

ACCA

STUDY TEXT

DIPLOMA IN INTERNATIONAL FINANCIAL REPORTING

BPP Learning Media is an **ACCA Approved Content Provider**. This means we work closely with ACCA to ensure this Study Text contains the information you need to pass your exam.

In this Study Text, which has been reviewed by the **ACCA examining team**, we:

- **Include** the revised IFRSs and IASs
- **Discuss** the **best strategies** for studying for your exams
- **Highlight** the **most important elements** in the syllabus and the **key skills** you will need
- **Signpost** how each chapter links to the syllabus and the study guide
- **Provide** lots of **exam focus points** demonstrating what is expected of you in the exam
- **Emphasise key points** in regular **fast forward summaries**
- **Test your knowledge** of what you've studied in **Quick Quizzes**
- **Examine your understanding** in our **Practice Question Bank**
- **Reference** all the **important topics** in our **full Index**

FOR EXAMS IN DECEMBER 2018 AND JUNE 2019

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Helping you to pass

BPP Learning Media – Approved Content Provider

As an ACCA **Approved Content Provider**, BPP Learning Media gives you the **opportunity** to use study materials reviewed by the ACCA examining team. By incorporating the examining team's comments and suggestions regarding the depth and breadth of syllabus coverage, the BPP Learning Media Study Text provides excellent, **ACCA-approved** support for your studies.

These materials are reviewed by the ACCA examining team. The objective of the review is to ensure that the material properly covers the syllabus and study guide outcomes, used by the examining team in setting the exams, in the appropriate breadth and depth. The review does not ensure that every eventuality, combination or application of examinable topics is addressed by the ACCA Approved Content. Nor does the review comprise a detailed technical check of the content as the Approved Content Provider has its own quality assurance processes in place in this respect.

Tackling studying

Studying can be a daunting prospect, particularly when you have lots of other commitments. The **different features** of the Study Text, the **purposes** of which are explained fully on the **Chapter features** page, will help you whilst studying and improve your chances of **exam success**.

Developing exam awareness

Our Study Texts are completely **focused** on helping you pass your exam.

Our advice on **Studying for the Diploma in International Financial Reporting (DiplFR)** outlines the **content** of the exam, the **necessary skills** you are expected to be able to demonstrate and any **brought forward knowledge** you are expected to have.

Exam focus points are included within the chapters to highlight when and how specific topics were examined, or how they might be examined in the future.

Testing what you can do

Testing yourself helps you develop the skills you need to pass the exam and also confirms that you can recall what you have learnt.

We include **Questions** – lots of them – both within chapters and in the **Practice Question Bank**, as well as **Quick Quizzes** at the end of each chapter to test your knowledge of the chapter content.

Chapter features

Each chapter contains a number of helpful features to guide you through each topic.

Topic list

Topic list	Topic list

What you will be studying in this chapter and the relevant section numbers, together with ACCA syllabus references.

Introduction

Puts the chapter content in the context of the syllabus as a whole.

Study Guide

Links the chapter content with ACCA guidance.

Exam Guide

Highlights how examinable the chapter content is likely to be and the ways in which it could be examined.

Knowledge brought forward from earlier studies

What you are assumed to know from previous studies/exams.

FAST FORWARD

Summarises the content of main chapter headings, allowing you to preview and review each section easily.

Examples

Demonstrate how to apply key knowledge and techniques.

Key terms

Definitions of important concepts that can often earn you easy marks in exams.

Exam focus points

When and how specific topics were examined, or how they may be examined in the future.



Question

Give you essential practice of techniques covered in the chapter.

Chapter Roundup

A full list of the Fast Forwards included in the chapter, providing an easy source of review.

Quick Quiz

A quick test of your knowledge of the main topics in the chapter.

Practice Question Bank

Found at the back of the Study Text with more comprehensive chapter questions. Cross referenced for easy navigation.

Studying for the Diploma in International Financial Reporting

Aim

To provide qualified accountants or graduates, possessing relevant country specific qualifications or work experience with an up to date and relevant conversion course, providing practical and detailed knowledge of the key International Financial Reporting Standards (IFRSs) and how they are interpreted and applied.

Objectives

On completion of the Diploma candidates should be able to:

- Understand and explain the structure of the international professional and conceptual framework of accounting
- Apply relevant International Financial Reporting Standards (IFRSs) to key elements of financial statements
- Identify and apply disclosure requirements for entities relating to the presentation of financial statements and notes
- Prepare group financial statements (excluding statements of cash flows for groups) including subsidiaries, associates and joint arrangements

Position of the course within the overall portfolio of ACCA's qualification framework

The DipIFR builds on the technical and/or practical knowledge acquired from recognised country specific accountancy qualifications or relevant work experience. The course introduces the candidate to the wider international framework of accounting and the system of standard setting. The DipIFR concentrates on the application of conceptual and technical financial knowledge that candidates have already obtained to the specific requirements of financial reporting under IFRSs.

The DipIFR also provides essential international financial reporting knowledge and principles that will prepare candidates for the increasingly global market place and keep them abreast of international developments and how they might apply to companies and businesses.

The prerequisite knowledge for DipIFR can either come from a country specific professional qualification, from possessing a relevant degree (giving exemptions from Accountant in Business (AB); Management Accounting (MA) and Financial Accounting (FA) and Corporate and Business Law (LW) of the ACCA qualification) and two years' accounting experience, or by having three years' full-time relevant accounting experience, supported by an employer's covering letter.

Approach to examining the syllabus

The examination lasts 3 hours and 15 minutes.

Most questions will contain a mix of computational and discursive elements. Some questions will adopt a scenario/case study approach. All questions are compulsory.

	<i>Number of marks</i>
One consolidation question	40
Three scenario questions	60
	<u>100</u>

The first question will attract 40 marks. It will involve preparation of one or more of the consolidated financial statements that are examinable within the syllabus. This question will include several issues that will need to be addressed prior to performing the consolidation procedures. Generally these issues will relate to the financial statements of the parent prior to their consolidation.

The other three questions will attract 20 marks each. These will often be related to a scenario in which questions arise regarding the appropriate accounting treatment and/or disclosure of a range of issues. In such questions candidates may be expected to comment on management's chosen accounting treatment and determine a more appropriate one, based on circumstances described in the question. Occasionally one of the questions might focus more specifically on the requirements of one specific IFRS.

Some IFRSs are very detailed and complex. In the DiplIFR exam candidates need to be aware of the principles and key elements of these Standards. Candidates will also be expected to have an appreciation of the background and need for international financial reporting standards and issues related to harmonisation of accounting in a global context.

The overall pass mark for the Diploma in International Financial Reporting is 50%.

Additional information

Candidates need to be aware that the exam year will run from 1 September to the following 31 August. The cut off relating to examinable documents will be set 12 months before the start of the year.

Knowledge of the new examinable regulations issued by 31 August will be required in examination sessions being held in the following calendar year. Documents may be examinable even if the effective date is in the future.

The documents listed as being examinable are the latest that were issued prior to 31 August 2017 and will be examinable in the December 2018 and June 2019 examination sessions.

This Study Text is for exams up to and including June 2019.

Syllabus and Study Guide

The complete syllabus and study guide can be found by visiting the exam resource finder on the ACCA website: www.accaglobal.com/uk/en/student/exam-support-resources.html

Examinable Documents

International Financial Reporting Standards	
IAS 1	Presentation of financial statements
IAS 2	Inventories
IAS 8	Accounting policies, changes in accounting estimates and errors
IAS 10	Events after the reporting period
IAS 12	Income taxes
IAS 16	Property, plant and equipment
IAS 19	Employee benefits
IAS 20	Accounting for government grants and disclosure of government assistance
IAS 21	The effects of changes in foreign exchange rates
IAS 23	Borrowing costs
IAS 24	Related party disclosures
IAS 27	Separate financial statements
IAS 28	Investments in associates and joint ventures
IAS 32	Financial instruments: Presentation
IAS 33	Earnings per share
IAS 36	Impairment of assets
IAS 37	Provisions, contingent liabilities and contingent assets
IAS 38	Intangible assets
IAS 40	Investment property
IAS 41	Agriculture
IFRS 1	First time adoption of International Financial Reporting Standards
IFRS 2	Share-based payment
IFRS 3	Business combinations
IFRS 5	Non-current assets held for sale and discontinued operations
IFRS 6	Exploration for and evaluation of mineral resources
IFRS 7	Financial instruments: disclosures
IFRS 8	Operating segments
IFRS 9	Financial instruments
IFRS 10	Consolidated financial statements
IFRS 11	Joint arrangements
IFRS 12	Disclosure of interests in other entities
IFRS 13	Fair value measurement
IFRS 15	Revenue from contracts with customers
IFRS 16	Leases
Other statements	
	The Conceptual Framework for Financial Reporting

Analysis of past exams

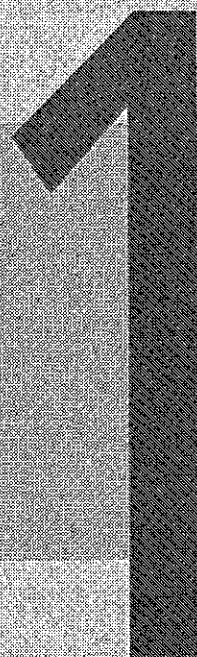
The analysis below shows the elements of the syllabus which have been examined under the current syllabus for the past four years.

Covered in Text chapter		Dec 17	Jun 17	Dec 16	Jun 16	Dec 15	Jun 15	Dec 14	Jun 14
	International sources of authority								
1	The IASB and the regulatory framework		✓						
2	The conceptual framework								
	Elements of financial statements								
3	Revenue			✓	✓	✓	✓	✓	✓
4 and 5	Accounting for tangible non-current assets		✓	✓		✓		✓	
6	Accounting for leases	✓	✓	✓			✓		✓
7	Intangible assets and goodwill		✓	✓					✓
8	Provisions, contingent liabilities and contingent assets	✓	✓	✓	✓	✓	✓	✓	
9	Employee benefits	✓						✓	✓
10	Financial instruments	✓	✓	✓	✓	✓	✓	✓	✓
11	Accounting for taxation	✓			✓	✓			✓
12	Foreign currency translation					✓			✓
13	Other assets: agriculture, mineral resources and inventories				✓	✓	✓		✓
14	Share-based payment	✓	✓	✓	✓	✓	✓	✓	✓
	Presentation of financial statements and additional disclosures								
15	Presentation of published financial statements								
16	Reporting financial performance			✓	✓	✓	✓	✓	
17	Earnings per share								
18	Related party disclosures and segment reporting	✓		✓	✓			✓	✓
19	Reporting for small and medium-sized entities								
	Financial reports for combined entities and joint arrangements								
20	Constitution of a group	✓		✓	✓	✓	✓	✓	✓
21	The consolidated statement of financial position	✓		✓		✓	✓	✓	
22	The consolidated statement of profit or loss		✓		✓			✓	✓
23	Accounting for associates								✓
24	Accounting for joint arrangements		✓						

P A R T A

International sources of authority

The IASB and the regulatory framework



Topic list	Syllabus reference
1 The need for a regulatory framework	A1
2 The International Accounting Standards Board (IASB)	A1
3 Scope and application of IFRSs	A1
4 Managing the change to IFRS	A1
5 Progress towards global harmonisation	A1
6 Benefits of and barriers to global harmonisation	A1

Introduction

In this chapter, we introduce the regulatory system run by the International Accounting Standards Board (IASB). We consider the structure of the IASB and how IFRSs are produced.

We then move on to consider how a company manages the change to IFRSs for the first time.

Finally we look at the progress towards harmonisation of accounting standards on a global scale, and the benefits of and barriers to this process.

Study guide

INTERNATIONAL SOURCES OF AUTHORITY	
A	INTERNATIONAL SOURCES OF AUTHORITY
A1	The International Accounting Standards Board and the regulatory framework
(a)	Discuss the need for International Financial Reporting Standards and possible barriers to their development
(b)	Explain the structure and constitution of the IASB and the standard setting process
(d)	Explain the progress towards international harmonisation
(e)	Account for the first-time adoption of International Financial Reporting Standards

1 The need for a regulatory framework

1.1 Introduction

The regulatory framework is the most important element in ensuring relevant and faithfully presented financial information and thus meeting the needs of shareholders and other users.

Without a single body overall responsible for producing financial reporting standards and a framework of general principles within which they can be produced, there would be no means of enforcing compliance with accounting regulations. Also, accounting regulations would be unable to evolve in a structured way in response to changes in economic conditions.

1.2 Principles-based versus rules-based systems

FAST FORWARD

A principles-based system works within a set of laid down principles. A rules-based system regulates for issues as they arise. Both of these have advantages and disadvantages.

The *Conceptual Framework*, which is discussed in more detail in the following chapter, provides the background of principles within which standards can be developed. This system is intended to ensure that standards are not produced which are in conflict with each other and also that any departure from a standard can be judged on the basis of whether or not it is in keeping with the principles set out in the *Conceptual Framework*. This is a **principles-based** system.

In the absence of a reporting framework, a more **rules-based** approach has to be adopted. This leads to a large mass of regulation designed to cover every eventuality. However, a large volume of regulatory measures does not always detect or prevent financial irregularity. One presumed advantage of rules-based systems is that the exercise of judgement is minimised. Auditors who fear litigation tend to prefer rules-based systems. It could be that a rules-based approach is appropriate for controversial areas in accounting.

1.3 Impact of globalisation

FAST FORWARD

The need for harmonised financial reporting standards arises as a result of the globalisation of business activities and operations. Harmonised financial reporting standards are intended to provide:

- A platform for wider investment choice
- A more efficient capital market
- Lower cost of capital
- Enhanced business development

The current reality is that the world's **capital markets operate** more and more freely **across borders**.

As the modern business imperative moves towards the globalisation of operations and activities, there is an underlying commercial logic that also requires a **truly global capital market**. Harmonised financial reporting standards are intended to provide:

- A platform for wider investment choice
- A more efficient capital market
- Lower cost of capital
- Enhanced business development

Globally, users of financial statements need **transparent** and **comparative information** to help them **make economic decisions**.

2 The International Accounting Standards Board (IASB)

FAST FORWARD

The IASB develops IFRSs. The main objectives of the IFRS Foundation are to raise the standard of financial reporting and eventually bring about global harmonisation of accounting standards.

2.1 Introduction

The IASB is an independent, privately funded body that develops and approves IFRSs. Prior to 2003, standards were issued as International Accounting Standards (IASs). In 2003, IFRS 1 was issued and all new standards are now designated as IFRSs.

Important

Throughout this Study Text, we will use the abbreviation IFRSs to include both IFRSs and IASs.

The members of the IASB come from several countries and have a variety of backgrounds, with a mix of auditors, preparers of financial statements, users of financial statements and academics.

The IASB operates under the oversight of the **IFRS Foundation**.

2.2 The IFRS Foundation

The IFRS Foundation (formally called the International Accounting Standards Committee Foundation or IASCF) is a not for profit, private sector body that oversees the IASB.

The objectives of the IFRS Foundation are to:

- (a) Develop a single set of high quality, understandable, enforceable and globally accepted IFRSs through its standard-setting body, the IASB
- (b) Promote the use and vigorous application of those standards
- (c) Take account of the needs of a range of sizes and types of entities in diverse economic settings (eg entities operating in emerging economies and small and medium-sized entities (SMEs))
- (d) Promote and facilitate adoption of IFRSs through the convergence of national accounting standards and IFRSs.

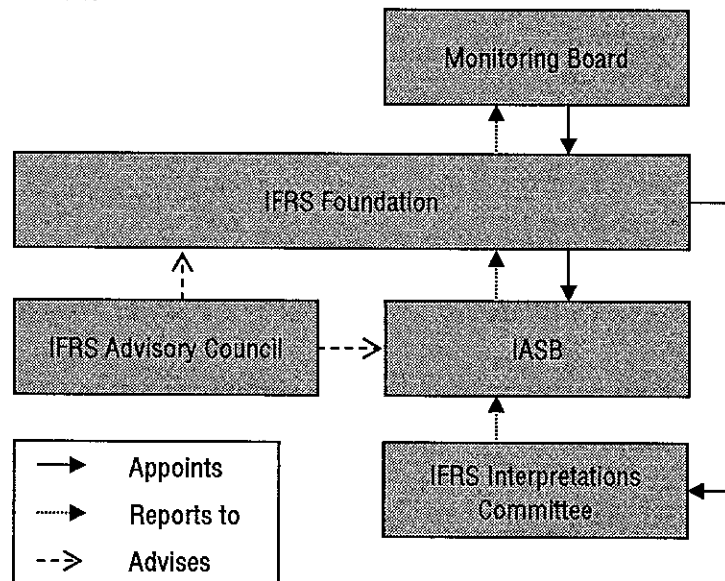
The IFRS Foundation is currently made up of 22 Trustees, who essentially monitor and fund the IASB, the IFRS Advisory Council and the IFRS Interpretations Committee. The Trustees are appointed from a variety of geographical and functional backgrounds.

Exam focus point

Knowledge of the objectives of the IFRS Foundation is important so as to provide you with the background to IFRS.

2.3 Structure of the IFRS Foundation

The structure is as follows.



Trustees. The Trustees comprise a group of individuals with diverse geographic and functional backgrounds. The Trustees appoint the Members of the Board, the IFRS Interpretations Committee and the IFRS Advisory Council. In addition to monitoring the Foundation's effectiveness and raising its funds, the Trustees will approve the budget and have responsibility for constitutional changes.

IFRS Advisory Council. The IFRS Advisory Council provides a formal vehicle for further groups and individuals with diverse geographic and functional backgrounds to give advice to the Board and, at times, to advise the Trustees. It is consulted by the IASB on all major projects and its meetings are open to the public. It advises the IASB on prioritisation of its work and on the implications of proposed standards for users and preparers of financial statements.

IFRS Interpretations Committee. The Interpretation Committee provides timely guidance on the application and interpretation of International Financial Reporting Standards. It deals with newly identified financial reporting issues not specifically addressed in IFRSs, or issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop.

2.4 IFRSs – advantages and disadvantages

The advantages and disadvantages of adopting IFRSs have to be considered by each adopting country and are being widely debated in the US at the moment.

The main advantages are seen to be:

- A business can present its financial statements on the same basis as its foreign competitors, making comparison easier.
- Cross-border listing will be facilitated, making it easier to raise capital abroad.
- Companies with foreign subsidiaries will have a common, company-wide accounting language.
- Foreign companies which are targets for takeovers or mergers can be more easily appraised.

The disadvantages are perceived to be:

- The cost of implementing IFRSs
- The belief by some that there is a lower level of detail in IFRS (compared with US GAAP)

Countries which have national standards which are very prescriptive are worried about the principles-based standards in IFRSs which require the application of judgement. This is particularly so in the US. US accountants are subject to a high degree of litigation and their defence in court is usually that they complied with the relevant sub-section of one of the hundreds of detailed standards which make up US GAAP. They fear that adoption of IFRSs will remove this defence.

3 Scope and application of IFRSs

3.1 Setting of IFRSs

FAST FORWARD

IFRSs are developed through a formal system of due process and broad international consultation involving accountants, financial analysts and other users and regulatory bodies from around the world.

3.2 Due process

The overall agenda of the IASB will initially be set by discussion with the IFRS Advisory Council. The process for developing an individual standard would involve the following steps.

- Step 1** During the early stages of a project, the IASB may establish an **Advisory Committee** to give advice on issues arising in the project. Consultation with the Advisory Committee and the IFRS Advisory Council occurs throughout the project.
- Step 2** IASB may develop and publish **Discussion Papers** for public comment.
- Step 3** Following the receipt and review of comments, the IASB would develop and publish an **Exposure Draft** for public comment.
- Step 4** Following the receipt and review of comments, the IASB would issue a final **International Financial Reporting Standard**.

The period of exposure for public comment is normally 120 days. However, in exceptional circumstances, proposals may be issued with a comment period of 30 days. Draft IFRS Interpretations are normally exposed for a 90 day comment period.

(*Due Process Handbook*, 2016: para. 6.7)

3.3 Consultation with national standard-setters

The development of an IFRS involves an **open, public process of debating technical issues** and evaluating input sought through several mechanisms. Opportunities for interested parties to participate in the development of an IFRS would include, depending on the nature of the project:

- (a) Participation in the development of views as a member of the **IFRS Advisory Council**
- (b) Participation in **advisory groups**
- (c) Submission of a **comment letter** in response to a **discussion document**
- (d) Submission of a **comment letter** in response to an **Exposure Draft**
- (e) Participation in **public hearings**
- (f) Participation in **field visits and field tests**

The IASB publishes an annual report on its activities during the past year and priorities for next year. This report provides a basis and opportunity for comment by interested parties. In addition, it is required to undertake a public consultation on its future technical agenda every three years.

The IASB reports on its technical projects on its Website. It also publishes a report on IASB decisions immediately after each IASB meeting in its newsletter *IASB Update*.

3.4 Scope

Any limitation of the applicability of a specific IFRS is made clear within that standard. IFRSs are **not intended to be applied to immaterial items, nor are they retrospective**. Each individual IFRS lays out its scope at the beginning of the standard.

3.4.1 Application

Within each individual country **local regulations** govern, to a greater or lesser degree, the issue of financial statements. These local regulations include accounting standards issued by the national regulatory bodies and/or professional accountancy bodies in the country concerned.

IFRSs do not override local regulations on financial statements. Financial statements prepared in accordance with IFRSs should simply disclose the fact where IFRSs are complied with in all material respects.

The following is our **brief summary** of the main points.

- It is difficult if not impossible to comply with both local regulations/statutes as well as IFRSs.
- In the past the regulatory bodies have either amended their standards and/or lobbied for changes in the regulations/statutes.
- Financial statements do not comply with the requirements of IFRSs, as per IAS 1, unless all IFRSs are complied with.
- It is not appropriate to try to rectify non-compliance by resorting to disclosure or explanatory material.
- A pragmatic and practical response may be to prepare two sets of financial statements
 - Set 1 For local filing purposes and complying with local regulations
 - Set 2 For international publication purposes and complying with IFRSs.

Note. The company might also resort to the fair presentation override (see Chapter 15).

3.5 Interpretation of IFRSs

The IFRS Interpretations Committee (formerly known as IFRIC (International Financial Reporting Interpretations Committee) and the Standards Interpretations Committee) assists the IASB by improving existing Standards.

The IFRS Interpretations Committee has two main responsibilities:

- Review, on a timely basis, newly identified financial reporting issues not specifically addressed in IFRSs
- Clarify issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop in the absence of authoritative guidance, with a view to reaching a consensus on the appropriate treatment.

The IFRS Interpretations Committee also helps the IASB move towards international harmonisation by working with its equivalent national-level bodies.

The IFRS Interpretations Committee, like the IASB itself, adopts a **principle-based approach**. Its intention is to provide guidance that is in line with the rest of the IFRSs. It therefore bases itself, like each of the individual Standards, first and foremost on the IASB *Conceptual Framework*. It will then look at any relevant IFRSs for principles applying the *Conceptual Framework* to that particular area. It is absolutely essential to the work of the IFRS Interpretations Committee that its interpretations are in line with IASB *Conceptual Framework* principles, rather than any other accounting principles.

The IFRS Interpretations Committee then in turn informs the IASB of any inadequacies that it finds in the *Conceptual Framework* or in existing IFRSs. If it believes that they should be modified or that a new Standard should be developed, the IFRS Interpretations Committee informs the IASB so that it can consider whether or not to do so. This helps to ensure that the *Conceptual Framework* and existing IFRSs are kept up to date for the actual financial reporting issues that the IFRS Interpretations Committee has found with them.

The IFRS Interpretations Committee develops its interpretations through a due process of consultation and debate which includes making Draft Interpretations available for public comment. The IFRS Interpretations Committee's Interpretations that it makes publicly available are the consensus views that it has reached as a result of this process.

3.5.1 Authority and application of IFRS Interpretations Committee Interpretations

The IFRS Interpretations Committee issues 'Interpretations' which carry the same authority as IFRSs, in the sense that they set out consensus views that entities must adhere to if they describe their financial statements as being prepared in accordance with IFRS.

Interpretations are applicable from the date of issue or if they specify one, from their effective date. Some Interpretations may contain 'transitional provisions' that apply to their first application.

An Interpretation then ceases to apply when it is overridden by a new IFRS (or other authoritative IASB document). When this happens, this would be mentioned in the Exposure Draft of the new, overriding IFRS (or other document). The IASB would then inform the IFRS Interpretations Committee when this happens.

3.6 IFRS Interpretations Committee due process

The IFRS Interpretations Committee discusses technical matters in meetings that are open to public observation. The due process for each project normally, but not necessarily, involves the following steps (the steps that are required under the terms of the Constitution are indicated by an asterisk*):

- (a) Staff work to identify and review all the issues associated with the topic and to consider the application of the IASB's *Conceptual Framework* to the issues
- (b) Study of national accounting requirements and practice and an exchange of views about the issues with national standard setters, including national committees that have responsibility for interpretations of national standards
- (c) Publication of a draft Interpretation for public comment if no more than four of the IFRS Interpretations Committee's members have voted against the proposal *
- (d) Consideration of all comments received on a draft Interpretation within a reasonable period of time *
- (e) Approval by the IFRS Interpretations Committee of an Interpretation if no more than four of the IFRS Interpretations Committee's members have voted against the Interpretation after considering public comments on the draft Interpretation
- (f) Approval of the Interpretation by at least nine votes of the Board

4 Managing the change to IFRS

4.1 IFRS 1 *First-time Adoption of International Financial Reporting Standards*

FAST FORWARD

- IFRS 1 gives guidance to entities applying IFRS for the first time.
- The change to IFRS must be carefully managed.

The adoption of a new body of accounting standards will inevitably have a significant effect on the accounting treatments used by an entity and on the related **systems and procedures**.

IFRS 1 *First-time Adoption of International Financial Reporting Standards* was issued to ensure that an entity's first IFRS financial statements contain high quality information that:

- (a) Is transparent for users and comparable over all periods presented
- (b) Provides a suitable starting point for accounting under IFRSs
- (c) Can be generated at a cost that does not exceed the benefits to users

(IFRS 1: para. 1)

4.1.1 General principles

An entity applies IFRS 1 in its first IFRS financial statements.

An entity's first IFRS financial statements are the first annual financial statements in which the entity adopts IFRS by an **explicit and unreserved statement of compliance** with IFRS.

Any other financial statements (including fully compliant financial statements that did not state so) are not the first set of financial statements under IFRS.

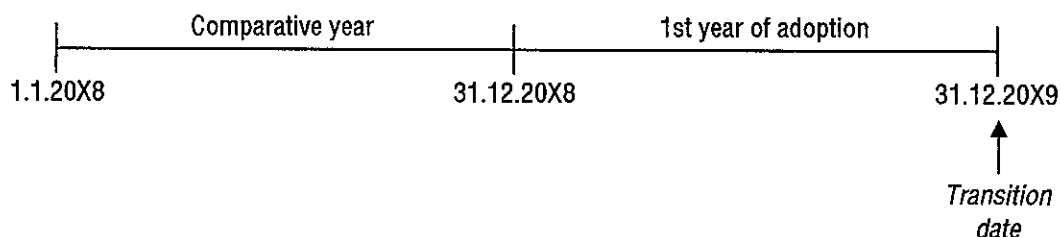
(IFRS 1: para. 3)

4.1.2 Opening IFRS statement of financial position

An entity **prepares and presents** an **opening IFRS statement of financial position** at the date of transition to IFRS as a starting point for IFRS accounting (IFRS 1: para. 6).

Generally, this will be the beginning of the **earliest comparative period shown** (ie full retrospective application). Given that the entity is applying a change in accounting policy on adoption of IFRS, IAS 1 *Presentation of Financial Statements* requires the presentation of **at least three statements of financial position** (SOPF) (and two of each of the other statements).

Illustration: Opening IFRS SOPF



Preparation of an opening IFRS statement of financial position typically involves adjusting the amounts reported at the same date under previous GAAP.

All adjustments are recognised **directly in retained earnings** (or, if appropriate, another category of equity) not in profit or loss.

4.1.3 Estimates

Estimates in the opening IFRS statement of financial position must be consistent with estimates **made at the same date under previous GAAP** even if further information is now available (in order to comply with IAS 10).

4.1.4 Transition process

(a) Accounting policies

The entity should select accounting policies that comply with IFRSs effective **at the end of the first IFRS reporting period**.

These accounting policies are used in the opening IFRS statement of financial position and throughout all periods presented. The entity does not apply different versions of IFRS effective at earlier dates.

(b) Derecognition of assets and liabilities

Previous GAAP statement of financial position may contain items that do not qualify for recognition under IFRS.

For example, IFRS does not permit capitalisation of research, staff training and relocation costs.

(c) Recognition of new assets and liabilities

New assets and liabilities may need to be recognised, for example deferred tax balances and certain provisions such as environmental and decommissioning costs.

(d) Reclassification of assets and liabilities

For example, compound financial instruments need to be split into their liability and equity components.

(e) Measurement

Value at which asset or liability is measured may differ under IFRS.

For example, discounting of deferred tax assets/liabilities not allowed under IFRS.

4.1.5 Main exemptions from applying IFRS in the opening IFRS statement of financial position

(a) **Property, plant and equipment, investment properties and intangible assets**

- (i) 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:

- (i) The same classification (acquisition or uniting of interests) is retained as under previous GAAP.
- (ii) 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.
- (iii) Items requiring a fair value measure for IFRSs are revalued at the date of transition to IFRSs.
- (iv) The carrying value of goodwill at the date of transition to IFRSs is the amount as reported under previous GAAP.

(c) **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.

(d) **Adoption of IFRS by subsidiaries, associates and joint ventures**

If a subsidiary, associate or joint venture adopts IFRS later than its parent then 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.

4.1.6 Disclosure

- (a) A **reconciliation of previous GAAP equity** to IFRSs is required at the date of transition to IFRSs and for the most recent financial statements presented under previous GAAP.
- (b) A **reconciliation of profit** for the most recent financial statements presented under previous GAAP.

Exam focus point

The transition to IFRS was tested in June 2017 for 7 marks. In the examiner's report, the examiner stated that 'only a few candidates specifically stated the need for an 'opening IFRS statement of financial position' and for reconciliations from previously reported figures to IFRS in the opening set of IFRS financial statements' (Examiner's Report June 2017, p4).

4.2 Practical issues

The implementation of the change to IFRS is likely to entail careful management in most companies. Here are some of the **change management considerations** that should be addressed.

- (a) **Accurate assessment of the task involved.** Underestimation or wishful thinking may hamper the effectiveness of the conversion and may ultimately prove inefficient.
- (b) **Proper planning.** This should take place at the overall project level, but a **detailed task analysis** could be drawn up to **control work performed**.
- (c) **Human resource management.** The project must be properly structured and staffed.

- (d) **Training.** Where there are **skills gaps**, remedial training should be provided.
- (e) **Monitoring and accountability.** An overly relaxed attitude could spell danger. Implementation progress should be **monitored** and **regular meetings** set up so that participants can **personally account for what they are doing** as well as **flag up any problems** as early as possible. **Project drift** should be avoided.
- (f) **Achieving milestones.** Successful completion of key steps and tasks should be appropriately acknowledged, ie what managers call 'celebrating success', so as to **sustain motivation and performance**.
- (g) **Physical resourcing.** The need for IT **equipment** and **office space** should be properly assessed.
- (h) **Process review.** Care should be taken not to perceive the change as a one-off quick fix. Any change in **future systems** and processes should be assessed and properly implemented.
- (i) **Follow-up procedures.** As with general good management practice, the **follow up procedures** should be planned in to **make sure that the changes stick** and that any further changes are identified and addressed.

4.2.1 Financial reporting infrastructure

As well as sound management judgement, implementation of IFRS requires a sound financial reporting infrastructure. Key aspects of this include the following:

- (a) **A robust regulatory framework.** For IFRS to be successful, they must be rigorously enforced.
- (b) **Trained and qualified staff.** Many preparers of financial statements will have been trained in local GAAP and not be familiar with the principles underlying IFRS, let alone the detail. Some professional bodies provide conversion qualifications – for example, the ACCA's Diploma in International Financial Reporting – but the availability of such qualifications and courses may vary from country to country.
- (c) **Availability and transparency of market information.** This is particularly important in the determination of fair values, which are such a key component of many IFRSs.
- (d) **High standards of corporate governance and audit.** This is all the more important in the transition period, especially where there is resistance to change.

Overall, there are significant advantages to the widespread adoption of IFRS, but if the transition is to go well, there must be a realistic assessment of potential challenges.

4.3 Other implementation challenges

4.3.1 More detailed rules

Implementation of International Financial Reporting Standards entails **a great deal of work** for many companies, particularly those in countries where local GAAP has not been so onerous. For example, many jurisdictions will not have had such detailed rules about recognition, measurement and presentation of financial instruments, and many will have had no rules at all about share-based payment.

A challenge for preparers of financial statements is also **a challenge for users**. When financial statements become far more complex under IFRS than they were under local GAAP, users may find them hard to understand, and consequently of little relevance.

4.3.2 Presentation

Many developed countries have legislation requiring set formats and layouts for financial statements. For example, in the UK there is the Companies Act 2006. IFRS demands that presentation is in accordance with IAS 1 *Presentation of Financial Statements*, but this standard allows alternative forms of presentation. In choosing between alternatives, **countries tend to adopt the format that is closest to local GAAP**, even if this is not necessarily the best format. For example, UK companies are likely to adopt the two-statement

format for the statement of profit or loss and other comprehensive income, because this is closest to the two-statement approach used in the past.

4.3.3 Concepts and interpretation

Although later IAS and IFRS are based to an extent on the IASB *Conceptual Framework*, there is **no consistent set of principles** underlying them. The *Conceptual Framework* itself is being revised, and there is controversy over the direction the revision should take. Consequently, preparers of accounts are likely to think in terms of the conceptual frameworks – if any – that they have used in developing local GAAP, and these may be different from that of the IASB. German accounts, for example, have traditionally been aimed at the tax authorities.

Where IFRS themselves give clear guidance, this may not matter but, where there is uncertainty, preparers of accounts will fall back on their traditional conceptual thinking.

4.3.4 Choice of accounting treatment

Although many so-called 'allowed alternatives' have been eliminated from IFRS in recent years, choice of treatment remains. For example, IAS 16 *Property, Plant and Equipment* gives a choice of either the cost model or the revaluation model for a class of property, plant or equipment.

It could be argued that choice is a good thing, as companies should be able to select the treatment that most fairly reflects the underlying reality. However, in the context of change to IFRS, there is a danger that companies **will choose the alternative that closely matches the approach followed under local GAAP, or the one that is easier to implement**, regardless of whether this is the best choice.

4.3.5 Inconsistency in recognition or measurement methods

As well as the broader choice of which accounting model to adopt (cost or revaluation, and so on), IFRS allows further choice on recognition and measurement within a particular reporting standard. In countries where local GAAP is not very developed on this matter, preparers of accounts might well **choose the least complex option**, or the option that does not involve making a decision, rather than the correct one.

4.3.6 Timing and exemptions taken

IFRSs have provision for early adoption, and this can affect comparability, although impact of a new standard must be disclosed under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Further, IFRS 1 *First-time Adoption of International Financial Reporting Standards* permits a number of exemptions during the periods of transition to IFRS. This gives scope for manipulation, as companies may take advantage of only those exemptions which produce a favourable view of the financial statements.

4.3.7 Subjectivity

The extent of the impact will vary, depending on how developed local GAAP was before the transition. However, in general it is likely that **management judgement will have a greater impact** on financial statements prepared under IFRS than under local GAAP. The main reasons for this are as follows:

- (a) The **volume** of rules and number of areas addressed by IFRS is likely to be greater than that under local GAAP
- (b) Many issues are perhaps **addressed for the first time**, for example share-based payment
- (c) IFRSs are likely to be **more complex** than local standards
- (d) IFRSs allow **choice** in many cases, which leads to subjectivity
- (e) Selection of **valuation method** (see above)

5 Progress towards global harmonisation

FAST FORWARD

Close co-ordination between IASB due process and due process of national standard-setters is important to the success of the IASB's mandate. This area is constantly changing.

You should be able to discuss **progress towards harmonisation**, **barriers to harmonisation** and the **advantages** of harmonisation.

5.1 Worldwide effect of IFRS and the IASB

The IASB, and before it the IASC, has now been in existence for more than 40 years, therefore it is worth looking at the effect it has had in that time.

5.1.1 Europe

FAST FORWARD

The EC has required that **since 2005** consolidated accounts of all listed companies should **comply with IFRS**.

The objective of the European Commission (EC) is to build a fully integrated, globally competitive market. A key element of this is the harmonisation of company law across the member states, supported by an effective enforcement regime. The commission is uniquely the only organisation whose accounting standards are legally enforceable, in the form of directives which must be included in the national legislation of member states. However, the directives have been criticised as they might become constraints on the application of worldwide standards, and may bring accounting standardisation and harmonisation into the political arena.

The EC adopted a regulation which required that from 2005 consolidated financial statements of listed companies were required to comply with IFRS. The implications of this measure are far reaching. However, member states currently have the discretion to extend the implementation of IFRS to include non-listed companies.

In 2009 the IASB issued the *IFRS for SMEs* (Small and medium-sized entities) and this was an important step toward the introduction of IFRS for all companies.

Many commentators believe that in the light of the EC's commitment to IFRS it is only a matter of time before national standard-setting bodies are, in effect, replaced by the IASB, with national standards falling into disuse. However, the IASB will continue to need input and expertise from valued national standard-setters.

5.1.2 United States of America

FAST FORWARD

Convergence between IFRS and US GAAP is **one of the bigger issues** in the global implementation of IFRS.

Convergence between IFRS and US GAAP is **one of the bigger issues** in the global implementation of IFRS. At present, all US entities must file accounts prepared under US GAAP. However, in 2002 the IASB and its US equivalent, the FASB (Financial Accounting Standards Board) agreed to harmonise their work plans, and to work towards reducing the differences between IFRS and US GAAP.

In 2008 the **Securities and Exchange Commission (SEC)** issued a 'roadmap' for the use of IFRS, proposing the eventual mandatory use of IFRS for all US public companies by 2014. At present, only overseas issuers of securities are allowed to file accounts under IFRS (without having to provide a reconciliation to US GAAP).

The SEC's 'roadmap' allowed some companies the option of using IFRS from 2010. It envisaged phasing in IFRS by requiring companies to file accounts under both IFRS and US GAAP for the two years 2012-2014, after which accounts would be prepared under IFRS alone.

This has **not played out in practice** and the pace of convergence has slowed over the past few years. The SEC's draft strategic plan for 2014–2018 states within its objectives:

Due to the increasingly global nature of the capital markets, the agency will work to promote higher quality financial reporting worldwide and will consider, among other things, whether a single set of high-quality global accounting standards is achievable.

(US SEC 2014, p. 8)

This appears to be a **step backwards from its previous roadmap**. However, the FASB continues to work collaboratively with the IASB. Two recent standards, IFRS 15 *Revenue from Contracts with Customers* and IFRS 16 *Leases* were both the **result of IASB/FASB collaboration**.

5.1.3 United Kingdom

Listed entities in the UK are required to prepare their consolidated financial statements in accordance with IFRS. Listed entities without any subsidiaries can choose to report under IFRS or UK GAAP. All other entities can choose to report under IFRS or UK GAAP. UK GAAP now consists of six standards, which are based on IFRS.

- FRS 100 *Application of Financial Reporting Requirements* – provides rules and guidance on how to select the appropriate accounting framework for a particular entity or group.
- FRS 101 *Reduced Disclosure Framework* – provides a reduced disclosure framework for qualifying entities, such as subsidiaries of groups reporting their individual entity financial statements under EU adopted IFRS.
- FRS 102 *The Financial Reporting Standard Applicable in the UK and Republic of Ireland* – replaces the majority of old UK accounting standards, adopts an IFRS-based framework and improves accounting for financial instruments. It is based on the IFRS for SMEs, amended to ensure compliance with company law. It is intended for the financial reports of all UK entities (with the exception of the group financial statements of listed entities which must be prepared in accordance with IFRS). 'Small' entities, as defined in UK law, can choose to report under Section 1A of FRS 102 which requires simpler formats and reduced disclosure. Similarly 'micro' entities can choose to report under FRS 105 – see below.
- FRS 103 *Insurance Contracts* – based on IFRS 4 and applicable to companies applying FRS 102 which hold insurance contracts.
- FRS 104 *Interim Financial Reporting* – based on IAS 34 and intended for use in the preparation of interim financial reports for those entities that apply FRS 102.
- FRS 105 *The Financial Reporting Standard Applicable to the Micro-entities Regime* – based on FRS 102, but significantly simplified for micro entities.

UK companies currently reporting under IFRS are allowed to move to FRS 101 or 102 if they are reporting under IFRS on a voluntary basis. Those companies required to report under IFRS (consolidated financial statements of a listed company) will continue to do so.

5.1.4 Japan

The IASB and the Accounting Standards Board of Japan (ASBJ) have been working together to achieve convergence of IFRSs and Japanese Generally Accepted Accounting Principles (GAAP) since 2005. This work was formalised in 2007 with the Tokyo Agreement. Since 2010, certain qualifying listed companies in Japan have been allowed to use IFRSs as designated by the Financial Services Agency of Japan (FSA) in their consolidated financial statements, in lieu of Japanese GAAP.

IFRSs may not be used in statutory separate financial statements.

Although Japan has considered potential mandatory adoption of IFRS by public companies for some time, a decision is yet to be made. Currently, Japan is promoting greater use of IFRSs based on voluntary adoption. For example, the ASBJ is considering approving 'endorsed IFRS' which would be available for voluntary adoption by Japanese companies.

5.1.5 Other

In certain countries, the application of IFRS is **mandatory** for all domestic listed companies. The following provides an example of some of the countries, but the list is not exhaustive: Barbados, Cyprus, China, Georgia, Jamaica, Jordan, Kenya, Kuwait, Malawi, Mauritius, Nepal, Peru, Serbia and Trinidad and Tobago.

Countries that implemented IFRS for the 2005 European ruling in respect of the consolidated financial statements of public listed companies include Austria, Belgium, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Liechtenstein, Lithuania, Luxembourg, the Netherlands, Norway, Poland, Portugal, Slovenia, Slovak Republic, Spain, Sweden and the United Kingdom.

Many non-European countries also require their listed companies to adopt IFRS. These include Australia, Bahamas, Bahrain, Chile, Costa Rica, Egypt, Hong Kong, Kenya, Kuwait, Mauritius, New Zealand, and South Africa.

There are some countries where the implementation of IFRS is **not mandatory but discretionary**. These include Aruba, Bermuda, Bolivia, Cayman Islands, Dominica, El Salvador, Gibraltar, Japan, Laos, Lesotho, Swaziland, Switzerland, Turkey, Uganda, Zambia and Zimbabwe.

However, there are several countries where the **use of IFRS is not currently permitted**. The following are some of the countries, but the list is not exhaustive: Cuba, Indonesia, Iran, India, Senegal, Thailand, Tunisia and Vietnam.

6 Benefits of and barriers to global harmonisation

FAST FORWARD

Harmonisation in accounting is likely to come from international accounting standards, but not in the near future. There are enormous difficulties to overcome, both technical and political.

6.1 Benefits of harmonisation

The benefits of harmonisation will be based on the benefits to users and preparers of accounts, as follows:

- (a) **Investors**, both individual and corporate, would gain confidence by being able to **evaluate the comparable financial results** of different companies internationally as well as nationally when making investment decisions.
- (b) **Multinational companies** would benefit from harmonisation for many reasons including the following:
 - (i) Better access would be gained to foreign investor funds.
 - (ii) Management control would be improved, because harmonisation would aid internal communication of financial information.
 - (iii) Appraisal of foreign entities for take-overs and mergers would be more straightforward.
 - (iv) It would be easier to comply with the reporting requirements of overseas stock exchanges.
 - (v) Preparation of group accounts would be less complex.
 - (vi) A reduction in audit costs might be achieved.
 - (vii) Transfer of accounting staff across national borders would be simpler.
- (c) **Governments of developing countries would save time and money** if they could adopt international standards and, if these were used internally, governments of developing countries could attempt to control the activities of foreign multinational companies in their own country. These companies could not 'hide' behind foreign accounting practices which may be difficult to understand.
- (d) **Tax authorities**. It would be easier to calculate the tax liability of investors, including multinationals who receive income from overseas sources.

- (e) **Regional economic groups usually promote trade** within a specific geographical region. This would be **aided by common accounting practices** within the region.
- (f) **Large international accounting firms would** benefit as accounting and auditing would be more straightforward if similar accounting practices existed throughout the world.

6.2 Barriers to harmonisation

There are undoubtedly many barriers to international harmonisation: if there were not then greater progress would probably have been made by now. The main problems are as follows:

- (a) **Different purposes of financial reporting.** In some countries the purpose is solely for tax assessment, while in others it is for investor decision-making.
- (b) **Different legal systems.** These prevent the development of certain accounting practices and restrict the options available.
- (c) **Different user groups.** Countries have different ideas about who the relevant user groups of financial reporting are and their respective importance. In the USA, investor and creditor groups are given prominence, while in Europe employees enjoy a higher profile.
- (d) **Needs of developing countries.** Developing countries are obviously behind in the standard-setting process and they need to first develop the basic standards and principles already in place in most developed countries.
- (e) **Nationalism** is demonstrated in an unwillingness to accept another country's standard.
- (f) **Cultural differences** result in objectives for financial reporting and accounting systems differing from country to country.
- (g) **Unique circumstances.** Some countries may be experiencing unusual circumstances which affect all aspects of everyday life and impinge on the ability of companies to produce proper reports, for example hyperinflation, civil war, currency restriction and so on.
- (h) **The lack of strong accountancy bodies.** Many countries do not have strong independent accountancy or business bodies which would support better standards and greater harmonisation.

Chapter Roundup

- A principles-based system works within a set of laid down principles. A rules-based system regulates for issues as they arise. Both of these have advantages and disadvantages.
- The need for harmonised financial reporting standards arises as a result of the globalisation of business activities and operations. Harmonised financial reporting standards are intended to provide:
 - A platform for wider investment choice
 - A more efficient capital market
 - Lower cost of capital
 - Enhanced business development
- The IASB develops IFRSs. The main objectives of the IFRS Foundation are to raise the standard of financial reporting and eventually bring about global harmonisation of accounting standards.
- IFRSs are developed through a formal system of due process and broad international consultation involving accountants, financial analysts and other users and regulatory bodies from around the world.
- IFRS 1 gives guidance to entities applying IFRS for the first time.
- The **change to IFRS** must be carefully managed.
- **Close co-ordination** between IASB due process and due process of national standard-setters is important to the success of the IASB's mandate. This area is constantly changing.
- You should be able to discuss **progress towards harmonisation, barriers to harmonisation** and the **advantages** of harmonisation.
- The EC has required that **since 2005** consolidated accounts of all listed companies should **comply with IFRS**.
- Convergence between IFRS and US GAAP is **one of the bigger issues** in the global implementation of IFRS.
- **Harmonisation** in accounting is likely to come from international accounting standards, but not in the near future. There are enormous difficulties to overcome, both technical and political.

Quick Quiz

- 1 Which of the following is **not** an objective of the IFRS Foundation?
 - A To enforce IFRSs in most countries
 - B To develop IFRSs through the IASB
 - C To bring about convergence of accounting standards and IFRSs
 - D To take account of the financial reporting needs of SMEs
- 2 Fill in the blanks.

