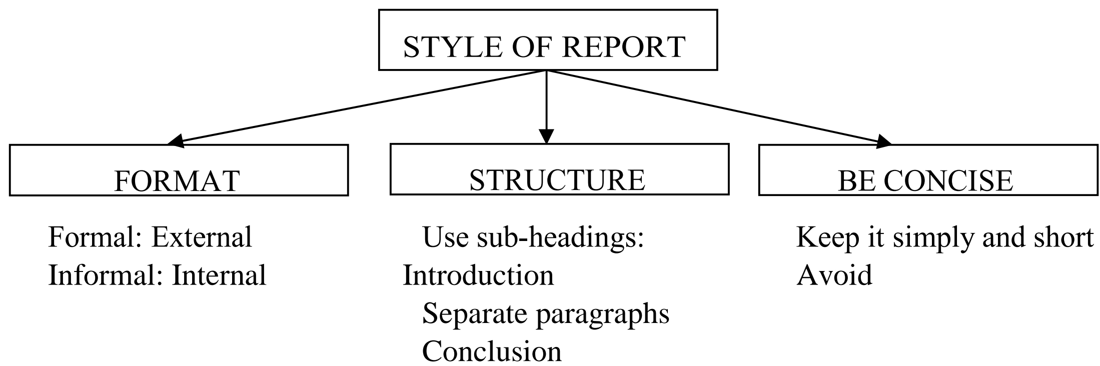
¤ Other information – is this consistent with other information?

EXAM TECHNIQUE:

• RATIO ANALYSIS-----------use appendices to show calculations / always show formula used • COMMENTS (cause) & CONSEQUENCES (effect)

3 steps

- The gearing ratio has moved from......}
- The gearing ratio measures.................} What is the overall picture? - The move may be due to................}



INTERPRETATION OF RATIOS

Ratios can generally be broken down into several key areas: profitability, liquidity, gearing and investment.

PROFITABILITY

Profitability ratios, as their name suggests, measure the organisation's ability to deliver profits. Profit is necessary to give investors the return they require, and to provide funds for reinvestment in the business. Three ratios are commonly used.

Return on capital employed (ROCE)

$$\frac{\text{Profit before interest and tax}}{\text{Shareholders' equity + debt}}$$

This ratio is generally considered to be the primary profitability ratio as it shows how well a business has generated profit from its long term financing. An increase in ROCE is generally considered to be an improvement.

So, Return on capital employed (sometimes known as return on investment or ROI) measures the return that is being earned on the capital invested in the business. It measures how efficiently and effectively management has deployed the resources available to it, irrespective of how those resources have been financed.

Candidates are sometimes confused about which profit and capital figures to use. What is important is to compare like with like. Operating profit (profit before interest) represents the profit available to pay interest to debt investors and dividends to shareholders. It is therefore compared with the long-term debt and equity capital invested in the business (non-current liabilities + total equity). By similar logic, if we wished to calculate return on ordinary share holders funds (the return to equity holders), we would use profit after interest and tax divided by total equity).

A return on capital is necessary to reward investors for the risks they are taking by investing in the company. As mentioned earlier, generally, the higher the ROCE figure, the better it is for investors. It should be compared with returns on offer to investors on alternative investments of a similar risk.

Movements in return on capital employed are best interpreted by examining profit margins and asset turnover in more detail (often referred to as the secondary ratios) as ROCE is made up of these component parts. For example, an improvement in ROCE could be due to an improvement in margins or more efficient use of assets.

Asset turnover

$$\frac{\text{Revenue}}{\text{Total assets - current liabilities}}$$

Asset turnover shows how efficiently management have utilised assets to generate revenue. When looking at the components of the ratio a change will be linked to either a movement in revenue, a movement in net assets, or both.

There are many factors that could both improve and deteriorate asset turnover. For example, a significant increase in sales revenue would contribute to an increase in asset turnover or, if the business enters into a sale and lease back agreement, then the asset base would become smaller, thus improving the result.

In other words, this ratio measures the ability of the organisation to generate sales from its capital employed. A possible variant is non-current asset turnover (revenue ÷ non-current assets). Generally

the higher the better, but in later studies you will consider the problems caused by overtrading (operating a business at a level not sustainable by its capital employed). Commonly a high asset turnover is accompanied with a low return on sales and vice versa. Retailers generally have high asset turnovers accompanied by low margins: Jack Cohen, the founder of Tesco, famously used the motto ‘Pile it high and sell it cheap‘!

Profit margins

$$\frac{\text{Gross profit}}{\text{Revenue}}$$

The gross profit margin looks at the performance of the business at the direct trading level. Typically variations in this ratio are as a result of changes in the selling price/sales volume or changes in cost of sales. For example, cost of sales may include inventory write downs that may have occurred during the period due to damage or obsolescence, exchange rate fluctuations or import duties.

Gross margin on the other hand focuses on the organisation‘s trading activities. Once again, in impleterms, the higher the better, with poor performance often being explained by prices being too low or costs being too high.

Changes in the gross profit percentage ratio can be caused by a number of factors. For example, a decrease may indicate greater competition in the market and therefore lower selling prices and a lower gross profit or, alternatively, an increase in the cost of purchases. An increase in the gross profit percentage may indicate that the company is in a position to exploit the market and charge higher prices for its products or that it is able to source its purchases at a lower cost.

$$\frac{\text{Operating profit}}{\text{Revenue}}$$

The operating profit margin (or net profit margin) is generally calculated by comparing the profit before interest and tax of a business to revenue, but, beware in the exam as sometimes the examiner specifically requests the calculation to include profit before tax.

Analysing the operating profit margin enables you to determine how well the business has managed to control its indirect costs during the period. In the exam when interpreting operating profit margin it is advisable to link the result back to the gross profit margin. For example, if gross profit margin deteriorated in the year then it would be expected that operating margin would also fall. However, if this is not the case, or the fall is not so severe, it may be due to good indirect cost control or perhaps there could be a one-off profit on disposal distorting the operating profit figure.

The relationship between the gross and the net profit percentage gives an indication of how well a company is managing its business expenses. If the net profit percentage has decreased over time while the gross profit percentage has remained the same, this might indicate a lack of internal control over expenses.

LIQUIDITY

This measures the ability of the organisation to meet its short-term financial obligations. Liquidity refers to the amount of cash a company can generate quickly to settle its debts. A reasonable level of liquidity is essential to the survival of a company, as poor cash control is one of the main reasons for business failure.

The two commonly used ratios are Current ratio and Quick ratio.

Current ratio

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

The current ratio compares liabilities that fall due within the year with cash balances, and assets that should turn into cash within the year. It assesses the company‘s ability to meet its short-term liabilities. The current ratio considers how well a business can cover the current liabilities with its current assets.

Therefore, this ratio compares a company‘s liquid assets (i.e. cash and those assets held which will soon be turned into cash) with short-term liabilities (payables/creditors due within one year).The

higher the ratio the more liquid the company. As liquidity is vital, a higher current ratio is normally preferred to a lower one.

Traditionally textbooks tell us that this ratio should exceed 2.0:1 for a company to be able to safely meet its current liabilities should they fall due. However this ideal will vary from industry to industry. For example, a business in the service industry would have little or no inventory and therefore could have a current ratio of less than 1. This does not necessarily mean that it has liquidity problems so it is better to compare the result to previous years or industry averages.
Many companies operate safely at below the 2:1 level.

A current ratio of less than one is often considered alarming as there might be going concern worries, but you have to look at the type of business before drawing conclusions. In a supermarket business, inventory will probably turn into cash in a stable and predictable manner, so there will always be a supply of cash available to pay the liabilities.

A very high current ratio is not necessarily good. It could indicate that a company is too liquid. Cash is often described as an 'idle asset = because it earns no return, and carrying too much cash is considered wasteful. A high ratio could also indicate that the company is not making sufficient use of cheap short term finance and it ratio may suggest that funds are being tied up in cash or other liquid assets, and may not be earning the highest returns possible.

Quick ratio (sometimes referred to as acid test ratio)

$$\frac{\text{Current assets - inventory}}{\text{Current liabilities}}$$

A stricter test of liquidity is the acid test ratio (also known as the quick ratio) which excludes inventory / stock as a current asset. This approach can be justified because for many companies inventory / stock cannot be readily converted into cash. In a period of severe cash shortage, a company may be forced to sell its inventory/stock at a discount to ensure sales.

The quick ratio excludes inventory as it takes longer to turn into cash and therefore places emphasis on the business's 'quick assets' and whether or not these are sufficient to cover the current liabilities. Here the ideal ratio is thought to be 1:1 but as with the current ratio, this will vary depending on the industry in which the business operates.

When assessing both the current and the quick ratios, look at the information provided within the question to consider whether or not the company is overdrawn at the year-end. The overdraft is an additional factor indicating potential liquidity problems and this form of finance is both expensive (higher rates of interest) and risky (repayable on demand).

In practice a company‘s current ratio and acid test should be considered alongside the company’s operating cash flow. A healthy cash flow will often compensate for weak liquidity ratios.

Caution should always be exercised when trying to draw definite conclusions on the liquidity of a company, as both the current ratio and the acid test ratio use figures from the Statement of financial position. The Statement of financial position is only a snapshot ‘of the financial position at the end of a specific period. It is possible that the Statement of financial position figures are not representative of the liquidity position during the year. This may be due to exceptional factors, or simply because the business is seasonal in nature and the Statement of financial position figures represent the cash position at just one particular point in the cycle.

Receivables collection period (in days)

$$\frac{\text{Receivables}}{\text{Credit sales}} \times 365$$

The receivables/debtors collection period (in days or months) provides an indication of how successful (or efficient) the debt collection process has been. For liquidity purposes the faster money is collected the better. Therefore, it is preferable to have a short credit period for receivables as this will aid a business's cash flow. However, some businesses base their strategy on long credit periods. When too high, it may be that some irrecoverable (bad) debts have not been provided for, or an

indication of worsening credit control. It may also be deliberate, e.g. the company has decided to offer three - months' credit in the current year, instead of two as in previous years. It may do this to try to stimulate higher sales and be more competitive than similar entities offering shorter credit periods.

If the receivables days are shorter compared to the prior period it could indicate better credit control or potential settlement discounts being offered to collect cash more quickly whereas an increase in credit periods could indicate a deterioration in credit control or potential bad debts. However, too much pressure on customers to pay quickly may damage a company's ability to generate sales.

Payables collection period (in days)

$$\frac{\text{Payables}}{\text{Credit purchases*}} \times 365$$

*(or use cost of sales if purchases figure is not available)

Payable days measures the average amount of time taken to pay suppliers. Because the purchases figure is often not available to analysts external to the business, the cost of sales figure is often used to approximate purchases.

An increase in payables days could indicate that a business is having cash flow difficulties and is therefore delaying payments using suppliers as a free source of finance. If the payables 'period is too long, it may be an indication of poor liquidity (perhaps at the overdraft limit), and there may be a danger of further or renewed credit being refused by suppliers. It is important that a business pays within the agreed credit period to avoid conflict with suppliers. If the payables days are reducing this indicates suppliers are being paid more quickly. This could be due to credit terms being tightened or taking advantage of early settlement discounts being offered.

Inventory days

$$\frac{\text{Closing (or average) inventory}}{\text{Cost of sales}} \times 365$$

It measures how long a company carries inventory before it is sold. Therefore, the inventory/stock turnover period indicates the average number of days that inventory/stock is held for. A company needs to carefully plan and manage its inventory/stock levels. Ideally, it must avoid tying up too much capital in inventory/stock, yet the inventory/stock levels must always be sufficient to meet customer demand.

Generally the lower the number of days that inventory is held the better as holding inventory for long periods of time constrains cash flow and increases the risk associated with holding the inventory. The longer inventory is held the greater the risk that it could be subject to theft, damage or obsolescence.

However, a business should always ensure that there is sufficient inventory to meet the demand of its customers. Too little inventory can result in production stoppages and dissatisfied customers.

If the holding period is long, it may be an indication of obsolete stock or poor sales achievement. Sales may have fallen (perhaps due to an economic recession), but the company has been slow to cut back on production, or an unnecessary build - up of inventory levels.

A change in the inventory/stock turnover period can be a useful indicator of how well a company is doing.

Inventory turnover can also be calculated using the following formula. It shows the above inventory days in terms of inventory turnover times.

Inventory turnover:

$$\frac{\text{Cost of sales}}{\text{(Average or closing) inventory}}$$

Liquidity problems may also be caused by 'overtrading'. In some ways this is a symptom of the success of the business. It is usually a lack of adequate financing and may be solved by an injection of capital.

GEARING/ CAPITAL GEARING

Company directors often spend a great deal of time and money to make this ratio appear in line with acceptable levels.

Current and potential investors will be interested in a company‘s financing arrangements. The extent to which a company is financed by outside parties is referred to as gearing. The level of gearing in a company is an important factor in assessing risk. A company that has borrowed money obviously has a commitment to pay future interest charges and make capital repayments. This can be a financial burden and possibly increase the risk of insolvency. Most companies will be geared to some extent.

The gearing ratio measures the company‘s commitments to its long-term lenders against the long-term capital in the company. The level of gearing will be influenced by a number of factors, for example the attitude of the owners and managers to risk, the availability of equity funds, and the type of industry in which the company operates.

Its main importance is that as borrowings rise, risk increases (in many ways) and as such, further borrowing is difficult and expensive. Many companies have limits to the amount of borrowings they are permitted to have. These may be in the form of debt covenants imposed by lenders or they may be contained in a company's Articles, such as a multiple of shareholders funds.

Measures of gearing

Gearing is basically a comparison of debt to equity. Preference shares are usually treated as debt for this purpose. There are two alternatives:

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

Also known as leverage, Capital gearing looks at the proportions of owner's capital and borrowed capital used to finance the business. Many different definitions exist; the two most commonly used ones are given above. When necessary in the exam, you will be told which definition to use.

A large proportion of borrowed capital is risky as interest and capital repayments are legal obligations and must be met if the company is to avoid insolvency. The payment of an annual equity dividend on the other hand is not a legal obligation. Despite its risks, borrowed capital is attractive to companies as lenders accept a lower rate of return than equity investors due to their secured positions. Also interest payments, unlike equity dividends, are corporation tax deductible.

Levels of capital gearing vary enormously between industries. Companies requiring high investment in tangible assets are commonly highly geared. Consequently, it is difficult to generalise about when capital gearing is too high. However, most accountants would agree that gearing is too high when the proportion of debt exceeds the proportion of equity.

The gearing ratio is of particular importance to a business as it indicates how risky a business is perceived to be based on its level of borrowing. As borrowing increases so does the risk as the business is now liable to not only repay the debt but meet any interest commitments under it. In addition, to raise further debt finance could potentially be more difficult and more expensive.

If a company has a high level of gearing it does not necessarily mean that it will face difficulties as a result of this. For example, if the business has a high level of security in the form of tangible non-current assets and can comfortably cover its interest payments () a high level of gearing should not give an investor cause for concern.

Interest cover

$$\text{Interest cover} = \frac{\text{Profit before interest and tax}}{\text{Interest}}$$

This is sometimes known as income gearing. It looks at how many times a company's operating profits exceed its interest payable. The higher the figure, the more likely a company is to be able to meet its interest payments. Anything in excess of four is usually considered to be safe.

As mentioned above, the interest cover ratio measures the amount of profit available to cover the interest payable by the company. The lower the level of interest cover the greater the risk to lenders that interest payments will not be met. If interest payments and capital repayments are not paid when they fall due there can be serious consequences for a company. In the event of a default, a lender may have the right to seize the assets on which the loan is secured and sell them to repay the amount outstanding.

Where lenders do not have security on their loan, they could still apply to the courts for the winding up of a company so that assets can be liquidated and debts repaid.

INVESTMENT RATIOS

Earnings per share

<u>Profit after tax and preference dividends</u>

Number of equity shares in issue

The earnings per share ratio of a company represents the relationship between the earnings made during an accounting period (and available to shareholders) and the number of shares issued. For ordinary shareholders, the amount available will be represented by the net profit after tax (less any preference dividend where applicable).

Many investment analysts regard the earnings per share ratio as a fundamental measure of a company's performance. The trend in earnings per share over time is used to help assess the investment potential of a company's shares. However, an attempt should be made to take into account the effect of a company increasing its retained earnings. Most companies retain a significant proportion of the funds they generate, and hence their earnings per share will increase even if there is no increase in profitability.

In isolation, this ratio is meaningless for inter-company comparisons. Its major usefulness is as part of the P/E ratio, and as a measure of profit trends.

Price/earnings ratio
Market price of equity share
EPS

This is calculated by dividing a company's market price by its EPS. Say the price of a company's shares is$2.40, and its last reported EPS was 20c. It would have a P/E ratio of 12. The mechanics of the movement of a company's P/E ratio are complex, but if this company's EPS improved to 24c in the following year, it would not mean that its P/E ratio would be calculated as 10 ($2.40/24c). It is more likely that its share price would increase such that it maintained or even improved its P/E ratio. If the share price increased to say $2.88, the P/E ratio would remain at 12 ($2.88/24c). This demonstrates the real importance of EPS in the way it has a major influence on a company's share price.

The price earnings ratio compares the benefits derived from owning a share with the cost of purchasing such a share. It provides a clear indication of the value placed by the capital market on those earnings and what it is prepared to pay for participation. It reflects the capital market assessment of both the amount and the risk of these earnings, albeit subject to overall market and economic considerations.

Earning yield
EPS
___
Market price per equity share

This is a relatively 'old' ratio which has been superseded by the P/E ratio. It is in fact its reciprocal.

Earnings yield is the EPS/share price x 100. In the above example, a P/E ratio of 12 would be equivalent to an earnings yield of 8.3%

Dividend yield

<u>Ordinary dividends appropriated in period</u>
Market price of equity shares

This is similar to the above except that the dividend per share is substituted for the EPS. It is a crude measure of the return to shareholders, but it does ignore capital growth which is often much higher than the return for dividends.

The dividend yield compares the amount of dividend per share with the market price of a share, and provides a direct measure of the return on investment in the shares of a company. Investors are able to use this ratio to assess the relative merits of different investment opportunities.

Dividend cover

<u>Profit after tax and preference dividends</u>
Ordinary dividends appropriated in period

This is the number of times the current year's dividend could have paid out of the current year's profit available to ordinary shareholders. It is a measure of security. A high figure indicates high levels of security. In other words, profits in future years could fall substantially and the company would still be able to pay the current level of dividends. An alternative view of a high dividend cover is that it indicates that the company operates a low dividend distribution policy.

The dividend cover ratio focuses on the security of the current rates of dividends, and therefore provides a measure of the likelihood that those dividends will be maintained in the future. It does this by measuring the proportion represented by current rates of dividends of the profits from which such dividends can be declared without drawing on retained earnings. The higher the ratio, the more profits can decline without dividends being affected.

LIMITATIONS OF RATIO ANALYSIS

1. It is an oversimplification of a harsh business world
2. Ratios are based on highly subjective accounting figures
3. Historical cost accounts do not take into account the impact of inflation
4. Ratios do not make allowances for external factors: economic or political
5. Users are more interested in future prospects rather than past events

Specific problems IN FR Exam

When marking this style of question there are some common weaknesses that are identified by examiner, some of which are highlighted below:

- Limited knowledge of ratio calculations
- Appraisal not linked to scenario
- Poor understanding of the topic
- Limited understanding of what accounting information represents
- Lack of commercial awareness
- Discursive elements often not attempted
- Inability to come to a conclusion
- Poor English.

The majority of questions that feature performance appraisal have an accompanying scenario to the question requirement. A weak answer will make no attempt to refer to this information in the appraisal and, therefore, will often score few marks. It is important that you carefully consider this information and incorporate it into your appraisal because it has been provided for a reason. Do not simply list all the possibilities of why a ratio may have changed; link the reason to the scenario that you have been provided with.

Exam approach

In an exam there is a (time) limit to the amount of ratios that may be calculated. A structured approach is useful where the question does not specify which ratios to calculate:

- Limit calculations to important areas and avoid duplication (e.g. inventory turnover and inventory holding periods)
- It is important to come to conclusions, as previously noted, candidates often get carried away with the ratio calculations and fail to comment on them
- Often there are some 'obvious' conclusions that must be made (e.g. liquidity has deteriorated dramatically, or a large amount of additional non-current assets have been purchased without a proportionate increase in sales).

SMALL AND MEDIUM SIZED ENTITIES (SMES)

REPORTING REQUIREMENTS OF SMES

International accounting standards are written to meet the needs of investors in international capital markets. Most companies adopting IFRS are large listed entities. The IASB has not stated that IFRSs only aimed at quoted companies, but certainly the majority of adopters are large entities. In many countries

IFRSs are used as national GAAP which means that unquoted small and medium-sized entities (SMEs) have to apply them.

A SME is often owned and managed by a small number of entrepreneurs, and may be a familyowned and family-run business. Large companies, in contrast, are run by professional boards of directors, who must be held accountable to their shareholders.

Some commentators suggest that SMEs and public entities should be allowed to use simplified or differing standards as the nature of their business is different from large quoted entities.

The principal aim when developing accounting standards for small to medium-sized enterprises (SMEs) is to provide a framework that generates relevant, reliable and useful information which should provide a high quality and understandable set of accounting standards suitable for SMEs.

Approaches/Options for IASB in Developing IFRS for SMEs

There were several approaches, which could have been taken in developing standards for SMEs.