The IFRS issues which aid users' interpretation of IFRSs.
- 3 What happened in 2005 for listed companies in the UK?
 - A IFRSs to be used for all financial statements
 - B IFRSs to be used for consolidated financial statements
- 4 What was the SEC 'Roadmap'?
- 5 The IASB is responsible for the standard-setting process. True or false?
- 6 Which preparers and users of accounts can be expected to benefit from global harmonisation of accounting?

Answers to Quick Quiz

- 1 A The IFRS Foundation has no powers of enforcement.
- 2 The IFRS **Interpretations Committee** issues **Interpretations** which aid users' interpretation of IFRSs.
- 3 B IFRSs to be used for consolidated financial statements
- 4 An agreement allowing some companies the option of using IFRS from 2010. It envisaged phasing in IFRS by requiring companies to file accounts under both IFRS and US GAAP for the two years 2012–2014, after which accounts would be prepared under IFRS alone.
- 5 True
- 6 Investors, multinational companies, governments of developing countries, the authorities (overseas income), regional economic groups, large international accounting firms

Now try the questions below from the Practice Question Bank

Number	Level	Marks	Time
Q1	Introductory	n/a	n/a
Q2	Introductory	n/a	n/a

2

The conceptual framework

Topic list	Syllabus reference
1 Conceptual framework and GAAP	A1
2 The IASB's <i>Conceptual Framework</i>	A1
3 The objective of general purpose financial reporting	A1
4 Underlying assumption	A1
5 Qualitative characteristics of useful financial information	A1
6 The elements of financial statements	A1
7 Recognition of the elements of financial statements	A1
8 Measurement of the elements of financial statements	A1
9 Fair presentation and compliance with IFRS	A1

Introduction

A conceptual framework for financial reporting can be defined as an attempt to codify existing **generally accepted accounting practice (GAAP)** in order to reappraise current accounting standards and to produce new standards.

Under IFRS we have the IASB *Conceptual Framework*.

Study guide

A1	The International Accounting Standards Board (IASB) and the regulatory framework
(c)	Understand and interpret the Financial Reporting Framework

Exam focus point

ACCA's website contains many useful articles, including the following relating to topics covered in this chapter:

- *The need for and an understanding of a conceptual framework*
- *IASB's Conceptual Framework for Financial Reporting*

Available at www.accaglobal.com/gb/en/student/exam-support-resources/fundamentals-exams-study-resources/f7/technical-articles.html.

1 Conceptual framework and GAAP

FAST FORWARD

There are advantages and disadvantages to having a conceptual framework.

1.1 The search for a conceptual framework

A **conceptual framework**, in the field we are concerned with, is a statement of generally accepted theoretical principles which form the frame of reference for financial reporting. These theoretical principles provide the basis for the development of new accounting standards and the evaluation of those already in existence.

The financial reporting process is concerned with providing information that is useful in the business and economic decision-making process. Therefore a conceptual framework will form the **theoretical basis** for determining which events should be accounted for, how they should be measured and how they should be communicated to the user.

Although it is theoretical in nature, a conceptual framework for financial reporting has highly practical final aims.

The **danger of not having a conceptual framework** is demonstrated in the way some countries' standards have developed over recent years; standards tend to be produced in a **haphazard and fire-fighting approach**. Where an agreed framework exists, the standard-setting body act as an architect or designer, rather than a fire-fighter, building accounting rules on the foundation of sound, agreed basic principles.

The lack of a conceptual framework also means that fundamental principles are tackled more than once in different standards, thereby producing **contradictions and inconsistencies** in basic concepts, such as those of prudence and matching. This leads to ambiguity and it affects the true and fair concept of financial reporting.

Another problem with the lack of a conceptual framework has become apparent in the USA. The large number of **highly detailed standards** produced by the Financial Accounting Standards Board (FASB) has created a financial reporting environment governed by specific rules rather than general principles. This would be avoided if a cohesive set of principles were in place.

A conceptual framework can also bolster standard setters **against political pressure** from various 'lobby groups' and interested parties. Such pressure would only prevail if it was acceptable under the conceptual framework.

1.2 Advantages and disadvantages of a conceptual framework

Advantages

- (a) The situation is avoided whereby standards are developed on a patchwork basis, where a particular accounting problem is recognised as having emerged, and resources were then channelled into **standardising accounting practice** in that area, without regard to whether that particular issue was necessarily the most important issue remaining at that time without standardisation.
- (b) As stated above, the development of certain standards (particularly national standards) has been subject to considerable **political interference** from interested parties. Where there is a conflict of interest between user groups on which policies to choose, policies deriving from a conceptual framework will be **less open to criticism** that the standard-setter buckled to external pressure.
- (c) Without a conceptual framework, some standards may concentrate on **profit or loss** whereas some may concentrate on the **valuation of net assets** (statement of financial position), so that they conflict with one another.

Disadvantages

- (a) Financial statements are intended for a **variety of users**, and it is not certain that a single conceptual framework can be devised which will suit all users.
- (b) Given the diversity of user requirements, there may be a need for a variety of accounting standards, each produced for a **different purpose** (and with different concepts as a basis).
- (c) It is not clear that a conceptual framework makes the task of **preparing and then implementing** standards any easier than without a framework.

2 The IASB's *Conceptual Framework*

FAST FORWARD

The IASB's *Conceptual Framework* describes the fundamental concepts for financial reporting and is used by the IASB to guide the development of IFRSs.

The IASB's *Conceptual Framework for Financial Reporting* is being issued in phases. The first phase, comprising Chapters 1 and 3, was the result of a joint project between the IASB and the United States' accounting standards setter, FASB, and was published in September 2010. The remaining text is taken from the IASB's 1989 *Framework for the Preparation and Presentation of Financial Statements*. The *Conceptual Framework* is therefore currently as follows:

Chapter 1: The objective of general purpose financial reporting

Chapter 2: The reporting entity (to be issued)

Chapter 3: Qualitative characteristics of useful financial information

Chapter 4: Remaining text of the 1989 *Framework*:

- Underlying assumption
- The elements of financial statements
- Recognition of the elements of financial statements
- Measurement of the elements of financial statements
- Concepts of capital and capital maintenance

Exam focus point

In March 2018, the IASB issued the new complete *Conceptual Framework*. The new complete *Conceptual Framework* is not currently examinable because it was issued after ACCA's cut-off date for examinable documents. The *Conceptual Framework* as described in this chapter remains examinable for exams up to June 2019.

2.1 Introduction

The introduction to the *Conceptual Framework* points out the fundamental reason why financial statements are produced worldwide, ie to **satisfy the requirements of external users**, but recognises that practice varies due to the individual pressures in each country. The preface emphasises the way **financial statements are used to make economic decisions** and thus financial statements should be prepared to this end. The types of economic decisions for which financial statements are likely to be used include the following:

- Decisions to buy, hold or sell equity investments
- Assessment of management stewardship and accountability
- Assessment of the entity's ability to pay employees
- Assessment of the security of amounts lent to the entity
- Determination of taxation policies
- Determination of distributable profits and dividends
- Inclusion in national income statistics
- Regulations of the activities of entities

(*Conceptual Framework: Introduction*)

Any additional requirements imposed by **national governments** for their own purposes should not affect financial statements produced for the benefit of other users.

The *Conceptual Framework* recognises that financial statements can be prepared using a **variety of models**. Although the most common is based on historical cost and a nominal unit of currency (ie pound sterling, US dollar etc), the *Conceptual Framework* can be applied to financial statements prepared under a range of models.

2.2 Purpose and status

The introduction gives a list of the purposes of the *Conceptual Framework*.

- (a) To assist the Board in the **development of future IFRSs** and in its review of existing IFRSs
- (b) To assist the Board in **promoting harmonisation** of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by IFRSs
- (c) To assist **national standard-setting bodies** in developing national standards
- (d) To assist **preparers of financial statements** in applying IFRSs and in dealing with topics that have yet to form the subject of an IFRS
- (e) To assist **auditors** in forming an opinion as to whether financial statements comply with IFRSs
- (f) To assist **users of financial statements** in interpreting the information contained in financial statements prepared in compliance with IFRSs. Users of accounting information consist of investors, employees, lenders, suppliers and other trade creditors, customers, government and their agencies and the public.
- (g) To provide those who are interested in the work of the IASB with **information** about its approach to the formulation of IFRSs

The *Conceptual Framework* is not an IFRS and so does not overrule any individual IFRS. In the (rare) case of conflict between an IFRS and the *Conceptual Framework*, the **IFRS will prevail**.

(*Conceptual Framework: Purpose and status*)

2.2.1 Scope

The *Conceptual Framework* deals with:

- (a) The **objective** of financial statements
- (b) The **qualitative characteristics** that determine the usefulness of information in financial statements

- (c) The **definition, recognition and measurement** of the elements from which financial statements are constructed
- (d) Concepts of **capital and capital maintenance**

(*Conceptual Framework: Scope*)

3 The objective of general purpose financial reporting

FAST FORWARD

The *Conceptual Framework* states that:

'The objective of general purpose financial reporting is to provide 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' (*Conceptual Framework: OB2*).

These users need information about:

- The **economic resources of the entity**
- The **claims against the entity**
- Changes in the entity's **economic resources and claims**

Information about the entity's **economic resources and the claims against it** helps users to assess the entity's liquidity and solvency and its likely needs for additional financing.

Information about a reporting entity's financial performance (the **changes in its economic resources and claims**) helps users to understand the return that the entity has produced on its economic resources. This is an indicator of how efficiently and effectively management has used the resources of the entity and is helpful in predicting future returns.

The *Conceptual Framework* makes it clear that this information should be prepared on an **accruals basis**.

Key term

Accruals basis. The effects of transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.

Financial statements prepared under the accruals basis show users past transactions involving cash and also obligations to pay cash in the future and resources which represent cash to be received in the future.

Information about a reporting entity's cash flows during a period also helps users assess the entity's **ability to generate future net cash inflows** and gives users a better understanding of its operations.

(*Conceptual Framework: OB2–11*)

4 Underlying assumption

FAST FORWARD

Going concern is the underlying assumption in preparing financial statements.

4.1 Going concern

Key term

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 need to liquidate or curtail materially the scale of its operations. It is 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**.

(*Conceptual Framework: para. 4.1*)

If the entity is not a going concern, an entity should use a different basis of accounting, such as to account for the organisation on a 'break up' basis. For example, a company loses its main customer and the future trading of the organisation is put into doubt, the directors may consider valuing the business based on what the individual assets are worth if the business went into liquidation (and the assets sold at their market value).

5 Qualitative characteristics of useful financial information

FAST FORWARD

The *Conceptual Framework* states that qualitative characteristics are the attributes that make financial information useful to users.

Chapter 3 of the *Conceptual Framework* distinguishes between **fundamental** and **enhancing** qualitative characteristics, for analysis purposes. Fundamental qualitative characteristics distinguish useful financial reporting information from information that is not useful or that is misleading. Enhancing qualitative characteristics distinguish more useful information from less useful information.

The two **fundamental qualitative** characteristics are **relevance** and **faithful representation**.

(*Conceptual Framework*: QC5)

5.1 Relevance

Key term

Relevance. Relevant information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or are already aware of it from other sources.

(*Conceptual Framework*: QC5)

The relevance of information is affected by its **nature** and its **materiality**.

Key term

Materiality. Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity.

(*Conceptual Framework*: QC11)

5.2 Faithful representation

Key term

Faithful representation. Financial reports represent **economic phenomena** in words and numbers. To be useful, financial information must not only represent relevant phenomena but must **faithfully represent** the phenomena that it purports to represent.

(*Conceptual Framework*: QC12)

To be a faithful representation information must be **complete**, **neutral** and **free from error**.

'A **complete** depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations' (*Conceptual Framework*: QC13).

'A **neutral** depiction is without bias in the selection or presentation of financial information' (*Conceptual Framework*: QC14). This means that information must not be manipulated in any way in order to influence the decisions of users.

'**Free from error** means there are no errors or omissions in the description of the phenomenon and no errors made in the process by which the financial information was produced' (*Conceptual Framework*: QC15). It does not mean that no inaccuracies can arise, particularly where estimates have to be made.

5.2.1 Substance over form

This is **not a separate qualitative characteristic** under the *Conceptual Framework*. The IASB says that to do so would be redundant because it is **implied in faithful representation**. Faithful representation of a transaction is only possible if it is accounted for according to its **substance and economic reality**.

5.3 Enhancing qualitative characteristics

5.3.1 Comparability

Key term

Comparability. Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or date.

(*Conceptual Framework*: QC21)

Consistency, although related to comparability, **is not the same**. It refers to the use of the same methods for the same items (ie consistency of treatment) either from period to period within a reporting entity or in a single period across entities.

The **disclosure of accounting policies** is particularly important here. Users must be able to distinguish between different accounting policies in order to be able to make a valid comparison of similar items in the financial statements of different entities.

When an entity **changes an accounting policy**, the change is applied retrospectively so that the results from one period to the next can still be usefully compared.

Comparability is **not the same as uniformity**. Entities should change accounting policies if those policies become inappropriate.

Corresponding information for preceding periods should be shown to enable comparison over time.

(*Conceptual Framework*: QC22–25)

5.3.2 Verifiability

Key term

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

(*Conceptual Framework*: QC26)

Information that can be independently verified is generally more decision-useful than information that cannot.

5.3.3 Timeliness

Key term

Timeliness. Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older information is the less useful it is.

(*Conceptual Framework*: QC29)

Information may become less useful if there is a delay in reporting it. There is a **balance between timeliness and the provision of reliable information**.

If information is reported on a timely basis when not all aspects of the transaction are known, it may not be complete or free from error.

Conversely, if every detail of a transaction is known, it may be too late to publish the information because it has become irrelevant. The overriding consideration is how best to satisfy the economic decision-making needs of the users.

5.3.4 Understandability

Key term

Understandability. Classifying, characterising and presenting information clearly and concisely makes it understandable.

(Conceptual Framework QC30)

Financial reports are prepared for users who have a **reasonable knowledge of business and economic activities** and who review and analyse the information diligently. Some phenomena are inherently complex and cannot be made easy to understand. Excluding information on those phenomena might make the information easier to understand, but without it those reports would be incomplete and therefore misleading. Therefore matters should not be left out of financial statements simply due to their difficulty as even well-informed and diligent users may sometimes need the aid of an advisor to understand information about complex economic phenomena.

The cost constraint on useful financial reporting

This is a pervasive constraint, not a qualitative characteristic. When information is provided, its benefits must exceed the costs of obtaining and presenting it. This is a **subjective area** and there are other difficulties: others, not the intended users, may gain a benefit; also the cost may be paid by someone other than the users. It is therefore difficult to apply a cost-benefit analysis, but preparers and users should be aware of the constraint.

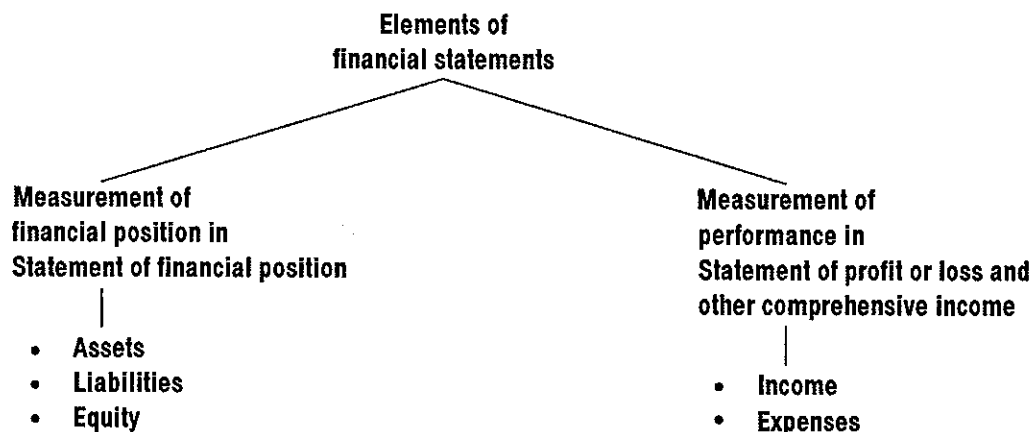
6 The elements of financial statements

FAST FORWARD

Transactions and other events are grouped together in broad **classes** and in this way their financial effects are shown in the financial statements. These broad classes are the **elements** of financial statements.

(Conceptual Framework para. 4.2)

The *Conceptual Framework* lays out these elements as follows.



A process of **sub-classification** then takes place for presentation in the financial statements, eg assets are classified by their nature or function in the business to show information in the best way for users to take economic decisions.

6.1 Financial position

We need to define the three terms listed under this heading above.

Key terms

- **Asset.** A resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.
- **Liability.** 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.
- **Equity.** The residual interest in the assets of the entity after deducting all its liabilities.

(Conceptual Framework: para. 4.4)

These definitions are important, but they do not cover the **criteria for recognition** of any of these items, which are discussed in the next section of this chapter. This means that the definitions may include items which would not actually be recognised in the statement of financial position because they fail to satisfy recognition criteria particularly the **probable flow of any economic benefit** to or from the business.

Whether an item satisfies any of the definitions above will depend on the **substance and economic reality** of the transaction, not merely its legal form. For example, consider a lease for a 'right-of-use' asset (see Chapter 6).

6.2 Assets

We can look in more detail at the components of the definitions given above.

Key term

Future economic benefit. The potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. The potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the cost of production.

(Conceptual Framework: para. 4.8)

Assets are usually employed to produce goods or services for customers; customers will then pay for these. **Cash itself** renders a service to the entity due to its command over other resources.

The existence of an asset, particularly in terms of **control**, is not reliant on:

- (a) **Physical form** (hence patents and copyrights); *nor*
- (b) **Legal rights** (hence leases).

Transactions or events **in the past** give rise to assets; those expected to occur in the future do not in themselves give rise to assets. For example, an intention to purchase a non-current asset does not, in itself, meet the definition of an asset.

(Conceptual Framework: para. 4.13)

6.3 Liabilities

Again we can look more closely at some aspects of the definition. An essential characteristic of a liability is that the entity has a **present obligation**.

Key term

Obligation. A duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

(Conceptual Framework: para. 4.15)

It is important to distinguish between a present obligation and a **future commitment**. A management decision to purchase assets in the future does not, in itself, give rise to a present obligation.

Settlement of a present obligation will involve the entity giving up resources embodying economic benefits in order to satisfy the claim of the other party. This may be done in various ways, not just by payment of cash.

Liabilities must arise from **past transactions or events**. In the case of, say, recognition of future rebates to customers based on annual purchases, the sale of goods in the past is the transaction that gives rise to the liability.

(*Conceptual Framework* para. 4.18)

6.3.1 Provisions

Is a provision a liability? The *Conceptual Framework* states that '[...] when a provision involves a present obligation and satisfies the rest of the definition [of a liability], it is a liability even if the amount has to be estimated. Examples include provisions for payments to be made under existing warranties and provisions to cover pension obligations' (para. 4.19).



Question

Assets and liabilities

Consider the following situations. In each case, do we have an asset or liability within the definitions given by the *Conceptual Framework*? Give reasons for your answer.

- (a) Pat Co has purchased a patent for \$20,000. The patent gives the company sole use of a particular manufacturing process which will save \$3,000 a year for the next five years.
- (b) Baldwin Co paid Don Brennan \$10,000 to set up a car repair shop, on condition that priority treatment is given to cars from the company's fleet.
- (c) Deals on Wheels Co provides a warranty with every car sold.

Answer

- (a) This is an asset, albeit an intangible one. There is a past event, control and future economic benefit (through cost savings).
- (b) This cannot be classified as an asset. Baldwin Co has no control over the car repair shop and it is difficult to argue that there are 'future economic benefits'.
- (c) The warranty claims in total constitute a liability; the business has taken on an obligation. It would be recognised when the warranty is issued rather than when a claim is made.

6.4 Equity

Equity is defined above as a **residual**, but it may be sub-classified in the statement of financial position. This will indicate legal or other restrictions on the ability of the entity to distribute or otherwise apply its equity. Some reserves are required by statute or other law, eg for the future protection of creditors. The amount shown for equity depends on the **measurement of assets and liabilities**. It has nothing to do with the market value of the entity's shares.

(*Conceptual Framework* para. 4.20)

6.5 Performance

Profit is used as a **measure of performance**, or as a basis for other measures (eg earnings per share). It depends directly on the measurement of income and expenses, which in turn depend (in part) on the concepts of capital and capital maintenance adopted.

(*Conceptual Framework* para. 4.24)

The elements of income and expense are therefore defined.

Key terms

- **Income.** 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.
- **Expenses.** 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.

(Conceptual Framework: para. 4.25)

6.6 Income

Both **revenue** and **gains** are included in the definition of income. **Revenue** arises in the course of ordinary activities of an entity.

Key term

Gains represent increases in economic benefits and as such they are no different in nature from revenue.

(Conceptual Framework: para. 4.30)

Gains include those arising on the disposal of non-current assets. The definition of income also includes **unrealised gains**, eg on revaluation of marketable securities.

6.7 Expenses

As with income, the definition of expenses includes losses as well as those expenses that arise in the course of ordinary activities of an entity.

Key term

Losses represent decreases in economic benefits and as such they are no different in nature from other expenses.

(Conceptual Framework: para. 4.34)

Losses will include those arising on the disposal of non-current assets. The definition of expenses will also include **unrealised losses**, eg the fall in value of an investment.

7 Recognition of the elements of financial statements

FAST FORWARD

Items which meet the definition of assets or liabilities may still not be recognised in financial statements because they must also meet certain **recognition criteria**.

Key term

Recognition. The process of incorporating in the statement of financial position or statement of profit or loss and other comprehensive income an item that meets the definition of an element and satisfies the following criteria for recognition:

- (a) It is probable that any future economic benefit associated with the item will flow to or from the entity
- (b) The item has a cost or value that can be measured with reliability

(Conceptual Framework: paras. 4.37–4.38)

Regard must be given to **materiality** (see Section 5 above).

7.1 Probability of future economic benefits

Probability here means the **degree of uncertainty** that the future economic benefits associated with an item will flow to or from the entity. This must be judged on the basis of the **characteristics of the entity's environment** and the **evidence available** when the financial statements are prepared.

7.2 Reliability of measurement

The cost or value of an item, in many cases, **must be estimated**. The *Conceptual Framework* states, however, that 'the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability' (para. 4.41). Where no reasonable estimate can be made, the item should not be recognised, although its existence should be disclosed in the notes, or other explanatory material.

Items may still qualify for recognition **at a later date** due to changes in circumstances or subsequent events.

7.3 Assets which cannot be recognised

The recognition criteria do not cover items which many businesses may regard as assets. A skilled workforce is an undoubted asset but workers can leave at any time so there can be no certainty about the probability of future economic benefits. A company may have come up with a new name for its product which is greatly increasing sales but, as it did not buy the name, the name does not have a cost or value that can be reliably measured, so it is not recognised.

(*Conceptual Framework*: para. 4.43)

7.4 Recognition of items

We can summarise the recognition criteria for assets, liabilities, income and expenses, based on the definition of recognition given above.

Item	Recognised in	When
Asset	The statement of financial position	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.
Liability	The statement of financial position	It is probable that an outflow 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	The statement of profit or loss and other comprehensive income	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	The statement of profit or loss and other comprehensive income	A 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.

8 Measurement of the elements of financial statements

FAST FORWARD

A number of different measurement bases are used in financial statements. They include:

- Historical cost
- Current cost
- Realisable (settlement) value
- Present value of future cash flows

Measurement is defined as follows.

Key term

Measurement. The process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the statement of financial position and statement of profit or loss and other comprehensive income.

(*Conceptual Framework*: para. 4.54)

Key terms

This involves the selection of a particular **basis of measurement**. A number of these are used to different degrees and in varying combinations in financial statements. They include the following.

Historical cost. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

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. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

Realisable (settlement) value. Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values; that is, the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

Present value. Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

(Conceptual Framework: para. 4.55)

Historical cost is the most commonly adopted measurement basis, but this is usually combined with other bases, eg inventory is carried at the lower of cost and net realisable value.

Recent standards use the concept of **fair value**, which is defined by **IFRS 13** as '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' (IFRS 13: Appendix A).

Example

A machine was purchased on 1 January 20X8 for \$3m. That was its original cost. It has a useful life of 10 years and under the **historical cost convention** it will be carried at **original cost less accumulated depreciation**. So in the financial statements at 31 December 20X9 it will be carried at:

$$\$3\text{m} - (0.3 \times 2) = \$2.4\text{m}$$

The **current cost** of the machine, which will probably also be its fair value, will be fairly easy to ascertain if it is not too specialised. For instance, two year old machines like this one may currently be sold for \$2.5m, so that will be an appropriate fair value.

The **net realisable value** of the machine will be the amount that could be obtained from selling it, less any costs involved in making the sale. If the machine had to be dismantled and transported to the buyer's premises at a cost of \$200,000, the NRV would be \$2.3m.

The **present value** of the machine will be the discounted value of the future cash flows that it is expected to generate. If the machine is expected to generate \$500,000 per annum for the remaining eight years of its life and if the company's cost of capital is 10%, present value will be calculated as:

$$\$500,000 \times 5.335^* = \$2667,500$$

* Cumulative present of \$1 per annum for eight years discounted at 10%

9 Fair presentation and compliance with IFRS

Most importantly, financial statements should **present fairly** the financial position, financial performance and cash flows of an entity. **Compliance with IFRS** is presumed to result in financial statements that achieve a fair presentation.

(IAS 1: para. 15)

IAS 1 stipulates that financial statements shall present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the *Conceptual Framework*.

The following points made by IAS 1 expand on this principle (para. 7).

- (a) **Compliance with IFRS** should be disclosed
- (b) **All relevant IFRS** must be followed if compliance with IFRS is disclosed
- (c) Use of an **inappropriate accounting treatment** cannot be rectified either by disclosure of accounting policies or notes/explanatory material

IAS 1 states what is required for a fair presentation.

- (a) Selection and application of **accounting policies**
- (b) **Presentation of information** in a manner which provides relevant, reliable, comparable and understandable information
- (c) **Additional disclosures** where required

Chapter Roundup

- There are advantages and disadvantages to having a conceptual framework.
- The IASB's *Conceptual Framework* describes the fundamental concepts for financial reporting and is used by the IASB to guide the development of IFRSs.
- The *Conceptual Framework* states that:
'The objective of general purpose financial reporting is to provide 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' (*Conceptual Framework*: OB2).
- **Going concern** is the underlying assumption in preparing financial statements.
- The *Conceptual Framework* states that qualitative characteristics are the attributes that make financial information useful to users.
- Transactions and other events are grouped together in broad **classes** and in this way their financial effects are shown in the financial statements. These broad classes are the **elements** of financial statements.
(*Conceptual Framework*: para. 4.2)
- Items which meet the definition of assets or liabilities may still not be recognised in financial statements because they must also meet certain **recognition criteria**.
- A number of different measurement bases are used in financial statements. They include:
 - Historical cost
 - Current cost
 - Realisable (settlement) value
 - Present value of future cash flows

Quick Quiz

- 1 Define a 'conceptual framework'.
- 2 What are the advantages and disadvantages of developing a conceptual framework?
- 3 The needs of which category of user are paramount when preparing financial statements?
- 4 Define 'relevance'.
- 5 In which two ways should users be able to compare an entity's financial statements?
- 6 A provision can be a liability. True or false?
- 7 Define 'recognition'.
- 8 The cost or value of items in the financial statements is never estimated. True or false?
- 9 What is the most common basis of measurement used in financial statements?

Answers to Quick Quiz

- 1 This is a statement of generally accepted theoretical principles, which form the frame of reference for financial reporting.
- 2 *Advantages*
 - Standardised accounting practice
 - Less open to criticism
 - Avoids standards that conflict with one another (statement of profit or loss and other comprehensive income v statement of financial position).*Disadvantages*
 - Variety of users, so not all will be satisfied
 - Variety of standards for different purposes
 - Preparing and implementing standards not necessarily any easier
- 3 Needs of investors
- 4 Information has relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming (or correcting) their past evaluations.
- 5
 - Through time to identify trends
 - With other entities' statements
- 6 True. It satisfies the definition of a liability but the amount may need to be estimated.
- 7 See Key Term Section 7.
- 8 False. Monetary values are often estimated.
- 9 Historical cost

Now try the questions below from the Practice Question Bank

Number	Level	Marks	Time
Q3	Introductory	n/a	n/a
Q4	Introductory	n/a	n/a

P
A
R
T

B

Elements of financial statements

Revenue

3

Topic list	Syllabus reference
1 IFRS 15 <i>Revenue from Contracts with Customers</i>	B1
2 Recognition and measurement	B1
3 Common types of transaction	B1
4 Presentation and disclosure	B1
5 Performance obligations satisfied over time	B1

Introduction

Income, as defined by the IASB *Conceptual Framework* includes both **revenues** and **gains**. Revenue is income arising in the ordinary course of an entity's activities and it may be called different names, such as sales, fees, interest, dividends or royalties. Revenue is usually the largest amount in a statement of profit or loss so it is important that it is correctly stated.

Revenue is now the subject of a new standard: IFRS 15 *Revenue from Contracts with Customers*.

This replaces both IAS 18 *Revenue* and IAS 11 *Construction Contracts*.

Study guide

B1	Revenue recognition
(a)	Explain and apply the principles of recognition of revenue:
	(i) Identification of contracts
	(ii) Identification of performance obligations
	(iii) Determination of transaction price
	(iv) Allocation of the price to performance obligations
	(v) Recognition of revenue when/as performance obligations are satisfied
(b)	Describe and apply the acceptable methods for measuring progress towards complete satisfaction of performance obligations
(c)	Explain and apply the criteria for the recognition of contract costs
(d)	Specifically account for the following types of transactions:
	(i) Principal versus agent
	(ii) Repurchase agreements
	(iii) Bill and hold arrangements
	(iv) Consignment agreements
(e)	Account for different types of consideration including variable consideration and where a significant financing component exists in the contract
(f)	Prepare financial statement extracts for contracts with multiple performance obligations, some of which are satisfied over time and some at a point in time.

1 IFRS 15 *Revenue from Contracts with Customers*

FAST FORWARD

IFRS 15 sets out rules for the recognition of revenue based on transfer of **control** to the customer from the entity supplying the goods or services.

1.1 Revenue

Income, as defined by the IASB *Conceptual Framework* includes both revenues and gains. Revenue is income arising in the ordinary course of an entity's activities and it may be called different names, such as sales, fees, interest, dividends or royalties.

(*Conceptual Framework*: para. 4.29)

IFRS 15 *Revenue from Contracts with Customers* was issued in May 2014. It is the result of a joint IASB and US Financial Accounting Standards Board (FASB) project on revenue recognition. It seeks to strike a balance between the IASB rules in IAS 18, which were felt to be too general, leading to a lot of diversity in practice, and the FASB regulations, which were too numerous.

IFRS 15 replaces both IAS 18 *Revenue* and IAS 11 *Construction Contracts*. It is effective for reporting periods beginning on or after 1 January 2018. Its core principle is that revenue is recognised to depict the transfer of goods or services to a customer in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

Under IFRS 15 the transfer of goods and services is based upon the transfer of **control**, rather than the transfer of risks and rewards as in IAS 18. **Control of an asset** is described in the standard as the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

For straightforward retail transactions IFRS 15 will have little, if any, effect on the amount and timing of revenue recognition. For contracts such as long-term service contracts and multi-element arrangements it could result in changes either to the amount or to the timing of revenue recognised.

**Exam focus
point**

There was a full question on the application of IFRS 15 in the December 2015 exam paper.

1.2 Scope

IFRS 15 applies to all contracts with customers except (para. 5):

- Leases within the scope of IFRS 16
- Insurance contracts within the scope of IFRS 4
- Financial instruments and other contractual rights and obligations within the scope of IFRS 9, IFRS 10, IFRS 11, IAS 27 or IAS 28
- Non-monetary exchanges between entities in the same line of business

1.3 Definitions

The following definitions are given in the standard.

Key term

Income. Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity, other than those relating to contributions from equity participants.

Revenue. Income arising in the course of an entity's ordinary activities.

Contract. An agreement between two or more parties that creates enforceable rights and obligations.

Contract asset. An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example the entity's future performance).

Receivable. An entity's right to consideration that is unconditional – ie only the passage of time is required before payment is due.

Contract liability. An entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.

Customer. A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

Performance obligation. A promise in a contract with a customer to transfer to the customer either:

- (a) A good or service (or a bundle of goods or services) that is distinct; or
- (b) A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

Stand-alone selling price. The price at which an entity would sell a promised good or service separately to a customer.

Transaction price. The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

(IFRS 15: Appendix A)

Revenue **does not include** sales taxes, value added taxes or goods and service taxes which are only collected for third parties, because these do not represent an economic benefit flowing to the entity.

2 Recognition and measurement

FAST FORWARD

Generally revenue is recognised when the entity has transferred promised goods or services to the customer. IFRS 15 follows a logical process for the recognition of revenue.

2.1 Revenue recognition

IFRS 15 requires that revenue is recognised and measured according to a number of key criteria.

As the key criteria follow a logical process, they have been shown here as 'steps':

- Step 1** Identify the contract with the customer
- Step 2** Identify the separate performance obligations
- Step 3** Determine the transaction price
- Step 4** Allocate the transaction price to the performance obligations
- Step 5** Recognise revenue when (or as) a performance obligation is satisfied

2.2 Step 1: Identify the contract with the customer

A contract with a customer is within the scope of IFRS 15 only when all of the following criteria have been met:

- (a) The parties have approved, and are committed to fulfilling, the terms of the contract.
- (b) Each party's rights regarding the goods and services to be transferred can be identified.
- (c) Clear identification of the payment terms for the goods and services.
- (d) The contract has commercial substance.
- (e) It is probable that the entity will collect the consideration to which it will be entitled.
- (f) The contract can be written, verbal or implied.

(IFRS 15: paras. 9–10)

2.3 Step 2: Identify the separate performance obligations

The key point is distinct goods or services. A contract includes promises to provide goods or services to a customer. Those promises are called performance obligations. A company would account for a performance obligation separately only if the promised good or service is distinct. A good or service is distinct if it is sold separately or if it could be sold separately because it has a distinct function and a distinct profit margin.

IFRS 15 states that a good or service that is promised to a customer is distinct if both of the following criteria are met:

- (a) The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (ie the good or service is capable of being distinct); and
- (b) The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (ie the good or service is distinct within the context of the contract).

(paras. 22, 27, 29)

2.3.1 Example: Identifying the separate performance obligations

Office Solutions, a limited company, has developed a communications software package called CommSoft. Office Solutions has entered into a contract with Logisticity to supply the following:

- (a) Licence to use CommSoft
- (b) Installation service. This may require an upgrade to the computer operating system, but the software package does not need to be customised.
- (c) Technical support for three years
- (d) Three years of updates for CommSoft

Office Solutions is not the only company able to install CommSoft, and the technical support can also be provided by other companies. The software can function without the updates and technical support.

Required

Explain whether the goods or services provided to Logisticity are **distinct** in accordance with IFRS 15 Revenue from Contracts with Customers.

Solution

CommSoft was delivered before the other goods or services and remains functional without the updates and the technical support. It may be concluded that Logisticity can benefit from each of the goods and services either on their own or together with the other goods and services that are readily available.

The promises to transfer each good and service to the customer are separately identifiable. In particular, the installation service does not significantly modify the software itself and, as such, the software and the installation service are separate outputs promised by Office Solutions rather than inputs used to produce a combined output.

In conclusion, the goods and services are distinct and amount to four performance obligations in the contract under IFRS 15.

2.4 Step 3: Determine the transaction price

The transaction price is the amount of consideration a company expects to be entitled to from the customer in exchange for transferring goods or services. The transaction price would reflect the company's probability-weighted estimate of **variable consideration** (including reasonable estimates of contingent amounts) in addition to the effects of the customer's credit risk and the time value of money (if material).

Variable contingent amounts are only included where it is highly probable that there will not be a reversal of revenue when any uncertainty associated with the variable consideration is resolved. Examples of where a variable consideration can arise include: discounts, rebates, refunds, price concessions, credits and penalties.

(IFRS 15: paras. 47–72)

2.4.1 Example: Determining the transaction price

Taplop supplies laptop computers to large businesses. On 1 July 20X5, Taplop entered into a contract with TrillCo, under which TrillCo was to purchase laptops at \$500 per unit. The contract states that if TrillCo purchases more than 500 laptops in a year, the price per unit is reduced retrospectively to \$450 per unit. Taplop's year end is 30 June.

- (a) As at 30 September 20X5, TrillCo had bought 70 laptops from Taplop. Taplop therefore estimated that TrillCo's purchases would not exceed 500 in the year to 30 June 20X6, and TrillCo would therefore not be entitled to the volume discount.
- (b) During the quarter ended 31 December 20X5, TrillCo expanded rapidly as a result of a substantial acquisition, and purchased an additional 250 laptops from Taplop. Taplop then estimated that TrillCo's purchases would exceed the threshold for the volume discount in the year to 30 June 20X6.

Required

Calculate the revenue Taplop would recognise in:

- (a) Quarter ended 30 September 20X5
- (b) Quarter ended 31 December 20X5

We need to apply the principles of IFRS 15 *Revenue from Contracts with Customers*.

Solution

- (a) Applying the requirements of IFRS 15 to TrillCo's purchasing pattern at 30 September 20X5, Taplop should conclude that it was highly probable that a significant reversal in the cumulative amount of revenue recognised (\$500 per laptop) would not occur when the uncertainty was resolved, that is when the total amount of purchases was known.

Consequently, Taplop should recognise revenue of $70 \times \$500 = \$35,000$ for the first quarter ended 30 September 20X5.

- (b) In the quarter ended 31 December 20X5, TrillCo's purchasing pattern changed such that it would be legitimate for Taplop to conclude that TrillCo's purchases would exceed the threshold for the volume discount in the year to 30 June 20X6, and therefore that it was appropriate to reduce the price to \$450 per laptop.

Taplop should therefore recognise revenue of \$109,000 for the quarter ended 31 December 20X5. The amount is calculated as from \$112,500 (250 laptops \times \$450) less the change in transaction price of \$3,500 (70 laptops \times \$50 price reduction) for the reduction of the price of the laptops sold in the quarter ended 30 September 20X5.

2.5 Step 4: Allocate the transaction price to the performance obligations

Where a contract contains more than one distinct performance obligation a company allocates the transaction price to all separate performance obligations in proportion to the stand-alone selling price of the good or service underlying each performance obligation. If the good or service is not sold separately, the company would have to estimate its stand-alone selling price.

So, if any entity sells a bundle of goods and/or services which it also supplies unbundled, the separate performance obligations in the contract should be priced in the same proportion as the unbundled prices. This would apply to mobile phone contracts where the handset is supplied 'free'. The entity must look at the stand-alone price of such a handset and some of the consideration for the contract should be allocated to the handset.

(IFRS 15: paras. 73–74, 78–79)

2.5.1 Example: Allocating the transaction price to the performance obligations

A mobile phone company gives customers a free handset when they sign a two-year contract for provision of network services. The handset has a stand-alone price of \$100 and the contract is for \$20 per month.

Prior to IFRS 15, the company would recognise no revenue in relation to the handset and a total of \$240 per annum in relation to the contract.

Under IFRS 15, revenue must be allocated to the handset because delivery of the handset constitutes a performance obligation. This will be calculated as follows:

	\$	%
Handset	100	17%
Contract – two years	480	83%
Total value	<u>580</u>	<u>100%</u>

As the total receipts are \$480, this is the amount which must be allocated to the separate performance obligations. Revenue will be recognised as follows (rounded to nearest \$).

	\$
Year 1	
Handset ($480 \times 17\%$)	82
Contract $(480 - 82)/2$	199
	<u>281</u>
Year 2	
Contract as above	<u>199</u>

So application of IFRS 15 has moved revenue of \$41 from Year 2 to Year 1.

2.6 Step 5: Recognise revenue when (or as) a performance obligation is satisfied

The entity satisfies a performance obligation by transferring **control** of a promised good or service to the customer. A performance obligation can be satisfied **at a point in time**, such as when goods are delivered to the customer, or **over time**. An obligation satisfied **over time** will meet one of the following criteria:

- The customer simultaneously receives and consumes the benefits as the performance takes place.
- 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.

The amount of revenue recognised is the amount allocated to that performance obligation in Step 4.

An entity must be able to **reasonably measure** the outcome of a performance obligation before the related revenue can be recognised.

In some circumstances, such as in the early stages of a contract, it may not be possible to reasonably measure the outcome of a performance obligation, but the entity expects to recover the costs incurred. In these circumstances, revenue is recognised only to the extent of costs incurred.

(IFRS 15: paras. 25, 31, 32)

2.7 Contract costs

(IFRS 15: paras. 39 to 45)

The incremental costs of **obtaining** a contract (such as sales commission) are **recognised as an asset** if the entity expects to recover those costs.

Costs that would have been incurred regardless of whether the contract was obtained are recognised as an expense as incurred.

Costs incurred in **fulfilling** a contract, unless within the scope of another standard (such as IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*) are recognised as an asset if they meet the following criteria (IFRS 15: para. 95):

- The costs relate directly to an identifiable contract (costs such as labour, materials, management costs)
- The costs generate or enhance resources of the entity that will be used in satisfying (or continuing to satisfy) performance obligations in the future; and
- The costs are expected to be recovered

Costs recognised as assets are amortised on a systematic basis consistent with the transfer to the customer of the goods or services to which the asset relates.

2.8 Performance obligations satisfied over time

(IFRS 15: paras. 39–45)

A performance obligation satisfied over time meets the criteria in Step 5 above and, if it entered into more than one accounting period, would previously have been described as a long-term contract.

In this type of contract an entity often has an enforceable right to payment for performance completed to date. The standard describes this as an amount that approximates the selling price of the goods or services transferred to date (for example recovery of the costs incurred by the entity in satisfying the performance plus a reasonable profit margin).

Methods of measuring the amount of performance completed to date encompass **output methods** and **input methods**.

Output methods recognise revenue on the basis of the value to the **customer** of the goods or services transferred. They include surveys of performance completed, appraisal of units produced or delivered etc.

Input methods recognise revenue on the basis of the **entity's** inputs, such as labour hours, resources consumed, costs incurred. If using a cost-based method, the costs incurred must contribute to the entity's progress in satisfying the performance obligation.

2.9 Performance obligations satisfied at a point in time

(IFRS 15: para. 38)

A performance obligation not satisfied over time will be satisfied at a point in time. This will be the point in time at which the customer obtains control of the promised asset and the entity satisfies a performance obligation.

Some indicators of control are:

- (a) The entity has a present right to payment for the asset.
- (b) The customer has legal title to the asset.
- (c) The entity has transferred physical possession of the asset.
- (d) The significant risks and rewards of ownership have been transferred to the customer.
- (e) The customer has accepted the asset.

3 Common types of transaction

FAST FORWARD

The application notes to IFRS 15 provide guidance on how to deal with a number of different transactions.

3.1 Warranties

(IFRS 15: para. B28)

If a customer has the option to purchase a warranty separately from the product to which it relates, it constitutes a distinct service and is accounted for as a separate performance obligation. This would apply to a warranty which provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

If the customer does not have the option to purchase the warranty separately, for instance if the warranty is required by law, that does not give rise to a performance obligation and the warranty is accounted for in accordance with IAS 37 (see Chapter 8).

3.2 Principal versus agent

(IFRS 15: paras. B34–B38)

An entity must establish in any transaction whether it is acting as principal or agent.

It is a principal if it controls the promised good or service before it is transferred to the customer. When the performance obligation is satisfied, the entity recognises revenue in the gross amount of the consideration to which it expects to be entitled for those goods or services.

It is acting as an agent if its performance obligation is to arrange for the provision of goods or services by another party. In this case the agent's revenue is measured at the fee or commission that it expects to be entitled to for arranging the provision of goods or services by the other party.

Indicators that an entity is a principal include the following:

- (a) The entity is primarily responsible for fulfilling the contract (eg it has responsibility for the goods or services meeting customer specifications).
- (b) The entity has inventory risk before the goods have been transferred to a customer or after transfer of control to the customer.
- (c) The entity has discretion in establishing prices for the specified goods or services.

3.3 Example: Principal versus agent

This example is adapted from the standard (IFRS 15: Illustrative example 45).

Fancy Goods Co (FG) operates a website that enables customers to purchase goods from a range of suppliers. The suppliers set the price that is to be charged and deliver directly to the customers, who have paid in advance. FG's website facilitates payment by customers and the entity is entitled to commission of 5% of the sales price.

The entity has no further obligation to the customer after arranging for the products to be supplied.

Required

Is FG a principal or an agent?

Solution

The following points are relevant:

- The supplier is primarily responsible for fulfilling a customer order rather than FG; FG is not obliged to provide goods if the supplier fails to deliver to the customer.
- FG does not have inventory risk at any time, as it does not deal with inventories at all.
- FG does not establish prices.

FG is therefore acting as an agent and should recognise revenue equal to the amounts received as commission.

3.4 Repurchase agreements

(IFRS 15: B64–66)

Under a repurchase agreement an entity sells an asset and promises, or has the option, to repurchase it. Repurchase agreements generally come in three forms.

- (a) An entity has an obligation to repurchase the asset (a forward contract).
- (b) An entity has the right to repurchase the asset (a call option).
- (c) An entity must repurchase the asset if requested to do so by the customer (a put option).

In the case of a forward or a call option the customer does not obtain control of the asset, even if the customer has physical possession. The entity will account for the contract as:

- (a) A lease in accordance with IFRS 16, if the repurchase price is below the original selling price; or
- (b) A financing arrangement if the repurchase price is equal to or greater than the original selling price. In this case the entity will recognise both the asset and a corresponding liability.

If the entity is obliged to repurchase at the request of the customer (a put option), it must consider whether or not the customer is likely to exercise that option.

If the repurchase price is lower than the original selling price and it is considered that the customer does not therefore have significant economic incentive to exercise the option, the contract should be accounted for as an outright sale, with a right of return. If the customer is considered to have a significant economic incentive to exercise the option, the entity should account for the agreement as a lease in accordance with IFRS 16.

If the repurchase price is greater than or equal to the original selling price and is above the expected market value of the option, the contract is treated as a financing arrangement.

3.5 Example: Contract with a call option

This example is taken from the standard (IFRS 15: Illustrative Examples, Example 62, Case A-Call option: financing, paras. IE316–IE318).

A Co enters into a contract with a customer (B Co) for the sale of a tangible asset on 1 January 20X7 for \$1m. The contract includes a call option that gives A Co the right to repurchase the asset for \$1.1m on or before 31 December 20X7.

This means that B Co does not obtain control of the asset, because the repurchase option means that it is limited in its ability to use and obtain benefit from the asset.

As control has not been transferred, A Co accounts for the transaction as a **financing arrangement**, because the exercise price is above the original selling price. A Co continues to recognise the asset and recognises the cash received as a financial liability. The difference of \$0.1m is recognised as interest expense.

If on 31 December 20X7 the option lapses unexercised, B Co now obtains control of the asset. A Co will derecognise the asset and recognise revenue of \$1.1m (the \$1m already received plus the \$0.1m charged to interest).

3.6 Example: Contract with a put option

(IFRS 15: Illustrative Examples, Example 62 Case B-Put option: lease, paras. IE319–IE321)

The same contract as above includes instead a put option that obliges A Co to repurchase the asset at B Co's request for \$900,000 on or before 31 December 20X7, at which time the market value is expected to be \$750,000.

In this case B Co has a significant economic incentive to exercise the put option because the repurchase price exceeds the market value at the repurchase date. This means that control does not pass to B Co. Since B Co will be exercising the put option, this limits its ability to use or obtain benefit from the asset.

In this situation A Co accounts for the transaction as a lease in accordance with IFRS 16. The asset has been leased to the customer for the period up to the repurchase and the difference of \$100,000 will be accounted for as payments received under an operating lease.

3.7 Consignment arrangements

(IFRS 15: paras. B77–B787)

When a product is delivered to a customer under a consignment arrangement, the customer (dealer) does not obtain control of the product at that point in time, so no revenue is recognised upon delivery.

Indicators of a consignment arrangement include:

- (a) The product is controlled by the entity until a specified event occurs, such as the product is sold on, or a specified period expires.
- (b) The entity can require the return of the product, or transfer it to another party.
- (c) The customer (dealer/distributor) does not have an unconditional obligation to pay for the product.

3.7.1 Required accounting

The following apply where it is concluded that control of the inventory **has been transferred** to the dealer.

- (a) The inventory should be recognised as such in the dealer's statement of financial position, together with a corresponding liability to the manufacturer.
- (b) Any deposit should be deducted from the liability and the excess classified as a trade payable.

Where it is concluded that control of the inventory **has not been transferred** to the dealer, the following apply.

- (a) The inventory should not be included in the dealer's statement of financial position until the transfer of control has taken place.
- (b) Any deposit should be included under 'other receivables'.

3.7.2 Example: Consignment arrangement

A wholesaler supplies goods to a retailer on a consignment basis. The wholesaler retains title until the goods are sold by the retailer. The retailer does not pay the wholesaler until the goods are sold and any unsold goods can be returned.

In this situation control of the goods is not transferred to the retailer until the goods are sold to the end-user, so it is only at that point that the wholesaler can recognise the revenue.



Question

Recognition

Jameson is a retailer of high-value items of diamond jewellery. A significant proportion of the items available for sale in Jameson's stores were handmade by Rochester Diamonds.

These items are held under a contractual arrangement with Rochester Diamonds, the terms of which specify that Rochester Diamonds retains the ability to change the selling price of the jewellery, and that Jameson is required to return any unsold jewellery after a period of nine months. When Jameson sells an item of jewellery to a customer, legal title to the jewellery passes from Rochester Diamonds to the customer.

Jameson has paid a significant deposit to Rochester Diamonds in order to hold the jewellery in its stores. This deposit is deducted, on a proportionate basis, from the amount payable to Rochester Diamonds when items are sold, or is refunded in full if items are returned. Jameson is not required to pay in full for the jewellery until it is sold on to a customer.

Should Jameson include the items of jewellery in its inventories balance?

Answer

Under IFRS 15, the items of jewellery should be recognised in the inventories of Jameson when Jameson obtains control of them. Therefore we need to assess whether Jameson has control of the items of jewellery.

Rochester Diamonds retains legal title to the items while they are with Jameson, and when they are sold, this title passes straight to the customer. Thus Jameson does not ever have legal title of the jewellery.

Rochester Diamonds retains the ability to change the selling price of the jewellery and is also exposed to the risk of the items not being sold, as unsold items must be returned after nine months. The risks and rewards of ownership of the jewellery therefore appear to lie with Rochester Diamonds, and not with Jameson.

Furthermore, Jameson does not have an unconditional obligation to pay for the jewellery; payment is conditional on the jewellery being sold to customers.

The arrangement therefore appears to be a consignment arrangement and control of the jewellery remains with Rochester Diamonds. As such, the jewellery should not be included in the inventories balance of Jameson.

3.8 Bill-and-hold arrangements

(IFRS 15: paras. B79–B82)

Under a bill-and-hold arrangement goods are sold but remain in the possession of the seller for a specified period, perhaps because the customer lacks storage facilities.

An entity will need to determine at what point the customer obtains control of the product. For some contracts, control will not be transferred until the goods are delivered to the customer. For others, a customer may obtain control even though the goods remain in the entity's physical possession. In this case the entity would be providing custodial services (which may constitute a separate performance obligation) to the customer over the customer's asset.

For a customer to have obtained control of a product in a bill and hold arrangement, the following criteria must all be met:

- (a) The reason for the bill-and-hold must be substantive (for example, requested by the customer).
- (b) The product must be separately identified as belonging to the customer.
- (c) The product must be ready for physical transfer to the customer.
- (d) The entity cannot have the ability to use the product or to transfer it to another customer.

3.9 Example: Bill and hold arrangement

This example is taken from the standard (IFRS 15: Illustrative Examples, Example 63, paras. IE323–IE327).

An entity enters into a contract with a customer on 1 January 20X8 for sale of a machine and spare parts. It takes two years to manufacture these and on 31 December 20X9 the customer pays for both the machine and the spare parts but only takes physical possession of the machine. The customer inspects and accepts the spare parts but requests that they continue to be stored at the entity's warehouse.

There are now three performance obligations – transfer of the machine, transfer of the spare parts and the custodial services. The transaction price is allocated to the three performance obligations and revenue is recognised when (or as) control passes to the customer.

The machine and the spare parts are both performance obligations satisfied at a point in time, and for both of them that point in time is 31 December 20X9. In the case of the spare parts, the customer has paid for them, the customer has legal title to them and the customer has control of them as they can remove them from storage at any time.

The custodial services are a performance obligation satisfied over time, so revenue will be recognised over the period during which the spare parts are stored.

3.10 Sale with a right of return

Where goods are sold with a right of return, an entity should not recognise revenue for goods that it expects to be returned. It can calculate the level of returns using the expected value method (the probability-weighted sum of amounts) or simply estimate the most likely amount. This will be shown as a refund liability and a deduction from revenue.

The entity also recognises an asset (adjusted against cost of sales) for its right to recover products from customers on settlement of the refund liability (IFRS 15: para. B20).

4 Presentation and disclosure

FAST FORWARD

The presentation and disclosure requirements are important in relation to contracts where performance obligations are satisfied over time, where there are likely to be contract assets and liabilities to be accounted for at the end of the reporting period.

4.1 Presentation

(IFRS 15: para. 105)

Contracts with customers will be presented in an entity's statement of financial position as a contract liability, a contract asset or a receivable, depending on the relationship between the entity's performance and the customer's payment.

A **contract liability** is recognised and presented in the statement of financial position where a customer has paid an amount of consideration prior to the entity performing by transferring control of the related good or service to the customer.

When the entity has performed but the customer has not yet paid the related consideration, this will give rise to either a **contract asset** or a **receivable**. A contract asset is recognised when the entity's right to consideration is conditional on something other than the passage of time, for instance future performance. A receivable is recognised when the entity's right to consideration is unconditional except for the passage of time.

Where revenue has been invoiced a receivable is recognised. Where revenue has been earned but not invoiced, it is recognised as a contract asset.

5 Performance obligations satisfied over time

FAST FORWARD

Where performance obligations are satisfied over time, an entity must determine what amounts to include as revenue and costs in each accounting period.

5.1 Contracts where performance obligations are satisfied over time

A company is building a large tower block that will house offices, under a contract with an investment company. It will take three years to build the block and over that time it will obviously have to pay for building materials, wages of workers on the building, architects' fees and so on. It will receive periodic payments from the investment company at various predetermined stages of the construction. How does it decide, in each of the three years, **what to include as income and expenditure** for the contract in profit or loss?

5.2 Example: Contract

Suppose that a contract is started on 1 January 20X5, with an estimated completion date of 31 December 20X6. The final contract price is \$1,500,000. In the first year, to 31 December 20X5:

- (a) Costs incurred amounted to \$600,000.
- (b) Half the work on the contract was completed.
- (c) Certificates of work completed have been issued, to the value of \$750,000.
- (d) It is estimated with reasonable certainty that further costs to completion in 20X6 will be \$600,000.

What is the contract profit in 20X5, and what entries would be made for the contract at 31 December 20X5?

Solution

This is a contract in which the performance obligation is satisfied **over time**. The entity is carrying out the work for the benefit of the customer rather than creating an asset for its own use and in this case it has an enforceable right to payment for work completed to date. We can see this from the fact that certificates of work completed have been issued.

The amount of payment that the entity is entitled to corresponds to the amount of performance completed to date (ie goods and/or services transferred), which approximates to the costs incurred in satisfying the performance obligation plus a reasonable profit margin.

In this case the contract is certified as 50% complete, measuring progress under the output method. At 31 December 20X5 the entity will recognise revenue of \$750,000 and cost of sales of \$600,000, leaving profit of \$150,000. The **contract asset** will be the costs to date plus the profit, that is \$750,000. We are not told that any of this amount has yet been invoiced, so none of this amount is classified as receivables.

5.3 Summary of accounting treatment

Statement of profit or loss

- (a) **Revenue and costs**
 - (i) Sales revenue and associated costs should be recorded in profit or loss as the contract activity progresses.
 - (ii) Include an appropriate proportion of total contract value as sales revenue in profit or loss.
 - (iii) The costs incurred in completing that amount of the performance obligation are matched with this sales revenue, resulting in the reporting of results which can be attributed to the proportion of work completed.
 - (iv) Sales revenue is the value of work carried out to date.

(b) **Profit recognised in the contract**

- (i) It must reflect the proportion of work carried out, which will be equivalent to the amount of performance obligation satisfied.
- (ii) It should take into account any known inequalities in profitability in the various stages of a contract.

Statement of financial position

(a) **Contract asset** (presented separately under current assets)

	\$
Costs to date	X
Plus recognised profits	<u>X</u>
	X
Less any recognised losses	<u>(X)</u>
	X
Less receivables (amounts invoiced)	<u>(X)</u>
Contract asset (amount due from the customer)	<u>X</u>

(b) **Receivables**

Unpaid invoices	X
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(c) **Contract liability**

Where (a) gives a net amount due to the customer this amount should be included as a contract liability, presented separately under current liabilities.

Example: Contract profits

P Co has the following contract in progress:

	\$m
Total contract price	750
Costs incurred to date	225
Estimated costs to completion	340
Payments invoiced and received	290

Now we will calculate the amounts to be recognised for the contract in the statement of profit or loss and statement of financial position assuming the amount of performance obligation satisfied is calculated using the proportion of costs incurred method.

1 *Estimated profit*

	\$m
Total contract price	750
Less costs incurred to date	(225)
Less estimated costs to completion	<u>(340)</u>
Estimated profit	<u>185</u>

2 *Percentage complete*

Costs to date/total estimated costs: $225/(225 + 340) = 40\%$

3 *Statement of profit or loss*

	\$m
Revenue ($40\% \times \$750$)	300
Cost of sales ($40\% \times (225 + 340)$)	<u>(226)</u>
Profit ($40\% \times 185$)	<u>74</u>

4 Statement of financial position

	\$m
Costs incurred to date	225
Recognised profits	74
Less receivable	(290)
Contract asset	<u>9</u>

How would we account for this if it was a **loss-making contract**?

IFRS 15 states that an entity's right to payment for performance completed to date should approximate the selling price of the service completed to date. Selling price would be recovery of costs incurred plus a reasonable profit margin. Where no profit can be estimated, revenue is limited to recoverable costs.

Where a loss is anticipated, this means that a proportion of the entity's costs will not be recovered, and this needs to be recognised.

We will reduce P Co's contract price to \$550m.

1 Estimated loss

	\$m
Total contract price	550
Less costs incurred to date	(225)
Less estimated costs to completion	(340)
Estimated loss – costs not recoverable	<u>(15)</u>

Note that the **full** estimated loss is recognised, even though the contract is only **partially complete**.

2 Percentage complete

Costs to date/total estimated costs: $225/(225 + 340) = 40\%$

3 Statement of profit or loss

	\$m
Revenue ($40\% \times \$550$)	220
Cost of sales (balancing figure)	(235)
Loss	<u>(15)</u>

4 Statement of financial position

	\$m
Costs incurred to date	225
Recognised loss	(15)
Less receivable	(290)
Contract liability	<u>(80)</u>



Question

Contract profits

The main business of Santolina Co is building work. At the end of September 20X3 there is an uncompleted contract on the books, details of which are as follows.

Date commenced	1.4.X1
Expected completion date	23.12.X3
	\$
Total contract revenue	290,000
Costs to 30.9.X3	210,450
Value of performance obligations satisfied to 30.9.X3	230,000
Amounts invoiced for work certified to 30.9.X3	210,000
Cash received to 30.9.X3	194,000
Estimated costs to completion at 30.9.X3	20,600

Santolina calculates satisfaction of performance obligations based on work certified as a percentage of contract price.

Required

Prepare calculations showing the amount to be included in the statement of profit or loss and statement of financial position at 30 September 20X3 in respect of the above contract.

Answer

This is a contract where performance obligations are recognised over time. It will be included in the statement of financial position at cost plus recognised profit less amounts invoiced.

The estimated final profit is:

	\$
Final contract price	290,000
Less: costs to date	(210,450)
estimated future costs	(20,600)
Estimated final profit	<u>58,950</u>

The recognised profit is found as follows:

$$\text{Estimated final profit} \times \frac{\text{Work certified}}{\text{Total contract price}}$$

$$\$58,950 \times \frac{230,000}{290,000} = \$58,950 \times 79.31\%$$

Profit recognised = \$46,753

STATEMENT OF PROFIT OR LOSS

	\$
Revenue (work certified)	230,000
Cost of sales ((210,450 + 20,600) × 79.31%)	(183,247)
Gross profit	<u>46,753</u>

STATEMENT OF FINANCIAL POSITION

Contract asset

	\$
Costs to date	210,450
Attributable profit	46,753
	<u>257,203</u>
Amounts invoiced	(210,000)
Contract asset	<u>47,203</u>
Contract receivables (210 – 194)	16,000



Question

IFRS 15 calculations

Haggrun Co has two contracts in progress, the details of which are as follows.

	<i>Happy (profitable)</i>	<i>Grumpy (loss-making)</i>
	\$'000	\$'000
Total contract revenue	300	300
Costs incurred to date	90	150
Estimated costs to completion	135	225
Payments invoiced and received	116	116

Haggrun measures satisfaction of performance obligations based on percentage of work certified as complete.

Required

Show extracts from the statement of profit or loss and other comprehensive income and the statement of financial position for each contract, assuming they are both certified as:

- (a) 40% complete; and
- (b) 36% complete.

Answer

Happy contract

- (a) 40% complete \$'000

Statement of profit or loss

Revenue ($300 \times 40\%$)	120
Cost of sales ($(90 + 135) \times 40\%$)	<u>(90)</u>
	<u>30</u>

Working

Profit to date

	\$'000
Total contract revenue	300
Costs to date	(90)
Cost to completion	<u>(135)</u>
Total expected profit	<u>75</u>
Profit to date ($75 \times 40\%$)	30

Statement of financial position

	\$'000
Costs to date	90
Profit recognised to date	30
Amounts invoiced	<u>(116)</u>
Contract asset	<u>4</u>

- (b) 36% complete \$'000

Statement of profit or loss

Revenue ($300 \times 36\%$)	108
Cost of sales ($(90 + 135) \times 36\%$)	<u>(81)</u>
Profit to date ($75 \times 36\%$)	<u>27</u>

Statement of financial position

Costs to date	90
Profit recognised to date	27
Amounts invoiced	<u>(116)</u>
Contract asset	<u>1</u>

Grumpy contract

- (a) 40% complete \$'000

Statement of profit or loss

Revenue ($300 \times 40\%$)	120
Cost of sales (balancing figure*)	<u>(195)</u>
Foreseeable loss (W)	<u>(75)</u>

Note that the **full foreseeable loss** is recognised even though the contract is **only partially complete**.

Working

	\$'000
Total contract revenue	300
Costs to date	(150)
Costs to complete	<u>(225)</u>
Foreseeable loss – costs which will not be recovered	<u>(75)</u>

Statement of financial position

Costs to date	150
Foreseeable loss	(75)
Amounts invoiced	<u>(116)</u>
Contract liability	<u>(41)</u>

*Costs to date $(150 + 225) \times 40\%$	150
Foreseeable loss $(75) \times 60\%$ **	<u>45</u>
	<u>195</u>

The other 40% is taken into account in costs to date. We make this adjustment to bring in the **whole of the foreseeable loss.

(b) *36% complete*

\$'000

Statement of profit or loss

Revenue $(300 \times 36\%)$	108
Cost of sales*	<u>(183)</u>
Foreseeable loss	<u>(75)</u>

Statement of financial position

Costs to date	150
Foreseeable loss	(75)
Amounts invoiced	<u>(116)</u>
Contract liability	<u>(41)</u>

*Costs to date $(150 + 225) \times 36\%$	135
Foreseeable loss $(75) \times 64\%$ **	<u>48</u>
	<u>183</u>

Chapter Roundup

- IFRS 15 sets out rules for the recognition of revenue based on transfer of control to the customer from the entity supplying the goods or services.
- Generally revenue is recognised when the entity has transferred promised goods or services to the customer. IFRS 15 follows a logical process for the recognition of revenue.
- The application notes to IFRS 15 provide guidance on how to deal with a number of different transactions.
- The presentation and disclosure requirements are important in relation to contracts where performance obligations are satisfied over time, where there are likely to be contract assets and liabilities to be accounted for at the end of the reporting period.
- Where performance obligations are satisfied over time, an entity must determine what amounts to include as revenue and costs in each accounting period.

Quick Quiz

- 1 What are **output methods** of measuring satisfaction of performance obligations?
- 2 What are the two types of contract dealt with in IFRS 15?
- 3 What is the transfer that must take place before revenue can be recognised?
- 4 What is a repurchase agreement?
- 5 List the five steps for recognising revenue under IFRS 15.

Answers to Quick Quiz

- 1 Methods of measurement based on value to the customer of goods or services transferred. Examples would be surveys of work performed.
- 2
 - Contracts where performance obligations are satisfied at a point in time
 - Contracts where performance obligations are satisfied over time
- 3 **Control** must be transferred before revenue can be recognised.
- 4 A repurchase agreement is one in which an entity sells an asset and promises, or has the option, to repurchase it.
- 5
 - 1 Identify the contract with the customer
 - 2 Identify the separate performance obligations
 - 3 Determine the transaction price
 - 4 Allocate the transaction price to the performance obligations
 - 5 Recognise revenue when (or as) a performance obligation is satisfied

Now try the questions below from the Practice Question Bank

Number	Level	Marks	Time
Q5	Introductory	13	25 mins

Accounting for tangible non-current assets

4

Topic list	Syllabus reference
1 IAS 16 <i>Property, Plant and Equipment</i>	B2
2 Depreciation accounting	B2
3 IAS 20 <i>Government Grants</i>	B2
4 IAS 40 <i>Investment Property</i>	B2
5 IAS 23 <i>Borrowing Costs</i>	B2

Introduction

IAS 16 should be familiar to you from your earlier studies, as should the mechanics of accounting for depreciation, revaluations of non-current assets and disposals of non-current assets. Some questions are given here for revision purposes.

IAS 20 on government grants is a straightforward standard and you should have few problems with it.

IAS 40 deals with investment properties, which can be treated differently from other property under IAS 16.

IAS 23 deals with borrowing costs, which will form part of the cost of a qualifying asset.

Study guide

B2	Property, plant and equipment
(a)	Define the initial cost of a non-current asset (including a self-constructed asset) and apply this to various examples of expenditure, distinguishing between capital and revenue items
(b)	Identify pre-conditions for the capitalisation of borrowing costs
(c)	Describe, and be able to identify, subsequent expenditures that should be capitalised, including appropriate borrowing costs
(d)	Compute the impact on the financial statements when property, plant and equipment is measured under revaluation model and a revaluation to fair value is made
(e)	Account for gains and losses on the disposal of revalued assets
(f)	Calculate depreciation on: <ul style="list-style-type: none"> – Revalued assets, and – Assets that have two or more major items or significant components
(g)	Apply the provisions of accounting standards relating to government grants and government assistance in relation to property, plant and equipment.
(j)	Discuss the way in which the treatment of investment properties differs from other properties
(k)	Apply the requirements of international financial reporting standards to investment properties

Exam focus point

ACCA's website contains many useful articles, including the following relating to topics covered in this chapter:

- *Examiner's guidance on treatment of revaluation of non-current assets*
- *How to account for property*

Available at www.accaglobal.com/gb/en/student/exam-support-resources/dipifr-study-resources/technical-articles.html

1 IAS 16 Property, Plant and Equipment

FAST FORWARD

IAS 16 covers all aspects of accounting for property, plant and equipment. This represents the bulk of items which are 'tangible' non-current assets.

Exam focus point

IAS 16 is a fundamental standard for DipIFR and is examined frequently. You need to become very familiar with its requirements. Be careful, as it can be surprisingly tricky in exam questions.

1.1 Scope

IAS 16 should be followed when accounting for property, plant and equipment *unless* another international accounting standard requires a **different treatment**.

IAS 16 **does not apply** to the following (paras. 2–3).

- Biological assets related to agricultural activity, apart from bearer plants (see below); biological assets are covered in IAS 41 *Agriculture*, see Chapter 13
- Mineral rights and mineral reserves, such as oil, gas and other non-regenerative resources
- Property, plant and equipment classified as held for sale (IFRS 5 *Non-Current Assets Held for Sale and Discontinued Operations*)

However, the standard applies to property, plant and equipment used to develop these assets.

1.1.1 Bearer plants

Bearer plants, such as grape vines, rubber trees and oil palms, are within the scope of IAS 16. Bearer plants are living plants which are solely used to grow produce over several periods and are not themselves consumed, being usually scrapped when no longer productive. They are measured at **accumulated cost** until maturity and then become subject to depreciation and impairment charges.

1.2 Definitions

IAS 16 gives a large number of definitions.

Key terms

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.

Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction.

Residual value is the net amount which the entity expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

Entity specific value is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life, or expects to incur when settling a liability.

Carrying amount is the amount at which an asset is recognised in the statement of financial position after deducting any accumulated depreciation and accumulated impairment losses.

An **impairment loss** is the amount by which the carrying amount of an asset exceeds its recoverable amount.

A **bearer plant** is a living plant that:

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

(IAS 16: para. 6)

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.

(IFRS 13: para. 9)

1.3 Recognition

In this context, recognition simply means incorporation of the item in the business's accounts, in this case as a non-current asset. The recognition of property, plant and equipment depends on two criteria.

- (a) It is probable that **future economic benefits** associated with the asset will flow to the entity
- (b) The cost of the asset to the entity can be **measured reliably**

(IAS 16: para. 7)

These recognition criteria apply to **subsequent expenditure** as well as costs incurred initially. There are no separate criteria for recognising subsequent expenditure. For example, if a shop building is extended to house a café or other revenue source, this meets the criteria of future economic benefits.

Property, plant and equipment can amount to **substantial amounts** in financial statements, affecting the presentation of the company's financial position and the profitability of the entity, through depreciation and also if an asset is wrongly classified as an expense and taken to profit or loss (IAS 16: para. 7).

1.3.1 First criterion: Future economic benefits

The **degree of certainty** attached to the flow of future economic benefits must be assessed. This should be based on the evidence available at the date of initial recognition (usually the date of purchase). The entity should be assured that it will receive the rewards attached to the asset and it will incur the associated risks, which will only generally be the case when the rewards and risks have actually passed to the entity. Until then, the asset should not be recognised.

1.3.2 Second criterion: Cost measured reliably

It is generally easy to measure the cost of an asset as the **transfer amount on purchase**, ie what was paid for it. **Self-constructed assets** can also be measured easily by adding together the purchase price of all the constituent parts (labour, material etc) paid to external parties.

(IAS 16: para. 10)

1.4 Separate items

Most of the time assets will be identified individually, but this will not be the case for **smaller items**, such as tools, dies and moulds, which are sometimes classified as inventory and written off as an expense.

Major components or spare parts, however, should be recognised as property, plant and equipment.

(IAS 16: para. 8)

For very **large and specialised items**, an apparently single asset should be broken down into its composite parts. This occurs where the different parts have different useful lives and different depreciation rates are applied to each part, eg an aircraft, where the body and engines are separated as they have different useful lives.

(IAS 16: para. 13)

1.5 Safety and environmental equipment

These items may be necessary for the entity to **obtain future economic benefits** from its other assets. For this reason they are recognised as assets. However the original assets plus the safety equipment should be reviewed for impairment.

(IAS 16: para. 11)

1.6 Initial measurement

Once an item of property, plant and equipment qualifies for recognition as an asset, it will initially be **measured at cost**.

(IAS 16: para. 15)

1.6.1 Components of cost

The standard lists the components of the cost of an item of property, plant and equipment.

- **Purchase price**, less any trade discount or rebate
- **Import duties** and non-refundable purchase taxes
- **Directly attributable costs** of bringing the asset to working condition for its intended use, eg:
 - The cost of site preparation
 - Initial delivery and handling costs
 - Installation costs
 - Testing
 - Professional fees (architects, engineers)
- **Initial estimate** of the unavoidable cost of dismantling and removing the asset and restoring the site on which it is located

(IAS 16: paras. 16–18)

The revised IAS 16 provides **additional guidance on directly attributable** costs included in the cost of an item of property, plant and equipment.

- (a) These costs bring 'the asset to the location and working conditions necessary for it to be capable of operating in the manner intended by management' (IAS 16: para. 16), including those costs to test whether the asset is functioning properly.
- (b) They are determined after deducting the net proceeds from selling any items produced when bringing the asset to its location and condition.

Income and related expenses of operations that are **incidental** to the construction or development of an item of property, plant and equipment should be **recognised** in profit or loss.

The following costs **will not be part of the cost** of property, plant or equipment unless they can be attributed directly to the asset's acquisition, or bringing it into its working condition.

- Administration and other general overhead costs
- Start-up and similar pre-production costs
- Initial operating losses before the asset reaches planned performance

All of these will be recognised as an **expense** rather than an asset.

(IAS 16: para. 11)

In the case of **self-constructed assets**, the same principles are applied as for acquired assets. If the entity's normal course of business is to make these assets and sell them externally, then the cost of the asset will be the cost of its production. This also means that unusual costs (wasted material or labour downtime costs) are excluded from the cost of the asset. An example of a self-constructed asset is when a building company builds its own head office.

(IAS 16: para. 22)

1.6.2 Subsequent expenditure

Parts of some items of property, plant and equipment may require replacement at regular intervals. IAS 16 gives examples of a furnace which may require relining after a specified number of hours or aircraft interiors which may require replacement several times during the life of the aircraft.

This cost is recognised in full when it is incurred and **added to the carrying amount of the asset**. It will be depreciated over its expected life, which may be different from the expected life of the other components of the asset. For example, the passenger seats of an aircraft may have a useful life of 5 years, whereas the engines may last for 10 years. The carrying amount of the items being replaced, such as the old passenger seats of an aircraft, are derecognised when the replacement takes place. This means that rather than having a useful life of 25 years for the entire aircraft, there are different depreciation rates for different, specific elements of it.

(IAS 16: para. 13)

Expenditure incurred in replacing or renewing a component of an item of property, plant and equipment must be **recognised in the carrying amount of the item**. The carrying amount of the replaced or renewed component must be derecognised. This also applies when a separate component of an item of property, plant and equipment is identified during a major inspection to allow the continued use of the asset.

(IAS 16: para. 13)

1.6.3 Exchanges of assets

IAS 16 specifies that exchange of items of property, plant and equipment, regardless of whether the assets are similar, are measured at **fair value, unless the exchange transaction lacks commercial substance** or the fair value of neither of the assets exchanged can be **measured reliably**. If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

(IAS 16: para. 24)

1.7 Measurement subsequent to initial recognition

The standard offers two possible treatments here, essentially a choice between keeping an asset recorded at **cost** or revaluing it to **fair value**.

- (a) **Cost model.** Carry the asset at its cost less depreciation and any accumulated impairment loss.

- (b) **Revaluation model.** Carry the asset at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. The revised IAS 16 makes clear that the **revaluation model is available only if the fair value of the item can be measured reliably.**

(IAS 16: paras. 29–31)

1.8 Revaluation model

The **market value** of land and buildings usually represents fair value, assuming existing use and line of business. Such valuations are usually carried out by professionally qualified valuers.

In the case of **plant and equipment**, fair value can also be taken as **market value**. Where a market value is not available, however, depreciated replacement cost should be used. There may be no market value where types of plant and equipment are sold only rarely or because of their specialised nature (ie they would normally only be sold as part of an ongoing business).

The frequency of valuation depends on the **volatility of the fair values** of individual items of property, plant and equipment. The more volatile the fair value, the more frequently revaluations should be carried out. Where the current fair value is very different from the carrying value then a revaluation should be carried out.

Most importantly, when an item of property, plant and equipment is revalued, **the whole class of assets to which it belongs should be revalued.**

All the items within a class should be **revalued at the same time**, to prevent selective revaluation of certain assets and to avoid disclosing a mixture of costs and values from different dates in the financial statements. A rolling basis of revaluation is allowed if the revaluations are kept up to date and the revaluation of the whole class is completed in a short period of time.

1.8.1 Accounting for a revaluation

How should any **increase in value** be treated when a revaluation takes place? The debit will be the increase in value in the statement of financial position, but what about the credit? IAS 16 requires the increase to be credited to other comprehensive income and accumulated in a **revaluation surplus** (part of owners' equity):

DEBIT	Asset value (statement of financial position)
CREDIT	Other comprehensive income (revaluation surplus)

1.8.2 Reversing a previous increase in value

If a revaluation results in a **decrease in the value** of an asset, the decrease should be recognised in other comprehensive income up to the amount of any existing revaluation surplus in relation to that asset:

DEBIT	Asset value (statement of financial position)
CREDIT	Other comprehensive income (revaluation surplus)

The decrease recognised in other comprehensive income reduces the amount accumulated in the revaluation surplus. If there is no revaluation surplus available, the decrease in value should be charged to profit or loss.

1.8.3 Reversing a previous decrease in value

If an asset has previously suffered a decrease in value that was charged to profit or loss, any increase in value on a subsequent revaluation should be recognised in profit or loss up to the value of the previously recognised decrease. Any excess should be recognised in other comprehensive income and accumulated in a revaluation surplus:

DEBIT	Asset value (statement of financial position)	
CREDIT	Profit or loss	With the amount of the previous decrease
CREDIT	Other comprehensive income (revaluation surplus)	With the amount of any remaining increase, over and above what has been taken to profit and loss.

(IAS 16: paras. 31–36)

1.8.4 Example: Revaluation surplus

Binkie Co has an item of land carried in its books at \$13,000. Two years ago a slump in land values led the company to reduce the carrying value from \$15,000. This was taken as an expense in profit or loss. There has been a surge in land prices in the current year, however, and the land is now worth \$20,000.

Account for the revaluation in the current year.

Solution

The double entry is:

DEBIT	Asset value (statement of financial position)	\$7,000	
CREDIT	Profit or loss		\$2,000
CREDIT	Other comprehensive income (revaluation surplus)		\$5,000

The case is similar for a **decrease in value** on revaluation. Any decrease should be recognised as an expense, except where it offsets a previous increase taken as a revaluation surplus in owners' equity. Any decrease greater than the previous upwards increase in value must be taken as an expense in profit or loss.

1.8.5 Example: Revaluation decrease

Let us simply swap round the example given above. The original cost was \$15,000, revalued upwards to \$20,000 two years ago. The value has now fallen to \$13,000.

Account for the decrease in value.

Solution

The double entry is:

DEBIT	Other comprehensive income (revaluation surplus)	\$5,000	
DEBIT	Profit or loss	\$2,000	
CREDIT	Asset value (statement of financial position)		\$7,000

There is a further complication when a **revalued asset is being depreciated**. As we have seen, an upward revaluation means that the depreciation charge will increase. Normally, a revaluation surplus is only realised when the asset is sold, but when it is being depreciated, part of that surplus is being realised as the asset is used. The amount of the surplus realised is the difference between depreciation charged on the revalued amount and the (lower) depreciation which would have been charged on the asset's original cost. **This amount can be transferred to retained (ie realised) earnings but NOT through profit or loss.**

1.8.6 Example: Revaluation and depreciation

Crinkle Co bought an asset for \$10,000 at the beginning of 20X6. It had a useful life of five years. On 1 January 20X8 the asset was revalued to \$12,000. The expected useful life has remained unchanged (ie three years remain).

Account for the revaluation and state the treatment for depreciation from 20X8 onwards.

Solution

On 1 January 20X8 the carrying value of the asset is $\$10,000 - (2 \times \$10,000 \div 5) = \$6,000$. For the revaluation:

DEBIT	Accumulated depreciation	\$4,000	
DEBIT	Asset value	\$2,000	
CREDIT	Revaluation surplus		\$6,000

The depreciation for the next three years will be $\$12,000 \div 3 = \$4,000$, compared to depreciation on cost of $\$10,000 \div 5 = \$2,000$. So each year, the extra \$2,000 can be treated as part of the surplus which has become realised:

DEBIT	Revaluation surplus	\$2,000	
CREDIT	Retained earnings		\$2,000

This is a movement on owners' equity and will be shown in the statement of changes in equity. It is not an item in profit or loss.

Exam focus point

Note that when a revaluation takes place, the depreciation for the period up to the date of revaluation should be deducted from the carrying value **before** calculating the revaluation surplus. The examining team has drawn attention to this as an error frequently made in exams.

1.9 Depreciation

The standard states:

- The **depreciable amount** of an item of property, plant and equipment should be allocated on a systematic basis over its useful life.
- The **depreciation method** used should reflect the pattern in which the asset's economic benefits are consumed by the entity.
- The **depreciation charge** for each period should be recognised as an expense unless it is included in the carrying amount of another asset.

(IAS 16: para. 48)

Land and buildings are dealt with separately even when they are acquired together because land normally has an unlimited life and is therefore not depreciated. In contrast buildings do have a limited life and must be depreciated. Any increase in the value of land on which a building is standing will have no impact on the determination of the building's useful life.

(IAS 16: para. 58)

1.9.1 Review of useful life

A review of the **useful life** of property, plant and equipment should be carried out **at least at each financial year end** and the depreciation charge for the current and future periods should be adjusted if expectations have changed significantly from previous estimates. Changes are changes in accounting estimates and are accounted for prospectively as adjustments to future depreciation.

(IAS 16: para. 51)

1.9.2 Example: Review of useful life

B Co acquired a non-current asset on 1 January 20X2 for \$80,000. It had no residual value and a useful life of ten years.

On 1 January 20X5 the remaining useful life was reviewed and revised to four years.

What will be the depreciation charge for 20X5?

Solution

	\$
Original cost	80,000
Depreciation 20X2 – 20X4 ($80,000 \times 3/10$)	(24,000)
Carrying amount at 31 December 20X4	<u>56,000</u>
Remaining life	4 years
Depreciation charge years 20X5 – 20X8 ($56,000/4$)	14,000

1.9.3 Review of depreciation method

The **depreciation method** should also be reviewed **at least at each financial year end** and, if there has been a significant change in the expected pattern of economic benefits from those assets, the method should be changed to suit this changed pattern. When such a change in depreciation method takes place the change should be accounted for as a **change in accounting estimate** and the depreciation charge for the current and future periods should be adjusted.

(IAS 16: para. 61)

1.9.4 Impairment of asset values

An **impairment loss** should be treated in the same way as a **revaluation decrease** ie the decrease should be **recognised as an expense**. However, a revaluation decrease (or impairment loss) should be charged directly against any related revaluation surplus to the extent that the decrease does not exceed the amount held in the revaluation surplus in respect of that same asset.

A **reversal of an impairment loss** should be treated in the same way as a **revaluation increase**, ie a revaluation increase should be recognised as income to the extent that it reverses a revaluation decrease or an impairment loss of the same asset previously recognised as an expense.

(IAS 16: para. 63)

1.10 Complex assets

These are assets which are made up of separate components. Each component is separately depreciated over their useful life (IAS 16: para. 13). Consider the following example of an aircraft. An aircraft could be considered as having the following components:

	Cost \$'000	Useful life
Fuselage	20,000	20 years
Undercarriage	5,000	500 landings
Engines	8,000	1,600 flying hours

Depreciation at the end of the first year, in which 150 flights totalling 400 hours were made would then be:

	\$'000
Fuselage	1,000
Undercarriage ($5,000 \times 150/500$)	1,500
Engines ($8,000 \times 400/1,600$)	2,000
	<u>4,500</u>

1.11 Overhauls

Where an asset requires regular overhauls in order to continue to operate, the cost of the overhaul is treated as an additional component and depreciated over the period to the next overhaul (IAS 16: para.14).

If in the case of the aircraft above, an overhaul was required at the end of year 3 and every third year thereafter at a cost of \$1.2 million this would then be capitalised as a separate component. \$1.2 million would be added to the cost and the depreciation (assuming 150 flights again) would therefore be:

	\$'000
Total as above	4,500
Overhaul ($\$1,200,000/3$)	400
	<u>4,900</u>

1.12 Retirements and disposals

When an asset is permanently **withdrawn from use, or sold or scrapped**, and no future economic benefits are expected from its disposal, it should be withdrawn from the statement of financial position.

(IAS 16: para. 67)

Gains or losses are the difference between the net disposal proceeds and the carrying amount of the asset. They should be recognised as income or expense in profit or loss.

(IAS 16: para. 71)

1.12.1 Disposal of a revalued asset

When a revalued asset is **disposed** of, the entity can choose whether to leave the amount in the revaluation surplus in equity or to transfer it directly to retained earnings. Any revaluation surplus may be **transferred directly to retained earnings**. Alternatively, it may be **left in equity** under the heading revaluation surplus.

The transfer to retained earnings **should not be made through profit or loss for the year**. In other words it must not be made as a reclassification adjustment.

1.13 Derecognition

An entity is required to **derecognise the carrying amount** of an item of property, plant or equipment that it disposes of on the date the **criteria for the sale** in IFRS 15 *Revenue from Contracts with Customers* would be met. This also applies to parts of an asset.

(IAS 16: para. 68)

An entity cannot classify as revenue a gain which it realises on the disposal of an item of property, plant and equipment (IAS 16: para. 68).



Question

Non-current assets

- (a) In a statement of financial position prepared in accordance with IAS 16, what does the carrying amount represent?
- (b) In a set of financial statements prepared in accordance with IAS 16, is it correct to say that the carrying amount in a statement of financial position cannot be greater than the market (net realisable) value of the partially used asset as at the end of the reporting period? Explain your reasons for your answer.

Answer

- (a) In simple terms the carrying amount of an asset is the cost of an asset less the 'accumulated depreciation', that is, all depreciation charged so far. It should be emphasised that the main purpose of charging depreciation is to ensure that profits are fairly reported. Thus depreciation is concerned with the statement of profit or loss rather than the statement of financial position. In consequence the carrying amount in the statement of financial position can be quite arbitrary. In particular, it does not necessarily bear any relation to the market value of an asset and is of little use for planning and decision making.

An obvious example of the disparity between carrying amount and market value is found in the case of buildings, which may be worth more than ten times as much as their carrying amount.

- (b) Carrying amount can in some circumstances be higher than market value (net realisable value). IAS 16 *Property, Plant and Equipment* states that the value of an asset cannot be greater than its 'recoverable amount'. However 'recoverable amount' as defined in IAS 16 is the amount recoverable from further use (IAS 16: para. 6). This may be higher than the market value.

This makes sense if you think of a specialised machine which could not fetch much on the secondhand market but which will produce goods which can be sold at a profit for many years.

Exam focus point

Property and/or other non-current assets are likely to be tested as they have come up on a number of papers.

2 Depreciation accounting

FAST FORWARD

Where assets held by an entity have a **limited useful life** to that entity it is necessary to apportion the value of an asset over its useful life.

2.1 Non-current assets

If an asset's life extends over more than one accounting period, it earns profits over more than one period. It is a **non-current asset**.

With the exception of land, **every non-current asset eventually wears out over time**. Machines, cars and other vehicles, fixtures and fittings, and even buildings do not last for ever. When a business acquires a non-current asset, it will have some idea about how long its useful life will be, and it might decide what to do with it.

- (a) Keep on using the non-current asset until it becomes **completely worn out**, useless, and worthless.
- (b) **Sell off** the non-current asset at the end of its useful life, either by selling it as a second-hand item or as scrap.

Since a non-current asset has a cost, and a limited useful life, and its value eventually declines, it follows that a charge should be made in profit or loss to reflect the use that is made of the asset by the business. This charge is called **depreciation**.

2.2 Definitions

Depreciation accounting is governed by IAS 16 *Property, Plant and Equipment*. These are some of the IAS 16 definitions concerning depreciation.

Key terms

Depreciation is the result of systematic allocation of the depreciable amount of an asset over its useful life. Depreciation for the accounting period is charged to net profit or loss for the period either directly or indirectly.

Depreciable assets are assets which:

- Are expected to be used during more than one accounting period
- Have a limited useful life
- Are held by an entity for use in the production or supply of goods and services, for rental to others, or for administrative purposes

Useful life is one of two things.

- The period over which a depreciable asset is expected to be used by the entity, or
- The number of production or similar units expected to be obtained from the asset by the entity.

Depreciable amount of a depreciable asset is the historical cost or other amount substituted for cost in the financial statements, less its residual value.

(IAS 16: paras. 50–54)

An 'amount substituted for cost' will normally be a **current market value** after a revaluation has taken place.

2.3 Depreciation

IAS 16 requires the depreciable amount of a depreciable asset to be allocated on a **systematic basis** to each accounting period during the useful life of the asset. **Every part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item must be depreciated separately.**

One way of defining depreciation is to describe it as a means of **spreading the cost** of a non-current asset over its useful life, and so matching the cost against the full period during which it earns profits for the business. Depreciation charges are an example of the application of the accrual assumption to calculate profits.

There are situations where, over a period, an asset has **increased in value**, ie its current value is greater than the carrying value in the financial statements. You might think that in such situations it would not be

necessary to depreciate the asset. The standard states, however, that this is irrelevant, and that depreciation should still be charged to each accounting period, based on the depreciable amount, irrespective of a rise in value.

An entity is required to begin depreciating an item of property, plant and equipment when it is available for use and to continue depreciating it until it is derecognised even if it is idle during the period.

2.4 What is depreciation?

The need to depreciate non-current assets arises from the **accruals assumption**. If money is expended in purchasing an asset then the amount expended must at some time be charged against profits. If the asset is one which contributes to an entity's revenue over a number of accounting periods it would be inappropriate to charge any single period (eg the period in which the asset was acquired) with the whole of the expenditure. Instead, some method must be found of spreading the cost of the asset over its useful economic life.

This view of depreciation as a process of allocation of the cost of an asset over several accounting periods is the view adopted by IAS 16. It is worth mentioning here two **common misconceptions** about the purpose and effects of depreciation.

- (a) It is sometimes thought that the carrying amount of an asset is equal to its net realisable value and that the object of charging depreciation is to **reflect the fall in value of an asset over its life**. This misconception is the basis of a common, but incorrect, argument which says that freehold properties (say) need not be depreciated in times when property values are rising. It is true that historical cost statements of financial position often give a misleading impression when a property's carrying amount is much below its market value, but in such a case it is open to a business to incorporate a revaluation into its books, or even to prepare its accounts based on current costs. This is a separate problem from that of allocating the property's cost over successive accounting periods.
- (b) Another misconception is that depreciation is provided **so that an asset can be replaced at the end of its useful life**. This is not the case.
 - (i) If there is no intention of replacing the asset, it could then be argued that there is no need to provide for any depreciation at all.
 - (ii) If prices are rising, the replacement cost of the asset will exceed the amount of depreciation provided.

2.5 Useful life

The following factors should be considered when **estimating the useful life** of a depreciable asset.

- Expected **physical wear and tear**
- **Obsolescence**
- Legal or other **limits** on the use of the assets

Once decided, the useful life should be **reviewed at least every financial year end** and depreciation rates adjusted for the current and future periods if expectations vary significantly from the original estimates. The effect of the change should be disclosed in the accounting period in which the change takes place.

The assessment of useful life requires **judgement** based on previous experience with similar assets or classes of asset. When a completely new type of asset is acquired (ie through technological advancement or through use in producing a brand new product or service) it is still necessary to estimate useful life, even though the exercise will be much more difficult.

The standard also points out that the physical life of the asset might be longer than its useful life to the entity in question. One of the main factors to be taken into consideration is the **physical wear and tear** the asset is likely to endure. This will depend on various circumstances, including the number of shifts for which the asset will be used, the entity's repair and maintenance programme and so on. Other factors to be considered include obsolescence (due to technological advances/improvements in production/

reduction in demand for the product/service produced by the asset) and legal restrictions, eg length of a related lease.

2.6 Residual value

In most cases the residual value of an asset is **likely to be immaterial**. If it is likely to be of any significant value, that value must be estimated at the date of purchase or any subsequent revaluation. The amount of residual value should be estimated based on the current situation with other similar assets, used in the same way, which are now at the end of their useful lives. Any expected costs of disposal should be offset against the gross residual value.

2.7 Depreciation methods

Consistency is important. The depreciation method selected should be applied consistently from period to period unless altered circumstances justify a change. When the method is changed, the effect should be quantified and disclosed and the reason for the change should be stated.

Various methods of allocating depreciation to accounting periods are available, but whichever is chosen must be applied **consistently** to ensure comparability from period to period. Change of policy is not allowed simply because of the profitability situation of the entity.

You should be familiar with the various **accepted methods of allocating depreciation** and the relevant calculations and accounting treatments, which are revised in questions at the end of this section.

The following questions are for revision purposes only.



Question

Depreciation methods

A lorry bought for a business cost \$17,000. It is expected to last for five years and then be sold for scrap for \$2,000. Usage over the five years is expected to be:

Year 1	200 days
Year 2	100 days
Year 3	100 days
Year 4	150 days
Year 5	40 days

Required

Work out the depreciation to be charged each year under:

- The straight line method
- The reducing balance method (using a rate of 35%)
- The machine hour method
- The sum-of-the digits method

Answer

- Under the straight line method, depreciation for each of the five years is:

$$\text{Annual depreciation} = \frac{\$17,000 - \$2,000}{5} = \$3,000$$

- Under the reducing balance method, depreciation for each of the five years is:

Year	Depreciation	
1	$35\% \times \$17,000$	= \$5,950
2	$35\% \times (\$17,000 - \$5,950) = 35\% \times \$11,050$	= \$3,868
3	$35\% \times (\$11,050 - \$3,868) = 35\% \times \$7,182$	= \$2,514
4	$35\% \times (\$7,182 - \$2,514) = 35\% \times \$4,668$	= \$1,634
5	Balance to bring book value down to \$2,000 = \$4,668 - \$1,634 - \$2,000	= \$1,034

- (c) Under the machine hour method, depreciation for each of the five years is calculated as follows.

Total usage (days) = 200 + 100 + 100 + 150 + 40 = 590 days

$$\text{Depreciation per day} = \frac{\$(17,000 - 2,000)}{590} = \$25.42$$

Year	Usage (days)	Depreciation (\$) (days × \$25.42)
1	200	5,084.00
2	100	2,542.00
3	100	2,542.00
4	150	3,813.00
5	40	1,016.80
		<u>14,997.80</u>

Note. The answer does not come to exactly \$15,000 because of the rounding carried out at the 'depreciation per day' stage of the calculation.

- (d) The sum-of-the-digits method begins by adding up the years of expected life. In this case, 5 + 4 + 3 + 2 + 1 = 15.

The depreciable amount of \$15,000 will then be allocated as follows:

Year	1	$15,000 \times 5/15 = 5,000$
	2	$15,000 \times 4/15 = 4,000$
	3	$15,000 \times 3/15 = 3,000$
	4	$15,000 \times 2/15 = 2,000$
	5	$15,000 \times 1/15 = 1,000$



Question

Depreciation discussion

- (a) What are the purposes of providing for depreciation?
- (b) In what circumstances is the reducing balance method more appropriate than the straight-line method? Give reasons for your answer.