- One course of action would have been for GAAP for SMEs to be developed on a national basis, with IFRS focusing on accounting for listed company activities. The main issue would have been that the practices developed for SMEs may not have been consistent and may have lacked comparability across national boundaries. Additionally, if a SME had wished to list its shares on a capital market, the transition to IFRS would have been more difficult.
- Another approach would have been to detail the exemptions given to smaller entities in the mainstream IFRS. In this case, an appendix would have been included within the standard detailing the exemptions given to smaller enterprises.
- A third approach would have been to introduce a separate set of standards comprising all the issues addressed in IFRS, which are relevant to SMEs.

Issuance of IFRS for SMEs

In July 2009, the International Accounting Standards Board (IASB) issued the IFRS for Small and Medium-sized Entities (IFRS for SMEs). This standard provides an alternative framework that can be applied by eligible entities in place of the full set of International Financial Reporting Standards (IFRSs).

The IFRS for SMEs is a self-contained standard, incorporating accounting principles based on existing

IFRSs which have been simplified to suit the entities that-fall within its scope

The Standard is organised by topic with the intention that the standard would be helpful to preparers and users of SME financial statements. The IFRS for SMEs and full IFRSs are separate and distinct frameworks. Entities that are eligible to apply the IFRS for SMEs, and that choose to do so, must apply that Standard in full and cannot choose the most suitable accounting policy from full IFRS or IFRS for SMEs.

Due to big differences between SMEs and large quoted companies, it is not clear whether there is any reason why SMEs should comply with IFRSs. There are arguments in favour of using SMEs, and arguments against.

Arguments against the use of IFRSs by SMEs

There are several reasons why SMEs should not adopt IFRSs for the preparation of their financial statements.

- Some IFRSs deal with subjects that are of little or no relevance to SMEs, such as accounting standards on consolidation, associates, joint ventures, deferred tax, construction contracts and standards that deal with complex issues of fair value measurement.
- The costs of complying with IFRSs can be high. For SMEs, the cost is proportionately much higher, and it is doubtful whether the benefits of complying with IFRSs would justify the costs.
- There are not many users of financial statements of SMEs, and they use the financial statements for a smaller range of decisions, compared to investors in international capital markets. So would it be a waste of time (as well as cost) to comply with IFRSs?

Arguments in Favour of the use of IFRSs by SMEs

There are also reasons why SMEs should adopt IFRSs for the preparation of their financial statements.

- If SMEs use different accounting rules and requirements to prepare their financial statements, there will be a =two-tier ‘system of accounting. This could make it difficult to compare results of larger and smaller companies, should the need arise. Confidence in the quality of financial reporting might be affected adversely.
- If SMEs prepared financial statements in accordance with their national GAAP, it will be impossible to compare financial statements of companies in different countries. If SMEs grow in size and eventually obtain a stock market quotation, they will have some difficulty in the transition from national GAAP to IFRSs.
- It has also been argued that full statutory accounts for SMEs would be in the public interest, and might help to protect other stakeholders in the company (such as suppliers, customers, lenders and employees).

IFRS for SMEs

The IFRS for SMEs is designed to facilitate financial reporting by small and medium-sized entities in a number of ways:

(a) It provides significantly less guidance than full IFRS.

(b) Many of the principles for recognising and measuring assets, liabilities, income and expenses in full IFRSs are simplified.

(c) Where full IFRSs allow accounting policy choices, the IFRS for SMEs allows only the easier option.

(d) Topics not relevant to SMEs are omitted.

(e) Significantly fewer disclosures are required.

(f) The standard has been written in clear language that can easily be translated

Scope

The IFRS is suitable for all entities except those whose securities are publicly traded and financial institutions such as banks and insurance companies. Although it has been prepared on a similar basis to IFRS, it is a stand-alone product and will be updated on its own timescale. There are no quantitative thresholds for qualification as a SME; instead, the scope of the IFRS is determined by a test of public accountability.

Effective date

In May 2015, the IASB completed its first comprehensive review of IFRS for SMEs and issued limited amendments; these are effective on 1 January 2017 with early application permitted. The IFRS will be revised only once every three years. It is hoped that this will further reduce the reporting burden for SMEs.

DEFINITIONS

Small and medium-sized entities are entities that:

- Do not have public accountability, and
- Publish general purpose financial statements for external users. Examples of internal users include owners who are not involved in managing the business, existing and potential creditors, and credit rating agencies. General purpose financial statements are those that present fairly financial position, operating results, and cash flows for external capital providers and others.

An entity has public accountability if:

- Its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments; or
- It holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses (e.g. banks, mutual fund, securities brokers/dealers and insurance companies).

The standard does not contain a limit on the size of an entity that may use the IFRS for SMEs provided that it does not have public accountability. Nor is there a restriction on its use by a public utility, not for profit entity, or public sector entity. A subsidiary whose parent or group uses full IFRSs may use the IFRS for SMEs if the subsidiary itself does not have public accountability. The standard does not require any special approval by the owners of an SME for it to be eligible to use the IFRS for SME. Listed companies, no matter how small, may not use the IFRS for SMEs.

Key Features of the IFRS for SMEs

A complete set of financial statements of an entity reporting under the IFRS for SMEs is similar to that required by full IFRS and comprises:

- A statement of financial position
- Either a single statement of comprehensive income, or a separate income statement and a separate statement of comprehensive income
- A statement of changes in equity
- A statement of cash flows
- Notes including a summary of significant accounting policies
- Comparative information

The IFRS for SMEs imposes a lesser burden on SMEs due to:

- Some topics in IFRSs being omitted because they are not relevant to typical SMEs
- The simplification of many of the recognition and measurement requirements available in full IFRSs
- Substantially fewer disclosures

Accounting Policies

For situations where the IFRS for SMEs does not provide specific guidance, it provides a hierarchy for determining a suitable accounting policy. An SME must consider, in descending order:

- The guidance in the IFRS for SMEs on similar and related issues.
- The definitions, recognition criteria and measurement concepts in Section 2 Concepts and Pervasive Principles of the standard.

Omitted Topics

There are a number of accounting standards and disclosures that may not be relevant for the users of SME financial statements. As a result the standard does not address the following topics: Earnings per share

- Interim accounting
- Segment reporting
- Insurance (because entities that issue insurance contracts are not eligible to use the standard) and
- Assets held for sale

Examples of options in full IFRS not included in the IFRS for SMEs

- Revaluation model for intangible assets
- Choice between cost and fair value models for investment property (measurement depends on the circumstances)
- Proportionate consolidation for investments in jointly controlled entities Options for government grants

SIMPLIFICATIONS

Following are the differences in IFRSs for SMEs from regular Standards. Remaining treatments are significantly same in both.

Investments in associates and joint ventures

- Can be measured at cost unless there is a published price quotation (Then fair value must be used).

- Jointly controlled entities can be accounted for using the cost model, the equity method or the fair value model (proportionate consolidation is not allowed).

Investment properties

- Must be measured at fair value (cost model not allowed, unless fair value cannot be measured reliably without undue cost or effort)
- If fair value cannot be calculated then must be treated as property, plant and equipment

Property, plant and equipment

- Historical cost-depreciation-impairment model or revaluation model
- Residual value, useful life and depreciation need to be reviewed only if there is an indication they may have changed since the most recent annual reporting date (full IFRSs require an annual review).
- Impairment testing and reversal

Borrowing costs

- All borrowing costs must be recognised as expense when incurred (cannot be capitalised)

Intangible assets

- Revaluation not allowed
- Research and development costs must be recognised as expenses (cannot be capitalised)
- Indefinite-life intangibles are a mortised over their useful lives, but if useful life cannot be reliably estimated then use the management‘s best estimate but not more than 10 years

Business combinations and Goodwill

- Acquisition (purchase) method used.
- Acquisition costs are capitalized in the cost of investment
- Goodwill is a mortised over its useful life (10 years if this can‘t be estimated reliably)
- Contingent considerations are included as part of the cost of investment if it is probable that the amount will be paid and its fair value can be measured reliably.

Leases

- Lease classified either as finance lease or operating lease and treated accordingly
- If a sale and leaseback results in a finance lease, the seller should not recognise any excess as a profit, but recognise the excess over the lease term. If a sale and leaseback results in an operating lease, and the transaction was at fair value, the seller shall recognise any profits immediately.

Government grants

- All grants are measured at the fair value of the asset received or receivable

Financial instruments

The standard eliminates the 'available-for-sale' and 'held-to maturity' classifications of IAS 39, Financial-instruments: recognition and measurement. All financial instruments are measured at a mortised cost using the effective interest method except that investments in non-convertible and non-put table ordinary and preference shares that are publicly traded or whose fair value can otherwise be measured reliably without undue cost or effort are measured at fair value through profit or loss. All a mortised cost instruments must be tested for impairment. At the same time the standard simplifies the hedge accounting and derecognition requirements. However, SMEs can choose to apply IAS 39 in full if they so wish.

Defined benefits plans

- The projected unit credit method is only used when it could be applied without undue cost or effort.
- Otherwise, en entity can simplify its calculation:
- Ignore estimated future salary increases
- Ignore future service of current employees (assume closure of plan)
- Ignore possible future in-service mortality
- Plan introductions, changes, curtailments, settlements: Immediate recognition (no deferrals)
- For group plans, consolidated amount may be allocated to parent and subsidiaries on a reasonable basis

- Actuarial gains and losses may be recognised in profit or loss or as an item of other comprehensive income – but No deferral of actuarial gains or losses, including no corridor approach and all past service cost is recognised immediately in profit or loss

Financial statements Presentation

In full IFRSs, a statement of changes in equity is required, presenting a reconciliation of equity items between the beginning and end of the period. Same is the requirement for SMEs. However, if the only changes to the equity during the period are a result of profit or loss, payment of dividends, correction of prior-period errors or changes in accounting policy, a combined statement of income and retained earnings can be presented instead of both a statement of comprehensive income and a statement of changes in equity.

Assets held for sale

- Assets held for sale are not covered in IFRSs for SMEs the decision to sell an asset is considered an impairment indicator.

Transition

The standard also contains a section on transition, which allows all of the exemptions in IFRS 1, First-time Adoption of International Financial Reporting Standards. It also contains 'impracticability' exemptions for comparative information and the restatement of the opening statement of financial position.

As a result of the above, the IFRS requires SMEs to comply with less than 10% of the volume of accounting requirements applicable to listed companies complying with the full set of IFRSs.

Application criteria

There is no universally agreed definition of an SME. No single definition can capture all the dimensions of a small or medium-sized business, or cannot be expected to reflect the differences between firms, sectors, or countries at different levels of development.

Most definitions based on size use measures such as number of employees, net assets total or annual turnover. However, none of these measures apply well across national borders. The IFRS for SMEs

is intended for use by entities that have no public accountability (i.e. its debt or equity instruments are not publicly traded).

Ultimately, the decision regarding which entities should use the IFRS for SMEs stays with national regulatory authorities and standard setters. These bodies will often specify more detailed eligibility criteria. If an entity opts to use the IFRS for SMEs, it must follow the standard in its entirety - it cannot cherry pick between the requirements of the IFRS for SMEs and those of full IFRSs.

The International Accounting Standards Board (IASB) makes it clear that the prime users of IFRSs are the capital markets. This means that IFRSs are primarily designed for quoted companies and not SMEs. The vast majority of the world's companies are small and privately owned, and it could be argued that IFRSs are not relevant to their needs or to their users. It is often thought that small business managers perceive the cost of compliance with accounting standards to be greater than their benefit.

Advantages of the IFRS for SMEs

(a) It is virtually a 'one stop shop'.
(b) It is structured according to topics, which should make it practical to use.
(c) It is written in an accessible style.
(d) There is considerable reduction in disclosure requirements.
(e) Guidance not relevant to private entities is excluded.

Disadvantages of the IFRS for SMEs

(a) It does not focus on the smallest companies.
(b) The scope extends to 'non-publicly accountable' entities. Potentially, the scope is too wide.
(c) The standard will be onerous for small companies.

Explanation

The main argument for separate SME accounting standards is the undue cost burden of reporting, which is proportionately heavier for smaller firms. The cost burden of applying the full set of IFRSs may not be justified on the basis of user needs. Further, much of the current reporting framework is based on the needs of large business, so SMEs perceive that the full statutory financial statements

are less relevant to the users of SME accounts. SMEs also use financial statements for a narrower range of decisions, as they have less complex transactions and therefore less need for a sophisticated analysis of financial statements.

Thus, the disclosure requirements in the IFRS for SMEs are also substantially reduced when compared with those in full IFRSs partly because they are not considered appropriate for users' needs and for cost benefit considerations.

Many disclosures in full IFRSs are more relevant to investment decisions in capital markets than to the transactions undertaken by SMEs.

There are arguments against different reporting requirements for SMEs in that it may lead to a two-tier system of reporting. Entities should not be subject to different rules, which could give rise to different 'true and fair views'.

The IFRS for SMEs is a self-contained set of accounting principles that are based on full IFRSs, but that have been simplified so that they are suitable for SMEs. The standard has been organised by topic with the intention that the standard would be user-friendly for preparers and users of SME financial statements.

The IFRS for SMEs and full IFRSs are separate and distinct frameworks. Entities that are eligible to apply the IFRS for SMEs, and that choose to do so, must apply that standard in full and cannot chose the most suitable accounting policy from full IFRS or IFRS for SMEs.

However, the standard for SMEs is naturally a modified version of the full standard, and not an independently developed set of standards. They are based on recognised concepts and pervasive principles and they will allow easier transition to full IFRS if the SME decides to become a public listed entity. In deciding on the modifications to make to IFRS, the needs of the users have been taken into account, as well as the costs and other burdens imposed upon SMEs by the IFRS.

Relaxation of some of the measurement and recognition criteria in IFRS had to be made in order to achieve the reduction in these costs and burdens. Some disclosure requirements are intended to meet

the needs of listed entities, or to assist users in making forecasts of the future. Users of financial statements of SMEs often do not make such kinds of forecasts. Small companies pursue different strategies, and their goals are more likely to be survival and stability rather than growth and profit maximisation.

The stewardship function is often absent in small companies, with the accounts playing an agency role between the owner-manager and the bank.

Where financial statements are prepared using the standard, the basis of presentation note and the auditor's report will refer to compliance with the IFRS for SMEs. This reference may improve access to capital. The standard also contains simplified language and explanations of the standards. In the absence of specific guidance on a particular subject, An SME may, but is not required to, consider the requirements and guidance in full IFRSs dealing with similar issues.
The IASB has produced full implementation guidance for SMEs.

The IFRS for SMEs is a response to international demand from developed and emerging economics for a rigorous and common set of accounting standards for smaller and medium-sized businesses that is much simpler than full IFRSs. The IFRS for SMEs should provide improved comparability for users of accounts while enhancing the overall confidence in the accounts of SMEs, and reducing the significant costs involved of maintaining standards on a national basis.

SPECIALISED, NOT-FOR-PROFIT AND PUBLIC SECTOR ENTITIES

TYPES OF ENTITY

Most of this study text is about the financial statements of profit-making entities, such as limited liability companies.

Other types of entity also prepare and publish financial statements. These entities include:

- Not-for-profit entities: such as charities, clubs and societies. Each of these organisations is set up for a specific purpose. For example, a charity might be set up to campaign for the protection of the natural environment or to help the poor.
- Public sector entities: these include central government bodies; local government bodies; and other organisations that operate for the benefit of the general public, such as state schools and hospitals. A public sector entity is owned by the state or by the general public.

Many different types of entity could be described under these headings. These entities are different from limited liability companies, partnerships and sole traders in one vital respect. They do not primarily exist to make a profit.

In practice, the terms 'specialised entity', 'not-for-profit entity' and 'public benefit entity' are often used inter changeably.

OBJECTIVES OF SPECIALISED ENTITIES

The main objective of large listed entities is to maximise their profits in order to provide a return to their owners (investors) in the form of a dividend. This may not be their only objective (for example, they may rovide employment to the local community, or aim to operate in a socially responsible way), but it is their main objective.

The objective of owner managed businesses (small privately owned entities) is also to make a profit.

In contrast, the main objective of a specialised entity is to carry out the activities for which it has been created. Again, this may not be the only objective, because all entities need some form of income. Many large charities, for example, carry out trading activities. However, making a profit is not the main aim. In fact, most not-for-profit entities will aim to break even, rather than to generate a surplus of income over expenditure.

In some public sector entities, performance is measured in terms of whether the entity provides value for money from the resources it has available. Assessment of performance will look at how well the resources have been used and it is often done using the 3 E's - economy, effectiveness and efficiency.

Economy means buying goods and services at a cheap price, so that the entity is not paying too much for its input costs, which could include accommodation, staff and other items.

Efficiency means operating so that inputs are used in the best possible way to provide a maximum output. In the case of a hospital, it may be making sure that the required service is provided at the lowest cost and wastage is kept to a minimum.

Effectiveness means that an organisation has met its goals by using the right resources at the right time.

Accounting standards and specialised entities
International accounting standards are designed for profit-making entities.

Whether they are relevant to not-for-profit entities will depend on the way in which they have to report and the information that they have to provide. There is a great deal of variation from organisation to organisation and from country to country.

In some countries, charities and public sector bodies are required to follow accounting standards specifically designed for the purpose (in the UK these are called Statements of Recommended Practice.)

Alternatively, the form and content of financial statements and the accounting treatments to be followed may be prescribed by law. IASs and IFRSs are probably largely irrelevant for these entities. Some not-for-profit entities may be able to draw up accounts in any form that its members or officers wish. Many not-for-profit entities prepare accounts on a cash basis, rather than on an accruals basis.

Public sector bodies may also use cash accounting. (This was the case in the UK until fairly recently.) IASs and IFRSs require accruals accounting.

In some countries, public sector bodies and many charities are increasingly expected to apply commercial-style accounting practices. Even for those entities that are not formally required to adopt them, IASs and IFRSs are a useful source of information on current best practice.

THE NOT-FOR-PROFIT SECTOR: REGULATORY FRAMEWORK

The IASB and the FASB are working on a framework for reporting, which includes not-forprofit entities.

The International Public Sector Accounting Standards Board (IPSAB) is developing a set of International Public Sector Accounting Standard based on IFRS.

Regulation of public not-for-profit entities, principally local and national governments and government a lagencies, is by the International Public Sector Accounting Standards Board (IPSAB), which comes under the International Federation of Accountants (IFAC).

Statement of Financial Activities

In addition to a statement of financial position, charities also produce a Statement of Financial Activities (SOFA), an Annual Report to the Charity Commission and sometimes an income and expenditure account. The Statement of Financial Activities is the primary statement showing the results of the charity's activities for the period.

The SOFA shows Incoming resources, Resources expended, and the resultant Net movement in funds.

Under incoming resources, income from all sources of funds are listed. These can include:
Subscription or membership fees

- Public donations
- Donations from patrons
- Government grants
- Income from sale of goods
- Investment income
- Publication sales
- Royalties

The resources expended will show the amount spent directly in furtherance of the Charity's objects. It will also show items which form part of any statement of profit or loss and other comprehensive income, such as salaries, depreciation, travelling and entertaining, audit and other professional fees. These items can be very substantial.

Charities, especially the larger charities, now operate very much in the way that profit-making entities do.

They run high-profile campaigns which cost money and they employ professional people who have to be paid. At the same time, their stakeholders will want to see that most of their donation is not going on running the business, rather than achieving the aims for which funds were donated.

One of the problems charities experience is that, even although the accruals basis is being applied, they will still have income and expenditure recognised in different periods, due to the difficulty of

correlating them. The extreme example is a campaign to persuade people to leave money to the charity in their will.

The costs will have to be recognised, but there is no way to predict when the income will arise.

Exam Approach

In the exam, you may be given a scenario involving a not-for-profit entity or public sector entity and asked to advise on a particular transaction. In many ways your advice should be no different for a not-for-profit entity as for a commercial profit-making entity, but you will need to be aware of the context of the question and the fact that the objectives of a not for profit entity differ from a standard trading entity.

Users of the financial statements of a not-for-profit entity are almost always interested in the way that the entity manages and uses its resources.

For example:

- A charity may be managed by trustees on behalf of its supporters and those who benefit from its activities.
- A public sector organisation is managed by elected officials on behalf of the general public.

Performance measurement of non- profit organisation

Additionally, if you have to interpret any information relating to not-for-profit and public sector entities then make sure you are aware who the users of that information are and what they will be interested in.

Typically, users will want to know whether:

- The entity has enough finance to achieve its objectives
- The money raised is being spent on the activities for which it was intended
- The public are receiving value for money (in the case of a public sector entity)
- Services are being provided economically, efficiently and effectively (in the case of a public sector entity)
- The level of spending is reasonable in relation to the services provided.

Additionally, standard ratios may not be suitable for these entities so you may have to look at other measures, such as non-financial rations including:

- The average time that hospital patients wait for treatment
- The number of schools built in an area
- Serious crimes per 1,000 of the population
- Number of complaints by members of the public in a given period
- Number of visits made to museums and art galleries in an area.

Entity Reconstructions

- You need to identify when an entity may no longer be viewed as a going concern and why a reconstruction might be an appropriate alternative to liquidation.
- You will not need to suggest a scheme of reconstruction, but you will need an outline of the accounting treatment.

Background

Most of a study text on financial accounting is inevitably concerned with profitable, even expanding businesses. It must of course be recognised that some companies fail. From a theoretical discounted cash flow viewpoint, a company should be wound up if the expected return on its value in liquidation is less than that required. In practice (and in law), a company is regarded as insolvent if it is unable to pay its debts. This term needs some qualification. It is not uncommon, for example, to find a company that continues to trade and pays its creditors on time despite the fact that its liabilities exceed its assets. On the other hand, a company may be unable to meet its current liabilities although it has substantial sums locked up in assets which cannot be liquidated sufficiently quickly.