Answer

- (a) The financial statements of a business try to recognise that the cost of a non-current asset is gradually consumed as the asset wears out. This is done by gradually writing off the asset's cost to profit or loss over several accounting periods. This process is known as depreciation, and is an example of the accruals assumption. IAS 16 *Property, Plant and Equipment* requires that depreciation should be allocated on a systematic basis to each accounting period during the useful life of the asset.

With regard to the accrual principle, it is fair that the profits should be reduced by the depreciation charge; this is not an arbitrary exercise. Depreciation is not, as is sometimes supposed, an attempt to set aside funds to purchase new non-current assets when required. Depreciation is not generally provided on freehold land because it does not 'wear out' (unless it is held for mining etc).

- (b) The reducing balance method of depreciation is used instead of the straight line method when it is considered fair to allocate a greater proportion of the total depreciable amount to the earlier years and a lower proportion to the later years on the assumption that the benefits obtained by the business from using the asset decline over time.

In favour of this method it may be argued that it links the depreciation charge to the costs of maintaining and running the asset. In the early years these costs are low and the depreciation charge is high, while in later years this is reversed.



Question

Depreciation accounting

A business purchased two rivet-making machines on 1 January 20X5 at a cost of \$15,000 each. Each had useful life of five years and a nil residual value. The straight line method of depreciation is used.

Owing to an unforeseen slump in market demand for rivets, the business decided to reduce its output of rivets, and switch to making other products instead. On 31 March 20X7, one rivet-making machine was sold (on credit) to a buyer for \$8,000.

Later in the year, however, it was decided to abandon production of rivets altogether, and the second machine was sold on 1 December 20X7 for \$2,500 cash.

Prepare the machinery account, provision for depreciation of machinery account and disposal of machinery account for the accounting year to 31 December 20X7.

Answer

MACHINERY ACCOUNT

		\$			\$
20X7			20X7		
1 Jan	Balance b/f	30,000	31 Mar	Disposal of machinery account	15,000
			1 Dec	Disposal of machinery account	15,000
		<u>30,000</u>			<u>30,000</u>

ACCUMULATED DEPRECIATION OF MACHINERY

		\$			\$
20X7			20X7		
31 Mar	Disposal of machinery account*	6,750	1 Jan	Balance b/f	12,000
1 Dec	Disposal of machinery account**	8,750	31 Dec	Profit or loss***	3,500
		<u>15,500</u>			<u>15,500</u>

* Depreciation at date of disposal = \$6,000 + \$750

** Depreciation at date of disposal = \$6,000 + \$2,750

*** Depreciation charge for the year = \$750 + \$2,750

DISPOSAL OF MACHINERY

		\$			\$
20X7			20X7		
31 Mar	Machinery account	15,000	31 Mar	Account receivable (sale price)	8,000
			31 Mar	Provision for depreciation	6,750
1 Dec	Machinery	15,000	1 Dec	Cash (sale price)	2,500
			1 Dec	Provision for depreciation	8,750
		<u>30,000</u>	31 Dec	Profit or loss (loss on disposal)	4,000
					<u>30,000</u>

You should be able to calculate that there was a loss on the first disposal of \$250, and on the second disposal of \$3,750, giving a total loss of \$4,000.

Workings

1 At 1 January 20X7, accumulated depreciation on the machines will be:

$$2 \text{ machines} \times 2 \text{ years} \times \frac{\$15,000}{5} \text{ per machine pa} = \$12,000, \text{ or } \$6,000 \text{ per machine}$$

- 2 Monthly depreciation is $\frac{\$3,000}{12} = \250 per machine per month
- 3 The machines are disposed of in 20X7.
 - (a) On 31 March – after three months of the year. Depreciation for the year on the machine = 3 months \times \$250 = \$750.
 - (b) On 1 December – after 11 months of the year. Depreciation for the year on the machine = 11 months \times \$250 = \$2,750

3 IAS 20 *Government grants*

FAST FORWARD

It is common for entities to receive government grants for various purposes (grants may be called subsidies, premiums, etc). They may also receive other types of assistance which may be in many forms.

3.1 Scope

The treatment of government grants is covered by IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*.

IAS 20 does **not** cover the following situations.

- Accounting for government grants in financial statements reflecting the effects of **changing prices**
- Government assistance given in the form of '**tax breaks**'
- Government acting as **part-owner** of the entity

3.2 Definitions

These definitions are given by IAS 20.

Key terms

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

Government assistance. Action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria.

Government grants. 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 and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

Grants related to assets. Government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire non-current assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

Grants related to income. Government grants other than those related to assets.

Forgivable loans. Loans which the lender undertakes to waive repayment of under certain prescribed conditions.

(IAS 20: para. 3)

Fair value. 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.

(IFRS 13: para. 9)

You can see that there are many **different forms** of government assistance: both the type of assistance and the conditions attached to it will vary. Government assistance may have encouraged an entity to undertake something it otherwise would not have done.

How will the receipt of government assistance affect the financial statements?

- (a) An appropriate method must be found to account for any **resources transferred**.
- (b) The extent to which an entity has **benefited** from such assistance during the reporting period should be shown.

3.3 Government grants

An entity should not recognise government grants (including non-monetary grants at fair value) until it has **reasonable assurance** that (IAS 20: para. 3):

- The entity will comply with any **conditions** attached to the grant
- The entity will **actually receive** the grant

Even if the grant has been received, this does not prove that the conditions attached to it have been or will be fulfilled.

It makes no difference in the treatment of the grant whether it is received in cash or given as a reduction in a liability to government, ie the **manner of receipt is irrelevant**.

Any related **contingency** should be recognised under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, once the grant has been recognised.

In the case of a **forgivable loan** (as defined in key terms above) from government, it should be treated in the same way as a government grant when it is reasonably assured that the entity will meet the relevant terms for forgiveness.

3.3.1 Accounting treatment of government grants

IAS 20 requires grants to be recognised as income over the relevant periods to match them with related costs which they have been received to compensate. This should be done on a systematic basis. **Grants should not, therefore, be credited directly to equity.**

It would be against the accruals concept to credit grants to income on a receipts basis, so a **systematic basis of matching** must be used. A receipts basis would only be acceptable if no other basis was available.

It will usually be easy to identify the **costs related to a government grant**, and thereby the period(s) in which the grant should be recognised as income, ie when the costs are incurred. Where grants are received in relation to a depreciating asset, the grant will be recognised over the periods in which the asset is depreciated **and** in the same proportions.



Question

Recognition

Arturo Co receives a government grant representing 50% of the cost of a depreciating asset which costs \$40,000. How will the grant be recognised if Arturo Co depreciates the asset:

- (a) Over four years straight line; or
- (b) At 40% reducing balance?

The residual value is nil. The useful life is four years.

The grant should be recognised in the same proportion as the depreciation.

(a) Straight line

	Depreciation	Grant income
	\$	\$
Year 1	10,000	5,000
2	10,000	5,000
3	10,000	5,000
4	10,000	5,000

(b) Reducing balance

	Depreciation	Grant income
	\$	\$
Year 1	16,000	8,000
2	9,600	4,800
3	5,760	2,880
4 (remainder)	8,640	4,320

In the case of **grants for non-depreciable assets**, certain obligations may need to be fulfilled, in which case the grant should be recognised as income over the periods in which the cost of meeting the obligation is incurred. For example, if a piece of land is granted on condition that a building is erected on it, then the grant should be recognised as income over the building's life.

There may be a **series of conditions** attached to a grant, in the nature of a package of financial aid. An entity must take care to identify precisely those conditions which give rise to costs which in turn determine the periods over which the grant will be earned. When appropriate, the grant may be split and the parts allocated on different bases.

An entity may receive a grant as compensation for expenses or losses which it has **already incurred**. Alternatively, a grant may be given to an entity simply to provide immediate financial support where no future related costs are expected. In cases such as these, the grant received should be recognised as income of the period in which it becomes receivable.

3.3.2 Non-monetary government grants

A non-monetary asset may be transferred by government to an entity as a grant, for example a piece of land, or other resources. The **fair value** of such an asset is usually assessed and this is used to account for both the asset and the grant. Alternatively, both may be valued at a nominal amount.

(IAS 20: para. 23)

3.3.3 Presentation of grants related to assets

There are two choices here for how government grants related to assets (including non-monetary grants at fair value) should be shown in the statement of financial position.

- (a) Set up the grant as **deferred income**.
- (b) **Deduct the grant** in arriving at the **carrying amount** of the asset.

These are considered to be acceptable alternatives and we can look at an example showing both.

Example: Accounting for grants related to assets

A company receives a 20% grant towards the cost of a new item of machinery, which cost \$100,000. The machinery has an expected life of four years and a nil residual value. The expected profits of the company, before accounting for depreciation on the new machine or the grant, amount to \$50,000 per annum in each year of the machinery's life.

Solution

The results of the company for the four years of the machine's life would be as follows.

(a) *Reducing the cost of the asset*

	Year 1	Year 2	Year 3	Year 4	Total
	\$	\$	\$	\$	\$
Profit before depreciation	50,000	50,000	50,000	50,000	200,000
Depreciation*	<u>20,000</u>	<u>20,000</u>	<u>20,000</u>	<u>20,000</u>	<u>80,000</u>
Profit	<u>30,000</u>	<u>30,000</u>	<u>30,000</u>	<u>30,000</u>	<u>120,000</u>

*The depreciation charge on a straight line basis, for each year, is $\frac{1}{4}$ of $\$(100,000 - 20,000) = \$20,000$.

Statement of financial position at year end (extract)

	\$	\$	\$	\$
Non-current asset	80,000	80,000	80,000	80,000
Depreciation 25%	<u>20,000</u>	<u>40,000</u>	<u>60,000</u>	<u>80,000</u>
Carrying amount	<u>60,000</u>	<u>40,000</u>	<u>20,000</u>	<u>—</u>

(b) *Treating the grant as deferred income*

	Year 1	Year 2	Year 3	Year 4	Total
	\$	\$	\$	\$	\$
Profit as above	50,000	50,000	50,000	50,000	200,000
Depreciation	(25,000)	(25,000)	(25,000)	(25,000)	(100,000)
Grant	<u>5,000</u>	<u>5,000</u>	<u>5,000</u>	<u>5,000</u>	<u>20,000</u>
Profit	<u>30,000</u>	<u>30,000</u>	<u>30,000</u>	<u>30,000</u>	<u>120,000</u>

Statement of financial position at year end (extract)

	Year 1	Year 2	Year 3	Year 4
	\$	\$	\$	\$
Non-current asset at cost	100,000	100,000	100,000	100,000
Depreciation 25%	<u>(25,000)</u>	<u>(50,000)</u>	<u>(75,000)</u>	<u>(100,000)</u>
Carrying amount	<u>75,000</u>	<u>50,000</u>	<u>25,000</u>	<u>—</u>
Government grant deferred income	<u>15,000</u>	<u>10,000</u>	<u>5,000</u>	<u>—</u>

Whichever of these methods is used, the **cash flows** in relation to the purchase of the asset and the receipt of the grant are often disclosed separately because of the significance of the movements in cash flow.

Deducting the grant from the cost of the asset is simpler, but the deferred income method has the advantage that the non-current asset continues to be carried at cost in the financial statements.

3.3.4 Presentation of grants related to income

These grants are a credit in profit or loss, but there is a choice in the method of disclosure.

- (a) Present as a **separate credit** or under a general heading, eg 'other income'
- (b) **Deduct from the related expense**

(IAS 20: para. 29)

Some would argue that offsetting income and expenses in the statement of profit or loss is not good practice. Others would say that the expenses would not have been incurred had the grant not been available, so offsetting the two is acceptable. Although both methods are acceptable, disclosure of the grant may be necessary for a **proper understanding** of the financial statements, particularly the effect on any item of income or expense which is required to be separately disclosed.

3.3.5 Repayment of government grants

If a grant must be repaid it should be accounted for as a **revision of an accounting estimate** (see IAS 8).

- (a) **Repayment of a grant related to income:** apply first against any unamortised deferred income set up in respect of the grant; any excess should be recognised immediately as an expense.
- (b) **Repayment of a grant related to an asset:** increase the carrying amount of the asset or reduce the deferred income balance by the amount repayable. The cumulative additional depreciation that would have been recognised to date in the absence of the grant should be immediately recognised as an expense.

It is possible that the circumstances surrounding repayment may require a review of the **asset value** and an impairment of the new carrying amount of the asset.

3.4 Government assistance

Some forms of government assistance are excluded from the definition of government grants.

- (a) Some forms of government assistance '**cannot reasonably have a value placed on them**' (IAS 20: para. 34), eg free technical or marketing advice, provision of guarantees.
- (b) There are transactions with government which '**cannot be distinguished from the entity's normal trading transactions**' (IAS 20: para. 34), eg government procurement policy resulting in a portion of the entity's sales. Any segregation would be arbitrary.

Disclosure of such assistance may be necessary because of its significance; its nature, extent and duration should be disclosed. Loans at low or zero interest rates are a form of government assistance, but the imputation of interest does not fully quantify the benefit received.

4 IAS 40 *Investment Property*

FAST FORWARD

An entity may own land or a building **as an investment** rather than for use in the business. It may therefore generate cash flows largely independently of other assets which the entity holds. The treatment of investment property is covered by IAS 40.

4.1 Definitions

Consider the following definitions.

Key terms

Investment property is property (land or a building – or part of a building – or both) held (by the owner or by the lessee as a right-of-use asset) 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 as a right-of-use asset) for use in the production or supply of goods or services or for administrative purposes.

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.

Cost is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction.

Carrying amount is the amount at which an asset is recognised in the statement of financial position.

(IAS 40: para. 5)

Examples of investment property include:

- (a) **Land held for long-term capital appreciation** rather than for short-term sale in the ordinary course of business
- (b) A **building** owned by the reporting entity (or held by the entity as a right-of-use asset) and **leased out under an operating lease**
- (c) A building held by a **parent** and leased to a **subsidiary**. Note, however, that while this is regarded as an investment property in the individual parent company financial statements, in the **consolidated** financial statements this property will be regarded as owner-occupied (because it is occupied by the group) and will therefore be treated in accordance with IAS 16.
- (d) Property that is being constructed or developed for future use as an investment property



Question

Investment

Rich Co owns a piece of land. The directors have not yet decided whether to build a factory on it for use in its business or to keep it and sell it when its value has risen.

Would this be classified as an investment property under IAS 40?

Answer

Yes. If an entity has not determined that it will use the land either as an owner-occupied property or for short-term sale in the ordinary course of business, the land is considered to be held for capital appreciation.

4.2 Accounting treatment

IAS 40 *Investment Property* prescribes the accounting treatment for investment property and related disclosure requirements.

An asset held by an entity as a right-of-use asset under IFRS 16 and leased out under an operating lease is treated as investment property (IAS 40: para. 8).

You now know what is an investment property under IAS 40. Below are examples of items that are **not** investment property.

Type of non-investment property	Applicable IAS
Property intended for sale in the ordinary course of business	IAS 2 <i>Inventories</i>
Property being constructed or developed on behalf of third parties	IFRS 15 <i>Revenue from Contracts with Customers</i>
Owner-occupied property	IAS 16 <i>Property, Plant and Equipment</i>

Some properties may be **partly owner-occupied and partly held for investment purposes**. Under IAS 40, if these portions could be sold separately (or leased out separately under a finance lease), an entity should account for the portions separately. If the portions could not be sold separately, the property is investment property only if an insignificant portion is held for use in the production or supply of goods or services or for administrative purposes ie if only an insignificant part is owner-occupied.

4.3 Recognition

Investment property should be recognised as an asset when **two conditions** are met.

- (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**.'

(IAS 40: para. 16)

4.4 Initial measurement

An investment property should be measured initially at its **cost**, including transaction costs.

A right-of-use asset classified as an investment property should be measured in accordance with IFRS 16.

4.5 Measurement subsequent to initial recognition

IAS 40 (para. 32) requires an entity to **choose between two models**.

- The fair value model
- The cost model

Whatever policy it chooses should be applied to **all of its investment property**.

4.5.1 Fair value model

Key term

- (a) After initial recognition, an entity that chooses the **fair value model** should measure all of its investment property at fair value, except in the extremely rare cases where this cannot be measured reliably. In such cases it should apply the IAS 16 cost model.
- (b) A gain or loss arising from a change in the fair value of an investment property should be recognised in net profit or loss for the period in which it arises.
- (c) The fair value of investment property (in accordance with IFRS 13) should reflect market conditions at the end of the reporting period.

(IAS 40: paras. 33, 35, 40)

This was the first time that the IASB allowed a fair value model for non-financial assets. This is not the same as a revaluation, where increases in carrying amount above a cost-based measure are recognised as revaluation surplus. Under the fair-value model all changes in fair value are recognised in profit or loss.

The standard elaborates on **issues relating to fair value**.

- (a) Fair value assumes that an orderly transaction has taken place between market participants, ie both buyer and seller are reasonably informed about the nature and characteristics of the investment property.
- (b) A buyer participating in an orderly transaction is **motivated but not compelled** to buy. A seller participating in an orderly transaction is neither an over-eager nor a forced seller, nor one prepared to sell at any price or to hold out for a price not considered reasonable in the current market.
- (c) **Fair value is not the same as 'value in use'** as defined in IAS 36 *Impairment of Assets*. Value in use reflects factors and knowledge specific to the entity, while fair value reflects factors and knowledge relevant to the market.
- (d) In determining fair value an entity **should not double count assets**. For example, elevators or air conditioning are often an integral part of a building and should be included in the investment property, rather than recognised separately.
- (e) When a lessee uses the fair value model to measure an investment property that is held as a right-of-use asset, it shall measure the right-of-use asset, and not the underlying property, at fair value.

- (f) In those rare cases where the **entity cannot determine the fair value of an investment property reliably**, the cost model in **IAS 16** must be applied until the investment property is disposed of. The **residual value must be assumed to be zero**.
 - (g) When lease payments are at market rates, the fair value of an investment property held by a lessee as a right-of-use asset, net of all expected lease payments, should be zero.
- (IAS 40: paras. 50–55)

4.5.2 Cost model

The cost model is the **cost model in IAS 16** for owned assets. Assets held by lessees as right-of-use assets are measured at cost in accordance with IFRS 16. Investment property should be measured at **depreciated cost, less any accumulated impairment losses**. An entity that chooses the cost model should **disclose the fair value of its investment property**.

(IAS 40: paras. 56, 79)

4.5.3 Changing models

Once the entity has chosen the fair value or cost model, it should apply it to all its investment property. It **should not change from one model to the other unless the change will result in a more appropriate presentation**. IAS 40 states that it is highly unlikely that a change from the fair value model to the cost model will result in a more appropriate presentation.

(IAS 40: para. 31)

4.6 Transfers

Transfers to or from investment property should **only** be made **when there is a change in use**. For example, owner occupation commences so the investment property will be treated under IAS 16 as an owner-occupied property.

When there is a transfer from investment property carried at fair value to owner-occupied property or inventories, the property's cost for subsequent accounting under IAS 16 or IAS 2 should be its fair value at the date of change of use.

Conversely, an owner-occupied property may become an investment property and need to be carried at fair value. An entity should apply IAS 16 up to the date of change of use. It should treat any difference at that date between the carrying amount of the property under IAS 16 and its fair value as a revaluation under IAS 16.

(IAS 40: paras. 57–65)

4.7 Worked example: Transfer to investment property

A business owns a building which it has been using as a head office. In order to reduce costs, on 30 June 20X9 it moved its head office functions to one of its production centres and is now letting out its head office. Company policy is to use the fair value model for investment property.

The building had an original cost on 1 January 20X0 of \$250,000 and was being depreciated over 50 years. At 31 December 20X9 its fair value was judged to be \$350,000.

How will this appear in the financial statements at 31 December 20X9?

Solution

The building will be depreciated up to 30 June 20X9.

	\$
Original cost	250,000
Depreciation 1.1.X0 – 1.1.X9 ($250/50 \times 9$)	(45,000)
Depreciation to 30.6.X9 ($250/50 \times 6/12$)	(2,500)
Carrying amount at 30.6.X9	202,500
Revaluation surplus	147,500
Fair value at 30.6.X9	<u>350,000</u>

The difference between the carrying amount and fair value is taken to a **revaluation surplus** in accordance with IAS 16.

However the building will be subjected to a fair value exercise at each year end and these gains or losses will go to **profit or loss**. If at the end of the following year the fair value of the building is found to be \$380,000, \$30,000 will be credited to profit or loss.

4.8 Disposals

Derecognise (eliminate from the statement of financial position) an investment property on disposal or when it is permanently withdrawn from use and no future economic benefits are expected from its disposal.

Any **gain or loss** on disposal is the difference between the net disposal proceeds and the carrying amount of the asset. It should generally be **recognised as income or expense in profit or loss**.

Compensation from third parties for investment property that was impaired, lost or given up shall be recognised in profit or loss when the compensation becomes receivable.

(IAS 40: paras. 66–69)

5 IAS 23 *Borrowing Costs*

FAST FORWARD

IAS 23 looks at the treatment of **borrowing costs**, particularly where the related borrowings are applied to the construction of certain assets. These are what are usually called 'self-constructed assets', where an entity builds its own inventory or non-current assets over a substantial period of time.

5.1 Definitions

Only two definitions are given by the standard.

Key terms

Borrowing costs. Interest and other costs incurred by an entity in connection with the borrowing of funds.

Qualifying asset. An asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

(IAS 23: para. 5)

Note that the standard does not define 'substantial period of time' but an asset that normally takes more than a year to be ready for use will usually be a qualifying asset.

Generally borrowing costs will be capitalised where the impact is material.

The standard lists what may be **included in borrowing costs**.

- Interest on bank overdrafts and short-term and long-term borrowings
- Finance charges in respect of leases recognised in accordance with IFRS 16
- Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs

(IAS 23: para. 6)

Depending on the circumstances, any of the following may be qualifying assets.

- Inventories
- Manufacturing plants
- Power generation facilities
- Intangible assets
- Investment properties

(IAS 23: para. 7)

Financial assets and inventories that are manufactured, or otherwise produced over a short period of time are **not qualifying assets**. Assets that are ready for their intended use or sale when purchased are not qualifying assets.

5.2 IAS 23 capitalisation

All eligible borrowing costs must be **capitalised**.

Only borrowing costs that are **directly attributable** to the acquisition, construction or production of a qualifying asset can be capitalised as part of the cost of that asset. The standard lays out the criteria for determining which borrowing costs are eligible for capitalisation.

(IAS 23: para. 8)

5.2.1 Borrowing costs eligible for capitalisation

Those borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset must be identified. These are the borrowing costs that **would have been avoided** had the expenditure on the qualifying asset not been made. This is obviously straightforward where funds have been borrowed for the financing of one particular asset.

Difficulties arise, however, where the entity uses a **range of debt instruments** to finance a wide range of assets, so that there is no direct relationship between particular borrowings and a specific asset. For example, all borrowings may be made centrally and then lent to different parts of the group or entity. Judgement is therefore required, particularly where further complications can arise (eg foreign currency loans).

Once the relevant borrowings are identified, which relate to a specific asset, then the **amount of borrowing costs available for capitalisation** will be the actual borrowing costs incurred on those borrowings during the period, **less** any investment income on the temporary investment of those borrowings. It would not be unusual for some or all of the funds to be invested before they are actually used on the qualifying asset.

(IAS 23: paras.10–15)



Question

Capitalisation

On 1 January 20X6 Stremans Co borrowed \$1.5m to finance the production of two assets, both of which were expected to take a year to build. Work started during 20X6. The loan facility was drawn down and incurred on 1 January 20X6, and was utilised as follows, with the remaining funds invested temporarily.

	Asset A \$'000	Asset B \$'000
1 January 20X6	250	500
1 July 20X6	250	500

The loan rate was 9% and Stremans Co can invest surplus funds at 7%.

Required

Ignoring compound interest, calculate the borrowing costs which may be capitalised for each of the assets and consequently the cost of each asset as at 31 December 20X6.

Answer

	Asset A \$	Asset B \$
Borrowing costs		
To 31 December 20X6 $\$500,000/\$1,000,000 \times 9\%$	<u>45,000</u>	<u>90,000</u>
Less investment income		
To 30 June 20X6 $\$250,000/\$500,000 \times 7\% \times 6/12$	<u>(8,750)</u>	<u>(17,500)</u>
	<u>36,250</u>	<u>72,500</u>
Cost of assets		
Expenditure incurred	500,000	1,000,000
Borrowing costs	<u>36,250</u>	<u>72,500</u>
	<u>536,250</u>	<u>1,072,500</u>

The June 2013 exam included a seven mark question part on borrowing costs, but with a twist: the asset was being constructed jointly with another investor. Being a joint operation, 50% of the borrowing cost was recognised in the financial statements.

In a situation where **borrowings are obtained generally**, but are applied in part to obtaining a qualifying asset, then the amount of borrowing costs eligible for capitalisation is found by applying the 'capitalisation rate' to the expenditure on the asset.

The **capitalisation rate** is the weighted average of the borrowing costs applicable to the entity's borrowings that are outstanding during the period, **excluding** borrowings made specifically to obtain a qualifying asset. However, there is a cap on the amount of borrowing costs calculated in this way: it must not exceed actual borrowing costs incurred.

Sometimes one overall weighted average can be calculated for a group or entity, but in some situations it may be more appropriate to use a weighted average for borrowing costs for **individual parts of the group or entity**.

(IAS 23: para. 14)



Question

Construction

Acruni Co had the following loans in place at the beginning and end of 20X6.

	1 January 20X6	31 December 20X6
	\$m	\$m
10% Bank loan repayable 20X8	120	120
9.5% Bank loan repayable 20X9	80	80

On 1 January 20X6, Acruni Co began construction of a qualifying asset, a piece of machinery for a hydro-electric plant, using existing borrowings. Expenditure drawn down for the construction was: \$30m on 1 January 20X6, \$20m on 1 October 20X6.

Required

Calculate the borrowing costs that can be capitalised for the hydro-electric plant machine.

Answer

$$\text{Capitalisation rate} = \text{weighted average rate} = \left(10\% \times \frac{120}{120+80}\right) + \left(9.5\% \times \frac{80}{120+80}\right) = 9.8\%$$

$$\begin{aligned} \text{Borrowing costs} &= (\$30\text{m} \times 9.8\%) + (\$20\text{m} \times 9.8\% \times 3/12) \\ &= \$3.43\text{m} \end{aligned}$$

5.2.2 Carrying amount exceeds recoverable amount

A situation may arise whereby the carrying amount (or expected ultimate cost) of the qualifying asset exceeds its recoverable amount or net realisable value. In these cases, the carrying amount must be **written down or written off**, as required by other IASs. In certain circumstances (again as allowed by other IASs), these amounts may be written back in future periods.

(IAS 23: para. 16)

5.2.3 Commencement of capitalisation

Three events must be taking place for capitalisation of borrowing costs to be started.

- (a) Expenditure on the asset is being incurred
- (b) Borrowing costs are being incurred
- (c) Activities are in progress that are necessary to prepare the asset for its intended use or sale

Expenditure must result in the payment of cash, transfer of other assets or assumption of interest-bearing liabilities. **Deductions from expenditure** will be made for any progress payments or grants received in connection with the asset. IAS 23 allows the **average carrying amount** of the asset during a period (including borrowing costs previously capitalised) to be used as a reasonable approximation of the expenditure to which the capitalisation rate is applied in the period. Presumably more exact calculations can be used.

Activities necessary to prepare the asset for its intended sale or use extend further than physical construction work. They encompass technical and administrative work prior to construction, eg obtaining permits. They do **not** include holding an asset when no production or development that changes the asset's condition is taking place, eg where land is held without any associated development activity.

(IAS 23: paras. 17–19)

5.2.4 Suspension of capitalisation

If active development is **interrupted for any extended periods**, capitalisation of borrowing costs should be suspended for those periods.

Suspension of capitalisation of borrowing costs is not necessary for **temporary delays** or for periods when substantial technical or administrative work is taking place.

(IAS 23: paras. 20–21)

5.2.5 Cessation of capitalisation

Once substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete, then capitalisation of borrowing costs should cease. This will normally be when **physical construction of the asset is completed**, although minor modifications may still be outstanding.

The asset may be completed in **parts or stages**, where each part can be used while construction is still taking place on the other parts. Capitalisation of borrowing costs should cease for each part as it is completed. The example given by the standard is a business park consisting of several buildings.

(IAS 23: paras. 22–25)

Chapter Roundup

- IAS 16 covers all aspects of accounting for property, plant and equipment. This represents the bulk of items which are **'tangible' non-current assets**.
- Where assets held by an entity have a **limited useful life** to that entity it is necessary to apportion the value of an asset over its useful life.
- It is common for entities to receive government grants for various purposes (grants may be called subsidies, premiums, etc). They may also receive other types of assistance which may be in many forms.
- An entity may own land or a building **as an investment** rather than for use in the business. It may therefore generate cash flows largely independently of other assets which the entity holds. The treatment of investment property is covered by IAS 40.
- IAS 23 looks at the treatment of **borrowing costs**, particularly where the related borrowings are applied to the construction of certain assets. These are what are usually called 'self-constructed assets', where an entity builds its own inventory or non-current assets over a substantial period of time.

Quick Quiz

- 1 Define depreciation.
- 2 Which of the following elements can be included in the production cost of a non-current asset?
 - (i) Purchase price of raw materials
 - (ii) Architect's fees
 - (iii) Import duties
 - (iv) Installation costs
- 3 Market value can usually be taken as fair value.
True ☐
False ☐
- 4 Investment properties must always be shown at fair value.
True ☐
False ☐
- 5 What is the correct treatment for property being constructed for future use as investment property?

Answers to Quick Quiz

- 1 See Para 2.2
- 2 All of them.
- 3 True, but see IFRS 13 for more detail
- 4 False. The cost model may be used, provided it is used consistently.
- 5 It is treated as an investment property under IAS 40.

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q6	Examination	20	39 mins

5

Impairment of assets

Topic list	Syllabus reference
1 IAS 36 <i>Impairment of Assets</i>	B3
2 Cash generating units	B3
3 Goodwill and the impairment of assets	B3
4 Accounting treatment of an impairment loss	B3

Introduction

IAS 36 is an important standard. Impairment rules apply to both tangible and intangible assets.

Study guide

B3	Impairment of assets
(a)	Identify circumstances which indicate that an impairment of an asset may have occurred
(b)	Describe what is meant by a cash-generating unit
(c)	Define and calculate the recoverable amount of an asset and any associated impairment losses
(d)	State the basis on which impairment losses should be allocated, and allocate a given impairment loss to the assets of a cash-generating unit.
(e)	Account for the reversal of an impairment loss that was recognised in a previous period

1 IAS 36 *Impairment of Assets*

FAST FORWARD

Impairment is determined by comparing the carrying amount of the asset with its recoverable amount. This is the higher of its **fair value less costs of disposal** and its **value in use**.

There is an established principle that assets should not be carried at above their recoverable amount. An entity should write down the carrying amount of an asset to its recoverable amount if the carrying amount of an asset is not recoverable in full. IAS 36 puts in place a detailed methodology for carrying out impairment reviews and related accounting treatments and disclosures.

1.1 Scope

IAS 36 applies to all tangible, intangible and financial assets except inventories, assets arising from construction contracts, deferred tax assets, assets arising under IAS 19 *Employee Benefits* and financial assets within the scope of IFRS 9 *Financial Instruments*. This is because those standards already have rules for recognising and measuring impairment. Note also that IAS 36 does not apply to non-current assets held for sale, which are dealt with under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

Key terms

An **impairment loss** is the amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount.

Carrying amount is the amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.

(IAS 36: para. 6)

The basic principle underlying IAS 36 is relatively straightforward. If an asset's value in the financial statements is higher than its realistic value, measured as its 'recoverable amount', the asset is judged to have suffered an impairment loss. It should therefore be reduced in value, by the amount of the **impairment loss**. The amount of the impairment loss should be **written off against profit** immediately.

The main accounting issues to consider are therefore:

- How is it possible to **identify when** an impairment loss may have occurred?
- How should the **recoverable amount** of the asset be measured?
- How should an 'impairment loss' be **reported in the financial statements**?

1.2 Identifying a potentially impaired asset

An entity should assess at the end of each reporting period whether there are any indications of impairment to any assets. The concept of **materiality** applies, and only material impairment needs to be identified.

If there are indications of possible impairment, the entity is required to make a formal estimate of the **recoverable amount** of the assets concerned.

IAS 36 suggests how **indications of a possible impairment** of assets might be recognised. The suggestions are based largely on common sense.

(a) **External sources of information**

- (i) A fall in the asset's market value that is more significant than would normally be expected from passage of time over normal use
- (ii) A significant change in the technological, market, legal or economic environment of the business in which the assets are employed
- (iii) An increase in market interest rates or market rates of return on investments likely to affect the discount rate used in calculating value in use
- (iv) The carrying amount of the entity's net assets being more than its market capitalisation

(b) **Internal sources of information:** evidence of obsolescence or physical damage, adverse changes in the use to which the asset is put, or the asset's economic performance

(IAS 36: para. 12)

Even if there are no indications of impairment, the following assets must **always** be tested for impairment annually.

- (a) An intangible asset with an **indefinite useful life**
- (b) **Goodwill** acquired in a business combination

1.3 Measuring the recoverable amount of the asset

What is an asset's recoverable amount?

Key term

The **recoverable amount of an asset** should be measured as the **higher value** of:

- (a) The asset's fair value less costs of disposal
- (b) Its value in use

(IAS 36: para. 6)

An asset's fair value less costs of disposal is the price that would be received to sell the asset in an orderly transaction between market participants at the measurement date, less direct disposal costs, such as legal expenses.

- (a) If there is an **active market** in the asset, the fair value should be based on the **market price**, or on the price of recent transactions in similar assets.
- (b) If there is **no active market** in the asset it might be possible to **estimate** fair value using best estimates of what market participants might pay in an orderly transaction.

Fair value less costs of disposal **cannot** be reduced, however, by including within costs of disposal any **restructuring or reorganisation expenses**, or any costs that have already been recognised in the financial statements as liabilities.

The concept of 'value in use' is very important.

Key term

The **value in use** is the present value of the future cash flows expected to be derived from an assets or cash-generating unit (IAS 36: para. 6).

1.4 Recognition and measurement of an impairment loss

The rule for assets at historical cost is:

Rule to learn

If the recoverable amount of an asset is lower than the carrying amount, the carrying amount should be reduced by the difference (ie the impairment loss) which should be charged as an expense in profit or loss.

The rule for assets held at a revalued amount (such as property revalued under IAS 16) is:

Rule to learn

The impairment loss is to be treated as a revaluation decrease under the relevant IAS.

In practice this means:

- To the extent that there is a revaluation surplus held in respect of the asset, the impairment loss should be charged to other comprehensive income (and shown in the revaluation surplus).
- Any excess should be charged to profit or loss.

(IAS 36: paras. 60–61)

1.5 Example: Calculating an impairment loss

A Co holds an item of machinery which it believes is impaired. The following information is relevant:

- The machine is held at historical cost
- The carrying amount of the machinery is \$10,500
- The fair value of the machinery is \$10,000, the cost of selling is \$500
- The present value of the value in use of the machinery is estimated to be \$9,000

Required

Determine whether the machinery is impaired and if so, calculate the impairment loss.

Solution

The carrying amount of the machinery must be compared to its recoverable amount.

The recoverable amount is the higher of:

- (a) The machinery's fair value less costs of disposal: $10,000 - 500 = \$9,500$
- (b) Its value in use: \$9,000

Therefore the recoverable amount is \$9,500.

The carrying amount of the machinery is therefore greater than its recoverable amount, so the machinery is impaired.

The impairment loss is: $\$10,500 - \$9,500 = \$1,000$.

2 Cash generating units

FAST FORWARD

When it is not possible to calculate the recoverable amount of a single asset, then that of its **cash-generating unit** should be measured instead.

2.1 Use of cash-generating unit

The IAS goes into quite a large amount of detail about the important concept of cash generating units. As a basic rule, the recoverable amount of an asset should be calculated for the **asset individually**. However, there will be occasions when it is not possible to estimate such a value for an individual asset, particularly in the calculation of value in use. This is because cash inflows and outflows cannot be attributed to the individual asset.

If it is not possible to calculate the recoverable amount for an individual asset, the recoverable amount of the asset's cash-generating unit should be measured instead.

Key term

A **cash-generating unit** is the smallest identifiable group of assets for which independent cash flows can be identified and measured (IAS 36: para. 6).



Question

Cash-generating unit I

Can you think of some examples of how a cash-generating unit would be identified?

Answer

Here are two possibilities.

- (a) A mining company owns a private railway that it uses to transport output from one of its mines. The railway now has no market value other than as scrap, and it is impossible to identify any separate cash inflows with the use of the railway itself. Consequently, if the mining company suspects an impairment in the value of the railway, it should treat the mine as a whole as a cash generating unit, and measure the recoverable amount of the mine as a whole.
- (b) A bus company has an arrangement with a town's authorities to run a bus service on four routes in the town. Separately identifiable assets are allocated to each of the bus routes, and cash inflows and outflows can be attributed to each individual route. Three routes are running at a profit and one is running at a loss. The bus company suspects that there is an impairment of assets on the loss-making route. However, the company will be unable to close the loss-making route, because it is under an obligation to operate all four routes, as part of its contract with the local authority. Consequently, the company should treat all four bus routes together as a cash generating unit, and calculate the recoverable amount for the unit as a whole.



Question

Cash-generating unit II

Minimart belongs to a retail store chain Maximart. Minimart makes all its retail purchases through Maximart's purchasing centre. Pricing, marketing, advertising and human resources policies (except for hiring Minimart's cashiers and salesmen) are decided by Maximart. Maximart also owns five other stores in the same city as Minimart (although in different neighbourhoods) and 20 other stores in other cities. All stores are managed in the same way as Minimart. Minimart and four other stores were purchased five years ago and goodwill was recognised.

Required

What factors will Maximart consider when determining if Minimart meets the definition of a cash generating unit?

Answer

In identifying Minimart's cash-generating unit, an entity considers whether, for example:

- (a) Internal management reporting is organised to measure performance on a store-by-store basis.
- (b) The business is run on a store-by-store profit basis or on a region/city basis.

All Maximart's stores are in different neighbourhoods and probably have different customer bases. So, although Minimart is managed at a corporate level, Minimart generates cash inflows that are largely independent from those of Maximart's other stores. Therefore, it is likely that Minimart is a cash-generating unit.

If an active market exists for the output produced by the asset or a group of assets, this asset or group should be identified as a cash generating unit, even if some or all of the output is used internally.

Cash-generating units should be identified consistently from period to period for the same type of asset unless a change is justified.

The group of net assets less liabilities that are considered for impairment should be the same as those considered in the calculation of the recoverable amount. (For the treatment of goodwill and corporate assets see below.)

2.2 Example: Recoverable amount and carrying amount

Fourways Co is made up of four cash generating units. All four units are being tested for impairment. Assets and liabilities will be allocated to them as follows.

- (a) Property, plant and equipment and separate intangibles will be allocated to the cash-generating units as far as possible.
- (b) Current assets such as inventories, receivables and prepayments will be allocated to the relevant cash-generating units.
- (c) Liabilities (eg payables) will be deducted from the net assets of the relevant cash-generating units (provided that the recoverable amount of the cash generating unit cannot be calculated without consideration of those liabilities (IAS 36: para. 76).
- (d) The net figure for each cash-generating unit resulting from this exercise will be compared to the relevant recoverable amount, computed on the same basis.

3 Goodwill and the impairment of assets

3.1 Allocating goodwill to cash-generating units

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** (or groups of cash-generating units) that are expected to benefit from the synergies of the combination. Each unit to which the goodwill is so allocated should:

- (a) 'Represent the **lowest level** within the entity at which the goodwill is monitored for internal management purposes' and
- (b) 'Not be **larger than a reporting segment** determined in accordance with IFRS 8 *Operating Segments*'

(IAS 36: para. 80)

It may be impracticable to complete the allocation of goodwill before the first reporting date after a business combination, particularly if the acquirer is accounting for the combination for the first time using provisional values. The initial allocation of goodwill must be completed before the end of the first reporting period after the acquisition date.

3.2 Testing cash-generating units with goodwill for impairment

A cash-generating unit to which goodwill has been allocated is tested for impairment annually. The **carrying amount** of the unit, including goodwill, is **compared with the recoverable amount**. If the carrying amount of the unit exceeds the recoverable amount, the entity must recognise an impairment loss.

The annual impairment test may be performed at any time during an accounting period, but must be performed at the **same time every year**.

3.3 Example: Allocation of impairment loss

A cash-generating unit comprises the following:

	\$m
Building	30
Plant and equipment	6
Goodwill	10
Current assets	<u>20</u>
	<u>66</u>

Following a recession, an impairment review has estimated the recoverable amount of the cash-generating unit to be \$50 million.

How do we allocate the impairment loss?

The loss will be applied first against the goodwill and then against the tangible non-current assets on a pro-rata basis. The current assets are considered to be stated at fair value and hence no impairment loss is allocated to them (this is covered further in the next section). After writing off the goodwill, the balance to be allocated is \$6m. This is pro-rated over the total of \$36m for the remaining non-current assets at a rate of \$1m per \$6m.

	<i>Carrying amount</i>	<i>Impairment loss</i>	<i>Carrying amount post-impairment</i>
	\$m	\$	\$
Building	30	(5)	25
Plant and equipment	6	(1)	5
Goodwill	10	(10)	–
Current assets	<u>20</u>	<u>–</u>	<u>20</u>
	<u>66</u>	<u>(16)</u>	<u>50</u>

4 Accounting treatment of an impairment loss

If, and only if, the recoverable amount of an asset is less than its carrying amount in the statement of financial position, an impairment loss has occurred. This loss should be **recognised immediately**.

- The asset's **carrying amount** should be reduced to its recoverable amount in the statement of financial position.
- The **impairment loss** should be recognised immediately in profit or loss (unless the asset has been revalued upwards in which case the loss is treated as a revaluation decrease).

After reducing an asset to its recoverable amount, the **depreciation charge** on the asset should then be based on its new carrying amount, its estimated residual value (if any) and its estimated remaining useful life.

An impairment loss should be recognised for a **cash-generating unit** if (and only if) the recoverable amount for the cash-generating unit is less than the carrying amount in the statement of financial position for all the assets in the unit. When an impairment loss is recognised for a cash-generating unit, the loss should be allocated between the assets in the unit in the following order.

- First to the carrying amount of any **goodwill** allocated to the cash generating unit
- Then to all other assets in the cash-generating unit, on a **pro rata basis**

(IAS 36: para. 104)

If any individual assets within a cash generating unit can be specifically identified as being impaired, for example, because they are damaged or have become obsolete, then the carrying amount of those assets should be reduced first.

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

- (a) Its fair value less costs of disposal
- (b) Its value in use (if determinable)
- (c) Zero

(IAS 36: para. 105)

Any remaining amount of an impairment loss should be recognised as a liability if required by other IASs.

Allocating an impairment loss to goodwill is further complicated by the choice in IFRS 3 to value the non-controlling interest at fair value or at the proportionate share of net assets. This is covered in Chapter 21.

4.1 Example 1: Impairment loss

A company that extracts natural gas and oil has a drilling platform in the Caspian Sea. It is required by legislation of the country concerned to remove and dismantle the platform at the end of its useful life. Accordingly, the company has included an amount in its financial statements for removal and dismantling costs, and is depreciating this amount over the platform's expected life.

The company is carrying out an exercise to establish whether there has been an impairment of the platform.

- (a) Its carrying amount in the statement of financial position is \$3m.
- (b) The company has received an offer of \$2.8m for the platform from another oil company. The bidder would take over the responsibility (and costs) for dismantling and removing the platform at the end of its life.
- (c) The present value of the estimated cash flows from the platform's continued use is \$3.3m (before adjusting for dismantling costs).
- (d) The carrying amount in the statement of financial position for the provision for dismantling and removal is currently \$0.6m.

What should be the value of the drilling platform in the statement of financial position, and what, if anything, is the impairment loss?

Solution

Fair value less costs of disposal	=	\$2.8m
Value in use	=	PV of cash flows from use less the carrying amount of the provision/liability = $\$3.3\text{m} - \$0.6\text{m} = \$2.7\text{m}$
Recoverable amount	=	Higher of these two amounts, ie \$2.8m
Carrying value	=	\$3m
Impairment loss	=	\$0.2m

The carrying value should be reduced to \$2.8m

4.2 Example 2: Impairment loss

A company has acquired another business for \$4.5m: tangible assets are valued at \$4.0m and goodwill at \$0.5m.

An asset with a carrying value of \$1m is destroyed in a terrorist attack. The asset was not insured. The loss of the asset, without insurance, has prompted the company to assess whether there has been an impairment of assets in the acquired business and what the amount of any such loss is.

The recoverable amount of the business (a single cash generating unit) is measured as \$3.1m.

Solution

There has been an impairment loss of \$1.4m (\$4.5m – \$3.1m).

The impairment loss will be recognised in profit or loss. The loss will be allocated between the assets in the cash generating unit as follows.

- (a) A loss of \$1m can be attributed directly to the uninsured asset that has been destroyed.
- (b) The remaining loss of \$0.4m should be allocated to goodwill.

The carrying value of the assets will now be \$3m for tangible assets and \$0.1m for goodwill.

4.3 Reversal of an impairment loss

The annual assessment to determine whether there may have been some impairment should be **applied to all assets**, including assets that have already been impaired in the past.

In some cases, the recoverable amount of an asset that has previously been impaired might turn out to be **higher** than the asset's current carrying value. In other words, there might have been a reversal of some of the previous impairment loss.

In which case, the carrying amount of the asset should be increased to its **new recoverable amount**, and:

- (a) If the asset is carried at revalued amount (for example under IAS 16), the reversal of the impairment loss should be accounted for as a revaluation increase (so applying IAS 16: recognised in other comprehensive income and accumulated as a revaluation surplus in equity).
- (b) If the asset is not carried at revalued amount, the reversal of the impairment loss should be **recognised immediately** as income in profit or loss.

(IAS 36: para. 119)

The asset cannot be revalued to a carrying amount that is higher than its value would have been if the asset had not been impaired originally, ie its **depreciated carrying amount** had the impairment not taken place. Depreciation of the asset should now be based on its new revalued amount, its estimated residual value (if any) and its estimated remaining useful life.

An exception to this rule is for **goodwill**. An impairment loss for goodwill should not be reversed in a subsequent period (IAS 36: para. 124).



Question

Reversal of impairment loss

A cash generating unit comprising a factory, plant and equipment etc and associated purchased goodwill becomes impaired because the product it makes is overtaken by a technologically more advanced model produced by a competitor. The recoverable amount of the cash generating unit falls to \$60m, resulting in an impairment loss of \$80m, allocated as follows.

	Carrying amounts before impairment	Carrying amounts after impairment
	\$m	\$m
Goodwill	40	–
Patent (with no market value)	20	–
Tangible non-current assets (market value \$60m)	80	60
Total	140	60

After three years, the entity makes a technological breakthrough of its own, and the recoverable amount of the cash generating unit increases to \$90m. The carrying amount of the tangible non-current assets had the impairment not occurred would have been \$70m.

Required

Calculate the reversal of the impairment loss.

Answer

The reversal of the impairment loss is recognised to the extent that it increases the carrying amount of the tangible non-current assets to what it would have been had the impairment not taken place, ie a reversal of the impairment loss of \$10m is recognised and the tangible non-current assets written back to \$70m. Reversal of the impairment is not recognised in relation to the patent because the effect of the external event that caused the original impairment has not reversed – the original product is still overtaken by a more advanced model. Reversal of an impairment to goodwill is not permitted under IAS 36.

Exam focus point

An exam question may ask you to calculate and allocate an impairment loss. Make sure you know the order in which to allocate the loss.

Chapter Roundup

- Impairment is determined by comparing the carrying amount of the asset with its recoverable amount. This is the higher of its **fair value less costs of disposal** and its **value in use**.
- When it is not possible to calculate the recoverable amount of a single asset, then that of its **cash-generating unit** should be measured instead.

Quick Quiz

- 1 Define recoverable amount of an asset.
- 2 How is an impairment loss on a revalued asset treated?
- 3 How is an impairment loss allocated to the assets in a cash-generating unit?
- 4 Describe the circumstances under which impairment losses may be reversed.
- 5 Non-depreciable assets with a carrying amount of \$300,000 were found to have a recoverable amount of \$280,000 at 31 December 20X5. On 31 December 20X6 the recoverable amount had increased to \$310,000. How much of this reversal may be recognised?

Answers to Quick Quiz

- 1 Higher of **fair value less costs of disposal** and **value in use**
- 2 As a revaluation decrease
- 3 In the following order: (a) against any damaged or destroyed assets; then (b) against goodwill; then (c) against all other non-current assets on a *pro rata* basis.
- 4 An impairment loss recognised in prior periods for an asset other than goodwill shall be reversed if, and only if, there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. An impairment loss recognised for goodwill shall not be reversed in a subsequent period.
- 5 \$20,000 of the impairment reversal may be recognised, that is the carrying amount may be increased to the amount recorded prior to the impairment.

Accounting for leases

6

Topic list	Syllabus reference
1 IFRS 16	B4
2 Lessee accounting	B4
3 Sale and leaseback	B4
4 Lessor accounting	B4

Introduction

Leasing transactions are extremely common so this is an important practical subject. Lease accounting is regulated by IFRS 16, which replaces IAS 17.

Study guide

B4	Leases
(a)	Account for right-of-use assets and lease liabilities in the records of the lessee.
(b)	Explain the exemption from the recognition criteria for leases in the records of the lessee.
(c)	Account for sale and leaseback transactions in the financial statements of lessees.
(d)	Explain the distinction between operating and finance leases from a lessor perspective.
(e)	Account for operating leases and finance leases in the financial statements of lessors.

Exam focus point

IFRS 16 was tested as a full 20-mark question in the December 2016 exam. The examiner stated that 'performance on this question was disappointing overall. [The question] tested various aspects of IFRS 16 – the new leasing standard. Whilst some candidates produced pleasing answers to question 3 it was evident that many candidates were not aware of the new standard at all. It is essential to keep up to date to ensure success in this examination' (Examiner's Report December 2017, p1).

1 IFRS 16

FAST FORWARD

IFRS 16 was brought in to ensure that all assets are shown on the statement of financial position, including leased assets. Under the previous standard (IAS 17) operating leases were not recognised as assets of the reporting entity.

1.1 Why was IFRS 16 issued?

IFRS 16 *Leases* was published in January 2016 and is effective from 1 January 2019. Companies can choose to apply IFRS 16 before that date but only if they also apply IFRS 15 *Revenue from Contracts with Customers*.

IFRS 16 replaces IAS 17 *Leases*. IAS 17 classified leases into operating leases and finance leases for lessees, similar to the approach used for lessor accounting in IFRS 16 (IAS 17: para. 8).

In the lessee's books, operating leases were not recognised as liabilities in the statement of financial position and instead the lease rentals were recorded as an expense in profit or loss (IAS 17: para. 33). However, finance leases were recorded in the lessee's books as an asset and a corresponding liability (IAS 17: para. 20).

Therefore the classification of a lease as an operating or finance lease had a considerable impact on the financial statements, most notably on indebtedness, gearing ratios, ROCE and interest cover.

IAS 17 was criticised because the distinction between finance leases and operating leases in IAS 17 was very subjective and because that distinction resulted in an incentive to classify all leases as operating leases, therefore understating liabilities. It was also argued that the IAS 17 accounting treatment of operating leases was inconsistent with the definition of assets and liabilities in the IASB's *Conceptual Framework*.

IFRS 16 was brought in to address these criticisms.

1.2 Objective

IFRS 16 sets out the principles for the recognition, measurement, presentation and disclosure of leases. The objective is to ensure that lessees and lessors provide relevant information in a manner that faithfully represents those transactions (IFRS 16: para. IN1).

1.3 Main features

IFRS 16 introduces a single lessee accounting model and requires a lessee to **recognise assets and liabilities** for all leases with a term of more than 12 months, unless the underlying asset is of low value. For short-term leases or low value assets, the lease payments are simply charged to profit or loss as an expense (see below). Note that IFRS 16 does not define a 'low value' asset.

For all other leases, the **lessee recognises a right-of-use asset**, representing its right to use the underlying asset and a lease liability representing its obligation to make lease payments (IFRS 16: para. IN10). For lessors, there is little change from the IAS 17 requirements. **Lessors** will continue to recognise the **distinction between finance and operating leases**.

1.4 Identifying a lease

Key terms

Lease. A contract, or part of a contract, that conveys the right to use an asset, the **underlying asset**, for a period of time in exchange for consideration.

Underlying asset. An asset that is the subject of a lease, for which the right to use that asset has been provided by a **lessor** to a **lessee**.

(IFRS 16: Appendix A)

An entity must identify whether a contract contains a **lease**, which is the case if the contract conveys the **right to control** the use of an identified asset for a period of time in exchange for consideration (IFRS 16: para. 9).

The right to control the use of an identified asset depends on the lessee having:

- (a) 'The right to obtain **substantially all of the economic benefits** from use of the identified asset, and
- (b) The right to **direct the use** of the identified asset' (IFRS 16: para. B9).

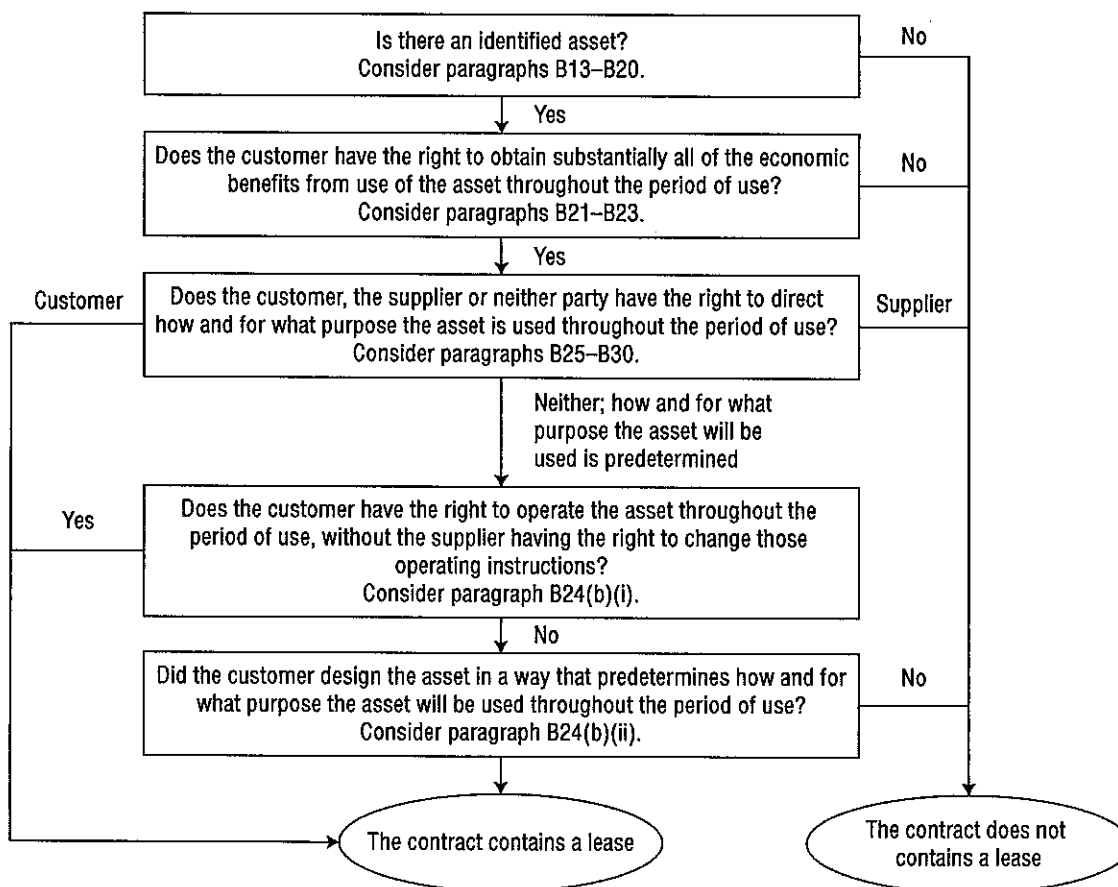
The right to direct the use of the asset will arise when either:

- (i) The customer has the right to direct **how and for what purpose** the asset is used during the whole term of usage; or
- (ii) Relevant decisions about use of the asset are **pre-determined** and the customer can operate the asset without the supplier having the right to change those operating instructions, or **the customer designed the asset** in a way that predetermines how and for what purpose the asset will be used throughout the period of use, for example, a piece of factory equipment designed to the specifications of the customer.

(IFRS 16: para. B24).

Even if an asset is specified, a customer does not have the right to direct the use of an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use (IFRS 16: para. B14). Some contracts may contain elements that are not leases, such as service contracts. These must be separated out from the lease and accounted for separately (IFRS 16: para. 13).

The following flowchart, from IFRS 16 Appendix B (para. B31), may help you in determining whether a contract contains a lease.



1.5 Identifying a lease: Examples

1.5.1 Example 1: Is it a lease?

Coketown Council has entered into a five-year contract with Carefleet Co, under which Carefleet Co supplies the council with ten vehicles for the purposes of community transport. Carefleet Co owns the relevant vehicles, all ten of which are specified in the contract. Coketown Council determines the routes taken for community transport and the charges and eligibility for discounts. The council can choose to use the vehicles for purposes other than community transport. When the vehicles are not being used, they are kept at the council's offices and cannot be retrieved by Carefleet Co unless Coketown Council defaults on payment. If a vehicle needs to be serviced or repaired, Carefleet Co is obliged to provide a temporary replacement vehicle of the same type.

Conclusion: this is a lease. There is an identifiable asset, the ten vehicles specified in the contract. The council has a right to use the vehicles for the period of the contract. Carefleet Co does not have the right to substitute any of the vehicles unless they are being serviced or repaired. Therefore Coketown Council would need to recognise a right-of-use asset and a lease liability in its statement of financial position.

1.5.2 Example 2: Is it a lease?

Broketown Council has recently made substantial cuts to its community transport service. It will now provide such services only in cases of great need, assessed on a case by case basis. It has entered into a two-year contract with Fleetcar Co for the use of one of its minibuses for this purpose. The minibus must seat ten people, but Fleetcar Co can use any of its ten-seater minibuses when required. The minibuses are held on Fleetcar Co's premises and are only made available to Broketown Council on request.

Conclusion: this is not a lease. There is no identifiable asset. Fleetcar Co can exchange one minibus for another. Therefore, Broketown Council should account for the rental payments as an expense in profit or loss.

1.5.3 Example 3: Is it a lease?

This example is based on illustrative example 3 from the IFRS 16 illustrative examples.

Kabal enters into a ten-year contract with a utilities company (Telenew) for the right to use three specified, physically distinct dark fibres within a larger fibre-optic cable connecting North Town to South Town. Kabal makes the decisions about the use of the fibres by connecting each end of the fibres to its electronic equipment (ie Kabal 'lights' the fibres and decides what data, and how much data, those fibres will transport). If the fibres are damaged, Telenew is responsible for the repairs and maintenance. Telenew owns extra fibres, but can substitute those for Kabal's fibres only for reasons of repairs, maintenance or malfunction (and is obliged to substitute the fibres in these cases).

Conclusion: this is a lease. The contract contains a lease of dark fibres. Kabal has the right to use the three dark fibres for ten years.

There are three identified fibres. The fibres are explicitly specified in the contract and are physically distinct from other fibres within the cable. Telenew cannot substitute the fibres other than for reasons of repairs, maintenance or malfunction (IFRS 16: para. B18).

Kabal has the right to control the use of the fibres throughout the ten-year period of use because:

- (a) Kabal has the right to obtain substantially all of the economic benefits from use of the fibres over the ten-year period of use and Kabal has exclusive use of the fibres throughout the period of use.
- (b) Kabal has the right to direct the use of the fibres because IFRS 16: para. B24 applies:
 - (i) The customer has the right to direct how and for what purpose the asset is used during the whole of its period of use, or
 - (ii) The relevant decisions about use are pre-determined and the customer can operate the asset without the supplier having the right to change those operating instructions.

Kabal makes the relevant decisions about how and for what purpose the fibres are used by deciding (i) when and whether to light the fibres and (ii) when and how much output the fibres will produce (ie what data, and how much data, those fibres will transport). Kabal has the right to change these decisions during the ten-year period of use.

Although Telenew's decisions about repairing and maintaining the fibres are essential to their efficient use, those decisions do not give Telenew the right to direct how and for what purpose the fibres are used. Consequently, Telenew does not control the use of the fibres during the period of use.

1.6 Recognition exemptions

IFRS 16 provides an optional exemption from the full requirements of the standard for:

- (a) **Short-term leases.** These are leases with a lease term of 12 months or less. This election is made by class of underlying asset. A lease that contains a purchase option cannot be a short-term lease.
- (b) **Low value leases.** These are leases where the underlying asset has a low value when new. This election can be made on a lease-by-lease basis.

IFRS 16 does not give an amount which is considered to be 'low value'. However, it does give examples of items that would be considered to be low value, including tablet and personal computers, small items of office furniture and telephones (IFRS 16: para. B8). Additionally, the assessment of whether an underlying asset is of low value is not dependent on the size or circumstances of the lessee. So different lessees are expected to reach the same conclusion as to whether a particular underlying asset is of low value (IFRS 16: para. B4).

An underlying asset qualifies as low value only if two conditions apply:

- (i) 'The lessee can benefit from using the underlying asset.
- (ii) The underlying asset is not highly dependent on, or highly interrelated with, other assets'

(IFRS 16: para. B5).

'If the entity elects to take the exemption, lease payments are **recognised as an expense** on a **straight-line basis over the lease term** or another systematic basis, if more representative of the pattern of the lessee's benefits' (IFRS 16: para. 6).

2 Lessee accounting

FAST FORWARD

At commencement of the lease, the lessee recognises a **right-of-use asset** and a **lease liability**.

2.1 Recognition

At the **commencement date**, which is the date the lessor makes the underlying asset available for use by the lessee, the lessee recognises:

- A **lease liability**
- A **right-of-use asset**.

Key terms

- **Right-of-use asset.** An asset that represents a lessee's right to use an **underlying asset** for the **lease term**.
- **Lease term.** The **non-cancellable period** for which a lessee has the **right to use** an underlying asset, together with both:
 - (a) periods covered by an **option to extend** the lease if the lessee is **reasonably certain to exercise** that option; and
 - (b) periods covered by an **option to terminate** the lease if the lessee is **reasonably certain not to exercise** the option.

(IFRS 16: Appendix A)

2.2 Lease liability

The lease liability is initially measured at the **present value of lease payments not paid at the commencement date**, discounted at the **interest rate implicit in the lease** (IFRS 16: para. 26). If that rate cannot be readily determined, the lessee's incremental borrowing rate should be used (IFRS 16: para. 26).

Key terms

- **Interest rate implicit in the lease.**
The discount rate that, at the inception of the lease, causes the aggregate present value of:
 - (a) The lease payments, and
 - (b) The **unguaranteed residual value**to be equal to the sum of:
 - (a) The fair value of the **underlying asset**, and
 - (b) Any initial direct costs.
- **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 similar value to the **right of use asset** in a similar economic environment.
- **Unguaranteed residual value.** That portion of the residual value of the underlying asset, the realisation of which by the lessor is not assured.

(IFRS 16: Appendix A)

The **lease liability** includes:

- Fixed payments, less any **lease incentives**
- **Variable payments** that depend on an index (eg the consumer price index) or rate (eg market rent)
- Amounts expected to be payable under residual value guarantees
- Purchase options (if reasonably certain to be exercised).

(IFRS 16: Appendix A)

Lease incentives. Payments made by the lessor to the lessee, or the reimbursement or assumption by the lessor of costs of the lessee.

(IFRS 16: Appendix A)

Other variable payments (eg that arise due to level of use of the asset) are accounted for as period costs in profit or loss as incurred.

After the commencement date the carrying amount of the lease liability is **increased by interest charges** on the outstanding liability and **reduced by lease payments** made (IFRS 16: para. 36).

2.3 Right-of-use asset

The right-of-use asset is initially measured at **cost**, which includes:

- (a) The amount of the **initial** measurement of the lease liability (the present value of lease payments **not** paid at the commencement date)
- (b) Any lease payments made **at/before** the commencement date, less any **lease incentives** received
- (c) Any initial direct costs (eg legal costs) incurred by the lessee
- (d) Any costs which the lessee will incur for dismantling and removing the underlying asset or restoring the site at the end of the lease term

Subsequently, the right-of-use asset is **normally measured at cost less accumulated depreciation and impairment losses** in accordance with the cost model of IAS 16 *Property, Plant and Equipment* (IFRS 16: para. 29).

Under this model, the right-of-use asset is **depreciated** from the commencement date to the **earlier of the end of its useful life or the end of the lease term**. However, if ownership of the underlying asset is expected to be transferred to the lessee at the end of the lease, the right-of-use asset should be depreciated over the **useful life** of the underlying asset (IFRS 16: paras. 31 and 32).

Alternatively, the right-of-use asset is accounted for in accordance with:

- (a) The **revaluation model of IAS 16**. This is **optional** where the right-of-use asset relates to a class of property, plant and equipment which is measured under the revaluation model, and where elected, must apply to all right-of-use assets relating to that class; or
- (b) The **fair model of IAS 40 Investment Property**. This is **compulsory** if the right-of-use asset meets the definition of investment property and the lessee uses the fair value model for its investment property.

2.4 Presentation

In the statement of financial position **right-of-use assets** can be presented on a separate line under non-current assets or they can be included in the total of corresponding underlying assets and disclosed in the notes.

Lease liabilities should be either presented separately from other liabilities or disclosed in the notes (IFRS 16: para. 47(b)).

IFRS 16 does not specify that lease liabilities should be split between non-current and current liabilities, but this should be done as best practice.

2.5 Allocating the finance charge

As the company benefits from paying the lease over a period of time, the total amount paid will therefore include **capital and interest payments**. The interest is referred to as an interest charge or finance charge.

IFRS 16 requires the finance charge to be **allocated** to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period, ie applying the

interest rate implicit in the lease (the lease's internal rate of return) to the amount of capital outstanding to calculate the finance charge for the period. (The lessee's incremental borrowing rate may be used if the interest rate implicit in the lease cannot be determined.)

Consequently, at the **start** of the lease the **finance charges will be large** as the outstanding lease liability is large. Towards **the end** of the lease's life, the **finance charge will be smaller** as the outstanding lease liability is smaller.

This is commonly called the **actuarial method**.

2.6 Example: Allocating the finance charge

This example is based on IFRS 16 Illustrative example 13.

A lessee enters into a five-year lease of a building which has a remaining useful life of ten years. Lease payments are \$50,000 per annum, payable at the beginning of each year.

The lessee incurs initial direct costs of \$20,000 and receives lease incentives of \$5,000. There is no transfer of the asset at the end of the lease and no purchase option.

The interest rate implicit in the lease is not immediately determinable but the lessee's incremental borrowing rate is 5%.

At the commencement date the lessee pays the initial \$50,000, incurs the direct costs and receives the lease incentives.

The lease liability is measured at the present value of the remaining four payments:

	\$
\$50,000/1.05	47,619
\$50,000/1.05 ²	45,351
\$50,000/1.05 ³	43,192
\$50,000/1.05 ⁴	41,135
	<u>177,297</u>

Exam focus point

This present value calculation has been included for completeness of the illustration. In the exam, you will not be expected to calculate the present value in this way. Instead the question will specify a value for the cumulative present value of \$1 payable in x years' time at a certain discount rate so that you can calculate the present value quickly and easily. In this illustration, the cumulative present value of \$1 payable annually in advance for four years is \$3.456. Therefore the lease liability would be calculated as \$50,000 × 3.456 = \$172,800.

Assets and liabilities will initially be recognised as follows:

		<i>Debit</i>	<i>Credit</i>
		\$	\$
Right-of-use asset:			
Initial payment	50,000		
Discounted liability	177,297		
Initial direct costs	20,000		
Incentives received	<u>(5,000)</u>		
		242,297	
Lease liability			177,297
Cash	(50,000 + 20,000 – 5,000)		65,000
		<u>242,297</u>	<u>242,297</u>

At the end of year 1 the liability will be measured as:

	\$
Opening balance	177,297
Interest 5%	8,865
	<u>186,162</u>

Current liability	50,000
Non-current liability	<u>136,162</u>
	<u>186,162</u>

The right-of-use asset will be depreciated over five years, being the shorter of the lease term and the useful life of the underlying asset.

Now we will see how this would work out if the lease payments were made **in arrears**.

At the commencement date the lessee would incur the direct costs and receive the lease incentives.

The lease would be measured at the present value of **five** payments:

	\$
\$50,000/1.05	47,619
\$50,000/1.05 ²	45,351
\$50,000/1.05 ³	43,192
\$50,000/1.05 ⁴	41,135
\$50,000/1.05 ⁵	<u>39,176</u>
	<u>216,473</u>

Assets and liabilities would be recognised as follows:

		Debit \$	Credit \$
Right-of-use asset:			
Discounted liability	216,473		
Direct costs	20,000		
Lease incentives	<u>(5,000)</u>		
		231,473	
Lease liability			216,473
Cash (20,000 – 5,000)			<u>15,000</u>
		<u>231,473</u>	<u>231,473</u>

At the end of year 1 the liability will be measured as:

	\$
Opening balance	216,473
Interest 5%	10,824
Lease payment year 1	<u>(50,000)</u>
Year-end balance	<u>177,297</u>

In order to ascertain the split between non-current and current liabilities, we work out the balance at the end of year 2:

	\$
Opening balance	177,297
Interest 5%	8,865
Lease payment year 2	<u>(50,000)</u>
Year-end balance	<u>136,162</u>

The statement of financial position will show:

	\$
Non-current liability	136,162
Current liability (177,297 – 136,162)	<u>41,135</u>
	<u>177,297</u>

Note that when payments are made in arrears the next instalment due will contain interest, so this is effectively deducted to arrive at the capital repayment.

2.7 Calculation of the lease liability

The calculation of the lease liability to be included in the financial statements can be summarised as follows. Here the lease commencement date is 1.1.X1 and the interest rate implicit in the lease is x%.

If lease payments are made in arrears:

		\$
1.1.X1	Lease liability (present value of future lease payments)	X
1.1.X1 – 31.12.X1	Interest at x%	X
31.12.X1	Instalment in arrears	(X)
31.12.X1	Liability carried down	X
1.1.X2 – 31.12.X2	Interest at x%	X
31.12.X2	Instalment in arrears	(X)
31.12.X2	Liability due in more than 1 year	X

If lease payments are made in advance:

		\$
1.1.X1	Lease liability (present value of future lease payments)	X
1.1.X1 – 31.12.X1	Interest at x%	X
31.12.X1	Liability carried down	X
1.1.X2	Instalment in advance	(X)
	Liability due in more than 1 year	X



Question

Lessee accounting

Company A makes up its accounts to 31 December each year. It enters into a lease (as a lessee) to lease an item of equipment with the following terms:

Inception of lease:	1 January 20X1
Term:	Five years: \$2,000 paid at commencement of lease, followed by four payments of \$2,000 payable at the start of each subsequent year
Fair value:	\$8,000
Present value of future lease payments:	\$6,075
Useful life:	Eight years
Interest rate implicit in the lease:	12%

Required

Show how should this lease should be accounted for in Company A's statement of financial position as at 31 December 20X1.

Answer

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X1 (EXTRACT)

	\$
<i>Non-current assets</i>	
Right-of-use asset (W1)	6,460
<i>Non-current liabilities</i>	
Lease liability (W2)	4,804
<i>Current liabilities</i>	
Lease liability ((6,804 – 4,804) W2)	2,000

Workings

1 Right-of-use asset

	\$
Initial measurement of lease liability	6,075
Payments made before or at commencement of lease	<u>2,000</u>
Right-of-use asset	<u>8,075</u>

Depreciate over the shorter of the useful life or the lease term:

Depreciation charge = $\$8,075/5 = \$1,615$

Carrying amount at 31.12.X1 = $\$8,075 - \$1,615 = \underline{\underline{\$6,460}}$

2 Lease liability

		\$
1.1.X1	Liability b/d	6,075
1.1.X1 – 31.12.X1	Interest at 12%	<u>729</u>
31.12.X1	Liability c/d	6,804
1.1.X2	Instalment 2 (in advance)	<u>(2,000)</u>
1.1.X2	Liability due in more than one year	<u>4,804</u>

3 Sale and leaseback

FAST FORWARD

A sale and leaseback transaction involves the sale of an asset and the leasing back of the same asset.

Exam focus point

The DipIFR syllabus only considers the effects of a sale and leaseback in the financial records of the lessee.

A sale and leaseback transaction involves the sale of an asset and the leasing back of the same asset. The key question in determining the accounting treatment is: **does the transaction constitute a sale?** This is determined by considering when the **performance obligation** is satisfied in accordance with IFRS 15 *Revenue from Contracts with Customers* (IFRS 16: para. 99).

3.1 Transfer is a sale

If the transfer satisfies the IFRS 15 requirements to be accounted for as a sale:

- (1) The seller/lessee measures the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the **right of use retained** by the seller/lessee. This is calculated as:

$$\text{Carrying amount} \times \frac{\text{present value of lease payments}}{\text{fair value}}$$

- (2) The seller/lessee **only recognises the amount of any gain or loss** on the sale that relates to the **rights transferred** to the buyer (IFRS 16: para. 100). This can be calculated in three stages:

Stage 1: Calculate the total gain Total gain = fair value – carrying amount

Stage 2: Calculate the gain that relates to the **rights retained**:

$$\text{Gain} \times \frac{\text{present value of lease payments}}{\text{fair value}} = \text{Gain relating to rights retained}$$

Stage 3: The gain relating to **rights transferred** is the balancing figure:

$$\text{Gain on rights transferred} = \text{total gain (Stage 1)} - \text{gain on rights retained (Stage 2)}$$

The right-of-use asset continues to be **depreciated as normal**, although a revision of its remaining useful life may be necessary to restrict it to the lease term.

3.1.1 Example: Sale and leaseback where the transfer is a sale

On 1 April 20X2, Wigton Co bought an injection moulding machine for \$600,000. The carrying amount of the machine as at 31 March 20X3 was \$500,000. On 1 April 20X3, Wigton Co sold it to Whitehaven Co for \$740,000, its fair value. Wigton Co immediately leased the machine back for five years, the remainder of its useful life, at \$160,000 per annum payable in arrears. The present value of the annual lease payments is \$700,000 and the transaction satisfies the IFRS 15 criteria to be recognised as a sale.

Required

What gain should Wigton Co recognise for the year ended 31 March 20X4 as a result of the sale and leaseback?

Solution

Stage 1: Total gain on the sale = fair value – carrying amount

$$= \$740,000 - \$500,000 = \$240,000$$

Stage 2: Gain relating to the rights retained = gain \times $\frac{\text{present value of lease payments}}{\text{fair value}}$

$$\begin{aligned} &= \$ (240,000 \times 700,000 / 740,000) \\ &= \$227,027 \end{aligned}$$

Stage 3: Gain relating to the rights transferred = total gain (Stage 1) – gain on rights retained (Stage 2)

$$\begin{aligned} &= \$240,000 - \$227,027 \\ &= \$12,973 \end{aligned}$$

Wigton Co should recognise a gain of \$12,973 for the year ended 31 March 20X4 as a result of the sale and leaseback.

3.1.2 Transaction not on market terms

If the fair value of the consideration for the sale does not equal the fair value of the asset, or if the lease payments are not at market rates, the following adjustments should be made:

- Any **below-market terms** should be accounted for as a **prepayment of lease payments** (the shortfall in consideration received from the lessor is treated as a lease payment made by the lessee)
- Any **above-market terms** are accounted for as **additional financing provided by the buyer/lessor** (the additional amount paid by the lessor is treated as additional liability, **not** as gain on the sale) (IFRS 16: para. 101(b))

Example: Sale and leaseback not on market terms

Adapted from IFRS 16 Illustrative example 24.

Sellalot Co sells a building to Buyalot Co for \$800,000 cash. The carrying amount of the building prior to the sale was \$600,000. Sellalot Co arranges to lease the building back for five years at \$120,000 per annum, payable in arrears. The remaining useful life is 15 years.

The transaction **satisfies the IFRS 15 criteria to be recognised as a sale**, so will be accounted for as a sale and leaseback.

At the date of sale the fair value of the building was \$750,000, so the **excess \$50,000** paid by Buyalot Co is **recognised as additional financing** provided by Buyalot Co.

- (1) The **lease liability** must be calculated.

The interest rate implicit in the lease is 4.5% and the present value of the annual payments is calculated as follows. Using a discount factor of 4.5% the cumulative present value of \$1 payable annually in arrears for five years is \$4.390.

Therefore, the cumulative present value of the lease payments is $\$120,000 \times 4.390 = \$526,800$

Of this, **\$476,800 relates to the lease** and **\$50,000 relates to the additional financing**.

- (2) The **right-of-use asset** must be measured.

At the commencement date, Sellalot Co measures the **right-of-use asset arising from the leaseback of the building at the proportion of the previous carrying amount of the building that relates to the right of use retained**.

This is calculated as:

$$\begin{aligned}\text{Right-of-use asset (arising from leaseback)} &= \text{carrying amount} \times \frac{\text{present value of lease payments}}{\text{fair value}} \\ &= \$600,000 \times 476,800/750,000 \\ &= \mathbf{\$381,440}\end{aligned}$$

The right-of-use asset will be **depreciated** over five years, being the shorter of the lease term and the useful life of the asset.

- (3) The **gain on the sale and leaseback** must be calculated.

Sellalot Co only recognises the amount of gain that relates to the **rights transferred**.

To calculate the gain:

$$\begin{aligned}\text{Stage 1: Total gain on the sale} &= \text{fair value} - \text{carrying amount} \\ &= \$750,000 - \$600,000 \\ &= \mathbf{\$150,000}\end{aligned}$$

$$\begin{aligned}\text{Stage 2: Gain relating to the rights retained} &= \text{gain} \times \frac{\text{present value of lease payments}}{\text{fair value}} \\ &= \$150,000 \times (476,800/750,000) \\ &= \mathbf{\$95,360}\end{aligned}$$

$$\begin{aligned}\text{Stage 3: Gain relating to the rights transferred} &= \text{total gain (Stage 1)} - \text{gain on rights retained (Stage 2)} \\ &= \$150,000 - \$95,360 \\ &= \mathbf{\$54,640}\end{aligned}$$

- (4) The transaction must be recorded in Sellalot Co's accounts.

At the commencement date the transaction will be recorded as follows:

	Debit	Credit
	\$	\$
Cash	800,000	
Right-of-use asset	381,440	
Building		600,000
Financial liability		526,800
Gain on rights transferred		54,640
	<u>1,181,440</u>	<u>1,181,440</u>

The gain will be recognised in profit or loss and the financial liability will be increased each year by the interest charge and reduced by the lease payments.



Question

Sale and leaseback

Capital Co entered into a sale and leaseback on 1 April 20X7. It sold a lathe with a carrying amount of \$300,00 for \$400,000 (equivalent to fair value) and leased it back over a five-year period, equivalent to its remaining useful life. The transaction constitutes a sale in accordance with IFRS 15.

The lease provided for five annual payments in arrears of \$90,000. The rate of interest implicit in the lease is 5%. Using a discount factor of 5% the cumulative present value of \$1 payable annually in arrears for five years is \$4.329.

Required

What are the amounts to be recognised in the financial statements at 31 March 20X8 in respect of this transaction?

Answer

- (1) Calculate the lease liability at commencement of the lease.

$$\$4.329 \times \$90,000 = \$389,610$$

- (2) Measure the right-of-use asset = carrying amount $\times \frac{\text{present value of lease payments}}{\text{fair value}}$

$$= 300,000 \times (389,610/400,000)$$

$$= \$292,208$$

- (3) Calculate the gain on the sale and leaseback.

Stage 1: Total gain on the sale = fair value – carrying amount

$$= \$400,000 - \$300,000$$

$$= \$100,000$$

Stage 2: Gain relating to the rights retained = gain $\times \frac{\text{present value of lease payments}}{\text{fair value}}$

$$= \$100,000 \times (389,610/400,000)$$

$$= \$97,402$$

Stage 3: Gain relating to the rights transferred = total gain (Stage 1) – gain on rights retained (Stage 2)

$$= \$100,000 - \$97,402$$

$$= \$2,598$$

- (4) Record the transaction in the accounts.

	<i>Debit</i>	<i>Credit</i>
	\$	\$
Cash	400,000	
Right-of-use asset	292,208	
Underlying asset (Lathe)		300,000
Liability		389,610
Gain on transfer		2,598
	692,208	692,208

The transaction will be shown in the financial statements as follows:

	\$
Statement of profit or loss	
Gain on transfer	2,598
Depreciation (292,208/5)	(58,442)
Interest (W)	(19,481)
Statement of financial position	
<i>Non-current asset</i>	
Right-of-use asset	292,208

<i>Non-current liabilities</i>		
Lease liability (W)		245,045
<i>Current liabilities</i>		
Lease liability (319,091 – 245,045) (W)		74,045
<i>Working – lease liability</i>		
		\$
1.4.X7	Lease liability (present value of future lease payments)	389,610
1.4.X7 – 31.3.X8	Interest at 5%	19,481
31.3.X8	Instalment paid in arrears	(90,000)
31.3.X8	Liability carried down	319,091
1.4.X8 – 31.3.X9	Interest at 5%	15,955
31.3.X9	Instalment paid in arrears	(90,000)
31.3.X9	Liability due in more than 1 year	<u>245,045</u>

Current liabilities reflect the amount of the lease liability that will become due within 12 months.

3.2 Transfer is not a sale

If the transfer does not satisfy the IFRS 15 requirements to be accounted for as a sale, the seller continues to recognise the transferred asset, and the transfer proceeds are treated as a financial liability, accounted for in accordance with IFRS 9. The transaction is more in the nature of a secured loan.

4 Lessor accounting

FAST FORWARD

- For lessor accounting IFRS 16 retains the IAS 17 distinction between finance leases and operating leases.
- **Finance leases:** record the amount due from the lessor in the statement of financial position at the net investment in the lease; recognise finance income to give a constant periodic rate of return.
- **Operating leases:** record as long-term asset and depreciate over useful life; record income on a straight-line basis over the lease term.

Exam focus point

The June 2017 exam contained an 8-mark question on accounting for a finance lease from the perspective of a lessor.

Several **definitions** are relevant to lessor accounting in particular.

Key terms

Finance lease. A lease that transfers substantially all the risks and rewards incidental to ownership of an underlying asset.

Operating lease. A lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

Guaranteed residual value is:

- For a lessee, that part of the residual value which is guaranteed by the lessee or by a party related to the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable)
- For a lessor, that part of the residual value which is guaranteed by the lessee or by a third party unrelated to the lessor who is financially capable of discharging the obligations under the guarantee.

Unguaranteed residual value is that portion of the residual value of the underlying asset, the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.

Gross investment in the lease is the sum of:

- (a) The lease payments receivable by the lessor under a finance lease, and
- (b) Any unguaranteed residual value accruing to the lessor.

Net investment in the lease is the gross investment in the lease discounted at the interest rate implicit in the lease.

Unearned finance income is the difference between:

- (a) The gross investment in the lease, and
- (b) The net investment in the lease.

(IFRS 16, Appendix A)

4.1 Finance leases

A **finance lease** is a lease that transfers substantially all the risks and rewards incidental to ownership of an underlying asset. It can be considered to be, like hire purchase, a form of instalment credit.

When we talk of **risks** here, we specifically mean the risks of ownership, not other types of risk. Risks of **ownership** include the possibility of losses from idle capacity or technological obsolescence, or variations in return due to changing economic conditions. The **rewards** are represented by the expectation of profitable operation over the assets economic life, and also any gain from appreciation in value or realisation of a residual value (IFRS 16: para. B53).

For lessors, but not lessees, finance leases are distinguished from operating leases.

4.1.1 Accounting treatment

IFRS 16 requires the **amount due from the lessee** under a finance lease to be recorded in the statement of financial position of a lessor as a receivable at the amount of the **net investment in the lease**.

The **recognition of finance income** under a finance lease should normally be based on a pattern to give a **constant periodic rate of return** on the lessor's net investment outstanding in respect of the finance lease in each period. In arriving at the constant periodic rate of return, a reasonable approximation may be made.

The lease payments (excluding costs for services) relating to the accounting period should be applied against the gross investment in the lease, so as to **reduce both the principal and the unearned finance income**.

The **estimated unguaranteed residual values** used to calculate the lessor's gross investment in a lease should be reviewed regularly. If there has been a reduction in the value, then the income allocation over the lease term must be revised. Any reduction in respect of amounts already accrued should be recognised immediately.

Initial direct costs incurred by lessors (eg commissions, legal fees and other costs that are directly attributable to negotiating and arranging a lease) are included in the initial measurement of the finance lease receivable.

4.1.2 Manufacturer/dealer lessors

IFRS 16 looks at the situation where manufacturers or dealers offer customers the choice of either buying or leasing an asset. There will be two types of income under such a lease.

- (a) Profit/loss equal to that from an **outright sale** (normal selling price less any discount)
- (b) **Finance income** over the lease term

IFRS 16 requires the following treatment (paras. 70–74):

- (a) Recognise the **selling profit/loss** in income for the period as if it was an outright sale.
- (b) If **interest rates are artificially low**, restrict the selling profit to that which would apply had a commercial rate been applied.

- (c) Recognise **costs** incurred in connection with negotiating and arranging a lease as an **expense** when the **selling profit** is recognised (at the start of the lease term).

4.2 Operating leases

4.2.1 Definition

An **operating lease** is a lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset, its useful life. The distinction between finance and operating leases applies only to lessors, not lessees.

4.2.2 Accounting treatment

An **asset** held for use in operating leases by a lessor should be recorded as a long-term asset and depreciated over its useful life. The basis for depreciation should be consistent with the lessor's policy on similar non-lease assets and follow the guidance in IAS 16.

Income from an operating lease, excluding charges for services such as insurance and maintenance, should be recognised on a **straight-line basis** over the period of the lease (even if the receipts are not on such a basis), unless another systematic and rational basis is more representative of the time pattern in which the benefit from the leased asset is receivable.

Initial direct costs incurred by lessors in negotiating and arranging an operating lease should be **added to the carrying amount** of the leased asset and recognised as an expense over the lease term on the same basis as lease income, i.e. capitalised and amortised over the lease term.

Lessors should refer to IAS 36 in order to determine whether a leased asset has become impaired.

A lessor who is a **manufacturer or dealer** should not recognise any selling profit on entering into an operating lease because it is not the equivalent of a sale.

Example: Operating lease

Alpha Co leased a machine with a remaining useful life of ten years to Beta Co. The lease commenced on 1 January 20X1 and is for a term of three years. Lease payments of \$3,600 are due on 31 December each year. As an incentive, Beta Co was given a rent-free period of two months at the commencement of the lease. Alpha Co is responsible for maintenance of the machine.

Required

Discuss the accounting treatment of the above lease in the financial statements of Alpha Co for the year ended 31 December 20X1, including relevant calculations.

Solution

Alpha Co retains the risks and rewards of ownership of the machine evidenced by the fact that the lease is only for a small portion of the useful life of the machine and the fact that Alpha is responsible for maintenance of the machine during the lease term. As such, the lease is an **operating lease** in the financial statements of Alpha Co.

The benefit received from the asset is earned over the three years of the lease. However, in the first year, Alpha only receives $\$3,600 \times 10/12 = \$3,000$. Lease rentals of \$10,200 ($\$3,000 + (\$3,600 \times 2 \text{ years})$) are received over the 3 year lease term.

In accordance with IFRS 16, Alpha should recognise income of \$3,400 ($\$10,200/3 \text{ years}$) in the year to 31 December 20X1, and in each of the following two years.

A receivable of \$400 should be recognised at 31 December 20X1 ($\$3,400 - \$3,000 \text{ cash received}$).

4.3 Subleases

A lessee, L, may sublease an asset which it in turn leases from another lessor, H. In this situation, H is the 'head lessor' who ultimately owns the asset from a legal perspective. L then becomes an 'intermediate

lessor'. An intermediate lessor must assess whether the sublease is a finance or operating lease in the context of the right-of-use asset being leased, not the actual underlying asset (IFRS 16: para. B 57).

Example: Sublease

(This example is adapted from Illustrative Example 18 of IFRS 16.)

Interliss, enters into a ten-year lease for 6,000 square metres of office space (the head lease) with Headliss, (the head lessor). At the beginning of year 5, Interliss subleases the 6,000 square metres of office space for the remaining six years of the head lease to a Subliss.

Solution

In this situation, Headliss is the head lessor, Interliss is the intermediate lessor, and Subliss is the sublessee. From the perspective of the intermediate lessor, at the time the sub-lease is entered into, the right-of-use asset has a six-year remaining life, and it is being sub-leased for the entirety of that remaining period of time. As such, the sub-lease is for a major part of the useful life of the right-of-use asset and the lease is classified as a finance lease.

Exam focus point

ACCA's website contains many useful articles, including on IFRS 16 *Leases*. These can be found in the following location.

Available at www.accaglobal.com/uk/en/student/exam-support-resources.html

Chapter Roundup

- IFRS 16 was brought in to ensure that all assets are shown on the statement of financial position, including leased assets. Under the previous standard (IAS 17) operating leases were not recognised as assets of the reporting entity.
- At commencement of the lease, the lessee recognises a **right-of-use asset** and a **lease liability**.
- A sale and leaseback transaction involves the sale of an asset and the leasing back of the same asset.
- For lessor accounting IFRS 16 retains the IAS 17 distinction between finance leases and operating leases.
- **Finance leases:** record the amount due from the lessor in the statement of financial position at the net investment in the lease, recognise finance income to give a constant periodic rate of return.
- **Operating leases:** record as long-term asset and depreciate over useful life, record income on a straight-line basis over the lease term.

Quick Quiz

- 1 A contract is, or contains, a lease if the contract conveys the right to an identified asset for a period of time in exchange for
- 2 A business acquires an asset under a high-value, five-year lease. What is the double entry?
- 3 List the disclosures required under IFRS 16 for lessees.
- 4 A lorry has an expected useful life of six years. It is acquired under a four year lease with no purchase options. Over which period should it be depreciated?
- 5 A company leases a tablet computer. What how should this lease be treated in its financial statements?
- 6 In a sale and leaseback transaction, the sale price is above fair value. How should this excess be treated under IFRS 16?

Answers to Quick Quiz

- 1 A contract is, or contains, a lease if the contract conveys the right to **control the use of** an identified asset for a period of time in exchange for **consideration** (IFRS 16: para. 9).
- 2 DEBIT Right-of-use asset account
CREDIT Lease liability
- 3 See Section 2.8.
- 4 The four-year term, being the shorter of the lease term and the useful life.
- 5 This is a low-value lease, so the company should recognise the lease rentals as an expense over the lease term.
- 6 Any above-market terms are accounted for as additional financing provided by the buyer/lessor. The additional amount paid by the lessor is treated as additional liability, **not** as gain on the sale (IFRS 16: para. 101(b)).

Now try the questions below from the Practice Question Bank

Number	Level	Marks	Time
Q7	Examination	10	20 mins
Q8	Examination	15	29 mins

7

Intangible assets and goodwill

Topic list	Syllabus reference
1 IAS 38 <i>Intangible Assets</i>	B5
2 Research and development costs	B5
3 Goodwill (IFRS 3)	B5

Introduction

We begin our examination of intangible non-current assets with a discussion of the IAS on the subject (**IAS 38**).

Goodwill and its treatment is a controversial area, as is the accounting for items similar to goodwill, such as brands. Goodwill is very important in **group accounts** and we will look at it again in Part D.

Study guide

B5	Intangible assets and goodwill
(a)	Discuss the nature and possible accounting treatments of both internally generated and purchased goodwill
(b)	Distinguish between goodwill and other intangible assets
(c)	Define the criteria for the initial recognition and measurement of intangible assets
(d)	Explain the principle of impairment tests in relation to purchased goodwill
(e)	Identify the circumstances in which a gain on a bargain purchase (negative goodwill) arises, and its subsequent accounting treatment
(f)	Describe and apply the requirements of IFRSs to internally generated assets other than goodwill (eg research and development)
<p>ACCA's website contains many useful articles, including the following relating to topics covered in this chapter:</p> <ul style="list-style-type: none"> • <i>Research and development</i> • <i>Impairment of goodwill</i> <p>Available at www.accaglobal.com/gb/en/student/exam-support-resources/fundamentals-exams-study-resources/f7/technical-articles.html</p>	

Exam focus point

1 IAS 38 *Intangible Assets*

FAST FORWARD

Intangible assets are defined by IAS 38 as non-monetary assets without physical substance.

1.1 The objectives of the standard

- (a) To establish the criteria for when an intangible asset may or should be **recognised**
- (b) To specify how intangible assets should be **measured**
- (c) To specify the **disclosure requirements** for intangible assets

1.2 Definition of an intangible asset

The definition of an intangible asset is a key aspect of the standard, because the rules for deciding whether or not an intangible asset may be **recognised** in the financial statements of an entity are based on the definition of what an intangible asset is.

Key term

An **intangible asset** is an identifiable non-monetary asset without physical substance. The asset must be:

- (a) Controlled by the entity as a result of events in the past
- (b) Something from which the entity expects future economic benefits to flow

(IAS 38: para. 8)

Examples of items that might be considered as intangible assets include computer software, patents, copyrights, motion picture films, customer lists, franchises and fishing rights. An item should not be recognised as an intangible asset, however, unless it **fully meets the definition** in the standard. The guidelines go into great detail on this matter.

1.3 Intangible asset: Must be identifiable

An intangible asset must be identifiable in order to distinguish it from goodwill. With non-physical items, there may be a problem with 'identifiability'.

- (a) If an intangible asset is **acquired separately through purchase**, there may be a transfer of a **legal right** that would help to make an asset identifiable.
- (b) An intangible asset may be identifiable if it is **separable**, ie if it could be rented or sold separately. However, 'separability' is not an essential feature of an intangible asset.

1.4 Intangible asset: Control by the entity

Another element of the definition of an intangible asset is that it must be under the control of the entity as a result of a past event. The entity must therefore be able to enjoy the future economic benefits from the asset, and prevent the access of others to those benefits. A **legally enforceable right** is evidence of such control, but is not always a **necessary** condition.

- (a) Control over **technical knowledge or know-how** only exists if it is protected by a **legal right** (IAS 38: para. 14).
- (b) The skill of employees, arising out of the benefits of **training costs**, are most unlikely to be recognisable as an intangible asset, because an entity does not control the future actions of its staff (IAS 38: para. 15).
- (c) Similarly, **market share and customer loyalty** cannot normally be intangible assets, since an entity cannot control the actions of its customers (IAS 38: para. 16).