The procedures and options open to a failing company will depend on the degree of financial difficulties it faces. If the outlook is hopeless, liquidation may be the only feasible solution. However, many firms in serious financial positions can be revived to the benefit of creditors, members and society. When considering any scheme of arrangement it is important to remember that the protection of creditors is usually of paramount importance. The position of the shareholders and in particular, the protection of class rights, must be considered but the creditors come first. This section considers some possibilities, but local legislation will govern these situations.

Going concern: The entity is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the entity has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations. (Framework) It is generally assumed that the entity has no intention to liquidate or curtail major operations. If it did, then the financial statements would be prepared on a different (disclosed) basis. Indications that an entity may no longer be a going concern include the following (from International Standard on Auditing, ISA 570 Going concern):

(a) Financial indicators, e.g. recurring operating losses, net liability or net current liability position, negative cash flow from operating activities, adverse key financial ratios, inability to obtain financing for essential new product development or other essential investments, default on loan or similar agreements, arrear as in dividends, denial of usual trade credit from suppliers, restructuring of debt, non-compliance with statutory capital requirements, need to seek new sources or methods of financing or to dispose of substantial assets.

(b) Operating matters, e.g. loss of key management without replacement, loss of a major market, key customers, licence, or principal suppliers, labour difficulties, shortages of important supplies or the emergence of a highly successful competitor.

(c) Other matters, e.g. pending legal or regulatory proceedings against the entity, changes in law or regulations that may adversely affect the entity; or uninsured or underinsured catastrophe such as a drought, earthquake or flood.

Internal reconstructions

A company may be able to enter into any type of scheme regarding either its creditors or its shareholders as long as the scheme does not conflict with general law or any particular statutory provision.

For a reconstruction of this type to be considered worthwhile in the first place, the business must have some future otherwise it might be better for the creditors if the company went into liquidation. In any scaling down of claims from creditors and loan stock holders, two conditions should be met.

(a) A reasonable chance of successful operations

(b) Fairness to parties

Transfer of Assets to a New Company

Another form of reconstruction is by means of voluntary liquidation whereby the liquidator transfers the assets of the company to a new company in exchange for shares or other securities in the new company.
The old company may be able to retain certain of its assets, usually cash, and make a distribution to the shareholders of the old company who still have an interest in the undertaking through their shareholding in the new company. There may be various rules governing the protection of noncontrolling shareholders.

Such a procedure would be applied to the company which is proposed to be or is in course of being wound up voluntarily. A company in liquidation must dispose of its assets (other than cash) by sale in order to pay its debts and distribute any surplus to its members. The special feature of this kind of reconstruction is that the business or property of Company P is transferred to Company Q in exchange for shares of the latter company which are allotted direct or distributed by the liquidator to members of Company P.

Obviously the creditors of Company P will have to be paid cash.
Finding the cash to pay creditors and to buy out shareholders who object to the scheme is often the major drawback to a scheme of this kind. It is unlikely to be used much because the same result can be more satisfactorily achieved by a takeover: Company Q simply acquires the share capital of Company P, which becomes its subsidiary, and the assets and liabilities are transferred from the subsidiary to the new holding company. In this situation usually no cash has to be found (although obviously there is no guarantee of success).

The advantage of transferring a business from one company to another (with the same shareholders in the end) is that by this means the business may be moved away from a company with a tangled history to a new company which makes a fresh start. As explained above this procedure can also be used to effect a merger of two companies each with an existing business

Accounting procedures for a transfer to a new company

The basic procedure when transferring the undertaking to a new company is as follows.

(a) To close off the ledger accounts in the books of the old company.

(b) To open up the ledger accounts in the books of the new company.

The basic procedure is as follows.

Step 1 Open a realisation account and transfer in all the assets and liabilities to be taken over by the new company at book value.

Step 2 Open a sundry members account with columns for ordinary and preference shareholders. Transfer in the share capital, reserve balances, assets written off and gains and losses on realisation.

Step 3 With the purchase consideration for the members:

DEBIT Sundry members a/c

CREDIT Realisation a/c

Take any profit or loss on realisation to the sundry members account (ordinary).

Step 4 In the new company, open a purchase of business account:

CREDIT it with assets taken over

(DEBIT asset accounts)

DEBIT it with liabilities taken over

(CREDIT liabilities a/cs)

DEBIT it with the purchase consideration

(CREDIT shares, loan stock etc)

Any balance is goodwill or a gain on a bargain purchase.

CURRENT DEVELOPMENTS

This Chapter includes topics currently under debate and all recent changes and standards issued by the IASB. The following have been incorporated in the chapter:

1. Practice Statement Management Commentary
2. IFRS 1 First Time Adoption of International Financial Reporting Standards
3. Convergence with US GAAP
4. IAS 21 – Does it need amending
5. The IASB‘s Principles of Disclosure Initiative
6. Future trends in sustainability reporting

IFRS PRACTICE STATEMENT: MANAGEMENT COMMENTARY

What is management commentary?

Management commentary is a narrative report that provides a context within which to interpret the financial position, financial performance and cash flows of an entity. It also provides management with an opportunity to explain its objectives and its strategies for achieving those objectives. Users routinely use the type of information provided in management commentary to help them evaluate an entity‘s prospects and its general risks, as well as the success of management‘s strategies for achieving its stated objectives.

For many entities, management commentary is already an important element of their communication with the capital markets, supplementing as well as complementing the financial statements.

Objective

The objective of the Practice Statement is to assist management in presenting useful management commentary that relates to financial statements that have been prepared in accordance with International Financial Reporting Standards (IFRSs).

Scope

The Practice Statement applies only to management commentary and not to other information presented in either the financial statements or the broader financial reports.

Framework for the presentation of management commentary

Purpose

- Management commentary should provide users of financial statements with integrated information that provides a context for the related financial statements. Such information explains management‘s view not only about what has happened, including both positive and negative circumstances, but also
- why it has happened and what the implications are for the entity‘s future.
- Management commentary complements and supplements the financial statements by communicating integrated information about the entity‘s resources and the claims against the entity and its resources, and the transactions and other events that change them.
- Management commentary should also explain the main trends and factors that are likely to affect the entity‘s future performance, position and progress. Consequently, management commentary looks not only at the present, but also at the past and the future.

Principles

In aligning with those principles, management commentary should include:

(a) Forward-looking information; and

(b) Information that possesses the qualitative characteristics described in the Conceptual Framework for Financial Reporting.

Management commentary should provide information to help users of the financial reports to assess the performance of the entity and the actions of its management relative to stated strategies and plans for progress. That type of commentary will help users of the financial reports to understand, for example:

(a) The entity‘s risk exposures, its strategies for managing risks and the effectiveness of those strategies;

(b) How resources that are not presented in the financial statements could affect the entity‘s operations; and

(c) How non-financial factors have influenced the information presented in the financial statements.

Presentation

Management commentary should be clear and straightforward. The form and content of management commentary will vary between entities, reflecting the nature of their business, the strategies adopted by management and the regulatory environment in which they operate.

Elements of management commentary

Although the particular focus of management commentary will depend on the facts and circumstances of the entity, management commentary should include information that is essential to an understanding of:

(a) The nature of the business;
(b) Management‘s objectives and its strategies for meeting those objectives;
(c) The entity‘s most significant resources, risks and relationships;
(d) The results of operations and prospects; and
(e) The critical performance measures and indicators that management uses to evaluate the entity‘s performance against stated objectives.

Application date

An entity may apply this Practice Statement to management commentary presented prospectively from 8 December 2010.

IFRS 1: FIRST-TIME ADOPTION OF INTERNATIONAL REPORTING STANDARDS

A first-time adopter of IFRSs is an entity that presents IFRS financial statements for the first time, and fully complies with the requirements of IFRSs.

The special requirements for a first-time adopter are set out in IFRS 1.

- A first-time adopter must adjust its statement of financial position produced under 'local GAAP' to a statement of financial position produced using IFRSs.
- This adjustment should be made by 'retrospective application' of the IFRSs.
- In order to make adjustments to move from a statement of financial position prepared under local GAAP to a statement of financial position prepared with IFRSs, a number of prior year adjustments must be made for all the accounting policy changes. These adjustments are made in the financial statements by adjusting the opening reserves in the first-time adopter's opening IFRS statement of financial position. These adjustments are usually made to the accumulated profits reserve (retained profits reserve).

Opening statement of financial position of a first-time adopter

The retrospective application of IFRSs means that adjustments are made to the first-time adopter's opening statement of financial position. This is the entity's statement of financial position at the date of transition to IFRSs.

IFRS 1 defines the date of transition to IFRSs as 'the beginning of the earliest period for which an entity presents full comparative information under IFRS in its first IFRS financial statements.' IFRS 1 also states that an entity must use the same accounting policies in its opening IFRS statement of financial position and throughout all the financial periods presented in its first IFRS financial statements.

These should be the IFRSs that apply as at the reporting date for the first IFRS financial statements (and any previous versions of IFRSs that may have applied at earlier dates should not be used).

Example 1

A company was a first-time adopter of IFRS and prepared its first IFRS financial statements for the year to 31 December 2003. In its financial statements, it prepared comparative financial information for the previous financial year.

The previous financial year is the year to 31 December 2004.
The date of transition to IFRS is the beginning of this period, which is 1 January 2004.
The opening IFRS statement of financial position of this first-time adopter is therefore 1st January 2004.

The adjustments made by retrospective application of IFRSs must therefore be made to a statement of financial position as at this date.

Opening IFRS statement of financial position: exemptions from IFRSs

The general rule in IFRS 1 is that in the opening IFRS statement of financial position, a first-time adopter must:

- Recognise all assets and liabilities whose recognition is required by IFRSs
- Not recognise assets or liabilities if IFRSs do not permit such recognition
- Re-classify items recognised under the previous GAAP as one type of asset, liability or component of equity if IFRSs require that they should be classified differently
- Apply IFRSs in measuring all assets and liabilities.

Main exemptions from applying IFRS in the opening IFRS statement of financial position

(a) Property, plant and equipment, investment properties and intangible assets

- Fair value/previous GAAP revaluation may be used as a substitute for cost at date of transition to IFRSs.

(b) Business combinations

For business combinations prior to the date of transition to IFRSs:

- The same classification (acquisition or uniting of interests) is retained as under previous GAAP.

- For items requiring a cost measure for IFRSs, the carrying value at the date of the business combination is treated as deemed cost and IFRS rules are applied from thereon.
- Items requiring a fair value measure for IFRSs are revalued at the date of transition to IFRS.

The carrying value of goodwill at the date of transition to IFRSs is the amount as reported under previous GAAP.

(c) Employee benefits

- Unrecognised actuarial gains and losses can be deemed zero at the date of transition to IFRSs. IAS 19 is applied from then on.

(d) Cumulative translation differences on foreign operations

- Translation differences (which must be disclosed in a separate translation reserve under IFRS) may be deemed zero at the date of transition to IFRS. IAS 21 is applied from then on.

(e) Adoption of IFRS by subsidiaries, associates and joint ventures

If a subsidiary, associate or joint venture adopts IFRS later than its parent it measures its assets and liabilities:

- Either: At the amount that would be included in the parent‘s financial statements, based on the parent‘s date of transition
- Or: At the amount based on the subsidiary (associate or joint venture)‘s date of transition.

Presentation and disclosure by a first-time adopter

IFRS 1 requires that a first-time adopter must include at least one year of comparative information in its first IFRS financial statements. (This is why the date of transition to IFRS cannot be later than the beginning of the previous financial year).

IFRS 1 also requires a first-time adopter to disclose the following reconciliations:

- A reconciliation of equity that was reported under the previous GAAP with the equity reported under

IFRSs, for both of the following dates: (1) the date of transition to IFRS and (2) the end of the last financial period in which the entity presented its financial statements under the previous GAAP.

- For example, suppose that a first-time adopter presents just one year of comparative information, and prepared its first IFRS financial statements for the year to 31 December 2005. The reconciliation of equity between 'old GAAP' and IFRSs should be made for both 1 January 2004 and 31 December 2004.
- A reconciliation of the profit or loss reported under the previous GAAP and the profit or loss using IFRSs, for the entity's most recent financial period before adopting IFRSs.
- If the entity recognises impairment losses for the first time in its opening IFRS statement of financial position, it should provide the information that would have been required by IAS 36 Impairment of assets if the impairment losses had been recognised in the financial period beginning with the date of transition to IFRS.

Adopting new accounting standards

Test your understanding 1 – Nat

Nat is a company that used to prepare financial statements under local national standards. Their first financial statements produced in accordance with IFRS Standards are for the year ended December 2005 and these will include comparative information for the previous financial year. Its previous GAAP financial statements are for the years ended 31 December 2003 and 2004. The directors are unsure about the following issues:

(i) Nat received $5 million in advance orders for a new product on 31 December 2003. These products were not dispatched until 2004. In line with its previous GAAP, this $5m was recognised as revenue.

(ii) A restructuring provision of $1 million relating to head office activities was recognised at 31 December 2003 in accordance with previous GAAP. This does not qualify for recognition as a liability in accordance with IAS 37.

(iii)Net made estimates of accrued expenses and provisions at 31 December 2003. Some of these estimates turned out to be understated. Nat believes that the estimates were reasonable and in line with the requirements of both its previous GAAP and IFRS Standards.

Required:

In accordance with IFRS 1, how should the above issues be dealt with?

Answer:

Test your understanding 1 – Nat

Comparative figures prepared under IFRS Standards for year ended 31 December 2004 must be presented. Nat's date of transition is therefore 1 January 2004 and an opening IFRS statement of financial position must be produced as at this date.

Some of the accounting policies that Nat uses in its opening IFRS statement of financial position differ from those that it used for the same date using its previous GAAP. The resulting adjustments arise from events and transactions before the date of transition to IFRS Standards.
Therefore, Nat should recognise those adjustments directly in retained earnings.

Transaction (i)

The sale does not meet the revenue recognition criteria per IFRS 15 Revenue from Contracts with Customers because control of the asset has not transferred from the seller to the customer. In the opening IFRS statement of financial position as at 1 January 2004, a contract liability should be recognised. The $5 million loss on recognition of this liability will be accounted for in retained earnings.

Transaction (ii)

The provision does not meet the criteria in IAS 37. In the opening IFRS statement of financial position as at 1 January 2004, the provision should be derecognized. The $1 million gain on derecognition of this provision will be accounted for in retained earnings.

Transaction (iii)

Although some of the accruals and provisions turned out to be under-estimates, Nat concluded that its estimates were reasonable and, therefore, no error has occurred. In accordance with IAS 8, this issue should be accounted for prospectively. Therefore the additional expense will be recognised within the profit or loss figures prepared in accordance with IFRS Standards for the year ended 31 December 2004.

CONVERGENCE WITH IFRS AND IMPROVEMENTS TO IFRSS

International Harmonisation

Comparable, transparent, and reliable financial information is fundamental for the smooth functioning of capital markets. In the global arena, the need for comparable standards of financial reporting has become paramount because of the dramatic growth in the number, reach, and size of multinational corporations, foreign direct investments, cross-border purchases and sales of securities, as well as the number of foreign securities listings on the stock exchanges. However, because of the social, economic, legal, and cultural differences among countries, the accounting standards and practices in different countries vary widely.

The credibility of financial reports becomes questionable if similar transactions are accounted for differently in different countries.

To improve the comparability of financial statements, harmonization of accounting standards is advocated. Harmonization strives to increase comparability between accounting principles by setting limits on the alternatives allowed for similar transactions. Harmonization differs from standardization in that the latter allows no room for alternatives even in cases where economic realities differ.

Advantages and disadvantages of harmonization

There are some strong arguments in favour of the harmonisation of accounting standards in all countries of the world, and in particular for the convergence of US GAAP and IFRSs.

However, there are also some arguments against harmonisation -even though these are probably not as strong as the arguments in favour.

Advantages of harmonization

1. Investors and analysts of financial statements can make better comparisons between the financial position, financial performance and financial prospects of entities in different countries.

This is very important, in view of the rapid growth in international investment by institutional investors.

2. For international groups, harmonisation will simplify the preparation of group accounts. If all entities in the group share the same accounting framework, there should be no need to make adjustments for consolidation purposes.

3. If all entities are using the same framework for financial reporting, management should find it easier to monitor performance within their group.

4. Global harmonisation of accounting framework may encourage growth in cross-border trading, because entities will find it easier to assess the financial position of customers and suppliers in other countries.

5. Access to international finance should be easier, because banks and investors in the international financial markets will find it easier to understand the financial information presented to them by entities wishing to raise finance.

Disadvantages of harmonisation

1. National legal requirements may conflict with the requirements of IFRSs. Some countries may have strict legal rules about preparing financial statements, as the statements are prepared mainly for tax purposes. Consequently, laws may need re-writing to permit the accounting policies required by IFRSs.
2. Some countries may believe that their framework is satisfactory or even superior to IFRSs.

This has been a problem with the US, although currently is not as much of an issue as in the past. 3. Cultural differences across the world may mean that one set of accounting standards will not be flexible enough to meet the needs of all users.

Convergence with US GAAP

The IASB and the US Financial Accounting Standards Board (FASB) have been working together since 2002 to achieve convergence of IFRSs and US generally accepted accounting principles (GAAP).

A common set of high quality global standards remains a priority of both the IASB and the FASB. In September 2002 the IASB and the FASB agreed to work together, in consultation with other national and regional bodies, to remove the differences between international standards and US

GAAP. This decision was embodied in a Memorandum of Understanding (MOU) between the boards known as the Norwalk Agreement.
The boards ‘commitment was further strengthened in 2006 when the IASB and FASB set specific milestones to be reached by 2008 (A roadmap for convergence 2006 – 2008).

Norwalk Agreement (MOU)

At their joint meeting in Norwalk, Connecticut, USA on September 18, 2002, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) each acknowledged their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting.

To achieve compatibility, the FASB and IASB (together, the ―Boards) agree, as a matter of high priority, to undertake a short-term project aimed at removing a variety of individual differences between U.S.

GAAP and International Financial Reporting Standards (IFRSs, which include International Accounting Standards, IASs);

In 2008 the two boards issued an update to the MOU, which identified a series of priorities and milestones to complete the remaining major joint projects by 2011, emphasising the goal of joint projects to produce common, principle-based standards instead of 'rule based approach' followed by FASB.

Common conceptual framework

In October 2004 the IASB and FASB agreed to develop a common conceptual frameworkwhich would be a significant step towards harmonisation of future standards. The project has been divided into two phases:

(a) The initial focus is on particular aspects of the frameworks dealing with objectives, qualitative characteristics, elements, recognition, and measurement, giving priority to issues affecting projects for new/ revised Standards.

(b) Later, they will consider the applicability of those concepts to other sectors, beginning with not for profit entities in the private sector.

Memorandum of understanding

In February 2006, the two Boards signed a 'Memorandum of Understanding'. This laid down a 'roadmap of convergence' between IFRSs and US GAAP in the period 2006-2008.

The aim was to remove by 2009 the requirement for foreign companies reporting under IFRSs listed on a US stock exchange to have to prepare a reconcile action to US GAAP.

Events moved faster than expected, and in November 2007 the US Securities and Exchange Commission (SEC) decided to allow non-US filers to report under IFRSs for years ended after 15 November 2007 with no reconciliation to US GAAP.

Consultation is also underway on the possibility of the use of IFRSs by US filers. In November 2008, the SEC published a proposal, titled Roadmap for the Potential Use of Financial Statements Prepared in accordance with International Financial Reporting Standards by U.S. Issuers. The proposed roadmap sets out milestones that, if achieved, could lead to the adoption of IFRSs in the US in 2014. It also proposes to permit the early adoption of IFRSs from 2010 for some US entities.

FASB/IASB projects

Some of the main results of the convergence project between FASB and the IASB have been:

(a) The issue of IFRS 5 Non-current assets held for sale and discontinued operations
(b) The issue of IFRS 8 Operating segments
(c) Revision of IAS 23 Borrowing costs, to align with US GAAP
(d) Revision of IAS 1 Presentation of financial statements and an agreement on common wording to be used in accounting standards
(e) Revision of IFRS 3 Business combinations and IAS 27 Consolidated and separate financial statements
(f) The issue of IFRS 9 Financial instruments, exposure drafts on impairment and hedging
(g) There are also Discussion Papers, Exposure drafts or completed/revised IFRSs on the following topics:

i. Conceptual Framework
ii. Financial statements presentation
iii. Leases iv. Revenue Recognition
v. Fair value measurement vi.
Income taxes vii.
Pension accounting

IAS 21 – DOES IT NEED AMENDING

The International Accounting Standards Board (IASB) recently initiated a research project, which examined a previous research. This research considered whether any work on IAS 21, The Effects of Changes in Foreign Exchange Rates, was appropriate. The following text looks at some of the issues raised by the project in the context of IAS 21.

The foreign exchange market is affected by many factors, and in countries with a floating exchange rate, their foreign exchange rates are inevitably exposed to volatility due to the effects of the different factors influencing the market. For example, the ongoing problem of Greece repaying its enormous debts has significantly affected the value of the euro.

As the barriers to international flows of capital are further relaxed, the volatility of the foreign exchange market is likely to continue. This volatility affects entities that engage in foreign currency transactions and there has been a resultant call in some quarters to amend IAS 21.