1.5 Intangible asset: Expected future economic benefits

An item can only be recognised as an intangible asset if economic benefits are expected to flow in the future from ownership of the asset. Economic benefits may come from the **sale** of products or services, or from a **reduction in expenditures** (cost savings).

An intangible asset, when recognised initially, must be measured at **cost**. It should be recognised if, and only if **both** the following occur.

- (a) 'It is probable that the **future economic benefits** that are attributable to the asset will **flow to the entity**.'
- (b) The **cost of the asset can be measured reliably**'. (IAS 38: para. 21)

Management has to exercise its judgement in assessing the degree of certainty attached to the flow of economic benefits to the entity. External evidence is best.

- (a) If an intangible asset is **acquired separately**, its cost can usually be measured reliably as its purchase price (including incidental costs of purchase such as legal fees, and any costs incurred in getting the asset ready for use).
- (b) When an intangible asset is acquired as **part of a business combination** (ie an acquisition or takeover), the cost of the intangible asset is its fair value at the date of the acquisition.

IFRS 3 explains that the fair value of intangible assets acquired in business combinations can normally be measured with sufficient reliability to be **recognised separately** from goodwill.

In accordance with IAS 20, intangible assets acquired by way of government grant and the grant itself may be recorded initially either at cost (which may be zero) or fair value.

(IAS 38: para. 44)

1.6 Exchanges of assets

If one intangible asset is exchanged for another, the cost of the intangible asset is measured at fair value unless (IAS 38: para. 45):

- (a) 'The exchange transaction lacks commercial substance, or
- (b) The fair value of neither the asset received nor the asset given up can be measured reliably'.

Otherwise, its cost is measured at the carrying amount of the asset given up.

1.7 Internally generated goodwill

Internally generated goodwill may **not** be recognised as an asset.

IAS 38 deliberately precludes recognition of internally generated goodwill because it requires that, for initial recognition, the cost of the asset rather than its fair value should be capable of being measured reliably and that it should be identifiable and controlled. Thus you do not recognise an asset which is subjective and cannot be measured reliably.

2 Research and development costs

FAST FORWARD

- Development costs are recognised as an asset if they meet certain criteria.
- An intangible asset is initially recognised at cost and subsequently carried either at cost or revalued amount.
- Costs that do not meet the recognition criteria should be expensed as incurred.
- An intangible asset with a finite useful life should be amortised over its useful life. An intangible asset with an indefinite useful life should not be amortised.

2.1 Research

Research activities by definition do not meet the criteria for recognition under IAS 38. This is because, at the research stage of a project, it cannot be certain that future economic benefits will probably flow to the entity from the project. There is too much uncertainty about the likely success or otherwise of the project. **Research costs should therefore be written off as an expense as they are incurred.**

IAS 38 (para. 56) gives the following examples of research costs:

- (a) 'Activities aimed at obtaining new knowledge
- (b) The search for, evaluation and final selection of, applications of research findings or other knowledge
- (c) The search for alternatives for materials, devices, products, processes, systems or services
- (d) The formulation, design evaluation and final selection of possible alternatives for new or improved materials, devices, products, systems or services'

2.2 Development

Development costs may qualify for recognition as intangible assets provided that the following strict criteria can be demonstrated (IAS 38: para. 57):

- (a) 'The technical feasibility of completing the intangible asset so that it will be available for use or sale
- (b) The entity's intention to complete the intangible asset and use or sell it
- (c) The entity's ability to use or sell the intangible asset
- (d) How the intangible asset will generate probable future economic benefits. Among other things, the entity 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 entity's ability to measure the expenditure attributable to the intangible asset during its development reliably'

Once these criteria are met, IAS 38 requires development expenditure to be capitalised (ie there is no option of not capitalising it).

In contrast with research costs development costs are incurred at a later stage in a project, and the probability of success should be more apparent. IAS 38 (para. 59) gives the following examples of development costs:

- (a) 'The design, construction and testing of pre-production or pre-use prototypes and models
- (b) The design of tools, jigs, moulds and dies involving new technology
- (c) The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production
- (d) The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services'

2.3 Other internally generated intangible assets

The standard prohibits the recognition of internally generated brands, mastheads, publishing titles and customer lists and similar items as intangible assets. These all fail to meet one or more (in some cases all) the definition and recognition criteria and in some cases are probably indistinguishable from internally generated goodwill.

2.4 Cost of an internally generated intangible asset

The costs allocated to an internally generated intangible asset should be only costs that can be directly attributed or allocated on a reasonable and consistent basis to creating, producing or preparing the asset for its intended use. The principles underlying the costs which may or may not be included are similar to those for other non-current assets and inventory.

The cost of an internally generated intangible asset is the sum of the expenditure incurred from the date when the intangible asset first meets the recognition criteria. If, as often happens, considerable costs have already been recognised as expenses before management could demonstrate that the criteria have been met, this earlier expenditure should not be retrospectively recognised at a later date as part of the cost of an intangible asset.

Exam focus point

The treatment of development costs is examined frequently. The December 2013 paper, for instance, tested it as part of the consolidation question in the form of an internally generated asset.



Question

Treatment

Doug Co is developing a new production process. During 20X3, expenditure incurred was \$100,000, of which \$90,000 was incurred before 1 December 20X3 and \$10,000 between 1 December 20X3 and 31 December 20X3. Doug Co can demonstrate that, at 1 December 20X3, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process is estimated to be \$50,000.

Required

How should the expenditure be treated?

Answer

At the end of 20X3, the production process is recognised as an intangible asset at a cost of \$10,000. This is the expenditure incurred since the date when the recognition criteria were met, that is 1 December 20X3. The \$90,000 expenditure incurred before 1 December 20X3 is expensed, because the recognition criteria were not met. It will never form part of the cost of the production process recognised in the statement of financial position.

2.5 Recognition of an expense

All expenditure related to an intangible which does not meet the criteria for recognition either as an identifiable intangible asset or as goodwill arising on an acquisition should be **expensed as incurred**. IAS 36 (para. 69) gives examples of such expenditure:

- Start up costs
- Advertising costs
- Training costs
- Business relocation costs

Prepaid costs for services, for example advertising or marketing costs for campaigns that have been prepared but not launched, can still be recognised as a **prepayment**.

2.6 Measurement of intangible assets subsequent to initial recognition

The standard allows two methods of valuation for intangible assets after they have been first recognised.

Applying the **cost model**, an intangible asset should be **carried at its cost**, less any accumulated amortisation and less any accumulated impairment losses.

The **revaluation model** allows an intangible asset to be carried at a revalued amount, which is its **fair value** at the date of revaluation, less any subsequent accumulated amortisation and any subsequent accumulated impairment losses.

- The fair value must be able to be measured reliably with reference to an **active market** in that type of asset.
- The **entire class** of intangible assets of that type must be revalued at the same time (to prevent selective revaluations).
- If an intangible asset in a class of revalued intangible assets cannot be revalued because there is **no active market** for this asset, the asset should be carried at its **cost less any accumulated amortisation and impairment losses**.
- Revaluations should be made with such **regularity** that the carrying amount does not differ from that which would be determined using fair value at the end of the reporting period.

Point to note

This treatment is not available for the initial recognition of intangible assets. This is because the cost of the asset must be reliably measured.

The guidelines state that there will not usually be an active market in an intangible asset; therefore the revaluation model will usually not be available. For example, although copyrights, publishing rights and film rights can be sold, each has a unique sale value. In such cases, revaluation to fair value would be inappropriate. A fair value might be obtainable however for assets such as fishing rights or quotas or taxi cab licences.

Where an intangible asset is revalued upwards to a fair value, the amount of the revaluation should be credited directly to equity under the heading of a **revaluation surplus**.

However, if a revaluation surplus is a **reversal of a revaluation decrease** that was previously charged against income, the increase can be recognised as income.

Where the carrying amount of an intangible asset is revalued downwards, the amount of the **downward revaluation** should be charged as an expense against income, unless the asset has previously been revalued upwards. A revaluation decrease should be first charged against any previous revaluation surplus in respect of that asset.



Question

Downward revaluation

An intangible asset is measured by a company at fair value. The asset was revalued by \$400 in 20X3, and there is a revaluation surplus of \$400 in the statement of financial position. At the end of 20X4, the asset is valued again, and a downward valuation of \$500 is required.

Required

State the accounting treatment for the downward revaluation.

Answer

In this example, the downward valuation of \$500 can first be set against the revaluation surplus of \$400. The revaluation surplus will be reduced to \$nil and a charge of \$100 made as an expense in 20X4.

When the revaluation model is used, and an intangible asset is revalued upwards, the cumulative revaluation surplus may be transferred to retained earnings when the surplus is eventually realised. The surplus would be realised when the asset is disposed of. However, the surplus may also be realised over time as the asset is used by the entity. The amount of the surplus realised each year is the difference between the amortisation charge for the asset based on the revalued amount of the asset, and the amortisation that would be charged on the basis of the asset's historical cost. The realised surplus in such cases should be transferred from revaluation surplus directly to retained earnings, and should not be taken through profit or loss.

2.7 Useful life

An entity should assess the useful life of an intangible asset, which may be **finite or indefinite**. An intangible asset has an indefinite useful life when there is **no foreseeable limit** to the period over which the asset is expected to generate net cash inflows for the entity.

Many factors are considered in determining the useful life of an intangible asset, including (IAS 38: para. 90):

- Expected usage
- Typical product life cycles
- Technical, technological, commercial or other types of obsolescence
- The stability of the industry; expected actions by competitors
- The level of maintenance expenditure required
- Legal or similar limits on the use of the asset, such as the expiry dates of related leases

Computer software and many other intangible assets normally have short lives because they are susceptible to technological obsolescence. However, uncertainty does not justify choosing a life that is unrealistically short.

The useful life of an intangible asset that arises from **contractual or other legal rights** should not exceed the period of the rights, but may be shorter depending on the period over which the entity expects to use the asset.

2.8 Amortisation period and amortisation method

An intangible asset with a finite useful life should be amortised over its **expected useful life**.

- (a) Amortisation should start when the asset is **available for use**.
- (b) Amortisation should cease at the earlier of the date that the asset is classified **as held for sale** in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* and the date that the asset is **derecognised**.

(c) The amortisation method used should reflect the **pattern in which the asset's future economic benefits are consumed**. If such a pattern cannot be predicted reliably, the straight-line method should be used.

(d) The amortisation charge for each period should normally be recognised **in profit or loss**.

(IAS 38: para. 97)

The **residual value** of an intangible asset with a finite useful life is **assumed to be zero** unless a third party is committed to buying the intangible asset at the end of its useful life or unless there is an active market for that type of asset (so that its expected residual value can be measured) and it is probable that there will be a market for the asset at the end of its useful life.

The amortisation period and the amortisation method used for an intangible asset with a finite useful life should be **reviewed at each financial year end**.

2.9 Intangible assets with indefinite useful lives

An intangible asset with an indefinite useful life **should not be amortised**. IAS 36 requires that such an asset is tested for impairment at least annually.

The useful life of an intangible asset that is not being amortised should be **reviewed each year** to determine whether it is still appropriate to assess its useful life as indefinite. Reassessing the useful life of an intangible asset as finite rather than indefinite is an indicator that the asset may be impaired and therefore it should be tested for impairment.



Question

Intangible asset

It may be difficult to establish the useful life of an intangible asset, and judgement will be needed.

Required

Consider how to determine the useful life of a **purchased** brand name.

Answer

Factors to consider would include the following.

- (a) Legal protection of the brand name and the control of the entity over the (illegal) use by others of the brand name (ie control over pirating)
- (b) Age of the brand name
- (c) Status or position of the brand in its particular market
- (d) Ability of the management of the entity to manage the brand name and to measure activities that support the brand name (eg advertising and PR activities)
- (e) Stability and geographical spread of the market in which the branded products are sold
- (f) Pattern of benefits that the brand name is expected to generate over time
- (g) Intention of the entity to use and promote the brand name over time (as evidenced perhaps by a business plan in which there will be substantial expenditure to promote the brand name)

2.10 Disposals/retirements of intangible assets

An intangible asset should be eliminated from the statement of financial position when it is disposed of or when there is no further expected economic benefit from its future use. On disposal the gain or loss arising from the **difference between the net disposal proceeds and the carrying amount** of the asset should be taken to profit or loss as a gain or loss on disposal (ie treated as income or expense).



Question

R&D

As an aid to your revision, list the examples given in IAS 38 of activities that might be included in either research or development.

Answer

IAS 38 gives these examples.

Research

- Activities aimed at obtaining new knowledge
- The search for, evaluation and final selection of, applications of research findings or other knowledge
- The search for alternatives for materials, devices, products, processes, systems or services
- The formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services

(IAS 38: para. 56)

Development

- The design, construction and testing of pre-production prototypes and models
- The design of tools, jigs, moulds and dies involving new technology
- The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production
- The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services

(IAS 38: para. 59)

3 Goodwill (IFRS 3)

FAST FORWARD

Purchased goodwill arising on consolidation is retained in the statement of financial position as an intangible asset under IFRS 3. It must then be reviewed annually for impairment.

3.1 What is goodwill?

Goodwill is created by good relationships between a business and its customers.

- (a) By building up a **reputation** (by word of mouth perhaps) for high quality products or high standards of service
- (b) By **responding promptly and helpfully** to queries and complaints from customers
- (c) Through the **personality of the staff** and their attitudes to customers

The value of goodwill to a business might be considerable. However, goodwill is not usually valued in the financial statements of a business at all, and we should not normally expect to find an amount for goodwill in its statement of financial position. For example, the friendly welcome given by a café's staff may contribute more to the café's profits than the fact that a new electronic cash register has recently been acquired. Even so, whereas the cash register will be recorded in the financial statements as a non-current asset, the value of staff would be ignored for accounting purposes.

On reflection, we might agree with this omission of goodwill from the financial statements of a business.

- (a) The goodwill is **inherent** in the business but it has not been paid for, and it does not have an 'objective' value. We can guess at what such goodwill is worth, but such guesswork would be a matter of individual opinion, and not based on hard facts.
- (b) Goodwill **changes** from day to day. One act of bad customer relations might damage goodwill and one act of good relations might improve it. Staff with a favourable personality might retire or leave to find another job, to be replaced by staff who need time to find their feet in the job, etc. Since goodwill is continually changing in value, it cannot realistically be recorded in the financial statements of the business.

3.2 Purchased goodwill

There is one exception to the general rule that goodwill has no objective valuation. This is **when a business is sold**. People wishing to set up in business have a choice of how to do it – they can either buy their own long-term assets and inventory and set up their business from scratch, or they can buy up an existing business from a proprietor willing to sell it. When a buyer purchases an existing business, he will have to purchase not only its long-term assets and inventory (and perhaps take over its accounts payable and receivable too) but also the goodwill of the business.

FAST FORWARD

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**.

3.3 How is the value of purchased goodwill decided?

When a business is sold, there is likely to be some purchased goodwill in the selling price. But **how is the amount of this purchased goodwill decided?**

This is not really a problem for accountants, who must simply record the goodwill in the financial statements of the new business. The value of the goodwill is a **matter for the purchaser and seller to agree upon in fixing the purchase/sale price**. However, two methods of valuation are worth mentioning here:

- (a) The seller and buyer agree on a price for the business **without specifically quantifying the goodwill**. The purchased goodwill will then be the difference between the price agreed and the value of the identifiable net assets in the books of the new business.
- (b) However, the calculation of goodwill often precedes the fixing of the purchase price and becomes a **central element of negotiation**. There are many ways of arriving at a value for goodwill and most of them are related to the profit record of the business in question.

No matter how goodwill is calculated within the total agreed purchase price, the goodwill shown by the purchaser in his accounts will be **the difference between the purchase consideration and his own valuation of the net assets acquired**. If A values his net assets at \$40,000, goodwill is agreed at \$21,000 and B agrees to pay \$61,000 for the business but values the net assets at only \$38,000, then the goodwill in B's books will be $\$61,000 - \$38,000 = \$23,000$.

3.4 IFRS 3 Business combinations

IFRS 3 covers the accounting treatment of goodwill acquired in a business combination.

Key term

Goodwill. An asset representing the future economic benefits arising from other assets acquired in a business combination that are not capable of being individually identified and separately recognised.
(IFRS 3: Appendix A)

Goodwill acquired in a business combination is **recognised as an asset** and is initially measured at **cost**. Cost is the excess of the cost of the combination over the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities.

After initial recognition goodwill acquired in a business combination is measured **at cost less any accumulated impairment losses**. It is **not amortised**. Instead it is tested for impairment at least annually, in accordance with IAS 36.

A **gain on a bargain purchase** (also known as 'negative goodwill') arises when the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities exceeds the cost of the business combination.

A gain on a bargain purchase can arise because the entity has genuinely obtained a bargain, perhaps for example because the seller has been forced to sell at a low price. However, it can also arise as the result of **errors** in measuring the fair value of either the cost of the combination or the acquiree's identifiable net assets.

Before recognising a gain on a bargain purchase, an entity should first **reassess** the amounts at which it has measured both the cost of the combination and the acquiree's identifiable net assets (IFRS 3: para. 36). This exercise should identify any errors.

Any gain on the bargain purchase remaining should be **recognised** immediately in profit or loss.



Question

Characteristics of goodwill

What are the main characteristics of goodwill which distinguish it from other intangible non-current assets? To what extent do you consider that these characteristics should affect the accounting treatment of goodwill? State your reasons.

Answer

Goodwill may be distinguished from other intangible non-current assets by reference to the following characteristics.

- (a) It is incapable of realisation separately from the business as a whole.
- (b) Its value has no reliable or predictable relationship to any costs which may have been incurred.
- (c) Its value arises from various intangible factors such as skilled employees, effective advertising or a strategic location. These indirect factors cannot be valued.
- (d) The value of goodwill may fluctuate widely according to internal and external circumstances over relatively short periods of time.
- (e) The assessment of the value of goodwill is highly subjective.

It could be argued that, because goodwill is so different from other intangible non-current assets it does not make sense to account for it in the same way. Thus the capitalisation and amortisation treatment would not be acceptable. Furthermore, because goodwill is so difficult to value, any valuation may be misleading, and it is best eliminated from the statement of financial position altogether. However, there are strong arguments for treating it like any other intangible non-current asset. This issue remains controversial.

Chapter Roundup

- Intangible assets are defined by IAS 38 as non-monetary assets without physical substance.
- Development costs are recognised as an asset if they meet certain criteria.
- An intangible asset is initially recognised at cost and subsequently carried either at cost or revalued amount.
- Costs that do not meet the recognition criteria should be expensed as incurred.
- An intangible asset with a finite useful life should be amortised over its useful life. An intangible asset with an indefinite useful life should not be amortised.
- Purchased goodwill arising on consolidation is retained in the statement of financial position as an intangible asset under IFRS 3. It must then be reviewed annually for impairment.
- 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**.

Quick Quiz

- 1 Intangible assets can only be recognised in a company's financial statements if:
 - It is probable that will flow to the entity.
 - The cost can be
- 2 What are the criteria which must be met before development expenditure can be deferred?
- 3 Start up costs must be expensed.
True ☐
False ☐
- 4 Peggy buys Phil's business for \$30,000. The business assets are a bar valued at \$20,000, inventories at \$3,000 and receivables of \$3,000. How much is goodwill valued at?
- 5 What method of accounting for goodwill arising on consolidation is required by IFRS 3?
- 6 How should a gain on a bargain purchase be accounted for under IFRS 3?

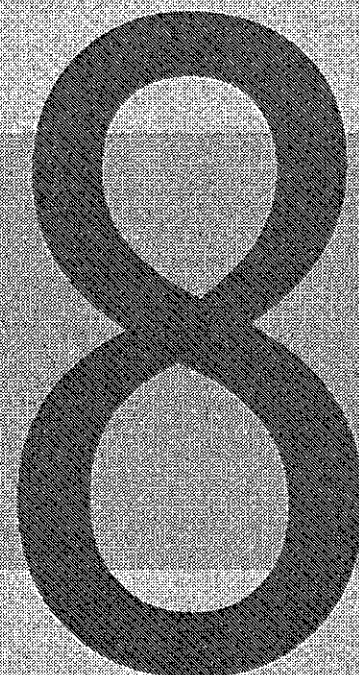
Answers to Quick Quiz

- 1 Future economic benefits; measured reliably
- 2 See Section 2.2
- 3 True
- 4 $\$30,000 - \$20,000 - \$3,000 - \$3,000 = \$4,000$
- 5 Cost less impairment losses
- 6 Recognised in profit or loss immediately

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q9	Introductory	10	20 mins

Provisions, contingent liabilities and contingent assets



Topic list	Syllabus reference
1 Provisions	B8
2 Provisions for restructuring	B8
3 Contingent liabilities and contingent assets	B8

Introduction

You will have come across provisions and contingencies in your earlier studies or professional work. However, you may be asked in more detail about IAS 37 for this paper.

Study guide

B8	Provisions, contingent assets and liabilities
(a)	Explain why an accounting standard on provisions is necessary – give examples of previous abuses in this area
(b)	Define provisions, legal and constructive obligations, past events and the transfer of economic benefits
(c)	State when provisions may and may not be made, and how they should be accounted for
(d)	Explain how provisions should be measured
(e)	Define contingent assets and liabilities – give examples and describe their accounting treatment
(f)	Identify and account for: <ul style="list-style-type: none"> – Onerous contracts – Environmental and similar provisions

1 Provisions

FAST FORWARD

Under IAS 37 (para. 14) a provision should be recognised when:

- An entity has a **present obligation**, legal or constructive
- It is probable that a **transfer of resources embodying economic benefits** will be required to settle it
- A **reliable estimate** can be made of its amount

1.1 Objective

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* aims to ensure that appropriate **recognition criteria** and **measurement bases** are applied to provisions, contingent liabilities and contingent assets and that **sufficient information** is disclosed in the **notes** to the financial statements to enable users to understand their nature, timing and amount.

1.2 Provisions

Before IAS 37, there was no accounting standard dealing with provisions. Companies wanting to show their results in the most favourable light used to make large 'one off' provisions in years where a high level of underlying profits was generated. These provisions, often known as 'big bath' provisions, were then available to shield expenditure in future years when perhaps the underlying profits were not as good.

In other words, provisions were used for profit smoothing. Profit smoothing is misleading.

Important

The key aim of IAS 37 is to ensure that **provisions are made only** where there are valid grounds for them.

IAS 37 views a provision as a liability.

Key terms

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

A **liability** is 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.

(IAS 37: para. 10)

The IAS distinguishes provisions from other liabilities such as trade creditors and accruals. This is on the basis that for a provision there is **uncertainty** about the timing or amount of the future expenditure. Whilst uncertainty is clearly present in the case of certain accruals the uncertainty is generally much less than for provisions.

1.3 Recognition

IAS 37 states that a provision should be **recognised** as a liability in the financial statements when:

- An entity has a **present obligation** (legal or constructive) as a result of a past event
- It is probable that an **outflow of resources embodying economic benefits** will be required to settle the obligation
- A **reliable estimate** can be made of the amount of the obligation

(IAS 37: para. 14)

1.4 Meaning of obligation

It is fairly clear what a legal obligation is. However, you may not know what a **constructive obligation** is.

Key term

Constructive obligation.

An obligation that derives from an entity's actions where:

- By an established pattern of past practice, published policies or a sufficiently specific current statement the entity has indicated to other parties that it will accept certain responsibilities; and
- As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

(IAS 37: para. 10)

For instance, an oil company may have an established practice of always making good any environmental damage caused by drilling, even though it is not legally obliged to do so. In this way, it has created a valid expectation that it will do this and it will have to recognise the constructive obligation and make a corresponding provision each time it drills a new well.

1.4.1 Probable transfer of resources

For the purpose of the IAS, a transfer of resources embodying economic benefits is regarded as '**probable**' if the event is **more likely than not** to occur. This appears to indicate a probability of more than 50%. However, the standard makes it clear that where there is a number of similar obligations the probability should be based on considering the population as a whole, rather than one single item.

1.4.2 Example: Transfer of resources

If a company has entered into a warranty obligation then the probability of transfer of resources embodying economic benefits may well be extremely small in respect of one specific item. However, when considering the population as a whole the probability of some transfer of resources is quite likely to be much higher. If there is a **greater than 50% probability** of some transfer of economic benefits then a **provision** should be made for the **expected amount**.

1.5 Measurement

Important

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period (IAS 37: para. 36).

The estimates will be determined by the **judgement** of the entity's management supplemented by the experience of similar transactions.

Allowance is made for **uncertainty**. Where the provision being measured involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities, ie **expected value**.

Where the provision involves a single item, such as the outcome of a legal case, provision is made **in full** for the most likely outcome.



Question

Warranty

Parker Co sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defect that becomes apparent within the first six months of purchase. The company's past experience and future expectations indicate the following pattern of likely repairs.

% of goods sold	Defects	Cost of repairs if all items suffered from these defects \$m
75	None	—
20	Minor	1.0
5	Major	4.0

Required

What is the provision required?

Answer

The cost is found using 'expected values' $(75\% \times \$\text{nil}) + (20\% \times \$1.0\text{m}) + (5\% \times \$4.0\text{m}) = \$400,000$.

1.5.1 Time value of money

Where the effect of the **time value of money** is material, the amount of a provision should be the **present value** of the expenditure required to settle the obligation. An appropriate **discount** rate should be used.

The discount rate should be a pre-tax rate that reflects current market assessments of the time value of money. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted.

Note. You will be given any relevant discount rates in the exam.

Example

A company knows that when it ceases a certain operation in five years' time it will have to pay environmental cleanup costs of \$5m.

The provision to be made now will be the present value of \$5m in five years' time.

The relevant discount rate in this case is 10%.

Therefore a provision will be made for:

	\$
$\$5\text{m} \times 0.62092^*$	3,104,600

*The discount rate for five years at 10%.

The following year the provision will be:

$\$5\text{m} \times 0.68301^{**}$	3,415,050
	<u>310,540</u>

**The discount rate for four years at 10%

The increase in the second year of \$310,450 will be charged to profit or loss. It is referred to as the **unwinding** of the discount. This is accounted for as a finance cost. The original provision of \$3,104,600 will be added to the cost of the assets involved in the operation and depreciated over five years.

1.5.2 Future events

Future events which are reasonably expected to occur (eg new legislation, changes in technology) may affect the measurement of the provision and should be taken into account.

1.5.3 Expected disposal of assets

Gains from the expected disposal of assets should not be taken into account in the measurement of a provision (IAS 38: para. 51).

1.5.4 Reimbursements

Some or all of the expenditure needed to settle a provision may be expected to be recovered from a third party. If so, the reimbursement should be recognised only when it is virtually certain that reimbursement will be received if the entity settles the obligation.

- The reimbursement should be treated as a separate asset, and the amount recognised should not be greater than the provision itself.
- The provision and the amount recognised for reimbursement may be netted off in profit or loss.

(IAS 38: para. 53)

1.5.5 Changes in provisions

At the end of each reporting period, a provision should be adjusted to reflect the current best estimate of the expected expenditure. A provision should be derecognised if the expenditure required to settle the related obligation is no longer probable (IAS 38: para. 59).

1.5.6 Use of provisions

Only expenditures related to the provision should be offset against it (IAS 37: para. 61). Setting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

1.6 Specific types of provision

It is easier to see the aims of IAS 37 if you look at examples of what can and cannot be recognised as a provision under IAS 37. Some of these we have already touched on.

Exam focus point

These examples are the sort of situation you may get in the exam.

- Warranties.** These are argued to be genuine provisions as on past experience it is probable, ie more likely than not, that some claims will emerge. The provision must be estimated, however, on the basis of the class as a whole and not on individual claims. There is a clear legal obligation in this case. Warranties are also covered by IFRS 15 *Revenue from Contracts with Customers* (see Chapter 3). The nature of the warranty granted will determine whether the warranty should be accounted for under IAS 37 or IFRS 15.
- Major repairs.** In the past it was quite popular for companies to provide for expenditure on a major overhaul to be accrued gradually over the intervening years between overhauls. Under IAS 37 this is no longer possible as IAS 37 would argue that this is a mere intention to carry out repairs, not an obligation. The entity can always sell the asset in the meantime. The only solution is to treat major assets such as aircraft, ships, furnaces etc as a series of smaller assets where each part is depreciated over shorter lives. Thus any major overhaul may be argued to be replacement and therefore capital rather than revenue expenditure.

- (c) **Self insurance.** In the past, a number of companies created a provision for self-insurance based on, for example, the expected cost of making good fire damage, instead of paying premiums to an insurance company. Under IAS 37 this kind of provision is no longer justifiable as the entity has no obligation until a fire or accident occurs. No obligation exists until that time.
- (d) **Environmental contamination.** If the company has an environmental policy such that other parties would expect the company to clean up any contamination or if the company has broken current environmental legislation then a provision for environmental damage must be made.
- (e) **Decommissioning or abandonment costs.** When an oil company initially purchases an oilfield it is put under a legal obligation to decommission the site at the end of its life. Prior to IAS 37 most oil companies set up the provision gradually over the life of the field so that no one year would be unduly burdened with the cost.

IAS 37, however, insists that a legal obligation exists on the initial expenditure on the field and therefore a liability exists immediately. This would appear to result in a large charge to profit and loss in the first year of operation of the field. However, the IAS takes the view that the cost of purchasing the field in the first place is not only the cost of the field itself but also the costs of putting it right again. Thus all the costs of decommissioning may be capitalised.

- (f) **Restructuring.** This is considered in detail below.
- (g) **Future operating losses.** Provisions are **not** recognised for future operating losses. They do not meet the definition of a liability and the general recognition criteria set out in the standard (IAS 37: para. 63).
- (h) **Onerous contracts.** IAS 37 defines an onerous contract as: 'a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it' (IAS 37: para. 68). For example a supply contract related to a particular product that an entity can no longer sell would be onerous. IAS 37 requires a provision to be recognised for an onerous contract, after recognising any impairment losses for assets related to the contract.

Example

Buster has a contract which it believes to be onerous. The contract is for the future purchase of 2,000 litres of a chemical which is to be used in the production of laundry detergent. Buster has sold its laundry detergent business but has been unable to assign the contract. The contract price is \$150 per litre. At 30 September 20X1, the spot price is \$90 per litre. If Buster cancels the contract, a cancellation fee of \$135,000 is payable.

Required

How should the contract be accounted for in the financial statements of Buster at 30 September 20X1?

Solution

Buster can either:

- Cancel the contract at a cost of \$135,000; or
- Fulfil the contract and sell the chemical at spot price, resulting in a loss of \$120,000 ($(2,000 \text{ litres} \times (150 - 90))$).

The contract is onerous and a provision must be created for the lower amount of \$120,000.

2 Provisions for restructuring

FAST FORWARD

One of the main purposes of IAS 37 was to target abuses of provisions for restructuring. Accordingly, IAS 37 lays down **strict criteria** to determine when such a provision can be made.

Key term

Restructuring. A programme that is planned and controlled by management, and materially changes either:

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

(IAS 37: para. 10)

IAS 37 (para. 70) gives the following **examples** of events that may fall under the definition of restructuring.

- (a) 'The **sale or termination** of a line of business;
- (b) The **closure of business locations** in a country or region or the **relocation** of business activities from one country region to another;
- (c) **Changes in management structure**, for example, the elimination of a layer of management; and
- (d) **Fundamental reorganisations** that have a material effect on the **nature and focus** of the entity's operations.'

The question is whether or not an entity has an obligation – legal or constructive – at the end of the reporting period. For this to be the case:

- An entity must have a **detailed formal plan** for the restructuring
- It must have **raised a valid expectation** in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it

Important

A mere management decision is not normally sufficient. Management decisions may sometimes trigger recognition, but only if earlier events such as negotiations with employee representatives and other interested parties have been concluded subject only to management approval.

Where the restructuring involves the **sale of an operation** then IAS 37 states that no obligation arises until the entity has entered into a **binding sale agreement**. This is because until this has occurred the entity will be able to change its mind and withdraw from the sale even if its intentions have been announced publicly.

2.1 Costs to be included within a restructuring provision

A restructuring provision should include only **direct expenditures** arising from the restructuring. Direct expenditures are those which it has been **necessary to incur** because of the restructuring and which are **not related to the ongoing activities** of the business.

Costs relating to marketing and new systems/distribution networks as well as costs relating to retraining or relocating existing staff should not be included in a restructuring provision (IAS 37: para. 81).



Question

Provision

In which of the following circumstances might a provision be recognised?

- (a) On 13 December 20X9 the board of an entity decided to close down a division. The accounting date of the company is 31 December. Before 31 December 20X9 the decision was not communicated to any of those affected and no other steps were taken to implement the decision.
- (b) The board agreed a detailed closure plan on 20 December 20X9 and details were given to customers and employees.
- (c) A company is obliged to incur clean-up costs for environmental damage (that has already been caused).
- (d) A company intends to carry out future expenditure to operate in a particular way in the future.

- (a) No provision would be recognised as the decision has not been communicated.
- (b) A provision would be made in the 20X9 financial statements.
- (c) A provision for such costs is appropriate.
- (d) No present obligation exists and under IAS 37 no provision would be appropriate. This is because the entity could avoid the future expenditure by its future actions, maybe by changing its method of operation.

3 Contingent liabilities and contingent assets

FAST FORWARD

An entity should not **recognise** a contingent asset or liability, but they should be **disclosed**.

Now that you understand provisions it will be easier to understand contingent assets and liabilities.

Key term

'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 entity; or
- (b) A present obligation that arises from past events but is not recognised because:
 - (i) It is not probable 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.'

(IAS 37: para. 10)

As a rule of thumb, probable means more than 50% likely. If an obligation is probable, it is not a contingent liability – instead, a provision is needed.

3.1 Treatment of contingent liabilities

Contingent liabilities **should not be recognised in financial statements** but they **should be disclosed**. The required disclosures are:

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

3.2 Contingent assets

Key term

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

(IAS 37: para. 10)

A contingent asset must not be recognised. Only when the realisation of the related economic benefits is **virtually certain** should recognition take place. At that point, **the asset is no longer a contingent asset!**

3.3 Example

A company is engaged in a legal dispute. The outcome is not yet known. A number of possibilities arise:

- It expects to have to pay about \$100,000. **A provision is recognised.**
- Possible damages are \$100,000 but it is not expected to have to pay them. **A contingent liability is disclosed.**
- The company expects to have to pay damages but is unable to estimate the amount. **A contingent liability is disclosed.**
- The company expects to receive damages of \$100,000 and this is virtually certain. **An asset is recognised.**
- The company expects to probably receive damages of \$100,000. **A contingent asset is disclosed.**
- The company thinks it may receive damages, but it is not probable. **No disclosure.**

Exam focus point

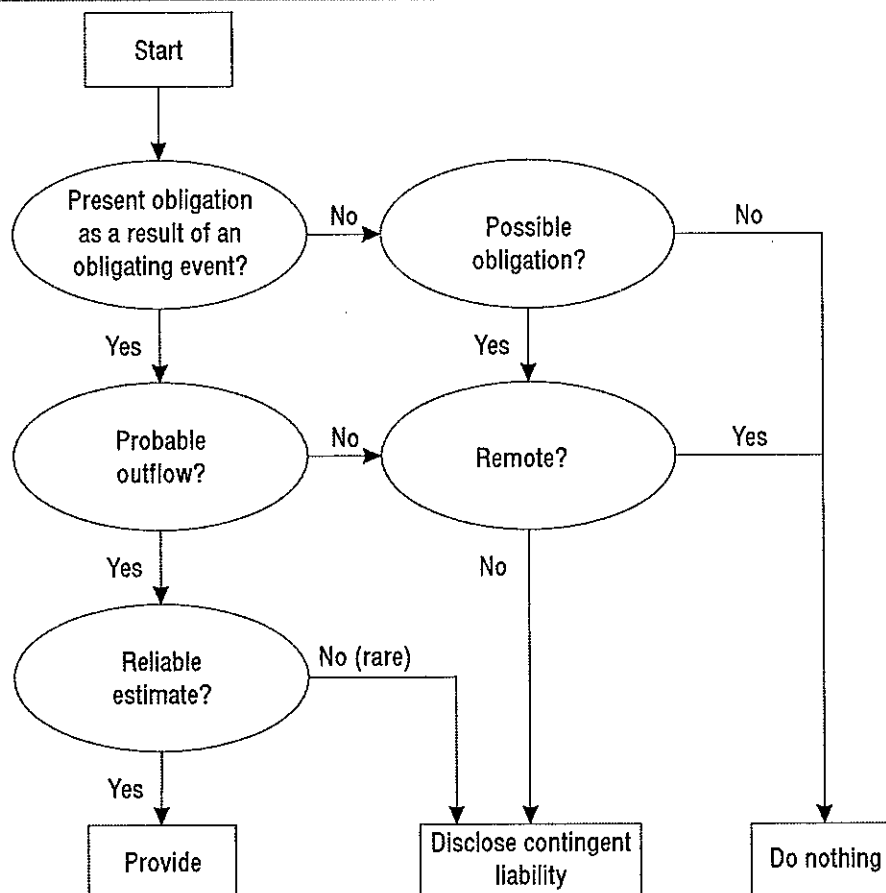
A legal dispute formed the basis of a question part in the December 2012 paper, with a company expecting to lose a court case but also to be covered by an insurance policy (the liability was probable and therefore provided for, but the asset was not recognised because it was not virtually certain – although disclosure was appropriate).

3.4 Flow chart

You must practise the questions below to apply your knowledge of IAS 37. But first study the flow chart, taken from IAS 37, which is a good summary of its requirements concerning provisions and contingent liabilities.

Exam focus point

If you learn this flow chart you should be able to deal with most questions you are likely to meet in an exam.



(IAS 37: Implementation Guidance, B)



Question

Accounting treatment

During 20X0 Smack Co gives a guarantee of certain borrowings of Pony Co, whose financial condition at that time is sound. During 20X1, the financial condition of Pony Co deteriorates and at 30 June 20X1 Pony Co files for protection from its creditors.

Required

What accounting treatment is required:

- (a) At 31 December 20X0?
- (b) At 31 December 20X1?

Answer

- (a) *At 31 December 20X0*

There is a present obligation as a result of a past obligating event. The obligating event is the giving of the guarantee, which gives rise to a legal obligation. However, at 31 December 20X0 no transfer of resources is probable in settlement of the obligation.

No provision is recognised. The guarantee is disclosed as a contingent liability unless the probability of any transfer is regarded as remote.

- (b) *At 31 December 20X1*

As above, there is a present obligation as a result of a past obligating event, namely the giving of the guarantee.

At 31 December 20X1 it is probable that a transfer of resources will be required to settle the obligation. A provision is therefore recognised for the best estimate of the obligation.



Question

Recognition of provision

Warren Co gives warranties at the time of sale to purchasers of its products. Under the terms of the warranty the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within a period of three years from the date of the sale. Should a provision be recognised?

Answer

Warren Co **cannot avoid** the cost of repairing or replacing all items of product that manifest manufacturing defects in respect of which warranties are given before the end of the reporting period, and a provision for the cost of this should therefore be made.

Warren Co is obliged to repair or replace items that fail within the entire warranty period. Therefore, in respect of **this year's sales**, the obligation provided for at the end of the reporting period should be the cost of making good items for which defects have been notified but not yet processed, **plus** an estimate of costs in respect of the other items sold for which there is sufficient evidence that manufacturing defects **will** manifest themselves during their remaining periods of warranty cover.



Question

Accounting treatment

After a wedding in 20X0 ten people died, possibly as a result of food poisoning from products sold by Callow Co. Legal proceedings are started seeking damages from Callow but it disputes liability. Up to the date of approval of the financial statements for the year to 31 December 20X0, Callow's lawyers advise that it is probable that it will not be found liable. However, when Callow prepares the financial statements for the year to 31 December 20X1 its lawyers advise that, owing to developments in the case, it is probable that it will be found liable.

Required

What is the required accounting treatment:

- (a) At 31 December 20X0?
- (b) At 31 December 20X1?

Answer

- (a) *At 31 December 20X0*

On the basis of the evidence available when the financial statements were approved, there is no obligation as a result of past events. No provision is recognised. The matter is disclosed as a contingent liability unless the probability of any transfer is regarded as remote.

- (b) *At 31 December 20X1*

On the basis of the evidence available, there is a present obligation. A transfer of resources in settlement is probable.

A provision is recognised for the best estimate of the amount needed to settle the present obligation.

Exam focus point

In the June 2016 examiner's report, the examiner commented that many candidates confused provisions and contingent liabilities – make sure you know the difference. The examiner also commented that candidates mentioned the creation of a provision in their answers, but did not further clarify that a provision was a liability, and not a component of equity. To ensure you gain maximum marks, make sure that you demonstrate to the examiner that you understand that a provision is a liability.

Chapter Roundup

- Under IAS 37 a provision should be recognised when:
 - An entity has a **present obligation**, legal or constructive
 - It is probable that a **transfer of resources embodying economic benefits** will be required to settle it
 - A **reliable estimate** can be made of its amount
- One the main purposes of IAS 37 was to target abuses of provisions for restructuring. Accordingly, IAS 37 lays down **strict criteria** to determine when such a provision can be made.
- An entity should not **recognise** a contingent asset or liability, but they should be **disclosed**.

Quick Quiz

- 1 A provision is a of timing or amount.
- 2 A programme is undertaken by management which converts the previously wholly owned chain of restaurants they ran into franchises. Is this restructuring?
- 3 Define contingent asset and contingent liability.
- 4 How should decommissioning costs on an oilfield be accounted for under IAS 37?
- 5 'Provisions for major overhauls should be accrued for over the period between overhauls'. Is this correct?

Answers to Quick Quiz

- 1 A provision is a **liability of uncertain** timing or amount.
- 2 Yes. The manner in which the business is conducted has changed.
- 3 See Section 3.
- 4 They should be capitalised as part of the initial expenditure on the oilfield.
- 5 No. It is not correct. See Section 1.5.

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q10	Examination	25	49 mins

9

Employee benefits

Topic list	Syllabus reference
1 IAS 19 <i>Employee Benefits</i>	B9
2 Short-term employee benefits	B9
3 Post-employment benefits	B9
4 Defined contribution plans	B9
5 Defined benefit plans: Recognition and measurement	B9
6 Defined benefit plans: Other matters	B9
7 Other long-term benefits	B9

Introduction

An increasing number of companies and other entities now provide a **pension and other employee benefits** as part of their employees' remuneration package. In view of this trend, it is important that there is standard best practice for the way in which employee benefit costs are **recognised, measured, presented and disclosed** in the sponsoring entities' accounts. Remember that we are talking about accounting by the employer, not the benefit scheme or plan.

Study guide

B9	Employment and post-employment benefit costs
(a)	Describe the nature of defined contribution and defined benefits schemes
(b)	Explain the recognition and measurement of defined benefit schemes in the financial statements of contributing employers
(c)	Account for defined benefit schemes in the financial statements of contributing employers

Note that whereas the syllabus uses the word 'scheme', IAS 19 uses the word 'plan', which has the same meaning. For consistency we will use the word plan throughout this chapter.

1 IAS 19 *Employee Benefits*

FAST FORWARD

IAS 19 *Employee Benefits* is a long and complex standard covering both short-term and long-term (post-employment) benefits. The complications arise when dealing with **post-employment benefits**.

Exam focus point

This is a very difficult topic – employee benefit costs are inherently complex and their accounting is both **problematic and controversial**.

IAS 19 *Employee Benefits* has been revised several times. The latest version was issued in June 2011. The reason for the revision was to address some of the main criticisms of the previous methods of accounting for pensions. Before we look at IAS 19, we should consider the nature of employee benefit costs and why there is an accounting problem which must be addressed by a standard.

1.1 The conceptual nature of employee benefit costs

When a company or other entity employs a new worker, that worker will be offered a **package of pay and benefits**. Some of these will be short-term and the employee will receive the benefit at about the same time as he or she earns it, for example basic pay, overtime and so on. Other employee benefits are **deferred**, however, the main example being retirement benefits (ie a pension).

The cost of these deferred employee benefits to the employer can be viewed in various ways. They could be described as **deferred salary** to the employee. Alternatively, they are a **deduction** from the employee's true gross salary, used as a tax-efficient means of saving. In some countries, tax efficiency arises on retirement benefit contributions because they are not taxed on the employee, but they are allowed as a deduction from taxable profits of the employer.

1.2 Accounting for employee benefit costs

Accounting for **short-term employee benefit costs** tends to be quite straightforward, because they are simply recognised as an expense in the employer's financial statements of the current period.

Accounting for the cost of **deferred employee benefits** is much more difficult. This is because of the large amounts involved, as well as the long time scale, complicated estimates and uncertainties. In the past, entities accounted for these benefits simply by charging profit or loss of the employing entity on the basis of actual payments made. This led to substantial variations in reported profits of these entities and disclosure of information on these costs was usually sparse.

1.3 IAS 19 Employee Benefits

IAS 19 is intended to prescribe the following.

- (a) When the cost of employee benefits should be **recognised as a liability or an expense**
- (b) The **amount** of the liability or expense that should be recognised

As a basic rule, the standard states the following (IAS 19: para. 1).

- (a) A **liability** should be recognised when an employee has provided a service in exchange for benefits to be received by the employee at some time in the future.
- (b) An **expense** should be recognised when the entity consumes the economic benefits from a service provided by an employee in exchange for employee benefits.

The basic problem is therefore fairly straightforward. An entity will often enjoy the **economic benefits** from the services provided by its employees in advance of the employees receiving all the employment benefits from the work they have done, for example they will not receive pension benefits until after they retire.

1.4 Categories of employee benefits

The standard recognises four categories of employee benefits, and proposes a different accounting treatment for each. These four categories are as follows (IAS 19: para. 5).

- (a) **'Short-term benefits** including, if expected to be settled wholly before 12 months after the end of the annual reporting period in which the employees render the related services:
 - Wages and salaries
 - Social security contributions
 - Paid annual leave
 - Paid sick leave
 - Paid maternity/paternity leave
 - Profit shares and bonuses
 - Paid jury service
 - Paid military service
 - Non-monetary benefits, eg medical care, housing, cars, free or subsidised goods
- (b) **Post-employment benefits**, eg pensions and post-employment medical care and post-employment insurance
- (c) **Other long-term benefits**, eg profit shares, bonuses or deferred compensation payable later than 12 months after the year end, sabbatical leave, long-service benefits and long-term disability benefits
- (d) **Termination benefits**, eg early retirement payments and redundancy payments'

Benefits may be paid to the employees themselves, to their dependants (spouses, children, etc) or to third parties.

1.5 Definitions

IAS 19 uses a great many important definitions. This section lists those that relate to the different categories of employee benefits.

Key terms

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 12 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 an employee's 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.

(IAS 19: para. 8)

2 Short-term employee benefits

FAST FORWARD

The accounting for **short-term employee benefits** is simple. The principles are the same as for any expense that is accrued over a period.

Accounting for short-term employee benefits is fairly straightforward, because there are **no actuarial assumptions** to be made, and there is **no requirement to discount** future benefits (because they are all, by definition, payable no later than 12 months after the end of the accounting period).

2.1 Recognition and measurement

The rules for short-term benefits are essentially an application of **basic accounting principles and practice**.

- (a) **Unpaid short-term employee benefits** as at the end of an accounting period should be recognised as an accrued expense. Any short-term benefits **paid in advance** should be recognised as a prepayment (to the extent that it will lead to, eg a reduction in future payments or a cash refund).
- (b) The **cost of short-term employee benefits** should be recognised as an **expense** in the period when the economic benefit is given, as employment costs (except insofar as employment costs may be included within the cost of an asset, eg property, plant and equipment).