IFRS 7, Financial Instruments: Disclosure requires disclosure of market risk, which is the risk that the fair value or cash flows of a financial instrument will fluctuate due to changes in market prices. Market risk reflects, in part, currency risk. In IFRS 7, the definition of foreign currency risk relates only to financial instruments. IFRS 7 and IAS 21 have a different conceptual basis. IFRS 7 is based upon the distinction between financial/non-financial elements, whereas IAS 21 utilises the monetary/non-monetary distinction.

The financial/non-financial distinction determines whether an item is subject to foreign currency risk under IFRS 7, whereas translation in IAS 21 uses monetary/non-monetary distinction, there by possibly causing potential conceptual confusion. Foreign currency risk is little mentioned in IAS 21 and on applying the definition in IFRS 7 to IAS 21, non-financial instruments could be interpreted

as carrying no foreign currency risk. Under IAS 21, certain monetary items include executory contracts, which do not meet the definition of a financial instrument. These items would be translated at the closing rate, but as such items are not financial instruments, they could be deemed not to carry foreign currency risk under IFRS 7.

Foreign currency translation should be conceptually consistent with the conceptual framework. IAS 21 was issued in 1983 with the objective of prescribing how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency.

There is little conceptual clarification of the translation requirements in IAS 21. The requirements of IAS 21 can be divided into two main areas: the reporting of foreign currency transactions in the functional currency; and the translation to the presentation currency. Exchange differences arising from monetary items are reported in profit or loss in the period, with one exception which is that exchange differences arising on monetary items that form part of the reporting entity‘s net investment in a foreign operation are recognised initially in other comprehensive income, and in profit or loss on disposal of the net investment.

However, it would be useful to re-examine whether it is more appropriate to recognise a gain or loss on a monetary item in other comprehensive income instead of profit or loss in the period and to define the objective of translation. Due to the apparent lack of principles in IAS 21, difficulty could arise in determining the nature of the information to be provided on translation.

There is an argument that the current accounting standards might not reflect the true economic substance of long-term monetary assets and liabilities denominated in foreign currency because foreign exchange rates at the end of the reporting period are used to translate amounts that are to be repaid in the future.

IAS 21 states that foreign currency monetary amounts should be reported using the closing rate with gains or losses recognised in profit or loss in the period in which they arise, even when the rate is abnormally high or low.

There are cases where an exchange rate change is likely to be reversed, and thus it may not be appropriate to recognise foreign exchange gains or losses of all monetary items as realised gains or losses. Thus there is an argument that consideration should be given as to whether foreign exchange gains or losses should be recognised in profit or loss or in other comprehensive income (OCI) based on the distinction between current items and non-current items.
Any potential fluctuation in profit or loss account would be reduced by recognising in OCI those foreign exchange gains or losses of non-current items with a high possibility of reversal. Furthermore, the question would arise as to whether these items recognised in OCI could be reclassified.

However, the IASB is currently determining via its conceptual framework project the purpose and nature of OCI, as there is no obvious principle that drives gains and losses out of profit or loss and into OCI, and there is no shared view among the IASB‘s constituents about what should be in profit or loss and what should be in OCI.

IAS 21 does provide some guidance on non-monetary items by stating that when a gain or loss on a nonmonetary item is recognised in OCI, any exchange component of that gain or loss shall be recognised in OCI.

Conversely, when a gain or loss on a non-monetary item is recognisedin profit or loss, any exchange component of that gain or loss shall be recognised in profit or loss.

Long-term liabilities
In the case of long-term liabilities, although any translation gains must be recognised in profit or loss, and treated as part of reported profit, in some jurisdictions, these gains are treated as unrealised for the purpose of computing distributable profit.

The reasoning is that there is a greater likelihood in the case of long-term liabilities that the favourable fluctuation in the exchange rate will reverse before repayment of the liability falls due.

As stated already, IAS 21 requires all foreign currency monetary amounts to be reported using the closing rate; non-monetary items carried at historical cost are reported using the exchange rate at

the date of the transaction and non-monetary items carried at fair value are reported at the rate that existed when the fair values were determined. As monetary items are translated at the closing rate, although the items are not stated at fair value, the use of the closing rate does provide some fair value information. However, this principle is not applied to non-monetary items as, unless an item is measured at fair value, the recognition of a change in the exchange rate appears not to provide useful information.

A foreign operation is defined in IAS 21 as a subsidiary, associate, joint venture, or branch whose activities are based in a country or currency other than that of the reporting entity. Thus the definition of a foreign operation is quite restrictive. It is possible to conduct operations in other ways; for example, using a foreign broker. Therefore, the definition of a foreign operation needs to be based upon the substance of the relationship and not the legal form.

Although the exchange rate at the transaction date is required to be used for foreign currency transactions at initial recognition, an average exchange rate may also be used. The date of a transaction is the date on which the transaction first qualifies for recognition in accordance with International Financial Reporting Standards. For practical reasons, a rate that approximates to the actual rate at the date of the transaction is often used. For example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate.

Average exchange rate

A question arises as to which exchange rate to use and therefore it would be useful to have more specific guidance on the use of the average exchange rate. IAS 21 allows a certain amount of flexibility in calculating the average rate. The determination of the average rate depends upon factors such as the frequency and value of transactions, the period over which the rate will apply and the nature of the entity‘s systems. There are a large number of methods that can be used to calculate the average rate, but no guidance is given in IAS 21 as to how such a rate is determined.

The IASB has completed its initial assessments on this project and decided that narrow scope amendments were unnecessary. In May 2015, it had no plans to undertake any additional work and is to remove this project from the research programme, subject to feedback in the next agenda consultation.

Foreign currency in individual financial statements

Test your understanding 1 – Chive

Chive is an entity located in a country whose currency is dollars ($).

Seventy per cent of Chive's sales are denominated in dollars and 30% of them are denominated in sterling (£). Chive does not convert receipts from customers into other currencies. Chive buys most of its inventories, and pays for a large proportion of operating costs, in sterling.
Chive has two bank loans outstanding. Both of these loans are denominated in dollars.
Required:
What is the functional currency of Chive?
Answer:
Test your understanding 1 – Chive

Firstly, the primary indicators of functional currency should be applied. Most of Chive's sales are denominated in dollars and so this would suggest that the dollar is its functional currency. However, since a lot of the costs of the business are denominated in sterling, it could be argued that is functional currency is sterling.

Since the primary indicators of functional currency are not clear out, it is important to look at the secondary indicators. Receipts are retained in both dollars and sterling. However, funding is generated in the form of dollar loans, which further suggests that dollar might be Chive's functional currency.

All things considered, it would seem that the functional currency of Chive is dollars. This means that any business transactions that are denominated in sterling must be translated into dollars in order to record them.
Test your understanding 2 – Butler, Waiter and Attendant

(d) An entity, Butler, has a reporting date of 31 December and a functional currency of dollars ($).
On 27 November 2006 Butler plc buys goods from a Swedish supplier for SwK 324,000.
On 19 December 2006 Butler plc pays the Swedish supplier in full.
Exchange rates were as follows:
27 November 2006 – SwK 11.15: $1
19 December 2006 – SwK 10.93: $1

Required:

Describe how the above transaction should be accounted for in the financial statements of Butler for the year ended 31 December 2006.

(e) An entity, Waiter, has a reporting date of 31 December and the dollar ($) as its functional currency. Waiter borrows in the foreign currency of the Kram (K). The loan of K 120,000 was taken out on 1 January 2007. A repayment of K 40,000 was made on 1 March 2007.
Exchange rates were as follows
1 January 2007 – K1: $2
1 March 2007 – K1: $3
31 December 2007 – K1: $3.5

Required

Describe how the above should be accounted for in the financial statements of Waiter for the year ended 31 December 2007.

(f) An entity, Attendant, has a reporting date of 31 December and has the dollar ($) as its functional currency. Attendant purchased a plot of land overseas on 1 March 2000. The entity paid for the land in the currency of the Rylands (R). The purchase cost of the land at 1 March 2000 was R 60,000. The value of the land at the reporting date was R 80,000.
Exchange rates were as follows:
1 March 2000 – R8: $1
31 December 2000 – R10: $1

Required:

Describe how the above transaction should be accounted for in the financial statements of Attendant for the year ended 31 December 2000 if the land is measured at:

- Cost
- Fair value.

Answer:

Test your understanding 2 – Butler, Waiter and Attendant

(d) The transaction on 27 November 2006 must be translated using the exchange rate on the transaction date.

The transaction is recorded at $29,058 (SwK 324,000/11.15).

Dr Purchase $29,058 Cr Payables $29,058 The cash settlement on 19 December 2006 must be translated using the exchange rate on the settlement date.

The cash settlement is recorded at $29,643 (SwK 324,000/10.93).

Dr Payables $29,058 Dr Profit or loss $585

Cr Cash $29,643

An exchange loss of $585 has arisen and this is recorded in the statement of profit or loss.

(e) On 1 January 2007, money was borrowed in Krams. This must be translated into the functional currency using the exchange rate on the transaction date.

The transaction is recorded at $240,000 (K 120,000 x 2).

Dr Cash $240,000 Cr Loans $240,000

The cash settlement on 1 March 2007 must be translated into the functional currency using the exchange rate on the settlement date.

The cash settlement is recorded at $120,000 (K 40,000 x 3).

Dr Loans $120,000 Cr Cash $120,000

Loans are a monetary liability. At the reporting date, the remaining loan of K 80,000 (K 120,000 – K 40,000) must be translated at the yearend exchange rate. This gives a closing liability of $280,000 (K 80,000 x 3.5).

The exchange loss on retranslation is calculated as follows:

	K	Rate	$
1 January 2007	120,000	2.0	240,000
1 March 2007	(40,000)	3.0	(120,000)
Exchange loss (bal. fig)			160,000

31 December 2007	80,000	3.5	280,000

The double entry to record this loss:

Dr Profit or loss $160,000

Cr Loans $160,000

(f) The asset is initially recognised at cost. This should be translated into the functional currency using the exchange rate on the purchase date. The land is therefore initially recorde at $7,500 ($60,000/8).

Land is not a monetary item so is therefore not retranslated. If held under the cost model, it will remain at $7,500.

If the land is held at fair value, then the valuation must be translated into dollars using the exchange rate in place when determined. Therefore, the land will be revalued to $8,000 (R 80,000/10).

The carrying value of the land must be increased by $500 ($8,000 - $7,500).

If the land is held under IAS 40 Investment Property, then the gain will be recorded in profit or loss.

If the land is held under IAS 16 Property, Plant and Equipment, then the gain will be recorded in other comprehensive income.

Test your understanding 3 – Highlight

(c) Highlight is an entity whose functional currency is the dollar ($) and has an annual reporting date of 31 December.

On 1 July 2003, Highlight purchased an item of plant and equipment on credit for Dn 400,000. On 1 November 2003, Highlight made a payment of Dn 180,000 to the supplier. The balance of the invoice remains outstanding.

Highlight has a policy of applying historical cost accounting and depreciating plant equipment at the rate of 20% per annum. The item of plant and equipment is not expected to have any residual value at the end of its useful life.

Relevant exchange rates to $1 are as follows:

	Dn
1 July 2003	10.0
1 November 2003	7.2

1 December 2003	9.0
31 December 2003	8.0

Required:

Prepare relevant extracts from Highlight's financial statements for the year ended 31 December 2003 to illustrate the impact of the above transactions.

(d) During 2003, Highlight entered into a number of transactions with Eraser, an overseas customer. On 1 November 2003, Highlight made credit sales to Eraser on 3 months credit for Dn 360,000. On 1 December 2003, Highlight made further credit sales to Eraser on 3 months credit for Dn 540,000.

By 31 December 2003, Highlight had received no payment from Eraser. As the receivables were still within their credit period, they were not regarded as being impaired.

Relevant exchange rates to $1 are as follow:

	Dn
1 July 2003	10.0
1 November 2003	7.2 1
December 2003	9.0 31
December 2003	8.0

Required:

Prepare relevant extracts from Highlight's financial statements for the year ended 31 December 2003 to illustrate the impact of the above transactions.

Answer:

Test your understanding 3 – Highlight

(c) Both the purchase of plant and equipment and the associated payable are recorded using the rate ruling at the date of the transaction (Dn 10 = $1), giving a value of $40,000. The partpayment made on 1 November is recorded using the rate applicable on that date, with the remaining dinar liability being restated in dollars at the closing rate at the reporting date. The exchange difference, in this case a loss of $12,500 (see calculation below), is taken to profit or loss as an operating expense.

		Dn	Rate	$
1/7/03	Payable recorded	400,000	10.0	40,000
1/1/03	Part-payment made	(180,000)	7.2	(25,000)

	Dn	Rate	$
Exchange loss (bal. fig.)			12,500
31/12/03 Payable outstanding	220,000	8.0	27,500

Plant and equipment, as a non-monetary item, is accounted for at historic cost and is therefore no retranslated. The depreciation charge is $4,000 ($40,000 x 1/5 x 6/12).

Extracts of the financial statements for the year ended 31 December 2003 are as follows:

Statement of profit or loss:	$
Cost of sales (depreciation)	(4,000)
Operating expenses (exchange loss)	(12,500)
Statement of financial position:	
Property, plant and equipment ($40,000 - $4,000)	36,000
Current liabilities	27,500

(d) Each of the sales invoices denominated in Dn must be translated into $ using the spot rate on the date of each transaction. Each transaction will result in recognition of revenue and a trade receivable at the following amounts:

1 November 2003: Dn 360,000/7.2 = $50,000

1 December 2003: Dn 540,000/9.0 = $60,000

Both amounts remain outstanding at the reporting date and must be restated into dollars using the closing rate of Dn8 = $1. The exchange difference, in this case a gain of $2,500 (see calculation below), is taken to profit or loss as an item of other operating income.

		Dn	Rate	$
1/11/03	Receivable recorded	360,000	7.2	50,000
	Receivable recorded	540,000	9.0	60,000
	Exchange gain (bal. fig.)			2,500
31/12/03	Receivable outstanding	900,000	8.0	112,500

Extracts of the financial statements for the year ended 31 December 2003 are as follows:

Statement of profit or loss:	$
Revenue ($50,000 + $60,000	110,000
Other operating income (exchange gain)	2,500

Statement of financial position:

Receivables	112,500

THE IASB’S PRINCIPLES OF DISCLOSURE INITIATIVE

The International Accounting Standards Board (IASB) has published a comprehensive discussion paper (DP) setting out the Board's preliminary views on disclosure principles that should be included in a general disclosure standard or in or in non-mandatory guidance on the topic.

Background

For the years 2017-2021 the IASB has chosen "Better communication" as its central theme, and in addition to the primary financial statements project and the IFRS Taxonomy this also includes the disclosure initiative. A related project is also the Conceptual Framework project. In fact, some concepts and financial reporting issues have been moved back and forth between different projects of this group.

The disclosure initiative itself is made up of a number of projects:

- Amendments to IAS 1 to remove barriers to the exercise of judgement and amendments to
- IAS 7 to improve disclosure of liabilities from financing activities have already been completed.
- Guidance on the application of materiality has been split into two projects and will see a final practice statement and an exposure draft of proposed amendments to IAS 1 and IAS 8 published in June.

The IASB's project on the principles of disclosure

The objective of the principles of disclosure project is to help preparers to communicate information more effectively, to improve disclosures for users of financial statements, and to help the Board to develop disclosure requirements in standards. Since IAS 1 Presentation of Financial Statements contains general requirements for disclosures in the financial statements, the project uses the IAS 1 requirements as a starting point to see whether parts of IAS 1 can be amended to reach the project's

objective or whether a new disclosure standard should be developed to replace parts of IAS 1 (both options a subsumed under the expression "general disclosure standard" throughout the DP).
Summary of main proposals Contents: The DP contains 110 pages and is divided into eight sections accompanied by an appendix. The paper is preceded by an executive summary describing the reasons behind publishing the DP, its reach, the main content of the document, the preliminary views of the Board, the terminology used, and the next steps. The paper itself is structured as follows:

Section Topic
1 Overview of the =disclosure problem ‘and the objective of this project
2 Principles of effective communication
3 Roles of the primary financial statements and the notes
4 Location of information
5 Use of performance measures in the financial statements
6 Disclosure of accounting policies
7 Centralised disclosure objectives
8 New Zealand Accounting Standards Board staff‛s approach to drafting disclosure requirements in IFRS Standards

Appendix Illustration of applying Method B in Section 7
The key issues dealt with in each section are summarised below.

Section 1 (Overview of the ‘disclosure problem’ and the objective of this project)
The first section offers background information on the disclosure initiative and discusses the "disclosure problem" that demonstrates the need for principles of disclosure. The section also outlines the objective of the project and the DP and describes the interactions with the other IASB projects.

Section 2 (Principles of effective communication)
The core of this section are the principles the Board believes entities should apply when preparing financial statements. Seven principles are identified ranging from the principle that the information provided should be entity-specific to avoid generic, boilerplate ‘language or information to the principle that the information should be provided in a format that is appropriate for that type of

information. Except for one, these principles were originally included in the 2013 Conceptual Framework DP. The Board has come to the conclusion that these principles should be provided either in a general disclosure standard or in non-mandatory guidance on the topic, not in the Conceptual Framework. New is the principle on formatting as the Board has received feedback that more effective use of formatting would improve how entities communicate information.

Section 3 (Roles of the primary financial statements and the notes)

This section contains a discussion of the roles of the different financial statements as the Board has received feedback that information in the primary financial statements is used more frequently and is subject to more scrutiny from users, auditors, and regulators. Entities also state that they find it difficult to decide what information should be presented in the primary financial statements instead of being disclosed in the notes, not least because of the inconsistent use of the terms =present‘ and =disclose‘ in IFRSs. Therefore, this section identifies and describes the role of the primary financial statements based on the objective of financial statements in the 2015 Conceptual Framework ED and sets out the implications of that role. It also descry be the role and content of the notes based on the proposals in the Conceptual Framework ED. The Board has also concluded that going forward it will also specify the intended location as being either =in the primary financial statements ‘or =in the notes‘ when it uses the terms 'present' or 'disclose' to indicate a location.

Section 4 (Location of information)

This section discusses providing information that is necessary to comply with IFRSs outside the financial statements and providing non-IFRS information within the financial statements. The Board‘s preliminary view is that a general disclosure standard should include a principle that an entity can provide information that is necessary to comply with IFRSs outside of the financial statements if the information it is provided within the entity‘s annual report and this location makes the annual report as a whole more understandable and if is clearly cross-referenced. Similarly, the Board has concluded that a general disclosure standard should not prohibit an entity from including non IFRS information in its financial statements as long as such information is clearly identified as not being prepared in accordance with IFRSs and the entity explains why the information is useful and has been included.

Section 5 (Use of performance measures in the financial statements)

The fifth section is dedicated to the fair presentation of performance measures in the financial statements. The Board‘s preliminary views are that the presentation of an EBITDA subtotal using the nature of expense method and the presentation of an EBIT subtotal under both a nature of expense method and a function of expense method comply with IFRSs if such subtotals are relevant to an understanding of the financial statements. The Board also believes that it should develop guidance in relation to the presentation of unusual or infrequently occurring items. However, the Board notes that both issues (EBITDA/EBIT and unusual items) will be dealt with within the Board‘s project on primary financial statements. On fair presentation of performance measures, the Board notes that this information must be displayed with equal or less prominence than the line items in the primary financial statements, reconciled to the most directly comparable IFRS measure, accompanied by an explanation of its relevance and reason, be neutral, free from error and clearly labelled, include comparative information, be classified, measured and presented consistently, and indicate whether it has been audited. This is entirely in line with guidelines already published by various securities regulators but now finds its way into IFRS literature.

Section 6 (Disclosure of accounting policies)

In this section, the IASB takes a closer look at how entities should disclose their accounting policies. The Board‘s preliminary views are that a general disclosure standard should include requirements to explain the objective of providing accounting policy disclosures. It should describe the categories of accounting policies, which are accounting policies that are always necessary for understanding information in the financial statements, accounting policies that alsore late to items, transactions or events that are material to the financial statements, and any other accounting policies. The Board has also come to the conclusion that there are alternatives for locating accounting policy disclosures, but that it can be presumed that entities disclose information about significant judgements and assumptions adjacent to disclosures about related accounting policies.

Section 7 (Centralised disclosure objectives)

This section discusses the development of a central set of disclosure objectives that consider the objective of financial statements and the role of the notes.

Such centralised objectives could be used by the Board as a basis for developing disclosure objectives and requirements in standards that are more unified and better linked to the overall objective of financial statements. The DP identifies two methods that could be used for developing centralised disclosure objectives: Method A would entail focusing on the different types of information disclosed about an entity's assets, liabilities, equity, income and expenses; Method B focusing on information about an entity's activities. The appendix to the DP provides two examples that illustrate the application of Method B to develop disclosure objectives and requirements. The DP notes that Board has not yet formed any preliminary views about the two methods. Finally, the DP asks whether respondents think that the Board should consider locating all disclosure objectives and requirements in IFRSs within a single standard (or set of standards) for disclosures.

Section 8 (New Zealand Accounting Standards Board staff's approach to drafting disclosure requirements in IFRS Standards)

The eighth section describes an approach that has been developed by the staff of the NZASB for drafting disclosure objectives and requirements in IFRSs. The main features of the approach are: an overall disclosure objective for each standard with sub objectives for each type of information required, a two-tier approach that would see the amount of information provided depend on the relative importance of an item or transaction to the reporting entity, greater emphasis on the need to exercise judgement, and less prescriptive wording in disclosure equirements. The DP notes that Board has not yet formed any views about the approach but would nevertheless welcome feedback as it could be used in the project on standards-level review of disclosures.