2.2 Short-term paid absences

There may be **short-term accumulating paid absences**. These are absences for which an employee is paid, and if the employee's entitlement has not been used up at the end of the period, they are carried forward to the next period. An example is paid holiday leave, where any unused holidays in one year are carried forward to the next year. The cost of the benefits of such absences should be **charged as an expense** as the employees render service that increases their entitlement to future compensated absences.

There may be **short-term non-accumulating paid absences**. These are absences for which an employee is paid when they occur, but an **entitlement to the absences does not accumulate**. The employee can be absent, and be paid, but only if and when the circumstances arise. Examples are maternity/paternity pay, (in most cases) sick pay, and paid absence for jury service.

2.3 Measurement

The cost of accumulating paid absences should be measured as the additional amount that the entity expects to pay as a result of the unused entitlement that has accumulated at the end of the reporting period.

2.4 Example: Unused holiday leave

A company gives its employees an annual entitlement to paid holiday leave. If there is any unused leave at the end of the year, employees are entitled to carry forward the unused leave for up to 12 months. At the end of 20X9, the company's employees carried forward in total 50 days of unused holiday leave. Employees are paid \$100 per day.

Required

State the required accounting for the unused holiday carried forward.

Solution

The short-term accumulating paid absences should be recognised as a cost (and related liability) in the year when the entitlement arises, ie in 20X9. The liability should be released as the carried forward holiday is used up or after 12 months if the carried forward holiday is not used.



Question

Sick leave

Plyman Co has 100 employees. Each is entitled to five working days of paid sick leave for each year, and unused sick leave can be carried forward for one year. Sick leave is taken on a LIFO basis (ie first out of the current year's entitlement and then out of any balance brought forward).

As at 31 December 20X8, the average unused entitlement is two days per employee. Plyman Co expects (based on past experience which is expected to continue) that 92 employees will take five days or less sick leave in 20X9, the remaining eight employees will take an average of 6½ days each.

Required

State the required accounting for sick leave.

Answer

Plyman Co expects to pay an additional 12 days of sick pay as a result of the unused entitlement that has accumulated at 31 December 20X8, ie $1\frac{1}{2}$ days \times 8 employees. The unused sick leave, equal to 12 days of sick pay, should be recognised as a cost (and related liability) in the period in which the entitlement arises, so the year to 31 December 20X8.

2.5 Profit sharing or bonus plans

Profit shares or bonuses payable within 12 months after the end of the accounting period should be recognised as an expected cost when the entity has a **present obligation to pay it**, ie when the employer has no real option but to pay it. This will usually be when the employer recognises the profit or other performance achievement to which the profit share or bonus relates. The measurement of the constructive obligation reflects the possibility that some employees may leave without receiving a bonus.

2.6 Example: Profit sharing plan

Mooro Co runs a profit sharing plan under which it pays 3% of its net profit for the year to its employees if none have left during the year. Mooro Co estimates that this will be reduced by staff turnover to 2.5% in 20X9.

Required

Which costs should be recognised by Mooro Co for the profit share?

Solution

Mooro Co should recognise a liability and an expense of 2.5% of net profit.

3 Post-employment benefits

FAST FORWARD

- There are two types of post-employment benefit plan:
 - Defined contribution plans
 - Defined benefit plans
- **Defined contribution plans** provide benefits commensurate with the fund available to produce them. Defined contribution plans are simple to account for as the benefits are defined by the contributions made.
- **Defined benefit plans** provide promised benefits and so contributions are based on estimates of how the fund will perform. Defined benefit plans are much more difficult to deal with as the benefits are promised and therefore define the contributions to be made.

Many employers provide post-employment benefits for their employees after they have stopped working. **Pension plans** are the most obvious example, but an employer might provide post-employment death benefits to the dependants of former employees, or post-employment medical care.

In the case of post-employment benefit plans, the plan receives regular contributions from the employer (and sometimes from current employees as well) and the money is invested in assets, such as stocks and shares and other investments. The post-employment benefits are paid out of the income from the plan assets (dividends, interest) or from money from the sale of some plan assets.

3.1 Definitions

IAS 19 sets out the following definitions relating to classification of plans.

Key terms

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.
(IAS 19: para. 8)

There are two types or categories of post-employment benefit plan, as given in the definitions above.

- (a) **Defined contribution plans.** With such plans, the employer (and possibly current employees too) pay regular contributions into the plan of a given or 'defined' amount each year. The contributions are invested, and the size of the post-employment benefits paid to former employees depends on how well or how badly the plan's investments perform. If the investments perform well, the plan will be able to afford higher benefits than if the investments performed less well.
- (b) **Defined benefit plans.** With these plans, the size of the post-employment benefits is determined in advance, ie the benefits are 'defined'. The employer (and possibly current employees too) pay contributions into the plan, and the contributions are invested. The size of the contributions is set at an amount that is expected to earn enough investment returns to meet the obligation to pay the post-employment benefits. If, however, it becomes apparent that the assets in the fund are insufficient, the employer will be required to make additional contributions into the plan to make up the expected shortfall. On the other hand, if the fund's assets appear to be larger than they need to be, and in excess of what is required to pay the post-employment benefits, the employer may be allowed to take a 'contribution holiday' (ie stop paying in contributions for a while).

(IAS 19: paras. 26–30)

It is important to make a clear distinction between the following.

- **Funding** a defined benefit plan, ie paying contributions into the plan
- **Accounting** for the cost of funding a defined benefit plan

The key difference between the two types of plan is the nature of the 'promise' made by the entity to the employees in the plan:

- (a) Under a **defined contribution** plan, the 'promise' is to pay the agreed amount of contributions. Once this is done, the entity has no further liability and no exposure to risks related to the performance of the assets held in the plan.
- (b) Under a **defined benefit** plan, the 'promise' is to pay the amount of benefits agreed under the plan. The entity is taking on a far more uncertain liability that may change in future as a result of many variables and has continuing exposure to risks related to the performance of assets held in the plan. In simple terms, if the plan assets are insufficient to meet the plan liabilities to pay pensions in future, the entity will have to make up any deficit.

4 Defined contribution plans

A typical defined contribution plan would be where the employing company agreed to contribute an amount of, say, 5% of employees' salaries into a post-employment plan.

Accounting for payments into defined contribution plans is straightforward.

- (a) The **obligation** is measured by the amounts to be contributed for that period.
- (b) There are no actuarial assumptions to make.
- (c) If the obligation is settled in the current period (or at least no later than 12 months after the end of the current period) there is **no requirement for discounting**.

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 recognised 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, eg 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**. The discount rate to be used is discussed below in Section 5.10.2.

5 Defined benefit plans: recognition and measurement

Accounting for defined benefit plans is much more complex. The complexity of accounting for defined benefit plans stems largely from the following factors.

- (a) The future benefits (arising from employee service in the current or prior years) **cannot be measured exactly**, but whatever they are, the employer will have to pay them, and the liability should therefore be recognised now. To measure these future obligations, it is necessary to use **actuarial assumptions**.
- (b) The obligations payable in future years should be valued, by discounting, on a **present value** basis. This is because the obligations may be settled in many years' time.
- (c) If actuarial assumptions change, the amount of required contributions to the fund will change, and there may be **actuarial gains or losses**. A contribution into a fund in any period will not equal the expense for that period, due to actuarial gains or losses.

IAS 19 defines the following key terms to do with defined benefit plans.

Key terms

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 policy issued 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.

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

(IAS 19: para. 8)

5.1 Outline of the method

FAST FORWARD

There is a **four-step method** for recognising and measuring the expenses and liability of a defined benefit pension plan.

An outline of the method used by an employer to account for the expenses and obligation of a defined benefit plan is given below. The stages will be explained in more detail later.

Step 1

Measure the deficit or surplus:

- (a) An **actuarial technique** (the **Projected Unit Credit Method**), should be used to make a reliable estimate of the amount of future benefits employees have earned from service in relation to the current and prior years. The entity must determine how much benefit should be attributed to service performed by employees in the current period, and in prior periods. Assumptions include, for example, assumptions about employee turnover, mortality rates, future increases in salaries (if these will affect the eventual size of future benefits such as pension payments).
- (b) The benefit should be **discounted** to arrive at the present value of the defined benefit obligation and the current service cost.
- (c) The **fair value** of any **plan assets** should be deducted from the present value of the defined benefit obligation.

Step 2

The surplus or deficit measured in Step 1 may have to be adjusted if a net benefit asset has to be restricted by the **asset ceiling**.

Step 3

Determine the amounts to be recognised in **profit or loss**:

- (a) **Current service cost**
- (b) Any **past service cost** and **gain or loss on settlement**
- (c) **Net interest** on the **net defined benefit liability (asset)**

Step 4

Determine the **re-measurements** of the **net defined benefit liability (asset)**, to be recognised in **other comprehensive income** (items that will **not be reclassified to profit or loss**):

- (a) **Actuarial gains and losses**
- (b) **Return on plan assets** (excluding amounts included in net interest on the net defined benefit liability (asset))
- (c) Any change in the effect of the **asset ceiling** (excluding amounts included in net interest on the net defined benefit liability (asset))

(IAS 19: para. 57)

5.2 Constructive obligation

IAS 19 makes it very clear that it is not only its legal obligation under the formal terms of a defined benefit plan that an entity must account for, but also for any **constructive obligation** that it may have. A constructive obligation, which will arise from the entity's informal practices, exists when the entity has no realistic alternative but to pay employee benefits, for example if any change in the informal practices would cause unacceptable damage to employee relationships.

5.3 The Projected Unit Credit Method

With this method, it is assumed that each period of service by an employee gives rise to an **additional unit of future benefits**. The present value of that unit of future benefits can be calculated, and attributed to the period in which the service is given. The units, each measured separately, build up to the overall obligation. The accumulated present value of (discounted) future benefits will incur interest over time, and an interest expense should be recognised.

These calculations are complex and would normally be carried out by an actuary. In the exam, you will be given the figures but the following example (from IAS 19) is included to explain the method.

5.4 Example: Defined benefit obligations and current service cost

A lump sum benefit is payable on termination of service and equal to 1% of final salary for each year of service. The salary in year 1 is \$10,000 and is assumed to increase at 7% (compound) each year. The discount rate used is 10% per year. The following table shows how the obligation builds up for an

employee who is expected to leave at the end of year 5, assuming that there are no changes in actuarial assumptions. For simplicity, this example ignores the additional adjustment needed to reflect the probability that the employee may leave the entity at an earlier or later date.

Year	1	2	3	4	5
	\$	\$	\$	\$	\$
Benefit attributed to:					
Prior years	0	131	262	393	524
Current year (1% × final salary)	131	131	131	131	131
Current and prior years	<u>131</u>	<u>262</u>	<u>393</u>	<u>524</u>	<u>655</u>
Opening obligation	—	89	196	324	476
Interest at 10%	—	9	20	33	48
Current service cost	<u>89</u>	<u>98</u>	<u>108</u>	<u>119</u>	<u>131</u>
Closing obligation	<u>89</u>	<u>196</u>	<u>324</u>	<u>476</u>	<u>655</u>

Notes:

- 1 The opening obligation is the present value of the benefit attributed to prior years.
- 2 The current service cost is the present value of the benefit attributed to the current year.
- 3 The closing obligation is the present value of the benefit attributed to current and prior years.

5.5 Actuarial assumptions

FAST FORWARD

Actuarial assumptions made should be unbiased and based on market expectations.

Discount rates used should be determined by reference to market yields on high-quality fixed-rate corporate bonds.

Actuarial assumptions are needed to **estimate the size of the future (post-employment) benefits** that will be payable under a defined benefits plan. The main categories of actuarial assumptions are as follows:

- (a) **Demographic assumptions** are about mortality rates before and after retirement, the rate of employee turnover, early retirement, claim rates under medical plans for former employees, and so on.
- (b) **Financial assumptions** include future salary levels (allowing for seniority and promotion as well as inflation) and the future rate of increase in medical costs (not just inflationary cost rises, but also cost rises specific to medical treatments and to medical treatments required given the expectations of longer average life expectancy).

(IAS 19: para. 76)

The standard requires actuarial assumptions to be neither too cautious nor too imprudent: they should be '**unbiased**'. They should also be based on '**market expectations**' at the year end, over the period during which the obligations will be settled.

5.6 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, ie 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 year end (if there are any) out of which the future obligations to current and past employees will be directly settled

The earlier parts of this section have looked at the recognition and measurement of the defined benefit obligation. Now we will look at issues relating to the assets held in the plan.

5.7 Plan assets

Plan assets are (IAS 19: paras. 113–115):

- (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.

Investments which may be used for purposes other than to pay employee benefits are not plan assets.

The standard requires that the plan assets are measured at fair value, as per IFRS 13.

IAS 19 includes the following **specific requirements**:

- (a) The plan assets should exclude any contributions due from the employer but not yet paid.
- (b) Plan assets are reduced by any liabilities of the fund that do not relate to employee benefits, such as trade and other payables.

5.8 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:

<i>Component</i>	<i>Recognised in</i>
(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)

5.9 Service costs

These comprise (IAS 19: para. 8):

- (a) **Current service cost**: the increase in the present value of the defined benefit obligation resulting from employee services during the period. The measurement and recognition of this cost was introduced in Section 5.1.
- (b) **Past service cost**: the increase or decrease in the present value of the defined benefit obligation for employee service in prior periods, resulting from plan amendments or curtailments.
- (c) **Any gain or loss on settlement**.

The detail relating to points (b) and (c) above will be covered in a later section. First, we will continue with the basic elements of accounting for defined benefit pension costs.

5.10 Net interest on the defined benefit liability (asset)

In Section 5.1 we looked at the recognition and measurement of the defined benefit obligation. This figure is the discounted **present value** of the future benefits payable. Every year the discount must be 'unwound', increasing the present value of the obligation as time passes through an interest charge.

5.10.1 Interest calculation

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)

×

Discount
rate

The **net defined benefit liability/(asset)** should be measured as at the **start** of the accounting period, taking account of changes during the period as a result of contributions paid into the plan and benefits paid out.

Many exam questions include the assumption that all payments into and out of the plan take place at the end of the year, so that the interest calculations can be based on the opening balances.

5.10.2 Discount rate

The **discount rate** adopted should be determined by reference to **market yields** on high quality fixed-rate corporate bonds. The bonds should be denominated in the same currency as the benefits to be paid. In the absence of a 'deep' market in such bonds, the yields on comparable government bonds should be used as reference instead. The maturity of the corporate bonds that are used to determine a discount rate should have a term to maturity that is consistent with the expected maturity of the post-employment benefit obligations, although a single weighted average discount rate is sufficient.

The guidelines comment that there may be some difficulty in obtaining a **reliable yield for long-term maturities**, say 30 or 40 years from now. This should not, however, be a significant problem: the present value of obligations payable in many years time will be relatively small and unlikely to be a significant proportion of the total defined benefit obligation. The total obligation is therefore unlikely to be sensitive to errors in the assumption about the discount rate for long-term maturities (beyond the maturities of long-term corporate or government bonds).

5.11 Re-measurements of the net defined benefit liability

Re-measurements of the net defined benefit liability/(asset) comprise (IAS 19: para. 127):

- (a) Actuarial gains and losses;
- (b) The return on plan assets; and
- (c) Any change in the effect of the **asset ceiling**.

The gains and losses relating to points (a) and (b) above will arise in every defined benefit plan so we will look at these in this section. The asset ceiling is a complication that is not relevant in every case, so it is dealt with separately, later in the chapter.

5.11.1 Actuarial gains and losses

FAST FORWARD

Actuarial gains and losses arise for several reasons, and IAS 19 requires these to be recognised in full in other comprehensive income.

At the end of each accounting period, a new valuation, using updated assumptions, should be carried out on the obligation. Actuarial gains or losses arise because of the following (IAS 19: para. 128):

- **Actual events** (eg employee turnover, salary increases) differ from the actuarial assumptions that were made to estimate the defined benefit obligations
- The effect of **changes to assumptions** concerning benefit payment options
- **Estimates are revised** (eg different assumptions are made about future employee turnover, salary rises, mortality rates, and so on)
- The effect of changes to the **discount rate**

Actuarial gains and losses are recognised in **other comprehensive income**. They are **not reclassified to profit or loss**.

5.11.2 Return on plan assets

FAST FORWARD

The return on plan assets must be calculated.

A new valuation of the plan assets is carried out at each period end, using current fair values. Any difference between the new value, and what has been recognised up to that date (normally the opening balance, interest, and any cash payments into or out of the plan) is treated as a 're-measurement' and recognised in other comprehensive income.

5.12 Example

At 1 January 20X2 the fair value of the assets of a defined benefit plan were valued at \$1,100,000 and the present value of the defined benefit obligation was \$1,250,000. On 31 December 20X2, the plan received contributions from the employer of \$490,000 and paid out benefits of \$190,000.

The current service cost for the year was \$360,000 and a discount rate of 6% is to be applied to the net liability/(asset).

After these transactions, the fair value of the plan's assets at 31 December 20X2 was \$1.5m. The present value of the defined benefit obligation was \$1,553,600.

Required

Calculate the gains or losses on remeasurement through OCI and the return on plan assets and illustrate how this pension plan will be treated in the statement of profit or loss and other comprehensive income and statement of financial position for the year ended 31 December 20X2.

Solution

It is always useful to set up a working reconciling the assets and obligation:

	Assets	Obligation
	\$	\$
Fair value/present value at 1/1/X2	1,100,000	1,250,000
Interest $(1,100,000 \times 6\%) / (1,250,000 \times 6\%)$	66,000	75,000
Current service cost		360,000
Contributions received	490,000	
Benefits paid	(190,000)	(190,000)
Return on plan assets excluding amounts in net interest (balancing figure) (OCI) (re-measurement)	34,000	—
Loss on re-measurement (balancing figure) (OCI)	—	58,600
	<u>1,500,000</u>	<u>1,553,600</u>

The following accounting treatment is required.

- (a) In the **statement of profit or loss and other comprehensive income**, the following amounts will be recognised.

In profit or loss:

	\$
Current service cost	360,000
Net interest on net defined benefit liability $(75,000 - 66,000)$	9,000

In other comprehensive income $(34,000 - 58,600)$ 24,600

- (b) In the **statement of financial position**, the net defined benefit liability of \$53,600 $(1,553,600 - 1,500,000)$ will be recognised.

6 Defined benefit plans: Other matters

We have now covered the basics of accounting for defined benefit plans. This section looks at the special circumstances of past service costs, curtailments and settlements.

6.1 Past service cost and gains and losses on settlement

FAST FORWARD

You should know how to deal with **past service costs and curtailments and settlements**.

In Section 5.9 we identified that the total service cost may comprise not only the current service costs but other items, past service cost and gains and losses on settlement. This section explains these issues and their accounting treatment.

6.1.1 Past service cost

Past service cost is the change in the present value of the defined benefit obligation resulting from a plan **amendment** or **curtailment**.

A plan **amendment** arises when an entity either introduces a defined benefits plan or **changes the benefits payable** under an existing plan. As a result, the entity has taken on additional obligations that it has not hitherto provided for. For example, an employer might decide to introduce a medical benefits plan for former employees. This will create a new defined benefit obligation, that has not yet been provided for.

A **curtailment** occurs when an entity **significantly reduces the number of employees covered by a plan**. This could result from an isolated event, such as closing a plant, discontinuing an operation or the termination or suspension of a plan.

Past service costs can be either **positive** (if the changes increase the obligation) or **negative** (if the change reduces the obligation).

6.1.2 Gains and losses on settlement

A **settlement** occurs either when an employer enters into a transaction to eliminate part or all of its post-employment benefit obligations (other than a payment of benefits to or on behalf of employees under the terms of the plan and included in the actuarial assumptions).

A curtailment and settlement might **happen together**, for example when an employer brings a defined benefit plan to an end by settling the obligation with a one-off lump sum payment and then scrapping the plan.

The gain or loss on a settlement is recognised in profit or loss when the settlement occurs:

DEBIT	Present value of obligation (as advised by the actuary)	X
CREDIT	Fair value of plan assets (any assets transferred)	X
CREDIT	Cash (paid directly by the entity)	X
CREDIT/DEBIT	Profit or loss (difference)	X

6.1.3 Accounting for past service cost and gains and losses on settlement

An entity should **re-measure the obligation** (and the related plan assets, if any) using current actuarial assumptions, before determining past service cost or a gain or loss on settlement.

The rules for recognition for these items are as follows:

Past service costs are recognised at the earlier of the following dates:

- When the plan amendment or curtailment occurs, and
- When the entity recognises related restructuring costs (in accordance with IAS 37, see Chapter 9) or termination benefits.

6.2 Asset ceiling test

When we looked at the recognition of the net defined benefit liability/(asset) in the statement of financial position at the beginning of Section 5 the term 'asset ceiling' was mentioned. This term relates to a threshold established by IAS 19 to ensure that any defined benefit asset (ie 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.

6.3 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 *Conceptual Framework*) because **all** of the following apply.

- The entity **controls a resource** (the ability to use the surplus to generate future benefits).
- That control is the **result of past events** (contributions paid by the entity and service rendered by the employee).
- 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**.

If the asset ceiling adjustment was needed in a subsequent year, the changes in its value would be treated as follows:

- Interest** (as it is a discounted amount) recognised in profit or loss as part of the net interest amount
- Other changes** recognised in profit or loss

6.4 Suggested approach and question

The suggested approach to defined benefit plans is to deal with the change in the obligation and asset in the following order.

Step	Item	Recognition	
1	Record opening figures: <ul style="list-style-type: none"> Asset Obligation 		
2	Interest cost on obligation <ul style="list-style-type: none"> 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) ($x\% \times b/d \text{ obligation}$)
		CREDIT	PV defined benefit obligation (SOPF)
3	Interest on plan assets <ul style="list-style-type: none"> 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 (SOPF)
		CREDIT	Interest cost (P/L) ($x\% \times b/d \text{ assets}$)

Step	Item	Recognition	
4	Current service cost <ul style="list-style-type: none"> Increase in the present value of the obligation resulting from employee service in the current period 	DEBIT	<i>Current service cost (P/L)</i>
		CREDIT	<i>PV defined benefit obligation (SOPF)</i>
5	Contributions <ul style="list-style-type: none"> As advised by actuary 	DEBIT	<i>Plan assets (SOPF)</i>
		CREDIT	<i>Company cash</i>
6	Benefits <ul style="list-style-type: none"> Actual pension payments made 	DEBIT	<i>PV defined benefit obligation (SOPF)</i>
		CREDIT	<i>Plan assets (SOPF)</i>
7	Past service cost <ul style="list-style-type: none"> Increase/decrease in PV obligation as a result of introduction or improvement of benefits 	Positive (increase in obligation): DEBIT <i>Past service cost (P/L)</i> CREDIT <i>PV defined benefit obligation (SOPF)</i> Negative (decrease in obligation): DEBIT <i>PV defined benefit obligation (SOPF)</i> CREDIT <i>Past service cost (P/L)</i>	
8	Gains and losses on settlement <ul style="list-style-type: none"> Difference between the value of the obligation being settled and the settlement price 	Gain DEBIT <i>PV defined benefit obligation (SOPF)</i> CREDIT <i>Service cost (P/L)</i> Loss DEBIT <i>Service cost (P/L)</i> CREDIT <i>PV defined benefit obligation (SOPF)</i>	
9	Re-measurements: actuarial gains and losses <ul style="list-style-type: none"> Arising from annual valuations of obligation On obligation, differences between actuarial assumptions and actual experience during the period, or changes in actuarial assumptions 	Gain DEBIT <i>PV defined benefit obligation (SOPF)</i> CREDIT <i>Other comprehensive income</i> Loss DEBIT <i>Other comprehensive income</i> CREDIT <i>PV defined benefit obligation (SOPF)</i>	
10	Re-measurements: return on assets (excluding amounts in net-interest) <ul style="list-style-type: none"> Arising from annual valuations of plan assets 	Gain DEBIT <i>FV plan assets (SOPF)</i> CREDIT <i>Other comprehensive income</i> Loss DEBIT <i>Other comprehensive income</i> CREDIT <i>FV plan assets (SOPF)</i>	
11	Disclose in accordance with the standard	See comprehensive question.	

Exam focus point

Defined benefit pension plans are frequently examined. It is important to make sure that you read the requirements of the question carefully. If the question asks you to **explain** an accounting treatment, you must do so as marks are specifically awarded for the explanation. In the December 2017 examiner's report, the examiner said of a question testing defined benefit pension plans that: 'a significant minority of candidates simply computed the re-measurement loss arising on the actuarial valuation of the plan without any explanations whatsoever of the accounting treatment of the constituent elements of the reconciliation. The computation of the re-measurement loss was often correct but such candidates only scored around half marks by not displaying the knowledge they apparently possessed in the form of supporting explanations.' To maximise your marks, ensure you explain your calculations when asked to do so.



Question

Comprehensive

For the sake of simplicity and clarity, all transactions are assumed to occur at the year end.

The following data applies to the post employment defined benefit compensation plan of BCD Co.

Discount rate: 10% (each year)

Present value of obligation at start of 20X2: \$1m

Market value of plan assets at start of 20X2: \$1m

The following figures are relevant.

	20X2	20X3	20X4
	\$'000	\$'000	\$'000
Current service cost	140	150	150
Benefits paid out	120	140	150
Contributions paid by entity	110	120	120
Present value of obligation at year end	1,200	1,650	1,700
Fair value of plan assets at year end	1,250	1,450	1,610

Additional information:

- (1) At the end of 20X3, a division of the company was sold. As a result of this, a large number of the employees of that division opted to transfer their accumulated pension entitlement to their new employer's plan. Assets with a fair value of \$48,000 were transferred to the other company's plan and the actuary has calculated that the reduction in BCD's defined benefit liability is \$50,000. The year end valuations in the table above were carried out **before** this transfer was recorded.
- (2) At the end of 20X4, a decision was taken to make a one-off additional payment to former employees currently receiving pensions from the plan. This was announced to the former employees before the year end. This payment was not allowed for in the original terms of the plan. The actuarial valuation of the obligation in the table above **includes** the additional liability of \$40,000 relating to this additional payment.

Required

Show how the reporting entity should account for this defined benefit plan in each of years 20X2, 20X3 and 20X4.

Answer

The actuarial gain or loss is established as a balancing figure in the calculations, as follows.

Present value of obligation

	20X2	20X3	20X4
	\$'000	\$'000	\$'000
PV of obligation at start of year	1,000	1,200	1,600
Interest cost (10%)	100	120	160
Current service cost	140	150	150
Past service cost			40
Benefits paid	(120)	(140)	(150)
Settlements		(50)	
(Gain) or loss on remeasurement through OCI: balancing figure	80	320	(100)
PV of obligation at end of year	<u>1,200</u>	<u>1,600*</u>	<u>1,700</u>

*(1,650 – 50)

Market value of plan assets

	20X2	20X3	20X4
	\$'000	\$'000	\$'000
Market value of plan assets at start of year	1,000	1,250	1,402
Interest on plan assets (10%)	100	125	140
Contributions	110	120	120
Benefits paid	(120)	(140)	(150)
Settlements	—	(48)	—
Gain on re-measurement through OCI: balancing figure	160	95	98
Market value of plan assets at year end	<u>1,250</u>	<u>1,402*</u>	<u>1,610</u>

*(1,450 – 48)

In the statement of financial position, the liability that is recognised is calculated as follows.

	20X2	20X3	20X4
	\$'000	\$'000	\$'000
Present value of obligation	1,200	1,600	1,700
Market value of plan assets	<u>1,250</u>	<u>1,402</u>	<u>1,610</u>
Liability/(asset) in statement of financial position	<u>(50)</u>	<u>198</u>	<u>90</u>

The following will be recognised in profit or loss for the year:

	20X2	20X3	20X4
	\$'000	\$'000	\$'000
Current service cost	140	150	150
Past service cost	—	—	40
Net interest on defined benefit liability (asset)	—	(5)	20
Gain on settlement of defined benefit liability	—	(2)	—
Expense recognised in profit or loss	<u>140</u>	<u>143</u>	<u>210</u>

The following re-measurements will be recognised in other comprehensive income for the year:

	20X2	20X3	20X4
	\$'000	\$'000	\$'000
Actuarial (gain)/loss on obligation	80	320	(100)
Return on plan assets (excluding amounts in net-interest)	<u>(160)</u>	<u>(95)</u>	<u>(98)</u>

7 Other long-term benefits

7.1 Definition

IAS 19 defines **other long-term employee benefits** as all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits if not expected to be settled wholly before 12 months after the end of the annual reporting period in which the employees render the related service.

The types of benefits that might fall into this category include (IAS 19: para. 153) long-term paid absences, such as sabbatical leave, profit-sharing and bonuses and long-term disability benefits.

7.2 Accounting treatment for other long-term benefits

There are many similarities between these types of benefits and defined benefit pensions. For example, in a long-term bonus plan, 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 post-employment benefits, this method does **not recognise re-measurements in other comprehensive income**.

The entity should recognise all of the following in **profit or loss** (IAS 19: para. 153):

- (a) **Service cost**
- (b) **Net interest** on the defined benefit liability (asset)
- (c) **Re-measurement** of the defined benefit liability (asset)

Chapter Roundup

- **IAS 19 Employee Benefits** is a long and complex standard covering both short-term and long-term (post-employment) benefits. The complications arise when dealing with **post-employment benefits**.
- The accounting for **short-term employee benefits** is simple. The principles are the same as for any expense that is accrued over a period.
- There are **two types of post-employment benefit plan**:
 - Defined contribution plans
 - Defined benefit plans
- **Defined contribution plans** provide benefits commensurate with the fund available to produce them. Defined contribution plans are simple to account for as the benefits are defined by the contributions made.
- **Defined benefit plans** provide promised benefits and so contributions are based on estimates of how the fund will perform. Defined benefit plans are much more difficult to deal with as the benefits are promised and therefore define the contributions to be made.
- There is a **four-step method** for recognising and measuring the expenses and liability of a defined benefit pension plan.
- **Actuarial assumptions** made should be unbiased and based on market expectations.
- **Discount rates** used should be determined by reference to market yields on high-quality fixed-rate corporate bonds.
- **Actuarial gains and losses** arise for several reasons, and IAS 19 requires these to be recognised in full in other comprehensive income.
- The **return on plan assets** must be calculated.
- You should know how to deal with **past service costs and curtailments and settlements**.

Quick Quiz

- 1 What are the four categories of employee benefits given by IAS 19?
- 2 What is the difference between defined contribution and defined benefit plans?
- 3 What is a 'constructive obligation' compared to a legal obligation?
- 4 How should a defined benefit expense be recognised in profit or loss for the year?
- 5 What causes actuarial gains or losses?

Answers to Quick Quiz

- 1
 - Short-term
 - Post-employment
 - Other long-term
 - Termination
- 2 See Section 3.1.
- 3 A constructive obligation exists when the entity has no realistic alternative than to pay employee benefits.
- 4 Current service cost + interest + expected return + recognised actuarial gains/losses + past service cost + curtailments or settlements.
- 5 Gains or losses due to changes in actuarial assumptions.

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q11	Introductory	n/a	n/a

Financial instruments

10

Topic list	Syllabus reference
1 Financial instruments	B7
2 Presentation of financial instruments	B7
3 Recognition of financial instruments	B7
4 Measurement of financial instruments	B7
5 Embedded derivatives	B7
6 Hedge accounting	B7
7 Disclosure of financial instruments	B7
8 Fair value measurement	B7/B15

Introduction

Financial instruments sounds like a daunting subject, and indeed this is a complex and controversial area. The numbers involved in financial instruments are often huge, but don't let this put you off. In this chapter we aim to simplify the topic as much as possible and to focus on the important issues.

Study guide

B7	Financial Instruments
(a)	Explain the definition of a financial instrument
(b)	Determine the appropriate classification of a financial instrument, including those instruments that are subject to 'split classification' – eg convertible loans
(c)	Discuss and account for the initial and subsequent measurement (including impairment in the case of financial assets) of financial assets and financial liabilities in accordance with applicable financial reporting standards and the finance costs associated with them
(d)	Discuss the conditions that are required for a financial asset or liability to be derecognised
(e)	Explain the conditions that are required for hedge accounting to be used
(f)	Prepare financial information for hedge accounting purposes, including the impact of treating hedging arrangements as fair value hedges or cash flow hedges
(g)	Describe the financial instrument disclosures required in the notes to the financial statements
B15	Fair value
(a)	Explain the principle under which fair value is measured according to IFRSs
(b)	Identify an appropriate fair value measurement for an asset or liability in a given set of circumstances

Exam focus point

Although the complexity of this topic makes it likely to come up in an exam, there are limits as to how detailed a question the examiner can reasonably set. You should concentrate on the essential points. It is likely that it will be examined within a larger scenario based question, so be prepared for numerical calculations on financial instruments within questions on other topics.

1 Financial instruments

FAST FORWARD

Financial instruments can be very complex, particularly **derivative instruments**, although **primary instruments** are more straightforward.

There are three accounting standards on financial instruments:

- (a) IAS 32 *Financial Instruments: Presentation*, which deals with:
 - (i) The classification of financial instruments between liabilities and equity
 - (ii) Presentation of certain compound instruments
- (b) IFRS 7 *Financial Instruments: Disclosures*, which revised, simplified and incorporated disclosure requirements previously in IAS 32.
- (c) IFRS 9 *Financial Instruments* replaces IAS 39 *Financial Instruments: Recognition and Measurement*. The standard covers:
 - (i) Recognition and derecognition
 - (ii) The measurement of financial instruments
 - (iii) Impairment
 - (iv) General hedge accounting (not macro hedge accounting, which is a separate IASB project, currently at the discussion paper stage)

1.1 Definitions

The most important definitions are common to all three standards.

FAST FORWARD

The important definitions to learn are:

- **Financial asset**
- **Financial liability**
- **Equity instrument**

Key terms

Financial instrument. Any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

Financial asset. Any asset that is:

- (a) Cash
- (b) An equity instrument of another entity
- (c) A contractual right to receive cash or another financial asset from another entity; or to exchange financial instruments 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.

Financial liability. Any liability that is:

- (a) A contractual obligation:
 - (i) To deliver cash or another financial asset to another entity, or
 - (ii) To exchange financial instruments with another entity under conditions that are potentially unfavourable; 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.

Equity instrument. Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

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.

Derivative. A financial instrument or other contract with all three of the following characteristics:

- (a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the 'underlying');
- (b) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- (c) It is settled at a future date.

(IAS 32: para. 11, AG3 to 23; IFRS 9: Appendix A; IFRS 13: Appendix A)

We should clarify some points arising from these definitions. First, one or two terms above should be themselves defined.

- (a) A '**contract**' need not be in writing, but it must comprise an agreement that has clear economic consequences and which the parties to it cannot avoid, usually because the agreement is enforceable in law.
- (b) An '**entity**' here could be an individual, partnership, incorporated body or government agency.

The definitions of **financial assets** and **financial liabilities** may seem rather circular, referring as they do to the terms financial asset and financial instrument. The point is that there may be a chain of contractual rights and obligations, but it will lead ultimately to the receipt or payment of cash or the acquisition or issue of an equity instrument.

Examples of **financial assets** include:

- (a) Trade receivables
- (b) Options
- (c) Shares (when used as an investment)

Examples of **financial liabilities** include:

- (a) Trade payables
- (b) Debenture loans payable
- (c) Redeemable preference (non-equity) shares
- (d) Forward contracts standing at a loss

As we have already noted, financial instruments include both of the following.

- (a) **Primary instruments:** eg receivables, payables and equity securities
- (b) **Derivative instruments:** eg financial options, futures and forwards, interest rate swaps and currency swaps, **whether recognised or unrecognised**

IAS 32 (Application Guidance, AG8) makes it clear that the following items are **not** financial instruments.

- (a) **Physical assets**, eg inventories, property, plant and equipment, leased assets and intangible assets (patents, trademarks etc)
- (b) **Prepaid expenses**, deferred revenue and most warranty obligations
- (c) Liabilities or assets that are **not contractual** in nature
- (d) Contractual rights/obligations that **do not involve transfer of a financial asset**, eg commodity futures contracts, operating leases for lessors



Question

Why not?

Can you give the reasons why the first two items listed above do not qualify as financial instruments?

Answer

Refer to the definitions of financial assets and liabilities given above.

- (a) **Physical assets:** control of these creates an opportunity to generate an inflow of cash or other assets, but it does not give rise to a present right to receive cash or other financial assets.
- (b) **Prepaid expenses, etc:** the future economic benefit is the receipt of goods/services rather than the right to receive cash or other financial assets.
- (c) **Deferred revenue, warranty obligations:** the probable outflow of economic benefits is the delivery of goods/services rather than cash or another financial asset.

Contingent rights and obligations meet the definition of financial assets and financial liabilities respectively (IAS 32: AG 20, 21), because the contractual rights or obligations exist because of a past transaction or event (eg assumption of a guarantee). However many contingent rights and obligations cannot be recognised as financial assets or financial liabilities in the financial statements because they do not meet the recognition criteria.

1.2 Derivatives

A **derivative** is a financial instrument that **derives** its value from the price or rate of an underlying item. Common **examples** of derivatives include (IAS 32: AG15):

- (a) **Forward contracts:** agreements to buy or sell an asset at a fixed price at a fixed future date
- (b) **Futures contracts:** similar to forward contracts except that contracts are standardised and traded on an exchange
- (c) **Options:** rights (but not obligations) for the option holder to exercise at a pre-determined price; the option writer loses out if the option is exercised
- (d) **Swaps:** agreements to swap one set of cash flows for another (normally interest rate or currency swaps)

The nature of derivatives often gives rise to **particular problems**. The **value** of a derivative (and the amount at which it is eventually settled) depends on **movements** in an underlying item (such as an exchange rate). This means that settlement of a derivative can lead to a very different result from the one originally envisaged. A company which has derivatives is exposed to **uncertainty and risk** (potential for gain or loss) and this can have a very material effect on its financial performance, financial position and cash flows.

Yet because a derivative contract normally has **little or no initial cost**, under traditional accounting it **may not be recognised** in the financial statements at all. Alternatively, it may be recognised at an amount which bears no relation to its current value. This is clearly **misleading** and leaves users of the financial statements unaware of the **level of risk** that the company faces. IAS 32 and IAS 39 (now replaced with IFRS 9) were developed in order to correct this situation.

2 Presentation of financial instruments

2.1 Objective

The objective of IAS 32 is:

'to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities' (IAS 32: para. 2).

2.2 Scope

IAS 32 should be applied in the presentation of **all types of financial instruments**, whether recognised or unrecognised (IAS 32: para. 4).

Certain items are **excluded** (IAS 32: para. 4).

- Interests in subsidiaries (IAS 27: Chapter 20)
- Interests in associates (IAS 28: Chapter 23)
- Interests in joint ventures (IFRS 11: Chapter 24)
- Pensions and other post-retirement benefits (IAS 19: Chapter 9)
- Insurance contracts
- Contracts for contingent consideration in a business combination
- Contracts that require a payment based on climatic, geological or other physical variables
- Financial instruments, contracts and obligations under share-based payment transactions (IFRS 2: Chapter 14)

2.3 Liabilities and equity

FAST FORWARD

Financial instruments must be classified as **liabilities** or **equity** according to their **substance**.

The critical feature of a financial liability is the **contractual obligation to deliver cash** or another financial asset.

The main thrust of IAS 32 here is that financial instruments should be presented according to their **substance, not merely their legal form**. In particular, entities which issue financial instruments should classify them (or their component parts) as **either financial liabilities, or equity** (IAS 32: para. 16).

The classification of a financial instrument as a liability or as equity depends on the following.

- The substance of the contractual arrangement on initial recognition
- The definitions of a financial liability and an equity instrument

(IAS 32: para. 15)

How should a **financial liability be distinguished from an equity instrument**? The critical feature of a **liability** is an **obligation** to transfer economic benefit (IAS 32: para. 17). Therefore, a financial instrument is a financial liability if there is a **contractual obligation** on the issuer either to deliver cash or another financial asset to the holder or to exchange another financial instrument with the holder under potentially unfavourable conditions to the issuer (IAS 32: para 11).

The financial liability exists **regardless of the way in which the contractual obligation will be settled**. The issuer's ability to satisfy an obligation may be restricted, eg by lack of access to foreign currency, but this is irrelevant as it does not remove the issuer's obligation or the holder's right under the instrument.

(IAS 32: para. 19)

Where the above critical feature is **not** met, then the financial instrument is an **equity instrument**. IAS 32 explains that although the holder of an equity instrument may be entitled to a *pro rata* share of any distributions out of equity, the issuer does **not** have a contractual obligation to make such a distribution (IAS 32: para. 17).

Although substance and legal form are often **consistent with each other**, this is not always the case. In particular, a financial instrument may have the legal form of equity, but in substance it is in fact a liability. Other instruments may combine features of both equity instruments and financial liabilities.

(IAS 32: para. 18)

IAS 32 para. 18 gives the example of **preference shares** which must be **redeemed** by the issuer for a fixed (or determinable) amount at a fixed (or determinable) future date. In such cases, the issuer has an **obligation**. Therefore the instrument is a **financial liability** and should be classified as such.

Another example is **cumulative irredeemable preference shares**. While the issuer does not redeem the preference shares, there is an obligation on the issuer to pay fixed dividends. If the entity has insufficient retained earnings in a given year, the dividends still must be paid in future years. Again, because the issuer has an obligation, the instrument should be classified as a financial liability.

The classification of the financial instrument is made when it is **first recognised** and this classification will continue until the financial instrument is removed from the entity's statement of financial position.

2.4 Contingent settlement provisions

An entity may issue a financial instrument where the way in which it is settled depends on:

- (a) The occurrence or non-occurrence of uncertain future events, or
- (b) The outcome of uncertain circumstances

that are beyond the control of both the holder and the issuer of the instrument. For example, an entity might have to deliver cash instead of issuing equity shares. In this situation it is not immediately clear whether the entity has an equity instrument or a financial liability.

Such financial instruments should be classified as **financial liabilities** unless the possibility of settlement is remote.

(IAS 32: para. 25)

2.5 Settlement options

When a derivative financial instrument gives one party a **choice** over how it is settled (eg, the issuer can choose whether to settle in cash or by issuing shares) the instrument is a **financial asset** or a **financial liability** unless **all the alternative choices** would result in it being an equity instrument (IAS 32: para. 26).

2.6 Compound financial instruments

FAST FORWARD

Compound instruments are split into **equity** and **liability** components and presented accordingly in the statement of financial position.

Some financial instruments contain both a liability and an equity element. In such cases, IAS 32 requires the component parts of the instrument to be **classified separately**, according to the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument.

One of the most common types of compound instrument is **convertible debt**. This creates a primary financial liability of the issuer and grants an option to the holder of the instrument to convert it into an equity instrument (usually ordinary shares) of the issuer. This is the economic equivalent of the issue of conventional debt plus a warrant to acquire shares in the future.

Although in theory there are several possible ways of calculating the split, the following method is used in IAS 32 (para. 31):

- (a) Calculate the value for the liability component.
- (b) Deduct this from the instrument as a whole to leave a residual value for the equity component.

The reasoning behind this approach is that an entity's equity is its residual interest in its assets amount after deducting all its liabilities.

The **sum of the carrying amounts** assigned to liability and equity will always be equal to the carrying amount that would be ascribed to the instrument **as a whole**.

(IAS 32: paras. 28–32)

2.7 Example: Valuation of compound instruments

Rathbone Co issues 2,000 convertible bonds at the start of 20X2. The bonds have a three-year term, and are issued at par with a face value of \$1,000 per bond, giving total proceeds of \$2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6%. Each bond is convertible at any time up to maturity into 250 common shares.

When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 9%. At the issue date, the market price of one common share is \$3. The dividends expected over the three-year term of the bonds amount to 14c per share at the end of each year. Using a discount rate of 9%, the present value of \$1 payable at the end of three years is \$0.772, the cumulative present value of \$1 paid annually in arrears for three years is \$2.531.

Required

What is the value of the equity component in the bond?

Solution

The liability component is valued first, and the difference between the proceeds of the bond issue and the fair value of the liability is assigned to the equity component. The present value of the liability component is calculated using a discount rate of 9%, the market interest rate for similar bonds having no conversion rights, as shown.

	\$
Present value of the principal: \$2,000,000 payable at the end of three years (\$2m × 0.772)	1,544,000
Present value of the interest: \$120,000 payable annually in arrears for three years (\$120,000 × 2.531)	303,720
Total liability component	1,847,720
Equity component (balancing figure)	152,280
Proceeds of the bond issue	<u>2,000,000</u>

The split between the liability and equity components remains the same throughout the term of the instrument, even if there are changes in the **likelihood of the option being exercised**. This is because it is not always possible to predict how a holder will behave. The issuer continues to have an obligation to make future payments until conversion, maturity of the instrument or some other relevant transaction takes place.

2.8 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 recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. Consideration paid or received shall be recognised directly in equity (IAS 32: para. 33).

2.9 Interest, dividends, losses and gains

As well as looking at statement of financial position presentation, IAS 32 considers how financial instruments affect the profit or loss (and movements in equity). The treatment varies according to whether interest, dividends, losses or gains relate to a financial liability or an equity instrument (IAS 32: paras. 35, 36, 40, 41).

- (a) Interest, dividends, losses and gains relating to a financial instrument (or component part) classified as a **financial liability** should be recognised as **income or expense** in profit or loss.
- (b) Distributions to holders of a financial instrument classified as an **equity instrument** should be **debited directly to equity** by the issuer.
- (c) **Transaction costs** of an equity transaction shall be accounted for as a **deduction from equity** (unless they are directly attributable to the acquisition of a business, in which case they are accounted for under IFRS 3).

2.10 Offsetting a financial asset and a financial liability

A financial asset and financial liability should **only be offset**, with the net amount reported in the statement of financial position, when an entity:

- (a) Has a legally enforceable right of set off; **and**
- (b) Intends to settle on a net basis, or to realise the asset and settle the liability simultaneously, ie at the same moment.

This will reflect the expected **future cash flows** of the entity in these specific circumstances. In all other cases, financial assets and financial liabilities are presented separately.

(IAS 32: para. 42, AG 38 A to F)

2.11 Puttable financial instruments and obligations arising on liquidation

IAS 32 requires that if the holder of a financial instrument can require the issuer to redeem it for cash it should be classified as a liability. Some ordinary shares and partnership interests allow the holder to 'put' the instrument (that is to require the issuer to redeem it in cash). Such shares might more usually be considered as equity, but application of IAS 32 results in their being classified as liabilities.

IAS 32 requires entities to classify such instruments as equity, so long as they meet certain conditions. IAS 32 further requires that instruments imposing an obligation on an entity to deliver to another party a pro rata share of the net assets only on liquidation should be classified as equity.

(IAS 32: para. 96A)

Exam focus point

There is a useful article on this subject entitled 'When does debt seem to be equity?' available on ACCA's website:

www.accaglobal.com/gb/en/student/exam-support-resources/dipifr-study-resources/technical-articles.html

3 Recognition of financial instruments

FAST FORWARD

- **All financial assets and liabilities** should be recognised in the statement of financial position, including derivatives.
- Financial assets should be derecognised when the **rights to the cash flows** from the asset **expire** or where **substantially all the risks and rewards of ownership** are transferred to another party.
- Financial liabilities should be derecognised when they are **extinguished**.

IFRS 9 establishes principles for recognising and measuring financial assets and financial liabilities. IFRS 9 is mandatorily effective for periods beginning on or after 1 January 2018 with early adoption permitted.