DISCLOSURE INITIATIVE (AMENDMENTS TO IAS 1)

Background

As a result of the IASB's Agenda Consultation 2011, the IASB received a request to review the disclosure requirements within the existing standards and to develop a disclosure framework.
The IASB has considered elements of presentation and disclosure as part of its revision of the Conceptual Framework for Financial Reporting. In addition, and to complement the work being done in relation to the Conceptual Framework project, the IASB started its Disclosure Initiative project during 2013. The Disclosure Initiative is a portfolio of projects affecting existing IFRSs, as well as other implementation and research projects.

The amendments to IAS 1 have resulted predominately from decisions made during the Disclosure Initiative project, with one additional proposal, regarding the presentation of an entity's share of other comprehensive income (OCI) from equity accounted interest in associates and joint ventures, arising from a submission received by the IFRS Interpretations Committee.

Summary of the proposals
The amendments made to IAS 1 are designed to address concerns expressed by constituents about existing presentation and disclosure requirements and to encourage entities to use judgement in the application of IAS 1 when considering the layout and content of their financial statements.

In addition, an amendment is made to IAS 1 to clarify the presentation of an entity's s hare of other comprehensive income (OCI) from its equity accounted interests in associates and joint ventures. The amendment requires an entity's share of other comprehensive income to be split between those items that will and will not be reclassified to profit or loss, and presented in aggregate as single line items within those two groups.

This would result in amendments to various paragraphs of IAS 1:
Materiality and aggregation (paragraphs 29 to 31)
Statement of financial position (paragraphs 54 to 55A), and statement of profit or loss and other comprehensive income (paragraphs 82 and 85 to 85B)
Notes to the financial statements (paragraphs 112 to 116)
Accounting policies (paragraphs 117 to 121)
Equity accounted investments (paragraph 82A).

Materiality and aggregation

Information is not to be aggregated or disaggregated in a manner that obscures material information and reduces the understandability of financial statements (e.g. aggregating items that have different natures or functions or overwhelming useful information with immaterial information)

Materiality applies to all four primary financial statements and the notes to the financial statements.

Even when a standard contains a list of specific minimum disclosure requirements, preparers need to assess whether each required disclosure is material, and consequently whether presentation or disclosure of that information is warranted. This combines with the existing definition of materiality in IAS 1.7, which requires consideration of items both individually and collectively, because a group of immaterial items may, when combined, be material. Preparers also need to consider whether particularly significant items mean that disclosures, in addition to minimum requirements specified in IFRSs, are required to provide an appropriate amount of information.

Statement of financial position and statement of profit or loss and other comprehendsive income

It is clarified that the requirements to present specific line items in the =statement of profit or loss and other comprehensive income 'and =statement of financial position'can be met by disaggregating these line items if this is relevant to an understanding of the entity's financial position and performance.

New requirements are introduced when an entity presents subtotals in primary statements in accordance with IAS 1.55 and 85. The amendments clarify that additional subtotals must be made up of items recognised in accordance with IFRSs, need to be presented and labelled in a manner that makes the subtotals understandable and consistent from period to period, and are not permitted to be displayed with more prominence than the subtotals and totals required by IFRSs.

Notes

It is emphasised that understandability and comparability of financial statements should be considered by an entity when deciding the order in which the notes are presented.

It is clarified that entities have flexibility for the order of the notes, which do not necessarily need to be presented in the order listed in IAS 1.114 (e.g. it may be decided to give more prominence to

areas that the entity considers to be most relevant to its financial performance and position, such as grouping together

Disclosure of accounting policies

The examples in IAS 1.120 of accounting policies for income taxes and foreign exchange gains and losses have been removed, because the examples were unclear about why a user of financial statements would always expect these specific policies to be disclosed.

Equity accounted investments

This amendment clarifies the presentation of an entity‘s share of other comprehensive income (OCI) from equity accounted associates and joint ventures.

The amendment would require entities to include two separate line items in OCI for those items, being amounts that will and will not be reclassified to profit or loss.

What the amendments mean

Respondents to the IASB‘s Agenda Consultation 2011 asked the IASB to review the disclosure requirements of existing IFRSs and to develop a disclosure framework. A number of these requests arose from the increasing length of many financial statements prepared in accordance with IFRS, and disclosure overload in those financial statements.

In 2013, to complement work being carried out to revise the Conceptual Frame-work the IASB started its Disclosure Initiative. This is made up of a number of short and medium term projects, and on-going activities, which are looking at how to improve presentation and disclosure principles in existing IFRSs.

The materiality requirements of IAS 1 have been amended to emphasise that information should not be aggregated or disaggregated in a way that obscures material information. The changes also highlight that materiality applies to all aspects of financial statements, including the primary financial statements, the notes and specific disclosures required by individual IFRSs. The purpose is to encourage entities (and others involved in the preparation and review of financial statements)

to give careful consideration to presentation requirements, and to the items that need to be included in financial statements.

The content of primary statement line items has been clarified including that as well as aggregating immaterial items individual lines that contain significant items may need to be disaggregated. Additional guidance has also been added for the use of subtotals, requiring that these are derived using amounts that are reported in accordance with IFRS.

The amendment related to the submission to the IFRS Interpretations Committee and addresses uncertainty about, and diversity in, the presentation of an entity‘s share of other comprehensive income (OCI) from equity accounted associates and joint ventures. The effect is to include two separate line items in OCI for items that will, and for items that will not, be reclassified to profit or loss.

What should entities do in response to the amendments?
Disclosure overload and the increased complexity of financial reporting have been key drivers in the IASB‘s decision to start its Disclosure Initiative. The amendments are designed to encourage entities to improve the understandability, comparability and clarity of their financial statements. Although the amendments do not introduce many new requirements to IAS 1 (and are not inconsistent with its existing guidance), they would encourage additional thought to be given to the content and layout of financial statements. Entities may wish to revisit:

- Their application of materiality
- The level of aggregation and disaggregation of line items in the financial statements
- The use of subtotals
- Presenting information in an orderly and logical manner
- The order of the notes to the financial statements
- The content and presentation of accounting policies
- The amount of information to disclose for material transactions so that the economic substance of the transaction can be adequately explained
- Which accounting policies are significant to users of financial statements in understanding specific transactions.

The focus on disclosing material and relevant information are likely to require on going application of judgement. Entities may also consider engagement with their auditors and shareholders as part of their process of determining which disclosures are material and relevant for the current reporting period.

Entities with interests in associates and/or joint ventures should note that the amendments may result in a different presentation of items within OCI.

FUTURE TRENDS IN SUSTAINABILITY REPORTING

Global Reporting Initiative (GRI) and international think tank and strategic advisory firm Sustain Ability have published the latest insights from the GRI Corporate Leadership Group on Reporting 2025 which explored four key trends fundamental to the UN Sustainable Development Goals: climate change, human rights, wealth inequality, and data and technology.

Content the insights, captured in the report Future Trends in Sustainability Reporting provide practical guidance to reporting organizations working to respond to the risks and opportunities that we face on our path to a sustainable future.

The publication presents key information on each sustainability trend. Highlights from the report include:

Climate change: There was clear consensus in the group that it is not a matter of if business should or can act on climate change but how and how fast they deliver change. Companies are solution providers: they are expected to be part of the solutions, from new energy models to efficiencies in the production and distribution of goods. Furthermore, clear and ambitious science-based targets are needed and greater company and country engagement is expected.

Human rights: Expectations of corporate reporting on the many facets of human rights are growing: human rights due diligence is now the expected minimum. Investors, rating agencies and regulators are increasingly seeking this information. Key human rights issues set to receive greater focus include labor rights and issues linked to natural resources. The group highlighted that modern slavery is a new form of severe labor abuse and is leading to a broader movement from a focus on audit and compliance to due diligence and collaboration. Conflict over natural resource wealth is also becoming a more recognized issue with land rights increasingly disputed.

Wealth inequality: Various challenges for business related to wealth inequality were discussed, including radically increasing the share of value captured by workers and small-scale producers for instance, achieving living wages for laborers and living incomes for small-scale producers. Eliminating economic gender inequality and gender discrimination is also becoming a key issue, as is tackling the race-to-the-bottom on public governance to attract investment. Calls to end the era of tax havens are increasingly expected, and breaking market concentration and addressing the unequal distribution of power will become imperative.

Data and Technology: When it comes to corporate reporting, data and technology are often seen as an opportunity and a challenge in equal measure. Challenges include securing sufficient internal buy-in; promoting the culture and creating awareness for good use of the internal systems that

deliver high-quality, comparable data; lack of availability of sensitive and confidential data; and a need for more analytical tools to better understand data. Opportunities include online reporting; embedding sustainability data into targets and performance management systems; monitoring and providing feedback loops to data providers; and better understanding the dynamics and other demands on the data to improve the information channels and lower the burden for colleagues.

EXPOSRURE DRAFTS

EXPOSURE DRAFT 2016/01
DEFINITION OF A BUSINESS AND ACCOUNTING
FOR PREVIOUSLY HELD INTERESTS

Background

Defining a business is important because the financial reporting requirements for the acquisition of a business are different from the requirements for the purchase of a group of assets that does not constitute a business.

The Post-Implementation Review (PIR) of IFRS 3 Business Combinations carried out by the IASB identified difficulties in applying the definition of a business.

IFRS 3 resulted from a joint project between the Board and the FASB, and the requirements in IFRS and USGAAP regarding business combinations are substantially converged. The proposed amendments to IFRS 3 and the Proposed Accounting Standards Update Clarifying the Definition of a Business (issued by the FASB in November 2015) are based on substantially converged tentative conclusions.

The IASB was also informed that there is diversity in practice in accounting for previously held interests in the assets and liabilities of a joint operation in two types of transactions: those in which an entity obtains control of a business that is a joint operation and those in which it obtains joint control of a business that is a joint operation.

The proposed amendments to IFRS 3 Business Combinations and IFRS

11 Joint Arrangements are intended to clarify the definition of a business and the accounting for these types of transactions involving joint operations.

IFRS 3 BUSINESS COMBINATIONS ACCOUNTING FOR PREVIOUSLY HELD INTERESTS

The IASB proposes to clarify that, when an entity obtains control of a business that is a joint operation, the entity applies the requirements for a business combination achieved in stages, including re-measuring previously held interests in the assets and liabilities of the joint operation to fair value.

It is proposed to apply the amendment to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after the effective date of the amendment, with early application permitted.

Definition of a business The
Board proposes:

a) To be considered a business, an acquired set of activities and assets must include, at a minimum, an input and a substantive process that together have the ability to contribute to the creation of outputs;
b) To remove the statement that a set of activities and assets is a business if market participants can replace the missing elements and continue to produce outputs;
c) To revise the definition of outputs to focus on goods and services provided to customers and to remove the reference to the ability to reduce costs;
d) To consider a set of activities and assets not to be a business if, at the transaction date, substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets;
e) To add guidance to help determine whether a substantive process has been acquired;
f) To add examples to help with the interpretation of what is considered a business; and
g) That an entity would not be required to apply the proposed amendments to transactions that occur before the effective date of the amendments.

Minimum requirements to be a business
The Board decided that to be considered a business, an acquisition must include, at a minimum, an input and a substantive process that together contribute to the ability to create outputs, i.e. it is not necessary for all of the inputs and processes needed to create outputs to be acquired for the set of activities and assets to be a business.

Market participant capable of replacing missing elements
It was noted that, currently, some sets of activities and assets may be considered to be a business for market participants who could integrate the set of activities and assets into their existing processes.

However, the same set of activities and assets may not be considered a business from the perspective of other market participants.

It is proposed that the ability of some market participants to integrate an acquired set of activities and assets should not be considered in determining whether the acquisition is a business combination. The Board believes that the assessment should be based on what has been acquired, rather than on how a market participant could potentially integrate the acquired activities and assets.

The proposed amendments would provide new tests to assess whether the minimum requirements for a set of assets and activities to be a business are met.

Definition of output

It is proposed to narrow the definition of outputs to focus on goods and services provided to customers.

The proposed definition excludes:

a) Returns in the form of lower costs; and

b) Other economic benefits provided directly to investors or other owners, members or participants.

This is consistent with how outputs are discussed in IFRS 15 Revenue from Contracts with Customers.

However, the Board decided to include in the definition other types of outputs due to the fact that not all entities have revenues that are within the scope of IFRS 15.

The proposed changes to the definition of outputs would narrow the types of outputs to be considered.

Fair value of the assets acquired is concentrated in a single asset.

It is proposed to provide a screening test that will make it easier in some cases to determine, without further analysis, that a set of activities and assets acquired does not constitute a business. It is proposed that further assessment of whether a set of activities and assets is a business would not be appropriate if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets.

The Board decided that it was not necessary to provide further guidance for application of the term substantially all.

It is important to note that the proposed screening test refers to the fair value of the gross assets acquired and not to the fair value of the total consideration paid or net assets. This is important, for example, when the net assets acquired include a significant component of debt or liabilities.

Evaluating whether an acquired process is substantive

Rather than trying to develop a single definition of what a substantive process is, it is proposed to add guidance to determine whether a process that has been acquired is substantive.

The clarifications propose two similar but distinct tests of acquired processes depending on whether the acquired set of activities and assets has outputs.

a) The acquired set of activities and assets does not have outputs

In these cases, the definition of a business is met only if the inputs acquired include both an organized workforce that performs a process that is critical to the creation of output and another input (or inputs) that is (or are) intended to be developed into outputs. The Board believes that the intellectual capacity of an organized workforce, i.e. their capacity to perform a process even if the process is not documented, is a process.

b) The acquired set of activities and assets has outputs

When the acquired set of activities and assets has outputs, there is more evidence that the acquired set is a business. Because inputs are already being converted into outputs, it is not important to consider the type of inputs acquired.

The IASB considers that it is only in some limited circumstances that an organised workforce is not required in order to conclude that the set of activities and assets is a business. These circumstances are:

a) The set has outputs; and
b) The acquired set includes a process (or a group of processes) that is unique or scarce, or is difficult to replace.

IFRS 11 JOINT ARRANGEMENTS

Accounting for previously held interests

The IFRS Interpretations Committee noted that there is diversity in practice in accounting for previously held interests in the assets and liabilities of a joint operation when an investor obtains joint control of a business that is a joint operation. The issue is whether an entity applies the principles on accounting for a business combination achieved in stages to those previously held interests when the investors obtains joint control.

The transaction subject to analysis is analogous to a transaction that results in an investment in an associate becoming an investment in a joint venture and vice versa. As stated in IAS 28 Investment in.

Associates and Joint Ventures, an investor does not apply the principles on accounting for a business combination achieved in stages to those previously held interests.

The Board proposes that, when an investor obtains joint control of a business that is a joint operation, the entity should not re-measure previously held interests in the assets and liabilities of the joint operation.

EXPOSURE DRAFT 2015/08
IFRS PRACTICE STATEMENT APPLICATION OF MATERIALITY IN FINANCIAL STATEMENTS

Background

During various stages of its Disclosure Initiative project, the IASB has been informed that there are difficulties around the practical application of materiality, with inappropriate assessments leading to irrelevant information being included, and material information being excluded, from financial statements. It has been suggested that a contributing factor is the lack of guidance in materiality in IFRS.

The concept of materiality links to the objective of general purpose financial reporting, which is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Whether information is material or not is a matter of judgement that depends on facts and circumstances affecting each entity. The (draft) Practice Statement aims to illustrate the types of factors that management should take into account when considering whether information is material or not. It is important to note that materiality should be considered within the context of a specific entity.

Aspects of the Exposure Draft to comment

Form of the guidance

A Practice Statement is not a Standard. The IASB‘s reasoning for issuing guidance on applying the concept of materiality in the financial statements in the form of a non-mandatory Practice Statement is based on the following:

- The (draft) Practice Statement will help to promote a greater understanding of the role of materiality in IFRS and how it should be applied in preparing financial statements
- If mandatory guidance was issued in a Standard, concerns could arise about creating conflicts with national legal frameworks
- The IASB would not prohibit an entity from providing additional information in order to meet
- local requirements in a jurisdiction
- Issuing mandatory guidance in a Standard could risk appearing prescriptive an detract from the need for judgement to be applied
- the IASB observed that issuing guidance as a separate non-mandatory document would help to emphasise that the concept of materiality is pervasive throughout IFRS

- The IASB decided that a Practice Statement was preferable to educational material because it will be subject to full due process (including public consultation) and it will be more accessible and formal because it would be included in the IFRS Bound Volume.

Content of the (draft) Practice Statement

The (draft) Practice Statement proposes guidance in three main areas:

a. Characteristics of materiality
b. How to apply the concept of materiality in practice when presenting and disclosing information in the financial statements
c. How to assess whether omissions and misstatements of information are material to the financial statements.

The IASB has requested comments on:

- Whether any additional content should be included in the (draft) Practice Standard
- Whether the guidance will be understandable by, and helpful to, preparers of financial statements
- Whether there is any content with which respondents do not agree
- Whether any paragraphs/sections are unnecessary
- Whether any aspects of the guidance will conflict with any legal requirements related to materiality within constituents 'jurisdictions.

EXPOSURE DRAFT 2015/03

CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

ED/2015/3 Conceptual Framework for Financial Reporting sets out the revised Conceptual Framework structured into an introduction, eight chapters, and two appendices:

- Objective of general purpose financial reporting (GPFR)
- Qualitative characteristics of useful financial information
- General purpose financial statements (GPFS) and reporting entities
- Elements of financial statements
- Recognition and derecognition
- Measurement
- Presentation and disclosure
- Concepts of capital and capital maintenance1

The key proposals in each chapter are summarised below:

Introduction

The first section offers background information. It also describes the purpose of theconceptual framework and its status within the hierarchy of IASB pronouncements. The ED explains that the Conceptual Framework's primary purpose is to assist the IASB in developing and revising IFRSs (even though it may be useful to parties other than the IASB) and that the framework does not override any specific IFRS. Should the IASB decide to issue a new or revised pronouncement that is in conflict with the framework, the IASB will highlight the fact and explain the reasons for the departure going for-ward.

Chapter 1 - The objective of general purpose financial reporting

This is the first of the two chapters that were finalised as part of the joint project with the FASB in 2010, so there are only limited changes. In essence, the IASB's proposals in this chapter aim at giving prominence to the importance of providing information that is needed to assess management's stewardship of the entity's resources.

Chapter 2 - Qualitative characteristics of useful financial information

This is the second of the two chapters that were finalised as part of the joint project with the FASB in 2010 (published as Chapter 3 in the 2010 Conceptual Framework). Again, proposed changes are

limited. However, the IASB proposes to reintroduce an explicit reference to the notion of prudence and states that the exercise of prudence supports neutrality. Prudence is defined as the exercise of caution when making judgements under conditions of uncertainty. The chapter also contains a proposed addition that would clarify that faithful representation means representation of the substance of an economic phenomenon instead of representation of its legal form only.

Chapter 3 - Financial Statements and the reporting entity

The ED states the objective of financial statements (to provide information about an entity's assets, liabilities, equity, income and expenses that is useful to financial statements users in assessing the prospects for future net cash inflows to the entity and in assessing management's stewardship of the entity's resources) and sets out the going concern assumption. Interestingly, the ED only mentions two statements explicitly: the statement of financial position and the statement(s) of financial performance (the latter being the former statement of comprehensive income); the statement of cash flows and the statement of changes in equity go unmentioned. The chapter also discusses the definition of a reporting entity and the boundary of a reporting entity. It also states the IASB's conviction that, generally, consolidated financial statements are more likely to provide useful information to users of financial statements than unconsolidated financial statements.

Chapter 4 - The elements of financial statements

The main focus of this chapter is on the definitions of assets, liabilities, and equity as well as income and expenses. The definitions are quoted below:

Asset: An asset is a present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits.

Liability: A liability is a present obligation of the entity to transfer an economic resource as a result of past events.

Equity: Equity is the residual interest in the assets of the entity after deducting all its liabilities.

Income: Income is increases in assets or decreases in liabilities that result in increases in equity, other than those relating to contributions from holders of equity claims.

Expenses: Expenses are decreases in assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to holders of equity claims.

Note that, other than in the DP, the IASB has backed away from changes in the definitions liabilities and equity that would address the problems that arise in classifying instruments with characteristics of both liabilities and equity. Exploring those problems has been transferred to the IASB's research project on financial instruments with the characteristics of equity.

Chapter 5 - Recognition and derecognition

The ED states that only items that meet the definition of an asset, a liability or equity are recognised in the statement of financial position and only items that meet the definition of income or expenses are to be recognised in the statement(s) of financial performance. However, their recognition depends on three criteria: their recognition provides users of financial statements with (1) relevant information about the asset or the liability and about any income, expenses or changes in equity, (2) a faithful representation of the asset or the liability and of any income, expenses or changes in equity, and (3) information that results in benefits exceeding the cost of providing that information. Nevertheless, the ED also maintains that whether the information provided is useful to users depends on the item and the specific facts and circumstances and requires judgement and possibly varying recognition requirements between standards. Derecognition requirements as presented in the ED are driven by two aims: the assets and liabilities retained after the transaction or other event that led to derecognition must be presented faithfully and the change in the entity's assets and liabilities as a result of that transaction or other event must also be presented faithfully. The ED also describes alternatives when it is not possible to achieve both aims.

Chapter 6 – Measurement

This chapter is dedicated to the description of different measurement bases (historical cost and current value (fair value and value in use/fulfilment value)), the information that they provide and their advantages and disadvantages. A table offers an overview of the information provided by various measurement bases. The ED also sets out factors to consider when selecting a measurement basis (relevance, faithful representation, enhancing qualitative characteristics, and factors specific to initial measurement) and points out that consideration of the objective of financial reporting, the qualitative characteristics of useful financial information and the cost constraint are likely to result in the selection of different measurement bases for different assets, liabilities and items of income and expense.

Appendix A of the ED supplements Chapter 6 and describes cash-flow-based measurement techniques for cases when a measure determined using a measurement basis cannot be observed.

Chapter 7 - Presentation and disclosure

In this chapter, the ED discusses concepts that determine what information is included in the financial statements and how that information should be presented and disclosed. The statement of statement of comprehensive income is newly described as "statement of financial performance", however, the ED does not specify whether this statement should consist of a single statement or two statements, it only requires that a total or subtotal for profit or loss must be provided. Notably, the ED does not define profit or loss, thus the question of what goes into profit or loss or into other comprehensive income is still unanswered.

Chapter 8 - Concepts of capital and capital maintenance

The proposals in this chapter were taken over from the existing Conceptual Framework with minor changes for consistency of terminology.

The IASB states that it would consider revising the description and discussion of capital maintenance if it were to carry out a future project on accounting for high inflation. However, it also states that no such work is currently planned.

TECHNICAL ARTICLES

Following are some important technical articles provided by the examining team of SBR. These are very important from exam point of view.

1. MEASUREMENT
2. GIVING INVESTORS WHAT THEY NEED
3. THE DEFINITION AND DISCLOSURE OF CAPITAL
4. CONCEPTS OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME 5. WHAT DIFFERENTIATES PROFIT OR LOSS FROM OTHER COMPREHENSIVE INCOME?

6. WHEN DOES DEBT SEEM TO BE EQUITY?

MEASUREMENT

The relevance of information provided by a particular measurement method depends on how it affects the financial statements. The cost should be justified by the benefits of reporting that information to existing and potential users. The different measures used should be the minimum necessary to provide relevant information and there should be infrequent changes with any necessary changes clearly explained.

Further it makes sense for comparability and consistency purposes, to use the same method for initial and subsequent measurement unless there is a good reason from not doing so.

The existing Conceptual Framework provides very little guidance on measurement, which constitutes a serious gap in the Framework. A single measurement basis may not provide the most relevant information to users and therefore IFRSs adopt a mixed measurement basis, which includes fair value, historical cost, and net realisable value. Different information from different measurement bases may be relevant in different circumstances. A particular measurement bases may be easier to understand, more verifiable and less costly to implement. However, if different measurement bases are used, it can be argued that the totals in financial statements have little meaning. Those that prefer a single measurement method favour the use of current values to provide the most relevant information.

A business that is profit orientated has processes to transform market input values (inventory for example) into market output values.(sales of finished products).Thus it makes sense that current valuesshould play a key role in measurement. Current market value would appear to be the most relevant measure of assets and liabilities for financial reporting purposes.

The IASB favour a mixed measurement approach whereby the most relevant measurement method is selected. It appears that investors feel that this approach is consistent with how they analyse financial statements and that the problems of mixed measurement are outweighed by the greater relevance achieved. In recent standards, it seems that the IASB felt that fair value would not provide the most relevant information in all circumstances. For example, IFRS 9 requires the use of cost in some cases and fair value in other cases, while IFRS 15 essentially applies cost allocation.

A factor to be considered when selecting a measurement basis is the degree of measurement uncertainty.

The Exposure Draft on the Conceptual Framework states that for some estimates, a high level of measurement uncertainty may outweigh other factors to such an extent that the resulting information may have little relevance. Most measurement is uncertain and requires estimation. For example, recoverable value for impairment, depreciation estimates and fair value measures at level 2 and 3 under IFRS 13.Consequently, the IASB believes that the level of uncertainty associated with the measurement of an item should be considered when assessing whether a particular measurement basis provides relevant information.

Measurement uncertainty could be considered too great with the result that the entity may not recognisethe asset or liability. An example of this would be research activities. However, sometimes a measure with a high degree of uncertainty provides the most relevant information about an item. For example, financial instruments for which prices are not observable. The IASB thinks that the level of measurement uncertainty that makes information lack relevance depends on the circumstances and can only be decided when developing particular standards.

It would be easier if measurement bases were categorised as either historical cost or current value. The Exposure Draft on the Conceptual Framework describes these two categories but also states that cash flow-based measurement techniques are generally used to estimate the measure of an asset or a liability as part of a prescribed measurement basis. Cash-flow-based measurement can be used to customize measurement bases, which can result in more relevant information but it may also be more difficult for users to understand. As a result the Exposure Draft does not identify those techniques as a separate category.

There are several areas of debate about measurement. For example, should any discussion of measurement bases include the use of entry and exit values, entity-specific values and the role of deprival value. Again should an entity‘s business model affect the measurement of its assets and liabilities. Many would advocate that different measurement methods should be applied that are dependent both on the nature of assets and liabilities and also, importantly, on how these are used in the business. For example, property can be measured at historical cost or fair value depending upon the business model.

In order to meet the objective of financial reporting, information provided by a particular measurement basis must be useful to users of financial statements. A measurement basis achieves this if the information is relevant and faithfully represents what it essentially is supposed to represent. In addition, the measurement basis needs to provide information that is comparable, verifiable, timely and understandable. The IASB believes that when selecting a measurement basis, the amount is more relevant if the way in which an asset or a liability contributes to future cash flows is considered. The IASB considers that the way in which an asset or a liability contributes to future cash flows depends, in part, on the nature of the business activities.

There are many different ways in which an asset or liability can be measured. Historical cost seems to be the easiest of these measures but even here, complexity can arise where there is a deferred payment or a payment, which involves an asset exchange. Subsequent accounting after initial recognition is not necessarily straightforward with historical cost as such matters as impairment of assets have to be taken into account and the latter is dependent upon rules, which can be sometimes subjective.

Current values have a variety of alternative valuation methods. These include market value, value-in-use and fulfilment value. Of these various methods, there is less ambiguity around current market prices as with any other measure of current value, there is likely to be specific rules in place to avoid inconsistency.

In the main, the details of how these different measurement methods are applied are set out in each accounting standard.

GIVING INVESTORS WHAT THEY NEED

Often the advice to investors is to focus upon cash and cash flow when analysing corporate reports.

However insufficient financial capital can cause liquidity problems and sufficiency of financial capital is essential for growth. Discussion of the management of financial capital is normally linked with entities that are subject to external capital requirements but it is equally important to those entities which do not have regulatory obligations.

WHAT IS IT?

Financial capital is defined in various ways. The term has no accepted definition having been interpreted as equity held by shareholders or equity plus debt capital including finance leases. This can obviously affect the way in which capital ‘is measured which has an impact on return on capital employed (ROCE).

An understanding of what an entity views as capital and its strategy for capital management is important to all companies and not just banks and insurance companies. Users have diverse views of what is important in their analysis of capital. Some focus on historical invested capital, others on accounting capital and others on market capitalisation.

INVESTOR NEEDS

Investors have specific but different needs for information about capital depending upon their approach to the valuation of a business. If the valuation approach is based upon a dividend model, then shortage of capital may have an impact upon future dividends. If ROCE is used for comparing the performance of entities, then investors need to know the nature and quantity of the historical capital employed in the business. There is diversity in practice as to what different companies see as capital and how it is managed.

There are various requirements for entities to disclose information about capital‘. In drafting IFRS 7,

Financial Instruments: Disclosures, the IASB considered whether it should require disclosures about capital. In assessing the risk profile of an entity, the management and level of an entity‘s capital is an important consideration.

The IASB believes that disclosures about capital are useful for all entities, but they are not intended to replace disclosures required by regulators as their reasons for disclosure may differ from those of the IASB. As an entity's capital does not relate solely to financial instruments, the IASB has included these disclosures in IAS V1, Presentation of Financial Statements rather than IFRS 7. IFRS 7 requires some specific disclosures about financial liabilities, it does not have similar requirements for equity instruments.

The IASB considered whether the definition of capital 'is different from the definition of equity in IAS 32, Financial Instruments; Presentation. In most cases disclosure capital would be the same as equity but it might also include or exclude some elements. The disclosure of capital is intended to give entities the ability to describe their view of the elements of capital if this is different from equity.

IAS 1 DISCLOSURES

As a result, IAS 1 requires an entity to disclose information that enables users to evaluate the entity's objectives, policies and processes for managing capital. This objective is obtained by disclosing qualitative and quantitative data. The former should include narrative information such as what the company manages as capital, whether there are any external capital requirements and how those requirements are incorporated into the management of capital.

Some entities regard some financial liabilities as part of capital whilst other entities regard capital as excluding some components of equity for example those arising from cash flow hedges. The IASB decided not to require quantitative disclosure of externally imposed capital requirements but rather decided that there should be disclosure of whether the entity has complied with any external capital requirements and, if not, the consequences of noncompliance. Further there is no requirement to disclose the capital targets set by management and whether the entity has complied with those targets, or the consequences of any noncompliance.

EXAMPLES

Examples of some of the disclosures made by entities include information as to how gearing is managed, how capital is managed to sustain future product development and how ratios are used to evaluate the appropriateness of its capital structure. An entity bases these disclosures on the information provided internally to key management personnel.

If the entity operates in several jurisdictions with different external capital requirements such that an aggregate disclosure of capital would not provide useful information, the entity may disclose separate information for each separate capital requirement.

Besides the requirements of IAS 1, the IFRS Practice Statement Management Commentary suggests that management should include forward-looking information in the commentary when it is aware of trends, uncertainties or other factors that could affect the entity‘s capital resources.

COMPANIES ACT

Additionally, some jurisdictions refer to capital disclosures as part of their legal requirements. In the UK, Section 414 of the Companies Act 2006 deals with the contents of the Strategic Report and requires a balanced and comprehensive analysis‘ of the development and performance of the business during the period and the position of the company at the end of the period.

The section further requires that to the extent necessary for an understanding of the development, performance or position of the business, the strategic report should include an analysis using key performance indicators. It makes sense that any analysis of a company‘s financial position should include consideration of how much capital it has and its sufficiency for the company‘s needs. The Financial Reporting Council Guidance on the Strategic Report suggests that comments should appear in the report on the entity‘s financing arrangements such as changes in net debt or the financing of long term liabilities.

CAPITALISATION TABLE

In addition to the annual report, an investor may find details of the entity‘s capital structure where the entity is involved in a transaction, such as a sale of bonds or equities.

It is normal for an entity to produce a capitalisation table in a prospectus showing the effects of the transactions on the capital structure. The table shows the ownership and debt interests in the entity but may show potential funding sources, and the effect of any public offerings.

The capitalisation table may present the pro forma impact of events that will occur as a result of an offering such as the automatic conversion of preferred stock, the issuance of common stock, or the use of the offering proceeds for the repayment of debt or other purposes. The IASB does not require such a table to be disclosed but it is often required by securities regulators.

For example, in the US, the table is used to calculate key operational metrics. Amedica Corporation announced in February 2016 that it had =made significant advancements in its ongoing initiative toward improving its capitalization table, capitalisation, and operational structure.

It can be seen that information regarding an entity‘s capital structure is spread across several documents including the management commentary, the notes to financial statements, interim accounts and any document required by securities regulators.

DEBT AND EQUITY

Essentially there are two classes of capital reported in financial statements, namely debt and equity.

However, debt and equity instruments can have different levels of right, benefit and risks. When an entity issues a financial instrument, it has to determine its classification either as debt or as equity. The result of the classification can have a significant effect on the entity‘s reported results and financial position. Liability classification impacts upon an entity‘s gearing ratios and result s in any payments being treated as interest and charged to earnings. Equity classification may be seen as diluting existing equity interests.

IAS 32 sets out the nature of the classification process but the standard is principle based and sometimes the outcomes are surprising to users. IAS 32 does not look to the legal form of an instrument but focuseson the contractual obligations of the instrument.

IAS 32 considers the substance of the financial instrument, applying the definitions to the instrument‘s contractual rights and obligations. The variety of instruments issued by entities makes

this classification difficult with the application of the principles occasionally resulting in instruments that seem like equity being accounted for as liabilities. Recent developments in the types of financial instruments issued have added more complexity to capital structures with the resultant difficulties in interpretation and understanding.

The IASB has undertaken a research project with the aim of improving accounting for financial instruments that have characteristics of both liabilities and equity. The IASB has a major challenge in determining the best way to report the effects of recent innovations in capital structure.

DIVERSITY AND DIFFICULTY

There is a diversity of thinking about capital, which is not surprising given the issues with defining equity, the difficulty in locating sources of information about capital and the diversity of business models in an economy.

Capital needs are very specific to the business and are influenced by many factors such as debt covenants, and preservation of debt ratings. The variety and inconsistency of capital disclosures does not help the decision making process of investors. Therefore the details underlying a company's capital structure are essential to the assessment of any potential change in an entity's financial flexibility and value.

THE DEFINITION AND DISCLOSURE OF CAPITAL

Why does it matter anyway?

This article is useful to those candidates studying for SBR, Strategic Business Reporting. It is structured in two parts: first, it considers what might be included as the capital of a company and, second, why this distinction is important for the analysis of financial information.

Essentially, there are two classes of capital reported in financial statements: debt and equity. However, debt and equity instruments can have different levels of right, benefit and risks. When an entity issues a financial instrument, it has to determine its classification either as debt or as equity. The result of the classification can have a significant effect on the entity's reported results and financial position. Liability classification impacts upon an entity's gearing ratios and results in any

payments being treated as interest and charged to earnings. Equity classification may be seen as diluting existing equity interests.

IAS 32, Financial Instruments: Presentation sets out the nature of the classification process but the standard is principle-based and sometimes the outcomes that result from its application are surprising to users. IAS 32 does not look to the legal form of an instrument but focuses on the contractual obligations of the instrument. IAS 32 considers the substance of the financial instrument, applying the definitions to the instrument‘s contractual rights and obligations.

MORE COMPLEXITY

The variety of instruments issued by entities makes this classification difficult with the application of the principles occasionally resulting in instruments that seem like equity being accounted for as liabilities.

Recent developments in the types of financial instruments issued have added more complexity to capital structures with the resultant difficulties in interpretation and understanding. Consequently, the classification of capital is subjective which has implications for the analysis of financial statements.

To avoid this subjectivity, investors are often advised to focus upon cash and cash flow when analyzing corporate reports. However, insufficient financial capital can cause liquidity problems and sufficiency of financial capital is essential for growth. Discussion of the management of financial capital is normally linked with entities that are subject to external capital requirements, but it is equally important to those entities that do not have regulatory obligations.

Financial capital is defined in various ways but has no widely accepted definition having been interpreted as equity held by shareholders or equity plus debt capital including finance leases.
This can obviously affect the way in which capital is measured, which has an impact on return on capital employed (ROCE).

An understanding of what an entity views as capital and its strategy for capital management is important to all companies and not just banks and insurance companies. Users have diverse views

of what is important in their analysis of capital. Some focus on historical invested capital, others on accounting capital and others on market capitalisation.

Investors have specific but different needs for information about capital depending upon their approach to the valuation of a business. If the valuation approach is based upon a dividend model, then shortage of capital may have an impact upon future dividends. If ROCE is used for comparing the performance of entities, then investors need to know the nature and quantity of the historical capital employed in the business. There is diversity in practice as to what different companies see as capital and how it is managed.

There are various requirements for entities to disclose information about =capital�GÇÿ. In drafting IFRS 7,

Financial Instruments: Disclosures, the IASB considered whether it should require disclosures about capital. In assessing the risk profile of an entity, the management and level of an entity‘s capital is an important consideration. The IASB believes that disclosures about capital are useful for all entities, but they are not intended to replace disclosures required by regulators as their reasons for disclosure may differ from those of the IASB. As an entity‘s capital does not relate solely to financial instruments, the IASB has included these disclosures in IAS 1, Presentation of Financial Statements rather than IFRS 7.

IFRS 7 requires some specific disclosures about financial liabilities; it does not have similar requirements for equity instruments.

The IASB considered whether the definition of capital is different from the definition of equity in IAS 32.
In most cases, capital would be the same as equity but it might also include or exclude some other elements. The disclosure of capital is intended to give entities the ability to describe their view of the elements of capital if this is different from equity.

As a result, IAS 1 requires an entity to disclose information that enables users to evaluate the entity ‘sobjectives policies and processes for managing capital. This objective is obtained by disclosing

qualitative and quantitative data. The former should include narrative information such as what the company manages as capital, whether there are any external capital requirements and how those requirements are incorporated into the management of capital. Some entities regard some financial liabilities as part of capital, while other entities regard capital as excluding some components of equity – for example, those arising from cash flow hedges.

The IASB decided not to require quantitative disclosure of externally imposed capital requirements but rather decided that there should be disclosure of whether the entity has complied with any external capital requirements and, if not, the consequences of noncompliance. Further, there is no requirement to disclose the capital targets set by management and whether the entity has complied with those targets, or the consequences of any noncompliance.

Examples of some of the disclosures made by entities include information as to how gearing is managed, how capital is managed to sustain future product development and how ratios are used to evaluate the appropriateness of its capital structure. An entity bases these disclosures on the information provided internally to key management personnel. If the entity operates in several jurisdictions with different external capital requirements, such that an aggregate disclosure of capital would not provide useful information, the entity may disclose separate information for each separate capital requirement.

TRENDS

Besides the requirements of IAS 1, the IFRS Practice Statement Management Commentary suggests that management should include forward-looking information in the commentary when it is aware of trends, uncertainties or other factors that could affect the entity‘s capital resources.

Additionally, some jurisdictions refer to capital disclosures as part of their legal requirements.
In the UK, Section 414 of the Companies Act 2006 deals with the contents of the Strategic Report and requires a balanced and comprehensive analysis‘ of the development and performance of the business during the period and the position of the company at the end of the period. The section further requires that to the extent necessary for an understanding of the development, performance or position of the business, the strategic report should include an analysis using key performance indicators. It makes sense that any analysis of a company‘s financial position should include consideration of how much capital it has and its sufficiency for the company‘s needs. The Financial

Reporting Council Guidance on the Strategic Report suggests that comments should appear in the report on the entity‘s financing arrangements such as changes in net debt or the financing of long-term liabilities.

In addition to the annual report, an investor may find details of the entity‘s capital structure where the entity is involved in a transaction, such as a sale of bonds or equities. It is normal for an entity to produce a capitalisation table in a prospectus showing the effects of the transactions on the capital structure. The table shows the ownership and debt interests in the entity but may show potential funding sources and the effect of any public offerings. The capitalisation table may present the pro forma impact of events that will occur as a result of an offering such as the automatic conversion of preferred stock, the issuance of common stock, or the use of the offering proceeds for the repayment of debt or other purposes.

The IASB does not require such a table to be disclosed but it is often required by securities regulators. For example, in the USA, the table is used to calculate key operational metrics. Amedica Corporation announced in February 2016 that it had = made significant advancements in its ongoing initiative toward improving its capitalization table, capitalization, and operational structure‘. It can be seen that information regarding an entity‘s capital structure is spread across several documents including the management commentary, the notes to financial statements, interim accounts and any document required by securities regulators.

The IASB has undertaken a research project with the aim of improving the accounting for financial instruments that have characteristics of both liabilities and equity. This is likely to be a major challenge in determining the best way to report the effects of recent innovations in capital structure. There is a diversity of thinking about capital that is not surprising given the issues with defining equity, the difficulty in locating sources of information about capital and the diversity of business models in an economy. Capital needs are very specific to the business and are influenced by many factors, such as debt covenants and preservation of debt ratings. The variety and inconsistency of capital disclosures does not help the decision making process of investors. Therefore, the details underlying a company‘s capital structure are essential to the assessment of any potential change in an entity‘s financial flexibility and value. An appreciation of these issues and their significance is important to candidates studying for SBR.

CONCEPTS OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

This article explains the current rules and the conceptual debate as to where in the statement of comprehensive income, profits and losses should be recognised.ie when should they be recognised in profit or loss and when in the other comprehensive income. Further, it explores the debate as to whether it is appropriate to recognise profits or losses twice!

The performance of a company is reported in the statement of profit or loss and other comprehensive income. IAS 1, Presentation of Financial Statements, defines profit or loss as the total of income less expenses, excluding the components of other comprehensive income'. Other comprehensive income (OCI) is defined as comprising items of income and expense (including reclassification adjustments) that arenot recognised in profit or loss as required or permitted by other IFRSs'. Total comprehensive income is defined as =the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners'.

It is a myth, and simply incorrect, to state that only realised gains are included in profit or loss (P/L) andthat only unrealised gains and losses are included in the OCI. For example, gains on the revaluation of land and buildings accounted for in accordance with IAS 16, Property Plant and Equipment (IAS 16 PPE), are recognised in OCI and accumulate in equity in Other Components of Equity (OCE). On the other hand, gains on the revaluation of land and buildings accounted for in accordance with IAS 40, Investment Properties, are recognised in P/L and are part of the Retained Earnings (RE). Both such gains areunrealised. The same point could be made with regard to the gains and losses on the financial asset of equity investments. If such financial assets are designated in accordance with IFRS 9, Financial Instruments (IFRS 9), at inception as Fair Value Through Other Comprehensive Income (FVTOCI) then the gains and losses are recognised in OCI and accumulated in equity in OCE. Whereas if management decides not tomake this election, then the investment will by default be designated and accounted for as Fair ValueThrough Profit or Loss (FVTP&L) and the gains and losses are recognised in P/L and become part of RE.

There is at present no overarching accounting theory that justifies or explains in which part of the statement gains and losses should be reported. The IASB's Conceptual Framework for Financial Reporting is silent on the matter. So rather than have a clear principles based approach what we currently have is a rules based approach to this issue. It is down to individual accounting standards to direct when gains and losses are to be reported in OCI. This is clearly an unsatisfactory approach. It is confusing for users.

In July 2013 the International Accounting Standards Board (IASB) published a discussion paper on its Conceptual Framework for Financial Reporting. This addressed the issue of where to recognise gains and losses. It suggests that the P/L should provide the primary source of information about the return an entity has made on its economic resources in a period. Accordingly the P/L should recognise the results of transactions, consumption and impairments of assets and fulfilment of liabilities in the period in which they occur. In addition the P/L would also recognise changes in the cost of assets and liabilities as well as any gains or losses resulting from their initial recognition. The role of the OCI would then be to support the P/L. Gains and losses would only be recognised in OCI if it made the P&L more relevant. In my view whilst this may be an improvement on the current absence of any guidance it does not provide the clarity and certainty users crave.

Recycling (the reclassification from equity to P&L)
Now let us consider the issue of recycling. This is where gains or losses are reclassified from equity to P/L as a reclassification adjustment. In other words gains or losses are first recognised in the OCI and then in a later accounting period also recognised in the P/L. In this way the gain or loss is reported in the total comprehensive income of two accounting periods and in colloquial terms is said to be recycled as it is recognised twice. At present it is down to individual accounting standards to direct when gains and losses are to be reclassified from equity to P/L as a reclassification adjustment. So rather than have a clear principles based approach on recycling what we currently have is a rules based approach to this issue.

This is clearly, again, an unsatisfactory approach but also as we shall see one addressed by the July 2013

IASB discussion paper on its Conceptual Framework for Financial Reporting

IAS 21, The Effects of Changes in Foreign Exchange Rates (IAS 21), is one example of a standard that requires gains and losses to be reclassified from equity to P/L as a reclassification adjustment. When a group has an overseas subsidiary a group exchange difference will arise on the re-translation of the subsidiary‘s goodwill and net assets. In accordance with IAS 21 such exchange differences are recognisedin OCI and so accumulate in OCE. On the disposal of the subsidiary, IAS 21 requires that the net cumulative balance of group exchange differences be reclassified from equity to P&L as a reclassification adjustment ie the balance of the group exchange differences in OCE is transferred to P/L to form part of the profit on disposal.

IAS 16 PPE is one example of a standard that prohibits gains and losses to be reclassified from equity to P/L as a reclassification adjustment. If we consider land that cost $10m which is treated in accordance with IAS 16 PPE. If the land is subsequently revalued to $12m, then the gain of $2m is recognised in OCI and will be taken to OCE. When in a later period the asset is sold for $13m, IAS 16 PPE specifically requires that the profit on disposal recognised in the P/L is $1m – ie the difference between the sale proceeds of $13m and the carrying value of $12m. The previously recognised gain of $2m is not recycled/reclassified back to P/L as part of the gain on disposal. However the $2m balance in the OCE reserve is now redundant as the asset has been sold and the profit is realised. Accordingly, there will be a transfer in the Statement of Changes in Equity, from the OCE of $2m into RE.

Double entry

For those who love the double entry let me show you the purchase, the revaluation, the disposal and the transfer to RE in this way.

On purchase		$m	$m
Dr	Land PPE	10	
Cr	Cash		10

On revaluation

Dr Land PPE 2

Cr	OCE and recognised in OCI		2

On disposal

Dr	Cash	13	
Cr	Land PPE		12
Cr	P/L		1

On transfer

Dr	OCE	2	
Cr	Retained Earnings		2

If IAS 16 PPE allowed the reclassification from equity to P&L as a reclassification adjustment, the profit on disposal recognised in P&L would be $3m including the $2m reclassified from equity to P&L and the last two double entries above replaced with the following.

On reclassification from equity to P/L		$m	$m
Dr	Cash	13	
Cr	Land PPE		12
Cr	P/L		3
Dr	OCE	2	

IFRS 9 also prohibits the recycling of the gains and losses on FVTOCI investments to P/L on disposal. The no reclassification rule in both IAS 16 PPE and IFRS 9 means that such gains on those assets are only ever reported once in the statement of profit or loss and other comprehensive income – ie are only included once in total comprehensive income. However many users, it appears, rather ignore the total
comprehensive income and the OCI and just base their evaluation of a company's performance on the P/L. These users then find it strange that gains that have become realised from transactions in the accounting period are not fully reported in the P/L of the accounting period. As such we can see the argument in favour of reclassification. With no reclassification the earnings per share will never fully include the gains on the sale of PPE and FVTOCI investments.

The following extract from the statement of comprehensive income summarises the current accounting treatment for which gains and losses are required to be included in OCI and, as required, discloses which gains and losses can and cannot be reclassified back to profit and loss.

Extract from the statement of profit or loss and other comprehensive income

	$m
Profit for the year	XX
Other comprehensive income	
Gains and losses that cannot be reclassified back to profit or loss	
Changes in revaluation surplus where the revaluation method is used in accordance with IAS 16	XX / (XX)
Remeasurements of a net defined benefit liability or asset recognised in accordance with IAS 19	XX / (XX)
Gains and losses on remeasuring FVTOCI financial assets in accordance with IFRS 9	XX / (XX)
Gains and losses that can be reclassified back to profit or loss	
Group exchange differences from translating functional currencies into presentation currency in accordance with IAS 21	XX / (XX)
The effective portion of gains and losses on hedging instruments in a cash flow hedge under IFRS 9	
Total comprehensive income	XX / (XX)
	XX / (XX)

The future of reclassification

In the July 2013 discussion paper on the Conceptual Framework for Financial Reporting the role of the OCI and the reclassification from equity to P/L is debated.

No OCI and no reclassification

It can be argued that reclassification should simply be prohibited. This would free the statement of profit or loss and other comprehensive income from the need to formally to classify gains and losses between P/L and OCI. This would reduce complexity and gains and losses could only ever be recognised once.

There would still remain the issue of how to define the earnings in earnings per share, a ratio loved by investors, as clearly total comprehensive income would contain too many gains and losses that were nonoperational, unrealised, outside the control of management and not relating to the accounting period.

Narrow approach to the OCI

Another suggestion is that the OCI should be restricted, should adopt a narrow approach. On this basis only bridging and mismatch gains and losses should be included in OCI and be reclassified from equity to P/L.

A revaluation surplus on a financial asset classified as FVTOCI is a good example of a bridging gain. The asset is accounted for at fair value on the statement of financial position but effectively at cost in P/L. As such, by recognising the revaluation surplus in OCI, the OCI is acting as a bridge between the statement of financial position and the P/L. On disposal reclassification ensures that the amount recognised in P/L will be consistent with the amounts that would be recognised in P/L if the financial asset had been measured at amortised cost.

The effective gain or loss on a cash flow hedge of a future transaction is an example of a mismatch gain or loss as it relates to a transaction in a future accounting period so needs to be carried forward so that it can be matched in the P/L of a future accounting period. Only by recognising the effective gain or loss in OCI and allowing it to be reclassified from equity to P/L can users to see the results of the hedging relationship.

Broad approach to the OCI

A third proposition is for the OCI to adopt a broad approach, by also including transitory gains and losses.

The IASB would decide in each IFRS whether a transitory remeasurement should be subsequently recycled.

Examples of transitory gains and losses are those that arise on the remeasurement of defined benefit pension funds and revaluation surpluses on PPE.

Conclusion

Whilst the IASB has not yet determined which approach will be adopted, its chairman Hans Hoogervorsthas gone on the record as saying =It is absolutely vital that the P/L contains all information that can be relevant to investors and that nothing of importance gets left out… and… the IASB should be very disciplined in its use of OCI as resorting to OCI too easily would undermine the credibility of net incomeso the OCI should only be used as an instrument of last resort‘.

WHAT DIFFERENTIATES PROFIT OR LOSS FROM OTHER COMPREHENSIVE INCOME?

The purpose of the statement of profit or loss and other comprehensive income (OCI) is to show an entity‘s financial performance in a way that is useful to a wide range of users so that they may attempt to assess the future net cash inflows of an entity. The statement should be classified and aggregated in a manner that makes it understandable and comparable. IFRS currently requires that the statement be presented as either one statement, being a combined statement of profit or loss and

other comprehensive income or two statements, being the statement of profit or loss and the statement of profit or loss and other comprehensive income. An entity has to show separately in OCI, those items which would be reclassified (recycled) to profit or loss and those items which would never be reclassified (recycled) to profit or loss. The related tax effects have to be allocated to these sections.

Profit or loss includes all items of income or expense (including reclassification adjustments) except those items of income or expense that are recognised in OCI as required or permitted by IFRS. Reclassification adjustments are amounts recycled to profit or loss in the current period that were recognised in OCI in the current or previous periods. An example of items recognised in OCI that may be reclassified to profit or loss are foreign currency gains on the disposal of a foreign operation and realised gains or losses on cash flow hedges. Those items that may not be reclassified are changes in a revaluation surplus under IAS 16, Property, Plant and Equipment, and actuarial gains and losses on a defined benefit plan under IAS 19, Employee Benefits.

However, there is a general lack of agreement about which items should be presented in profit or loss and in OCI. The interaction between profit or loss and OCI is unclear, especially the notion of reclassification and when or which OCI items should be reclassified. A common misunderstanding is that the distinction is based upon realised versus unrealised gains. This lack of a consistent basis for determining how items should be presented has led to an inconsistent use of OCI in IFRS. It may be difficult to deal with OCI on a conceptual level since the IASB are finding it difficult to find a sound conceptual basis. However, there is urgent need for some guidance around this issue.

Opinions vary but there is a feeling that OCI has become a =dumping ground ‘for anything controversial because of a lack of clear definition of what should be included in the statement.
Many users are thought to ignore OCI as the changes reported are not caused by the operating flows used for predictive purposes.

Financial performance is not defined in the Conceptual Framework but could be viewed as reflecting the value the entity has generated in the period and this can be assessed from other elements of the financial statements and not just the statement of profit or loss and other comprehensive income. Examples would be the statement of cash flows and disclosures relating to operating segments. The

presentation in profit or loss and OCI should allow a user to depict financial performance including the amount, timing and uncertainty of the entity‘s future net cash inflows and how efficiently and effectively the entity‘smanagement have discharged their duties regarding the resources of the entity.

Reclassification: for and against

There are several arguments for and against reclassification. If reclassification ceased, then there would be no need to define profit or loss, or any other total or subtotal in profit or loss, and any presentation decisions can be left to specific IFRSs. It is argued that reclassification protects the integrity of profit or loss and provides users with relevant information about a transaction that occurred in the period.

Additionally, it can improve comparability where IFRS permits similar items to be recognised in either profit or loss or OCI.

Those against reclassification argue that the recycled amounts add to the complexity of financial reporting, may lead to earnings management and the reclassification adjustments may not meet the definitions of income or expense in the period as the change in the asset or liability may have occurred in a previous period.

The original logic for OCI was that it kept income-relevant items that possessed low reliability from contaminating the earnings number. Markets rely on profit or loss and it is widely used. The OCI figure is crucial because it can distort common valuation techniques used by investors, such as the price/earnings ratio. Thus, profit or loss needs to contain all information relevant to investors. Misuse of OCI would undermine the credibility of net income. The use of OCI as a temporary holding for cash flow hedging instruments and foreign currency translation is noncontroversial.

However, other treatments such the policy of IFRS 9 to allow value changes in equity investments to go through OCI, are not accepted universally.

US GAAP will require value changes in all equity investments to go through profit or loss. Accounting for actuarial gains and losses on defined benefit schemes are presented through OCI and

certain large US corporations have been hit hard with the losses incurred on these schemes. The presentation of these items in OCI would have made no difference to the ultimate settled liability but if they had been presented in profit or loss, the problem may have been dealt with earlier. An assumption that an unrealised loss has little effect on the business is an incorrect one. The Discussion Paper on the Conceptual Framework considers three approaches to profit or loss and reclassification. The first approach prohibits reclassification. The other approaches, the narrow and broad approaches, require or permit reclassification. The narrow approach allows recognition in OCI for bridging items or mismatched remeasurements. While the broad approach has an additional category of transitory measurements (for example, remeasurement of a defined benefit obligation) which would allow the IASB greater flexibility. The narrow approach significantly restricts the types of items that would be eligible to be presented in OCI and gives the IASB little discretion when developing or amending IFRSs.

A bridging item arises where the IASB determines that the statement of comprehensive income would communicate more relevant information about financial performance if profit or loss reflected a different measurement basis from that reflected in the statement of financial position For example, if a debt instrument is measured at fair value in the statement of financial position, but is recognised in profit or loss using amortised cost, then amounts previously reported in OCI should be reclassified into profit or loss on impairment or disposal of the debt instrument. The IASB argues that this is consistent with the amounts that would be recognised in profit or loss if the debt instrument were to be measured at amortised cost.

A mismatched remeasurement arises where an item of income or expense represents an economic phenomenon so incompletely that, in the opinion of the IASB, presenting that item in profit or loss would provide information that has little relevance in assessing the entity‘s financial performance. An example of this is when a derivative is used to hedge a forecast transaction; changes in the fair value of the derivative may arise before the income or expense resulting from the forecast transaction. The argument is that before the results of the derivative and the hedged item can be matched together, any gains or losses resulting from the remeasurement of the derivative, to the extent that the hedge is effective and qualifies for hedge accounting, should be reported in OCI. Subsequently, those gains or losses are reclassified into profit or loss when the forecast transaction affects profit or loss. This allows users to see the results of the hedging relationship.

The IASB‘s preliminary view is that any requirement to present a profit or loss total or subtotal could also result in some items being reclassified. The commonly suggested attributes for differentiation between profit or loss and OCI (realised/unrealised, frequency of occurrence, operating/non-operating, measurement certainty/uncertainty, realisation in the short/long-term or outside management control) are difficult to distil into a set of principles.

Therefore, the IASB is suggesting two broad principles, namely:

(a) Profit or loss provides the primary source of information about the return an entity has made on its economic resources in a period.
(b) To support profit or loss, OCI should only be used if it makes profit or loss more relevant. The IASB feels that changes in cost-based measures and gains or losses resulting from initial recognition should not be presented in OCI and that the results of transactions, consumption and impairments of assets and fulfilment of liabilities should be recognised in profit or loss in the period in which they occur.

As a performance measure, profit or loss is more used although there are a number of other performance measures derived from the statement of profit or loss and OCI.

WHEN DOES DEBT SEEM TO BE EQUITY?
The difference between debt and equity in an entity‘s statement of financial position is not easy to distinguish for preparers of financial statements. Many financial instruments have both features with the result that this can lead to inconsistency of reporting.
The International Accounting Standards Board (IASB) agreed with respondents from its public consultation on its agenda (December 2012 report) that it needs greater clarity in its definitions of assets and liabilities for debt instruments. This should therefore help eliminate some uncertainty when accounting for assets and financial liabilities or non-financial liabilities. The respondents felt that defining the nature of liabilities would advance the IASB‘s thinking on distinguishing between financial instruments that should be classified as equity and those instruments that should be classified as liabilities.

The objective of IAS 32, Presentation is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and liabilities. The classification of a financial instrument by the issuer as either debt or equity can have a significant impact on the entity‘s gearing ratio, reported earnings, and debt covenants. Equity classification can avoid such impact but may be perceived negatively if it is seen as diluting existing equity interests. The distinction between debt and equity is also relevant where an entity issues financial instruments to raise funds to settle a business combination using cash or as part consideration in a business combination.

Understanding the nature of the classification rules and potential effects is critical for management and must be borne in mind when evaluating alternative financing options. Liability classification normally results in any payments being treated as interest and charged to earnings, which may affect the entity's ability to pay dividends on its equity shares.

The key feature of debt is that the issuer is obliged to deliver either cash or another financial asset to the holder. The contractual obligation may arise from a requirement to repay principal or interest or dividends. Such a contractual obligation may be established explicitly or indirectly but through the terms of the agreement. For example, a bond that requires the issuer to make interest payments and redeem the bond for cash is classified as debt. In contrast, equity is any contract that evidences a residual interest in the entity‘s assets after deducting all of its liabilities. A financial instrument is an equity instrument only if the instrument includes no contractual obligation to deliver cash or another financial asset to another entity, and if the instrument will or may be settled in the issuer's own equity instruments.

For instance, ordinary shares, where all the payments are at the discretion of the issuer, are classified as equity of the issuer. The classification is not quite as simple as it seems. For example, preference shares required to be converted into a fixed number of ordinary shares on a fixed date, or on the occurrence of an event that is certain to occur, should be classified as equity. A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity‘s own equity instruments. The classification of this type of contract is dependent on whether there is variability in either the number of equity shares delivered or variability in the amount of cash or financial assets received. A contract that will be settled by the entity receiving or delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash, or another financial asset, is an

equity instrument. This has been called the fixed for fixed ‘requirement. However, if there is any variability in the amount of cash or own equity instruments that will be delivered or received, then such a contract is a financial asset or liability as applicable. For example, where a contract requires the entity to deliver as many of the entity‘s own equity instruments as are equal in value to a certain amount, the holder of the contract would be indifferent whether it received cash or shares to the value of that amount. Thus, this contract would be treated as debt.

Other factors that may result in an instrument being classified as debt are:

- Is redemption at the option of the instrument holder?
- Is there a limited life to the instrument?
- Is redemption triggered by a future uncertain event that is beyond the control of both the holder and issuer of the instrument?
- Are dividends non-discretionary?

Similarly, other factors that may result in the instrument being classified as equity are whether the shares are non-redeemable, whether there is no liquidation date or where the dividends are discretionary.

The classification of the financial instrument as either a liability or as equity is based on the principle of substance over form. Two exceptions from this principle are certain puttable instruments meeting specific criteria and certain obligations arising on liquidation. Some instruments have been structured with the intention of achieving particular tax, accounting or regulatory outcomes, with the effect that their substance can be difficult to evaluate.
The entity must make the decision as to the classification of the instrument at the time that the instrument is initially recognised. The classification is not subsequently changed based on changed circumstances. For example, this means that a redeemable preference share, where the holder can request redemption, is accounted for as debt even though legally it may be a share of the issuer.

In determining whether a mandatorily redeemable preference share is a financial liability or an equity instrument, it is necessary to examine the particular contractual rights attached to the instrument's principal and return elements. The critical feature that distinguishes a liability from an equity instrument is the fact that the issuer does not have an unconditional right to avoid delivering

cash or another financial asset to settle a contractual obligation. Such a contractual obligation could be established explicitly or indirectly. However, the obligation must be established through the terms and conditions of the financial instrument. Economic necessity does not result in a financial liability being classified as a liability. Similarly, a restriction on the ability of an entity to satisfy a contractual obligation, such as the company not having sufficient distributable profits or reserves, does not negate the entity's contractual obligation.

Some instruments are structured to contain elements of both a liability and equity in a single instrument.

Such instruments – for example, bonds that are convertible into a fixed number of equity shares and carry interest – are accounted for as separate liability and equity components. 'Split accounting' is used to measure the liability and the equity components upon initial recognition of the instrument. This method allocates the fair value of the consideration for the compound instrument into its liability and equity components. The fair value of the consideration in respect of the liability component is measured at the fair value of a similar liability that does not have any associated equity conversion option. The equity component is assigned the residual amount. IAS 32 requires an entity to offset a financial asset and financial liability in the statement of financial position only when the entity currently has a legally enforceable right of set-off and intends either to settle the asset and liability on a net basis or to realise the asset and settle the liability simultaneously. An amendment to IAS 32 has clarified that the right of set-off must not be contingent on a future event and must be immediately available. It also must be legally enforceable for all the parties in the normal course of business, as well as in the event of default, insolvency or bankruptcy. Netting agreements, where thelegal right of offset is only enforceable on the occurrence of some future event – such as default of a partydo not meet the offsetting requirements.

Rights issues can still be classified as equity when the price is denominated in a currency other than the entity‘s functional currency. The price of the right is denominated in currencies other than the issuer‘s functional currency, when the entity is listed in more than one jurisdiction or is required to do so by law or regulation. A fixed price in a non-functional currency would normally fail the fixed number of shares for a fixed amount of cash requirement in IAS 32 to be treated as an equity instrument. As a result, it is treated as an exception in IAS 32 and therefore treated as equity.

Two measurement categories exist for financial liabilities: fair value through profit or loss (FVTPL) and amortised cost. Financial liabilities held for trading are measured at FVTPL, and all other financial liabilities are measured at amortised cost unless the fair value option is applied.

The IASB and FASB have been working on a project to replace IAS 32 and converge IFRS and US GAAP for a number of years. The =Financial instruments with characteristics of equity project (=FICE‘) resultedin a discussion paper in 2008, but has been put on hold.

Introduction

INTEGRATED REPORTING <IR>

In 2013, the International Integrated Reporting Council (IIRC) released a framework for integrated reporting. This followed a three-month global consultation and trials in 25 countries.

The framework establishes principles and concepts that govern the overall content of an integrated report.

An integrated report sets out how the organisation‘s strategy, governance, performance and prospects, which lead to the creation of value. There is no benchmarking for the above matters and the report is aimed primarily at the private sector but it could be adapted for public sector and not-for-profit organisations.

The aim is to give investors and shareholders a broader picture of how companies make their money and their prospects in the short, medium and long term.

Designed to be an approach to reporting which accurately conveys an organisation's business model and its sources of value creation over time, the IR model recognises six types of capital, with these being consumed by a business and also created as part of its business processes. It is the way that capitals are consumed, transformed and created which is at the heart of the IR model.

Purpose of integrated report

The primary purpose of an integrated report is to explain to providers of financial capital how an organisation creates value over time. An integrated report benefits all stakeholders interested in a company‘s ability to create value, including employees, customers, suppliers, business partners,

local communities, legislators, regulators and policymakers, although it is not directly aimed at all stakeholders. Providers of financial capital can have a significant effect on the capital allocation and attempting to aim the report at all stakeholders would be an impossible task and would reduce the focus and increase the length of the report. This would be contrary to the objectives of the report, which is value creation.

Historical financial statements are essential in corporate reporting, particularly for compliance purposes, but do not provide meaningful information regarding business value. Users need a more forward-looking focus without the necessity of companies providing their own forecasts and projections. Companies have recognised the benefits of showing a fuller picture of company value and a more holistic view of the organisation.

The International Integrated Reporting Framework will encourage the preparation of a report that shows their performance against strategy, explains the various capitals used and affected, and gives a longerterm view of the organisation.

The integrated report is creating the next generation of the annual report as it enables stakeholders to make a more informed assessment of the organisation and its prospects.

EXPLANATION

Definition: <IR> demonstrates how organisations really create value:

- It is a concise communication of an organisations strategy, governance and performance
- It demonstrates the links between its financial performance and its wider social, environmental and economic context
- It shows how organisations create value over the short, medium and long term
- Integrated reporting is about integrating material financial and non-financial information to enable investors and other stakeholders to understand how an organisation is really performing. An integrated report looks beyond the traditional time frame and scope of the current financial report by addressing the wider as well as longer-term consequences of decisions and action and by making clear the link between financial and non-financial value.

It is important that an integrated report demonstrates the link between an organisation's strategy, governance and business model

- An Integrated Report should be a single report which is the organization's primary report – in most jurisdictions the Annual Report or equivalent.

PRINCIPLE-BASED FRAMEWORK

The IIRC has set out a principle-based framework rather than specifying a detailed disclosure and measurement standard. This enables each company to set out its own report rather than adopting a checklist approach. The culture change should enable companies to communicate their value creation better than the often boilerplate disclosures under IFRS. The report acts as a platform to explain what creates the underlying value in the business and how management protects this value. This gives the report more business relevance rather than the compliance led approach currently used.

Integrated reporting will not replace other forms of reporting but the vision is that preparers will pull together relevant information already produced to explain the key drivers of their business's value.

Information will only be included in the report where it is material to the stakeholder's assessment of the business. There were concerns that the term 'materiality' had a certain legal connotation, with the result that some entities may feel that they should include regulatory information in the integrated report.

However, the IIRC concluded that the term should continue to be used in this context as it is well understood.

The integrated report aims to provide an insight into the company's resources and relationships that are known as the capitals and how the company interacts with the external environment and the capitals to create value. These capitals can be financial, manufactured, intellectual, human social and relationship, and natural capital, but companies need not adopt these classifications. Following are the capitals (resources and relationships) on which the organisation depends, how the organisation uses them and its impact upon them!

Financial capital: This comprises the pool of funds available to the business, which includes both debt and equity finance. This description of financial capital focuses on the source of funds.

Manufactured capital: This is the human-created, production-oriented equipment and tools used in production or service provision, such as buildings, equipment and infrastructure. Manufactured capital draws a distinction is between inventory (as a short-term asset) and plant and equipment (tangible capital).

Human capital: Is understood to consist of the knowledge, skills and experience of the company‘s employees and managers, as they are relevant to improving operational performance.

Intellectual capital: This is a key element in an organisation‘s future earning potential, with a close link between investment in R&D, innovation, human resources and external relationships, as these can determine the organisation‘s competitive advantage.

Natural capital:This is any stock of natural resources or environmental assets which provide a flow of useful goods or services, now and in the future.

Social and relationships capital: Comprises the relationships within anorganisation, as well as those between an organisation and its external stakeholders, depending on where social boundaries are drawn.

These relationships should enhance both social and collective well-being.
The purpose of this framework is to establish principles and content that governs the report, and to explain the fundamental concepts that underpin them. The report should be concise, reliable and complete, including all material matters, both positive and negative in a balanced way and without material error.

Key components

Integrated reporting is built around the following key components:

1. Organisational overview and the external environment under which it operates
2. Governance structure and how this supports its ability to create value

3. Business model
4. Risks and opportunities and how they are dealing with them and how they affect the company‘s ability to create value
5. Strategy and resource allocation
6. Performance and achievement of strategic objectives for the period and outcomes
7. Outlook and challenges facing the company and their implications
8. The basis of presentation needs to be determined, including what matters are to be included in the integrated report and how the elements are quantified or evaluated.

The framework does not require discrete sections to be compiled in the report but there should be a high level review to ensure that all relevant aspects are included. The linkage across the above content can create a key storyline and can determine the major elements of the report such that the information relevant to each company would be different.

RELATIONSHIP WITH STAKEHOLDERS

An integrated report should provide insight into the nature and quality of the organisation‘s relationships with its key stakeholders, including how and to what extent the organisation understands, takes into account and responds to their needs and interests. Further, the report should be consistent over time to enable comparison with other entities.

South African organisations have been acknowledged as among the leaders in this area of corporate reporting with many listed companies and large state-owned companies having issued integrated reports.

An integrated report may be prepared in response to existing compliance requirements – for example, a management commentary. Where that report is also prepared according to the framework, or even beyond the framework, it can be considered an integrated report. An integrated report may be either a standalone report or be included as a distinguishable part of another report or communication. For example, it can be included in the company‘s financial statements.

The IIRC considered the nature of value and value creation. These terms can include the total of all the capitals, the benefit captured by the company, the market value or cash flows of the organisation and the successful achievement of the company‘s objectives. However, the conclusion reached was

that the framework should not define value from any one particular perspective because value depends upon the individual company‘s own perspective. It can be shown through movement of capital and can be defined as value created for the company or for others. An integrated report should not attempt to quantify value as assessments of value are left to those using the report.

Many respondents felt that there should be a requirement for a statement from those =charged with governance ‘acknowledging their responsibility for the integrated report in order to ensure the reliability and credibility of the integrated report. Additionally, it would increase the accountability for the content of the report.

The IIRC feels the inclusion of such a statement may result in additional liability concerns, such as inconsistency with regulatory requirements in certain jurisdictions, and could lead to a higher level of legal liability. The IIRC also felt that the above issues might result in a slower take-up of the report and decided that those =charged with governance‘ should, in time, be required to acknowledge their responsibility for the integrated report while, at the same time, recognising that reports in which they were not involved would lack credibility.

There has been discussion about whether the framework constitutes suitable criteria for report preparation and for assurance. The questions asked concerned measurement standards to be used for the information reported and how a preparer can ascertain the completeness of the report. There were concerns over the ability to assess future disclosures, and recommendations were made that specific criteria should be used for measurement, the range of outcomes and the need for any confidence intervals be disclosed. The preparation of an integrated report requires judgment but there is a requirement for the report to describe its basis of preparation and presentation, including the significant frameworks and methods used to quantify or evaluate material matters. Also included is the disclosure of a summary of how the company determined the materiality limits and a description of the reporting boundaries.

The IIRC has stated that the prescription of specific KPIs and measurement methods is beyond the scope of a principles-based framework. The framework contains information on the principle-based approach and indicates that there is a need to include quantitative indicators whenever practicable and possible.

Additionally, consistency of measurement methods across different reports is of paramount importance.

There is outline guidance on the selection of suitable quantitative indicators.
A company should consider how to describe the disclosures without causing a significant loss of competitive advantage. The entity will consider what advantage a competitor could actually gain from information in the integrated report, and will balance this against the need for disclosure. Companies struggle to communicate value through traditional reporting. The framework can prove an effective tool for businesses looking to shift their reporting focus from annual financial performance to long-term shareholder value creation. The framework will be attractive to companies who wish to develop their narrative reporting around the business model to explain how the business has been developed.

SUMMARY – BENEFITS AND CHALLENGES
Benefits of <IR>
Integrated reporting gives a dashboard 'view of an organisation's activities and performance in this broader context.

- Systems and Accountability. The need to report on each type of capital would create and enhance a system of internal measurement which would record and monitor each type for the purposes of reporting.
- Decision-making. The connections made through <IR> enable investors to better evaluate the combined impact of the diverse factors, or =capitals', affecting the business.
- Reputation. The greater transparency and disclosure of <IR> should result in a decrease inreputation risk, which in turn should result in a lower cost of, and easier access to, sources of finance.
- Harmonisation. <IR> provides a platform for standard-setters and decision-makers to develop and harmonise business reporting. This in turn should reduce the need for costly bureaucracy imposed by central authorities.
- Communications. The information disclosed, once audited and published, would create a fuller and more detailed account of the sources of added value, and threats to value (i.e. risks), for shareholders and others.

- Relationships. The information will lead to a higher level of trust from, and engagement with, a wide range of stakeholders.

Challenges in IR

- Progress towards IR will happen at different speeds in different countries as regulations and directors duties vary across the globe
- Directors liability will increase as they will be reporting on the future and on evolving issues
- A balance will need to be created between benefits of reporting and the desire to avoid disclosing competitive information
- It will take time to convince management to overcome focus on short term rewards.

Use of concepts of materiality in applying the IR Framework

Integrated reporting (IR) takes a broader view of business reporting, emphasising the need for entities to provide Information to help investors assess the sustainability of their business model. IR is a process which results in Communication, through the integrated report, about value creation over time. An integrated report is a concise

Communication about how an organisation‘s strategy, governance, performance and prospects lead to the creation of Value over the short, medium and long term. The materiality definition for IR purposes would consider that material.

Matters are those which are of such relevance and importance that they could substantively influence the assessments of the intended report users. In the case of IR, relevant matters are those which affect or have the potential to affect the organisation‘s ability to create value over time. For financial reporting purposes, the nature or extent of an omission or misstatement in the organisation‘s financial statements deter mines relevance. Matters which are considered material for financial reporting purposes, or for other forms of reporting, may also be material for IR purposes if they are of such relevance and importance that they could change the assessments of providers of financial capital with regard to the organisation‘s ability to create value. Another feature of materiality for IR purposes is that the definition emphasises the involvement of senior management and those charged with governance in the materiality determination process in order for the organisation to determine how best to disclose its value creation development in a meaningful and transparent way.

THE PROFESSIONAL AND ETHICAL DUTIES OF THE ACCOUNTANT

Code of Ethics

(a) Integrity – to be straightforward and honest in all professional and business relationships.	A professional accountant shall not knowingly be associated with reports, returns, communications or other information where the professional accountant believes that the information: (a) Contains a materially false or misleading statement; (b) Contains statements or information furnished recklessly; or (c) Omits or obscures information required to be included where such omission or obscurity would be misleading.
(b) Objectivity – to not allow bias, conflict of interest or undue influence of others to override professional or business judgments	A professional accountant may be exposed to situations that may impair objectivity. It is impracticable to define and prescribe all such situations. A professional accountant shall not perform a professional service if a circumstance or relationship biases or unduly influences the accountant‘s professional judgment with respect to that service.
(c) Professional Competence	The principle of professional competence and due care

and Due Care – to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.	imposes the following obligations on all professional accountants: (a) To maintain professional knowledge and skill at the level required to ensure that clients or employers receive competent professional service; and (b) To act diligently in accordance with applicable technical and professional standards when providing professional services. Competent professional service requires the exercise of sound judgment in applying professional knowledge and skill in the performance of such service. Professional competence may be divided into two separate phases: (a) Attainment of professional competence; and (b) Maintenance of professional competence.

(d) Confidentiality – to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.	The principle of confidentiality imposes an obligation on all professional accountants to refrain from: (a) Disclosing outside the firm or employing organization confidential information acquired as a result of professional and business relationships without proper and specific authority or unless there is a legal or professional right or duty to disclose; and (b) Using confidential information acquired as a result of professional and business relationships The following are circumstances where professional accountants are or may be required to disclose confidential information or when such disclosure may be appropriate: (a) Disclosure is permitted by law and is authorized by the client or the employer; (b) Disclosure is required by law, for example: (i) Production of documents or other provision of evidence in the course of legal proceedings; or (ii) Disclosure to the appropriate public authorities of

	infringements of the law that come to light; and by law: (i) To comply with the quality review of a member body or professional body; (ii) To respond to an inquiry or investigation by a member body or regulatory body; (iii) To protect the professional interests of a professional accountant in legal proceedings; or (iv) To comply with technical standards and ethics requirements. In deciding whether to disclose confidential information, relevant factors to consider include: • Whether the interests of all parties, including third parties whose interests may be affected, could be harmed if the client or employer consents to the disclosure of information by the professional accountant. • Whether all the relevant information is known and substantiated, to the extent it is practicable; when the situation involves unsubstantiated facts, incomplete information or unsubstantiated conclusions, professional judgment shall be used in determining the type of disclosure to be made, if any. • The type of communication that is expected and to whom it is addressed. • Whether the parties to whom the communication is addressed are appropriate recipients.

(e) Professional Behavior to comply with relevant laws and regulations and avoid any action that discredits the profession.	The principle of professional behavior imposes an obligation on all professional accountants to comply with relevant laws and regulations and avoid any action that the professional accountant knows or should know may discredit the profession. This includes actions that a reasonable and informed third party, weighing all the specific facts and
	circumstances available to the professional accountant at that time, would be likely to conclude adversely affects the good reputation of the profession. In marketing and promoting themselves and their work, professional accountants shall not bring the profession into disrepute. Professional accountants shall be honest and truthful and not: (a) Make exaggerated claims for the services they are able to offer, The qualifications they possess, or experience they have gained; or (b) Make disparaging references or unsubstantiated comparisons to the work of others.

a) Self-interest threat – the threat that a financial or other interest will inappropriately influence the professional accountant‘s judgment or behavior;

b) Self-review threat – the threat that a professional accountant will not appropriately evaluate the results of a previous judgment made or service performed by the professional accountant, or by another individual within the professional accountant‘s firm or employing organization, on which the accountant will rely when forming a judgment as part of providing a current service;

c) Advocacy threat – the threat that a professional accountant will promote a client‘s or employer‘s position to the point that the professional accountant‘s objectivity is compromised;

d) Familiarity threat - the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work; and

e) Intimidation threat – the threat that a professional accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the professional accountant.

Ethical theories

'Absolutism' /Dogmatic/non-consequential list

Ethical absolutism is concerned with whether an action or conduct is right or wrong. Therefore, from the standpoint of ethical absolutes, some things are always right and some things are always wrong, no matter how one tries to rationalise them.

Ethical absolutism requires that individuals always defer to a set of rules to guide them in the ethical decision-making process. It holds that whether an action is ethical does not depend on the view of the person facing the dilemma; instead it depends on whether the action conforms to the given set of ethical rules and standards.

Absolutism takes no account of who is making the ethical judgement, but defers to universal principles which should guide anyone's behaviour in the situation, regardless of their background.

'Relativism' /pragmatic/consequential list

Ethical relativism is the broad acceptance that nothing is objectively right or wrong, but depends on the circumstances of the situation and the individuality of the person facing the situation or dilemma.

It suggests that an ethical position held by one person may be viewed as right for them, but may be wholly unacceptable to another person in the same situation. Relativism therefore insists that what is considered true by an individual replaces the search for an absolute truth by denying the existence

of objective moral standards. Rather, according to ethical relativism, individuals must evaluate actions on the basis of what they feel is best for them-selves.

Ethical relativism takes account of who is making the ethical decision and what their psychological, cultural and moral background is and accepts that different people will form different moral opinions of the most ethical approach to be taken in any given situation.

Kohlberg's Levels of Moral Development

Laurence Kohlberg devised a theory which explained the rationale behind human moral reasoning, where he was less concerned about the actual decision taken but rather the cognitive process which arrived at each judgement. Kohlberg described the development of individual moral and ethical reasoning through three discrete levels: pre-conventional, conventional and post-conventional.

<table>
<tr><td rowspan="2">At the pre-conventional level of moral reasoning, morality is conceived of in terms of rewards, punishments and instrumental motivations. Those demonstrating into lerance of norms and regulations in preference for self serving motives are typically pre-conventional.</td><td>1.1 Pre conventional– Obedience and punishment</td><td>At the most basic level, individuals make decisions based on punishment and reward and at this stage have not developed any particular ethical beliefs.
How can I avoid punishment?</td></tr>
<tr><td>1.2 Pre conventional– Instrumental purpose and Exchange</td><td>At a slightly higher level, individuals learn to do something for the promise of future benefits. What'sin it for me?</td></tr>
</table>

At the conventional level, morality is understood in terms of compliance with either or both of peer pressure/social expectations or regulations, laws and guidelines. A high degree of compliance is assumed to be a highly moral position. A person who is ethically engaged at the conventional level will consider it important to learn the rules and expectations which apply to them and then comply in	2.1 Conventional– Interpersonal accord and conformity	At this stage, individuals start to develop behavior patterns that are based on their family, friends, work colleagues and peers. Good behavior is that which pleases others in the immediate group Sometimes referred to as the =good boy–good girl 'orientation, this stage focuses on living up to social expectations and accepted roles in society. Due consideration is given to the expectations of peers with an emphasis on conformity when arriving at an appropriate decision.
	2.2 Conventional– Social accord and	The previous level expands from following the norms of a peer group into following the norms for society as a whole. Laws and
detail. These can concern legal rules, socialnorms and accepted standards of behaviour.	system maintenance	social norms As individuals progress towards this more advanced stage of moraldevelopment, focus shifts towards a sense of duty and responsibility by observing law and order, adhering to rules and respecting authority.

At the postconventional level, morality is understood in terms of conformance with higher 'or universal 'ethical principles as perceived by the person being considered. Post-conventional assumptions often challenge existing regulatory regimes and social norms, and so postconventional be haviour is often costly in personal terms. The nature of the higher 'ethical principles is subjective and specific to the person.	3.1 conventior Post Social and rights contract individual	The post conventional level recognises that individuals are separate from society and that the individual's perception may take precedence over society's view. Individuals start to challenge social norms. In this stage, the individual believes that laws that do not promote general welfare should be changed where necessary to meet the greater good for the greatest number. Laws are open to question but are still being upheld for the good of the community and in the name of democratic values.
	3.2 Post conventional– Universal ethical Principles	At the highest level, individuals will reject social norms by behaving in the way they believe to be right, and will campaign to change the views of others so that their norms become society's norms. Kohlberg believed that stage six existed but that very few individuals operated consistently at this level. Self - chosen ethical principals-high value is placed on justice, dignity, and equality of all persons.

Corporate Citizenship

Corporate citizenship is an approach which can be adopted by any business with the aim of shaping its core values so that they more closely align the decisions made each day by its directors, managers and employees with the needs of the society in which the business operates.

There are three principles which take into account successful corporate citizenship:

(i) Minimising any harm caused to society by the decisions and actions of a business, which could include avoiding harm to the natural environment as well as the social infrastructure.

(ii) Maximising any benefit created for society as a consequence of normal business activity. Any successful business will stimulate local economic activity and increase employment, but a good corporate citizen will do this with greater sensitivity to its environmental and social impacts.

(iii) Remaining clearly accountable and responsive to a wide range of its stakeholders, thereby combining business self-interest with a greater sense of responsibility towards society at large.

By embracing the corporate citizenship agenda, an organisation is able to recognise its fundamental rights and acknowledge that it has responsibilities towards the wider community.

Responsibilities of the business as a corporate citizen

Just as an individual has the responsibility to obey the law, fit in with the social and ethical norms of society, and behave in an appropriate way, so does a business.

Its responsibility is to always comply with the laws and social norms which apply in each country it deals with. This extends to being a good employer, maintaining prompt payment of payables accounts, encouraging good working conditions at supplier companies and similar areas of good business practice.

The 3 perspectives are:

1. Limited view: stakeholders considered when in business ‘interest (main groups considered are employees and local community)
2. Equivalent view: self interest is not primary motivation. Organization is focused on legal requirements and ethical fulfillment.
3. Extended view: Combination of self interest promoting the power that organizations have and wider responsibility towards society.

Ethical decision making model

THE AMERICAN ACCOUNTING ASSOCIATION (AAA) MODEL

The American Accounting Association (AAA) model comes from a report for the AAA written by Langenderfer and Rockness in 1990. In the report, they suggest a logical, seven-step process for decision making, which takes ethical issues into account.

The model begins, at Step 1, by establishing the facts of the case. While perhaps obvious, this step means that when the decision-making process starts, there is no ambiguity about what is under consideration.

Step 2 is to identify the ethical issues in the case. This involves examining the facts of the case and asking what ethical issues are at stake.

The third step is an identification of the norms, principles, and values related to the case. This involves placing the decision in its social, ethical, and, in some cases, professional behaviour context. In this last context, professional codes of ethics or the social expectations of the profession are taken to be the norms, principles, and values. For example, if stock market rules are involved in the decision, then these will be a relevant factor to consider in this step.

In the fourth step, each alternative course of action is identified. This involves stating each one, without consideration of the norms, principles, and values identified in Step 3, in order to ensure that each outcome is considered, however appropriate or inappropriate that outcome might be.

Then, in Step 5, the norms, principles, and values identified in Step 3 are overlaid on to the options identified in Step 4. When this is done, it should be possible to see which options accord with the norms and which do not.

In Step 6, the consequences of the outcomes are considered. Again, the purpose of the model is to make the implications of each outcome unambiguous so that the final decision is made in full knowledge and recognition of each one.

Finally, in Step 7, the decision is taken.