3.1 Scope

IFRS 9 applies to **all entities** and to **all types of financial instruments except** those specifically excluded, as listed below (IFRS 9: Chapter 2, para. 2.1).

- (a) Investments in **subsidiaries, associates, and joint ventures** that are accounted for under IFRS 10, IAS 27 or IAS 28
- (b) **Leases** covered in IFRS 16
- (c) **Employee benefit plans** covered in IAS 19
- (d) **Equity instruments issued by the entity** eg ordinary shares issued, or options and warrants
- (e) **Insurance contracts** and **financial guarantee contracts**
- (f) **Contracts for contingent consideration** in a business combination, covered in IFRS 3
- (g) **Loan commitments** that cannot be settled net in cash or another financial instrument
- (h) Financial instruments, contracts and obligations under **share based payment transactions**, covered in IFRS 2
- (i) Rights to **reimbursement** under IAS 37
- (j) Rights and obligations within the scope of **IFRS 15 Revenue from Contracts with Customers**

3.2 Initial recognition

Financial instruments should be recognised in the statement of financial position when the entity becomes a party to the **contractual provisions of the instrument** (IFRS 9: Chapter 3, para. 3.1.1).

Point to note

An important consequence of this is that all derivatives should be recognised in the statement of financial position.

Notice that this is **different** from the recognition criteria in the *Conceptual Framework* and in most other standards. Items are normally recognised when there is a probable inflow or outflow of resources and the item has a cost or value that can be measured reliably.

3.3 Example: Initial recognition

An entity has entered into two separate contracts:

- (a) A firm commitment (an order) to buy a specific quantity of iron.
- (b) A forward contract to buy a specific quantity of iron at a specified price on a specified date, provided delivery of the iron is not taken.

Contract (a) is a **normal trading contract**. The entity does not recognise a liability for the iron until the goods have actually been delivered. (Note that this contract is not a financial instrument because it involves a physical asset, rather than a financial asset.)

Contract (b) is a **financial instrument**. Under IFRS 9, the entity recognises a financial liability (an obligation to deliver cash) on the **commitment date**, rather than waiting for the closing date on which the exchange takes place.

Note that planned future transactions, no matter how likely, are not assets and liabilities of an entity – the entity has not yet become a party to the contract.

3.4 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 derecognise a **financial asset** when:

- (a) The **contractual rights** to the cash flows from the financial asset **expire**, or
- (b) The entity **transfers the financial asset or substantially all the risks and rewards of ownership** of the financial asset to another party.

(IFRS 9: Chapter 3, paras. 3.2.3–3.2.6)

The Application Guidance to IFRS 9 gives **examples of where an entity has transferred substantially all the risks and rewards of ownership**. These include:

- (a) 'An unconditional sale of a financial asset
- (b) A sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase [...]' (IFRS 9: Application Guidance, para. B3.2.4).

The Application guidance to IFRS 9 also **provides examples of situations where the risks and rewards of ownership have not been transferred**:

- (a) 'A sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return' (IFRS 9: Application Guidance, para. B3.2.5).
- (b) 'A sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity' (IFRS 9: Application Guidance, para. B3.2.5).
- (c) 'A sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur' (IFRS 9: Application Guidance, para. B3.2.5).

It is possible for only **part** of a financial asset or liability to be derecognised. This is allowed if the part comprises (IFRS 9: Chapter 3, para. 3.2.2(a)):

- (a) Only specifically identified cash flows; or
- (b) Only a fully proportionate (pro rata) share of the total cash flows.

For example, if an entity holds a bond it has the right to two separate sets of cash inflows: those relating to the principal and those relating to the interest. It could sell the right to receive the interest to another party while retaining the right to receive the principal.

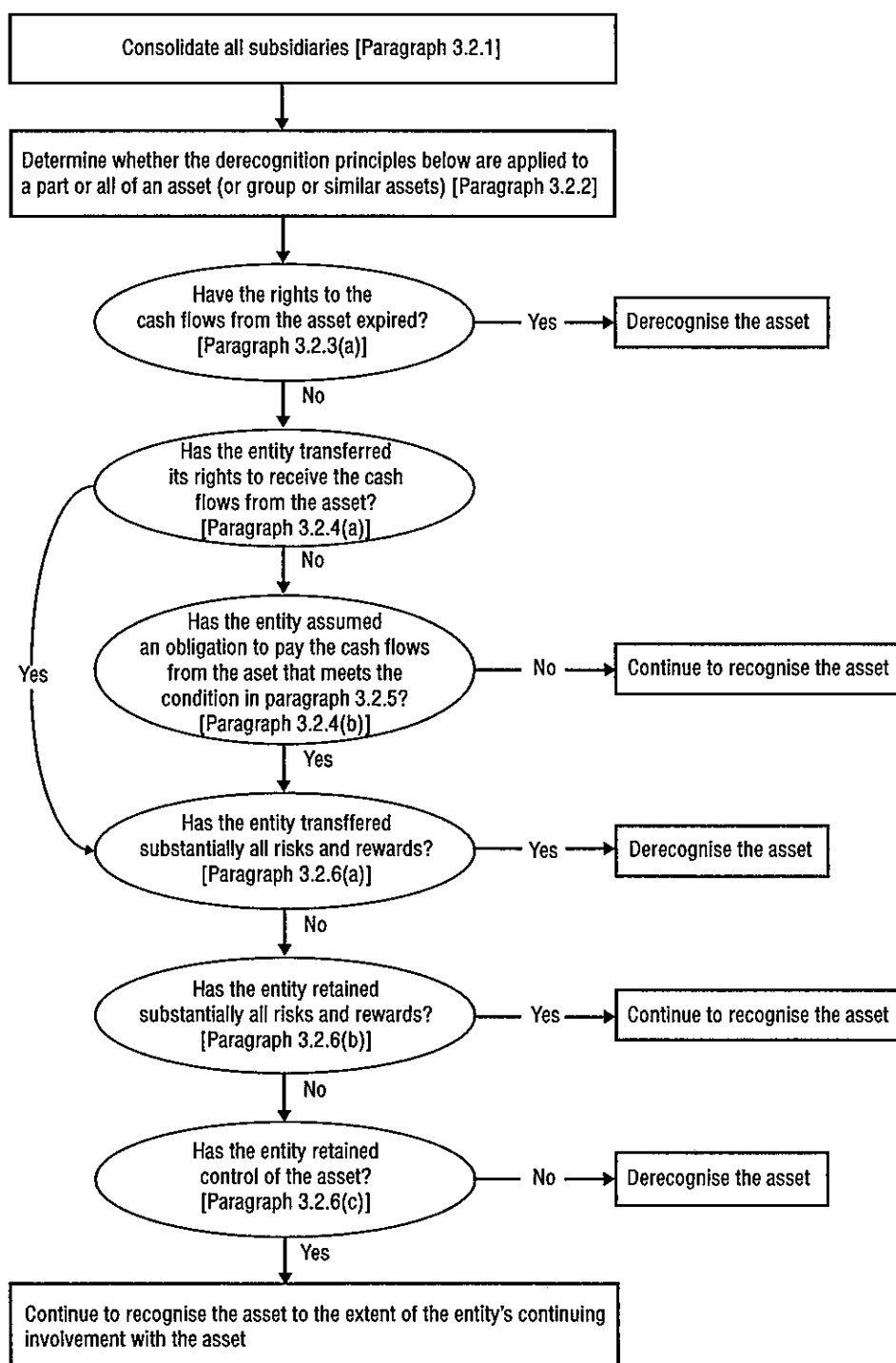
(IFRS 9: Chapter 3, para. 3.2.2(a))

On derecognition, the amount to be included in net profit or loss for the period is calculated as follows (IFRS 9: Chapter 3, para. 3.2.13):

Formula to learn

	\$
Carrying amount (measured at the date of derecognition) allocated to the part derecognised	X
Less consideration received for the part derecognised (including any new asset obtained less any new liability assumed)	(X)
Difference to profit or loss	<u>X</u>

The following flowchart, taken from the appendix to the standard, will help you decide whether, and to what extent, a financial asset is derecognised.



(IFRS 9: AG, Appendix B, para. B3.2.1)

3.4.1 Example: Derecognition

Discuss whether the following financial instruments would be derecognised.

- (a) AB sells an investment in shares, but retains a call option to repurchase those shares at any time at a price equal to their current market value at the date of repurchase.
- (b) EF enters into a stock lending agreement where an investment is lent to a third party for a fixed period of time for a fee.

Solution

- (a) AB **should derecognise** the asset as it only has an option (rather than an obligation) to purchase.
- (b) EF **should not derecognise** the asset as it has retained substantially all the risks and rewards of ownership. The stock should be retained in its books even though legal title is temporarily transferred.

3.5 Derecognition of financial liabilities

A financial liability is derecognised **when it is extinguished** – ie when the obligation specified in the contract is discharged or cancelled or expires (IFRS 9: Chapter 3, para. 3.3.1).

- (a) Where an existing borrower and lender of debt instruments exchange one financial instrument for another with substantially different terms, this is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability (IFRS 9: Chapter 3, para. 3.3.2).
- (b) 'A substantial modification of the terms of an existing financial liability or a part of it should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability' (IFRS 9: Chapter 3, para. 3.3.2). For this purpose, a 'substantial modification' of the terms arises where the discounted present value of cash flows under the new terms, discounted using the original effective interest rate, is at least 10% different from the discounted present value of the remaining cash flows of the original financial liability (IFRS 9: para. B3.3.6).

Any gain or loss on the derecognition of a financial liability (or part of a financial liability) is recognised in profit or loss (IFRS 9: Chapter 3, para. 3.3.3).

3.6 Classification of financial assets

FAST FORWARD

IFRS 9 requires that financial assets are **classified as measured** at either:

- **Amortised cost,**
- **Fair value through other comprehensive income, or**
- **Fair value through profit or loss**

There is an option to designate a financial asset **at fair value through profit or loss to reduce or eliminate an 'accounting mismatch'** (measurement or recognition inconsistency).

(IFRS 9: para. 5.2.1)

Exam focus point

The December 2016 exam featured an 8-mark question about the classification of financial assets and the basis of measurement for each classification. In the examiner's report, the examiner commented that 'only a minority of candidates were able to correctly describe when each measurement basis would be appropriate' (Examiner's Report December 2016, p 3).

3.6.1 Basis of classification

On **recognition**, IFRS 9 requires that financial assets are **classified as measured** at either (IFRS 9: para. 5.2.1):

- **Amortised cost,**
- **Fair value through other comprehensive income, or**
- **Fair value through profit or loss**

The IFRS 9 classification is made 'on the basis of both:

- (a) The **entity's business model** for managing the financial assets, and
- (b) The **contractual cash flow** characteristics of the financial asset' (IFRS 9: Chapter 4, para. 4.1.1).

3.6.2 Business model test

(IFRS 9: AG, paras. B4.1.1–B4.1.26)

IFRS 9 introduces a business model test that requires an entity to assess whether its **business objective for a debt instrument is to collect the contractual cash flows of the instrument as opposed to realising its fair value change from sale prior to its contractual maturity**. Note the following key points:

- (a) The assessment of a 'business model' is not made at an individual financial instrument level.
- (b) The assessment is based on how key management personnel actually manage the business, rather than management's intentions for specific financial assets.
- (c) An entity may have more than one business model for managing its financial assets and the classification need not be determined at the reporting entity level. For example, it may have one portfolio of investments that it manages with the objective of collecting contractual cash flows and another portfolio of investments held with the objective of trading to realise changes in fair value. It would be appropriate for entities like these to carry out the assessment for classification purposes at portfolio level, rather than at entity level.
- (d) Although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those assets until maturity. Thus an entity's business model can be to hold financial assets to collect contractual cash flows even when sales of financial assets occur.

3.6.3 Financial assets classification: Amortised cost

A financial asset is classified as measured at amortised cost where:

- (a) 'The **objective of the business model** within which the asset is held is to hold assets in order to collect contractual cash flows, and
- (b) 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 outstanding' (IFRS 9: para. 4.1.2).

Amortised cost is defined by IFRS 9 as follows.

Key term

Amortised cost The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the **effective interest method** of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any **loss allowance**.

(IFRS 9: Appendix A)

This is explained further in Section 4.4.

3.6.4 Financial assets classification: Fair value through other comprehensive income

A financial asset **must** be classified and measured at **fair value through other comprehensive income** (unless the asset is designated at fair value through profit or loss under the fair value option) if it meets both the following criteria:

- (a) 'The financial asset is held within a **business model** whose objective is achieved by both collecting contractual cash flows and selling financial assets.
- (b) 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' (IFRS 9: para. 4.1.2A).

3.6.5 Financial assets classification: Fair value through profit or loss

All other financial assets must be measured at fair value through profit or loss (IFRS 9: para. 4.1.4).

3.6.6 Financial assets classification: Fair value through profit or loss option to avoid an 'accounting mismatch'

Even if an instrument meets the above criteria for measurement at amortised cost or fair value through other comprehensive income, IFRS 9 allows such financial assets to be **'designated, at initial recognition, as being measured at fair value through profit or loss if a recognition or measurement inconsistency (an 'accounting mismatch') would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases'** (IFRS 9: para. 4.1.5).

3.6.7 Equity instruments

Equity instruments **may not be classified as measured at amortised cost and must be measured at fair value**. This is because contractual cash flows on specified dates are not a characteristic of equity instruments. However, if an equity instrument is **not held for trading**, an entity can make an **irrevocable election** at initial recognition to measure it at **fair value through other comprehensive income** with only dividend income recognised in profit or loss (IFRS 9: para. 5.7.5).

This is **different from the treatment of debt instruments**, where the **fair value through other comprehensive income classification is mandatory** for assets meeting the criteria, unless the fair value option through profit or loss option is chosen.

3.6.8 Business model test examples: Collecting contractual cash flows

The following examples, from the Application Guidance to IFRS 9, are of situations where the objective of an entity's business model may be to hold financial assets to collect the contractual cash flows.

Example 1

A Co holds investments to collect their contractual cash flows but would sell an investment in particular circumstances, perhaps to fund capital expenditure, or because the credit rating of the instrument falls below that required by A Co's investment policy.

Analysis

Although A Co may consider, among other information, the financial assets' fair values from a liquidity perspective (ie the cash amount that would be realised if A Co needs to sell assets), A Co's objective is to hold the financial assets and collect the contractual cash flows. Some sales would not contradict that objective. If sales became frequent, A Co might be required to reconsider whether the sales were consistent with an objective of collecting contractual cash flows.

(IFRS 9: Application Guidance, para. B4.1.4)

Example 2

B Co has a business model with the objective of originating loans to customers and subsequently to sell those loans to a securitisation vehicle. The securitisation vehicle issues instruments to investors.

B Co, the originating entity, controls the securitisation vehicle and thus consolidates it. The securitisation vehicle collects the contractual cash flows from the loans and passes them on to its investors in the vehicle.

It is assumed for the purposes of this example that the loans continue to be recognised in the consolidated statement of financial position because they are not derecognised by the securitisation vehicle.

Analysis

The consolidated group originated the loans with the objective of holding them to collect the contractual cash flows.

However, B Co has an objective of realising cash flows on the loan portfolio by selling the loans to the securitisation vehicle, so for the purposes of its separate financial statements it would not be considered to be managing this portfolio in order to collect the contractual cash flows.

(IFRS 9: Application Guidance, para. B4.1.4)

Example 3

C Co's business model is to purchase portfolios of financial assets, such as loans. Those portfolios may or may not include financial assets that are credit impaired. If payment on the loans is not made on a timely basis, C Co attempts to extract the contractual cash flows through various means – for example, by contacting the debtor through mail, telephone, and so on.

In some cases, C Co enters into interest rate swaps to change the interest rate on particular financial assets in a portfolio from a floating interest rate to a fixed interest rate.

Analysis

The objective of C Co's business model is to hold the financial assets and collect the contractual cash flows. The entity does not purchase the portfolio to make a profit by selling them.

The same analysis would apply even if C Co does not expect to receive all of the contractual cash flows (eg some of the financial assets are credit impaired at initial recognition).

Moreover, the fact that C Co has entered into derivatives to modify the cash flows of the portfolio does not in itself change C Co's business model.

(IFRS 9: Application Guidance, para. B4.1.4)

3.6.9 Contractual cash flow test in more detail

The requirement in IFRS 9 to assess the contractual cash flow characteristics of a financial asset is based on the concept that **only instruments with contractual cash flows of principal and interest on principal may qualify for amortised cost measurement**. By interest, IFRS 9 means consideration for the time value of money and the credit risk associated with the principal outstanding during a particular period of time (IFRS 9: para. B4.1.7A).



Question

Contractual cash flows

Would an investment in a convertible loan qualify to be measured at amortised cost under IFRS 9?

Answer

No, because of the inclusion of the conversion option which is not deemed to represent payments of principal and interest.

Measurement at amortised cost is permitted when the cash flows on a loan are entirely fixed (eg a fixed interest rate loan or zero coupon bond), or where interest is floating (eg a GBP loan where interest is contractually linked to GBP LIBOR), or combination of fixed and floating (eg where interest is LIBOR plus a fixed spread).

3.6.10 Examples of instruments that pass the contractual cash flows test

The following instruments satisfy the IFRS 9 criteria.

- (a) A variable rate instrument with a stated maturity date that permits the borrower to choose to pay three-month LIBOR for a three-month term or one-month LIBOR for a one-month term
- (b) A fixed term variable market interest rate bond where the variable interest rate is capped
- (c) A fixed term bond where the payments of principal and interest are linked to an unleveraged inflation index of the currency in which the instrument is issued

Worked examples of these can be located in the Application Guidance of IFRS 9, para. B4.1.13.

3.6.11 Examples of instruments that do not pass the contractual cash flows test

The following instruments do not satisfy the IFRS 9 criteria.

- (a) A bond that is convertible into equity instruments of the issuer (see question above)
- (b) A loan that pays an inverse floating interest rate (eg 8% minus LIBOR) (IFRS 9: para. B4.1.13)

3.6.12 Business model test example: Both collecting contractual cash flows and selling financial assets

The following examples, from the Application Guidance to IFRS 9, are of situations where the objective of an entity's business model is achieved by both collecting contractual cash flows and selling financial assets.

Example 4

C Co expects to incur capital expenditure in a few years' time. C Co invests its excess cash in short and long-term financial assets so that it can fund the expenditure when the need arises. Many of the financial assets have contractual lives that exceed C Co's anticipated investment period.

C Co will hold financial assets to collect the contractual cash flows and, when an opportunity arises, it will sell financial assets to re-invest the cash in financial assets with a higher return.

The remuneration of the managers responsible for the portfolio is based on the overall return generated by the portfolio.

Analysis

The objective of the business model is achieved by **both collecting contractual cash flows and selling financial assets**. C Co decides on an ongoing basis whether collecting contractual cash flows or selling financial assets will maximise the return on the portfolio until the need arises for the invested cash.

(IFRS 9: Application Guidance, para. B4.1.4C)



Question

Business model objective

D Co expects to pay a cash outflow in ten years to fund capital expenditure and invests excess cash in short-term financial assets. When the investments mature, D Co reinvests the cash in new short-term financial assets. D Co maintains this strategy until the funds are needed, at which time D Co uses the proceeds from the maturing financial assets to fund the capital expenditure. Only sales that are insignificant in value occur before maturity (unless there is an increase in credit risk).

Required

What is the objective of D's business model under IFRS 9?

The objective of D Co's business model is to hold financial assets to collect contractual cash flows. Selling financial assets is only incidental to D Co's business model.

The following example is taken from the Application Guidance to IFRS 9.

Example 5

F Bank holds financial assets to meet its everyday liquidity needs. The bank actively manages the return on the portfolio in order to minimise the costs of managing those liquidity needs. That return consists of collecting contractual payments as well as gains and losses from the sale of financial assets.

To this end, F Bank holds financial assets to collect contractual cash flows and sells financial assets to reinvest in higher yielding financial assets or to better match the duration of its liabilities. In the past, this strategy has resulted in frequent sales activity and such sales have been significant in value. This activity is expected to continue in the future.

Analysis

The objective of the business model is to maximise the return on the portfolio to meet everyday liquidity needs and F Bank achieves that objective by **both collecting contractual cash flows and selling financial assets**. In other words, **both collecting contractual cash flows and selling financial assets are integral** to achieving the business model's objective.

(IFRS 9: Application Guidance, para. B4.1.4C)

3.7 Classification of financial liabilities

All financial liabilities should be classified as measured at **amortised cost**, with the exception of (IFRS 9: para. 4.2.1):

- Financial liabilities at fair value through profit or loss (including most derivatives);
- Financial liabilities arising when transfer of financial asset does not qualify for derecognition; and
- Financial guarantee contracts and commitments to provide a loan at a below-market interest rate.

A financial liability is classified at fair value through profit or loss if (IFRS 9: Appendix B):

(a) It is **held for trading**, ie:

- (i) Is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
- (ii) On initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short term profit-taking; or
- (iii) Is a **derivative** (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

Or:

(b) Upon initial recognition it is irrevocably **designated at fair value through profit or loss**. This is permitted when it results in more relevant information because (IFRS 9: para. 4.2.2):

- (i) It eliminates or significantly reduces a measurement or recognition inconsistency ('accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or
- (ii) It is a group of financial liabilities or financial assets and liabilities and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy.

Derivatives are always measured at fair value through profit or loss.

3.8 Re-classification of financial assets

Financial assets are reclassified under IFRS 9 when, and only when, an entity **changes its business model** for managing financial assets (IFRS 9: para. 4.4.1). The reclassification should be applied **prospectively** from the reclassification date (IFRS 9: para. 5.6.1).

These rules **only apply to investments in debt instruments** as investments in equity instruments are always held at fair value and any election to measure them at fair value through other comprehensive income is an irrevocable one.

Reclassification of financial liabilities is not permitted.

The application guidance to IFRS 9 includes examples of circumstances when a reclassification is required or is not permitted.

3.8.1 Examples: Reclassification required

Reclassification is required in the following circumstances as given in the Application Guidance of the standard, because a **change in the business model** has taken place:

- (a) An entity has a portfolio of commercial loans that it holds to sell in the short term. The entity acquires a company that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash flows.
- (b) A financial services firm decides to shut down its retail mortgage business. That business no longer accepts new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.

(IFRS 9: Application Guidance, para. B4.4.1)

3.8.2 Examples: Reclassification not permitted

Reclassification is **not permitted** in the following circumstances, because a **change in the business model** has not taken place.

- (a) A change in intention related to particular financial assets (even in circumstances of significant changes in market conditions)
- (b) A temporary disappearance of a particular market for financial assets
- (c) A transfer of financial assets between parts of the entity with different business models.

(IFRS 9: Application Guidance, para. B4.4.3)

3.8.3 Gains and losses on reclassification of financial assets

If a financial asset is reclassified **from amortised cost to fair value**, any **gain or loss** arising from a difference between the previous carrying amount and fair value is **recognised in profit or loss**.

If a financial asset is reclassified **from fair value to amortised cost**, **fair value** at the date of reclassification becomes the **new carrying amount**.

4 Measurement of financial instruments

FAST FORWARD

- **Financial assets** should initially be measured at **cost = fair value**, with some exceptions (see below).
- **Transaction costs increase this amount for financial assets** classified as measured at amortised cost, or at fair value through other comprehensive income and **decrease this amount for financial liabilities** classified as measured at amortised cost.
- **Subsequent measurement** of both financial assets and financial liabilities **depends on how the instrument is classified**: at amortised cost or fair value.
- Financial instruments at **fair value through profit or loss** are measured at **fair value**; gains and losses are recognised in **profit or loss**.
- Financial assets held within a business model whose objective is achieved by **both collecting contractual cash flows** and selling financial assets **must** be measured at **fair value** with gains and losses recognised in **other comprehensive income**.
- If an **investment in equity instruments is not held for trading**, the entity **may** make an **irrevocable election** to recognise changes in the fair value in **other comprehensive income**.

4.1 Initial measurement: Financial assets

Financial instruments are initially measured at the transaction price, that is the **fair value** of the consideration given (IFRS 9: para. 5.1.1). In the case of financial assets classified as measured at **amortised cost** or at **fair value through other comprehensive income**, **transaction costs** directly attributable to the acquisition of the financial asset are **added** to this amount.

In some cases, the transaction price may not be equal to fair value. An example of this is where holders of share options exercise their options and purchase shares. The price paid by the option holders is likely to be less than the fair value of the shares (otherwise the options would not have been exercised). The shares should be initially measured at fair value, evidenced by a quoted price in an active market for identical shares, rather than at the transaction price.

4.2 Subsequent measurement of financial assets

Subsequent measurement of financial assets is dependent on how they are **classified** at initial recognition. As covered in Section 3, financial assets can be classified as measured (IFRS 9: para. 5.2.1):

- At **amortised cost**, using the **effective interest method**;
- At **fair value through other comprehensive income**; or
- At **fair value through profit or loss**

4.3 Financial assets measured at amortised cost

FAST FORWARD

Financial instruments at **amortised cost** are measured using the **effective interest method**.

Key terms

Amortised cost. The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the **effective interest method** of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any **loss allowance**.

Effective interest method. The method that is used in the calculation of the **amortised cost** of a **financial asset** or a **financial liability** and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period.

The effective interest rate. The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the **gross carrying amount** of a **financial asset** or to the **amortised cost** of a **financial liability**.

(IFRS 9: Appendix A)

In the exam if a question requires use of the amortised cost measurement method, the effective interest rate will be given.

4.4 Example: Financial asset at amortised cost

On 1 January 20X1 Abacus Co purchases a debt instrument for its fair value of \$1,000. The debt instrument is due to mature on 31 December 20X5. The instrument has a principal amount of \$1,250 and the instrument carries fixed interest at 4.72% that is paid annually. (The effective interest rate is 10%.)

How should Abacus Co account for the debt instrument over its five-year term?

Solution

Abacus Co will receive interest of \$59 ($1,250 \times 4.72\%$) each year and \$1,250 when the instrument matures.

Abacus must allocate the discount of \$250 and the interest receivable over the five-year term at a constant rate on the carrying amount of the debt. To do this, it must apply the effective interest rate of 10%.

The following table shows the allocation over the years:

Year	Amortised cost at beginning of year	Profit or loss: Interest income for year (@10%)	Interest received during year (cash inflow)	Amortised cost at end of year
	\$	\$	\$	\$
20X1	1,000	100	(59)	1,041
20X2	1,041	104	(59)	1,086
20X3	1,086	109	(59)	1,136
20X4	1,136	113	(59)	1,190
20X5	1,190	119	(1,250 + 59)	—

Each year the carrying amount of the financial asset is increased by the interest income for the year and reduced by the interest actually received during the year.

4.5 Financial assets measured at fair value

Where a financial asset is classified as measured at fair value, fair value is established at each period end in accordance with IFRS 13 *Fair Value Measurement* (see Section 8).

Any changes in fair value are normally recognised in profit or loss.

There are three **exceptions** to this rule:

- The asset is **part of a hedging relationship** (see Section 6).
- The financial asset is an investment in an **equity instrument not held for trading**. In this case the entity can make an **irrevocable election** to recognise changes in the fair value in **other comprehensive income**.
- It is a financial asset **measured at fair value through other comprehensive income** because it meets the criteria in IFRS 9 (para. 4.2.1A), that is the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

Note that direct costs of acquisition are capitalised only in the case of a financial asset or financial liability **not** held at fair value through profit or loss. If the asset or liability is held at fair value through profit or loss, the costs of acquisition are expensed. This means that in the case of **financial assets held at amortised cost, costs of acquisition are capitalised**. They would be added to the asset and deducted from the liability amount. Similarly, if an **irrevocable election** has been made to take **gains and losses** on the financial asset **to other comprehensive income**, costs of acquisition should be **added to the purchase cost**.

Investments whose **fair value cannot be reliably measured** should be measured at **cost**. This will only be the case in very rare circumstances.

4.6 Example: Asset measurement

On 8 February 20X8 Orange Co acquires a quoted investment in the shares of Lemon Co with the intention of holding it in the long term. The investment cost \$850,000. At Orange Co's year end of 31 March 20X8, the market price of an identical investment is \$900,000. How is the asset initially and subsequently measured?

Orange Co has elected to recognise changes in the fair value of the equity investment in other comprehensive income.

Solution

- The asset is initially recognised at the fair value of the consideration, being \$850,000
- At the period end it is re-measured to \$900,000
- This results in the recognition of \$50,000 in other comprehensive income



Question

Equity instrument and transaction costs

In January 20X6 Wolf purchased 10 million \$1 listed equity shares in Hall at a price of \$5 per share. Transaction costs were \$3m. Wolf's year end is 30 November.

At 30 November 20X6, the shares in Hall were trading at \$6.50. On 31 October 20X6 Wolf received a dividend from Hall of 20c per share.

Show the financial statement extracts of Wolf at 30 November 20X6 relating to the investment in Hall on the basis that:

- The shares were bought for trading.
- The shares were bought as a source of dividend income and were the subject of an irrevocable election at initial recognition to recognise them at fair value through other comprehensive income.

Answer

(i)

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME (EXTRACT)

	\$m
<i>Profit or loss for the year</i>	
Investment income ($10\text{m} \times (6.5 - 5.0)$)	15
Dividend income ($10\text{m} \times 20\text{c}$)	2
Transaction costs	(3)

STATEMENT OF FINANCIAL POSITION (EXTRACT)

Investments in equity instruments ($10\text{m} \times 6.5$)	65
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(ii)

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME (EXTRACT)

	\$m
<i>Profit or loss for the year</i>	
Dividend income	2
<i>Other comprehensive income</i>	
Gain on investment in equity instruments ($65 - 53$)	12

STATEMENT OF FINANCIAL POSITION (EXTRACT)

Investments in equity instruments
(10m × 6.5)

65

In accordance with IFRS 9 (para. 5.1.1), transaction costs are added to the fair value of all financial assets (other than those measured at fair value through profit or loss) on initial recognition, so the shares are initially recorded at \$53m. A gain of \$12m is recorded on subsequent remeasurement.

4.7 Initial measurement: Financial liabilities

IFRS 9 requires that financial liabilities are initially measured at transaction price, ie the fair value of consideration received except where part of the consideration received is for something other than the financial liability. In this case the financial liability is initially measured at fair value measured as for financial assets (see above). Transaction costs are deducted from this amount for financial liabilities classified as measured at amortised cost.

(IFRS 9: paras. 5.1.1–5.1.2)

4.8 Subsequent measurement of financial liabilities

After initial recognition, all financial liabilities should be measured at **amortised cost**, with the exception of financial liabilities at fair value through profit or loss (including most derivatives). These should be measured at **fair value**, but where the fair value is **not capable of reliable measurement**, they should be measured at **cost**.

(IFRS 9: para. 4.2.1–4.2.2)

4.9 Financial liabilities measured at amortised cost

The definitions of amortised cost, effective interest method and effective interest rate that are used for measurement of financial assets are also used for financial liabilities.

4.10 Example: Financial liability at amortised cost

Galaxy Co issues a bond for \$503,778 on 1 January 20X2. No interest is payable on the bond, but it will be redeemed on 31 December 20X4 for \$600,000. The effective interest rate of the bond is 6%.

Required

Calculate the charge to profit or loss of Galaxy Co for the year ended 31 December 20X2 and the balance outstanding at 31 December 20X2.

Solution

The bond is a 'deep discount' bond and is a financial liability of Galaxy Co. It is measured at amortised cost. Although there is no interest as such, the difference between the initial cost of the bond and the price at which it will be redeemed is a finance cost. This must be allocated over the term of the bond at a constant rate on the carrying amount.

The effective interest rate is 6%.

The charge to profit or loss for the year is \$30,226 ($503,778 \times 6\%$)

The balance outstanding at 31 December 20X2 is \$534,004 ($503,778 + 30,226$)



Question

Finance cost 1

On 1 January 20X3 Dazzle issued \$600,000 loan notes. Issue costs were \$200. The loan notes do not carry interest, but are redeemable at a premium of \$152,389 on 31 December 20X4. The effective finance cost of the debentures is 12%.

What is the finance cost in respect of the loan notes for the year ended 31 December 20X4?

Answer

The premium on redemption of the preferred shares represents a finance cost. The effective rate of interest must be applied so that the debt is measured at amortised cost.

At the time of issue, the loan notes are recognised at their net proceeds of \$599,800 (600,000 – 200).

The finance cost for the year ended 31 December 20X4 is calculated as follows:

	B/f	Interest @ 12%	C/f
	\$	\$	\$
20X3	599,800	71,976	671,776
20X4	671,776	80,613	752,389



Question

Finance cost 2

On 1 January 20X1, an entity issued a debt instrument with a coupon rate of 3.5% at a par value of \$6,000,000. The directly attributable costs of issue were \$120,000. The debt instrument is repayable on 31 December 20X7 at a premium of \$1,100,000.

What is the total amount of the finance cost associated with the debt instrument?

Answer

	\$
Issue costs	120,000
Interest $\$6,000,000 \times 3.5\% \times 7$	1,470,600
Premium on redemption	1,100,000
Total finance cost	<u>2,690,600</u>



Question

Classification

During the financial year ended 28 February 20X5, MN issued the two financial instruments described below. For **each** of the instruments, identify and explain whether or not the instrument should be classified as debt.

- Redeemable preference shares with a coupon rate 8%. The shares are redeemable on 28 February 20X9 at premium of 10%.
- A sale of share options, to be exercised at any time from 28 February 20X8.

Answer

- Debt.** The preference shares require regular distributions to the holders but more importantly have the debt characteristic of being redeemable. Therefore, according to IAS 32 they must be classified as debt.
- Not debt.** MN does not have an obligation to deliver cash or another financial asset, so this is not a financial liability. (Share options are accounted for under IFRS 2 *Share-based Payment*, which will be covered later in this Study Text.)



Question

Hybrid financial instrument

On 1 January 20X1, EFG issued 10,000 5% convertible bonds at their par value of \$50 each. The bonds will be redeemed on 1 January 20X6. Each bond is convertible at the option of the holder at any time during the five-year period. Interest on the bond will be paid annually in arrears.

The prevailing market interest rate for similar debt without conversion options at the date of issue was 6%. The present value of \$1 payable in 5 years' time at a discount rate of 6% is \$0.747. The cumulative present value of \$1 paid annually in arrears for 5 years at a discount rate of 6% is \$4.212.

At what value should the equity element of the hybrid financial instrument be recognised in the financial statements of EFG at the date of issue?

Answer

Top tip. The method to use here is to find the present value of the principal value of the bond, \$500,000 ($10,000 \times \50) and the interest payments of \$25,000 annually ($5\% \times \$500,000$) at the market rate for non-convertible bonds of 6%, using the discount factors given in the question. The difference between this total and the principal amount of \$500,000 is the equity element.

	\$
Present value of principal $\$500,000 \times 0.747$	373,500
Present value of interest $\$25,000 \times 4.212$	105,300
Liability value	478,800
Principal amount	500,000
Equity element	<u>21,200</u>



Question

Subsequent measurement

After initial recognition, all financial liabilities should be measured at amortised cost. True or false?

Answer

False. Some may be measured at fair value through profit or loss.

4.11 Financial liabilities at fair value through profit or loss

Financial liabilities which are held for trading are re-measured to fair value each year in accordance with IFRS 13 (see Section 8) with any gain or loss recognised in profit or loss (IFRS 9: para. 5.7.1).

4.11.1 Exceptions

The exceptions to the above treatment of financial liabilities are (IFRS 9: para. 5.7.1):

- (a) It is part of a hedging arrangement (see Section 6)
- (b) It is a financial liability designated as at fair value through profit or loss and the entity is required to present the effects of changes in the liability's **credit risk** in other comprehensive income (see Section 4.11.2 below).

4.11.2 Credit risk

IFRS 9 requires that financial liabilities which are **designated as measured at fair value through profit or loss are treated differently**. In this case (IFRS 9: para. 5.7.7):

- Any change in the fair value **resulting from credit risk** should be included in **other comprehensive income**; and
- The remaining amount of the change in fair value should be included in profit or loss.

This provision of IFRS 9 was in response to an anomaly regarding changes in the credit risk of a financial liability.

Changes in a financial liability's credit risk affect the fair value of that financial liability. This means that when an entity's creditworthiness deteriorates, the fair value of its issued debt will decrease (and vice versa).

The exception to this is where such treatment creates or enlarges an **accounting mismatch**, in which case it is recognised in profit or loss (IFRS 9: para. 5.7.7).

4.11.3 Accounting mismatch

IFRS 9 allows the recognition of the full amount of change in the fair value in the profit or loss only if the recognition of changes in the liability's **credit risk** in other comprehensive income would **create** or **enlarge** an **accounting mismatch** in profit or loss. That determination is made at initial recognition and is not reassessed.

An accounting mismatch is a measurement or recognition **inconsistency** arising from measuring assets or liabilities or recognising the gains or losses on them on different bases.

4.12 Impairment of financial assets

FAST FORWARD

Impairment of financial assets is governed by an expected loss model, which recognises expected credit losses for all financial instruments subject to impairment accounting.

Key term

Credit-impaired financial asset. A financial asset is credit impaired when one or more events have occurred that have a detrimental impact on the estimated future cash flows of that financial asset.
(IFRS 9: Appendix A)

The following are indications that a financial asset or group of assets may be impaired:

- (a) Significant financial difficulty of the issuer
- (b) A breach of contract, such as a default in interest or principal payments
- (c) The lender granting a concession to the borrower that the lender would not otherwise consider, for reasons relating to the borrower's financial difficulty
- (d) It becomes probable that the borrower will enter bankruptcy
- (e) The disappearance of an active market for that financial asset because of financial difficulties
- (f) The purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses

(IFRS 9: Appendix A)

It is not always possible to single out one particular event; rather, several events may combine to cause an asset to become credit-impaired.

4.13 Expected credit loss model

The impairment model in IFRS 9 is based on the premise of providing for **expected losses** (IFRS 9: para. 5.5.1). The financial statements should reflect the general pattern of deterioration or improvement in the credit quality of financial instruments within the scope of IFRS 9. This is a **forward-looking** impairment model.

4.13.1 Objective of the IFRS 9 impairment model

The objective of the IFRS 9 impairment model is to recognise expected credit losses for all financial instruments within the scope of the requirements. Expected credit losses are the expected shortfall in contractual cash flows. An entity should estimate expected credit losses considering past events, current conditions and reasonable and supportable forecasts (IFRS 9: para. 5.5.17).

4.13.2 Key definitions

Credit loss. The difference between all contractual cash flows that are due to an entity [...] and all the cash flows that the entity expects to receive (ie all cash shortfalls), discounted [...].

Expected credit losses. The weighted average of **credit losses** with the respective risks of a default occurring as the weights.

Lifetime expected credit losses. The **expected credit losses** that result from all possible default events over the expected life of a financial instrument.

Past due. A financial asset is past due when a counterparty has failed to make a payment when that payment was contractually due.

Purchased or originated credit-impaired financial asset. Purchased or originated financial asset(s) that are **credit impaired** on initial recognition.

(IFRS 9: Appendix A)

4.13.3 Scope

The impairment model applies to the following (IFRS 9: Chapter 2, para. 2.2).

- (a) Financial assets measured at amortised cost;
- (b) Financial assets mandatorily measured at fair value through other comprehensive income;
- (c) Loan commitments when there is a present obligation to extend credit (except where these are measured at fair value through profit or loss);
- (d) Financial guarantee contracts to which IFRS 9 is applied (except those measured at fair value through profit or loss);
- (e) Lease receivables within the scope of IFRS 16 *Leases*; and
- (f) Contract assets within the scope of IFRS 15 *Revenue from Contracts with Customers* (ie rights to consideration following transfer of goods or services).

4.13.4 Basic principle behind the model

The financial statements should reflect the **general pattern of deterioration or improvement in the credit quality of financial instruments** within the scope of the model.

IFRS 9 requires entities to base their measurement of expected credit losses on **reasonable and supportable information** that is available **without undue cost or effort**. This will include **historical, current and forecast information**.

Expected credit losses are **updated at each reporting date** for new information and changes in expectations, even if there has not been a significant increase in credit risk.

Note that if financial assets are measured at fair value through profit or loss, any impairment of the asset is automatically reflected in the measurement basis, so this model need not be applied.

4.13.5 On initial recognition

The entity must **create a credit loss allowance/provision equal to 12 months' expected credit losses**. This is calculated by **multiplying the probability of a default occurring in the next 12 months by the total lifetime expected credit losses that would result from that default**. (This is not the same as the expected cash shortfalls over the next 12 months.)

(IFRS 9: para. 5.5.5)

The intention is that the amount recognised on initial recognition acts as a proxy for the initial expectation of credit losses that are factored into the pricing of the instrument, which do not represent an economic loss to an entity because they are expected when pricing the instrument.

4.13.6 Subsequent years

If the **credit risk increases** significantly since initial recognition this amount will be replaced by **lifetime expected credit losses** (IFRS 9: para. 5.5.2). If the credit quality subsequently improves and the lifetime expected credit losses criterion is no longer met, the 12-month expected credit loss basis is reinstated (IFRS 9: para. 5.5.3).

Example

Orange Co advanced a three-year interest bearing loan of \$2m to Lemon Co on 1 July 20X4. At that date management estimates the risk of default in the next 12 months as 2% and the risk of default over the remaining term of the loan as 5.5%. The loss that would result from the default was estimated at \$800,000.

What is the amount of the credit loss provision that Orange Co should record on initial recognition?

Solution

The credit loss provision on initial recognition is based on the 12-month expected losses. A provision of \$16,000 ($2\% \times \$800,000$) should be recognised.

Example continued

Orange Co has a reporting date of 31 December. By 31 December 20X4 management estimates that the risk of default in the next 12 months is 3.5% and in the remaining term of the loan is 10.5%. The loss that would result from the default was estimated at \$750,000.

What is the amount of the credit loss provision that should be included in the statements of financial position as at 31 December 20X4?

Solution

Since the total risk of default has increased from 7.5% on initial recognition to 14% by 31/12/X4, this would seem to be a significant increase in credit risk. The credit loss provision must therefore be based on lifetime expected losses and would be \$105,000 ($(3.5\% + 10.5\%) \times \$750,000$).

Example continued

By 31 December 20X5 management estimates that the risk of default in the next 12 months is 1.5% and in the remaining term of the loan is 1%. The loss that would result from the default was estimated at \$450,000.

What is the amount of the credit loss provision that should be included in the statements of financial position as at 31 December 20X5?

Solution

Since the total risk of default has decreased from 14% on initial recognition to 2.5% by 31/12/X5, this would seem to be a significant improvement in credit quality. The 12-month expected credit loss basis is now reinstated, and a credit loss provision of \$6,750 ($1.5\% \times \$450,000$) should be included.

4.13.7 Rebuttable presumption: Provide if 30 days past due

There is a rebuttable presumption that lifetime expected losses should be provided for if contractual cash flows are 30 days past due (overdue) (IFRS 9: para. 5.5.11).

4.13.8 Financial instruments with low credit risk

Certain financial instruments have a low credit risk and would not, therefore, meet the lifetime expected credit losses criterion. Entities do not recognise lifetime expected credit losses for financial instruments that are equivalent to 'investment grade', which means that the asset has a low risk of default (IFRS 9: AG, para. B5.5.22).

4.13.9 Amount of impairment

The amount of the impairment to be recognised on these financial instruments **depends on whether or not they have significantly deteriorated** since their initial recognition.

For financial instruments whose credit quality has not significantly deteriorated since their initial recognition, the impairment represents the present value of expected credit losses that will result if a default occurs in the 12 months after the reporting date (**12 months expected credit losses**).

For financial instruments whose credit quality has significantly deteriorated since their initial recognition, or for those for which there is objective evidence of impairment, an impairment is recognised at the present value of expected credit shortfalls over their remaining life (**lifetime expected credit loss**). Entities are required to reduce the gross carrying amount of a financial asset in the period in which they no longer have a reasonable expectation of recovery.

(IFRS 9: paras. 5.5.3–5.5.10)

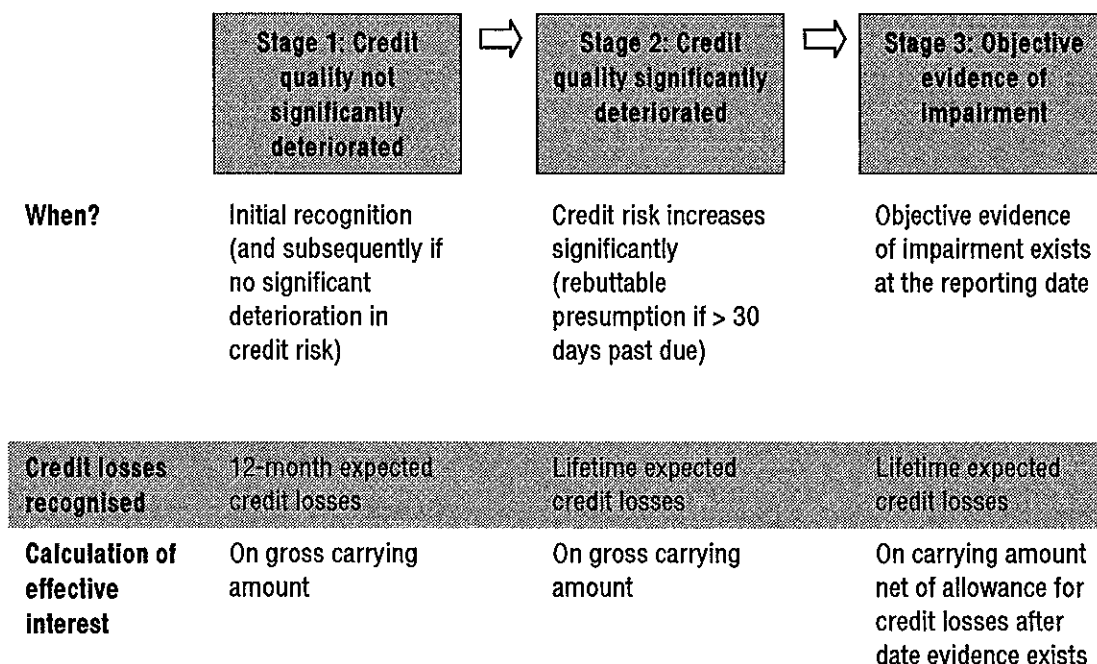
4.13.10 Interest

For financial instruments whose credit quality has not significantly deteriorated and for those whose credit quality has significantly deteriorated, interest revenue would be calculated on their **gross carrying amounts** (IFRS 9: Chapter 5, para. 5.4.1).

Interest revenue for financial instruments for which there is objective evidence of impairment would be recognised on a **net basis** (ie after deducting expected credit losses from their carrying amount) (IFRS 9: Chapter 5, para. 5.4.1).

4.13.11 Summary

The following table gives a useful summary of the process. Although IFRS 9 does not refer to 'three stages', it is useful as an aid to learning to consider it this way.



4.13.12 Measuring expected credit losses

Credit losses are the present value of all cash shortfalls. Expected credit losses are an estimate of credit losses over the life of the financial instrument. An entity should consider the following when measuring expected credit losses.

- (a) The **probability-weighted outcome**. Expected credit losses should not be a best or worst-case scenario, but should reflect the possibility that a credit loss will occur, and the possibility that it will not.
- (b) The **time value of money**: they should be discounted at the reporting date.
- (c) **Reasonable and supportable information** that is available without undue cost or effort, including information about past events, current conditions and forecasts of future conditions. A 'crystal ball' is not required.

(IFRS 9: para. 5.5.17)

4.13.13 Example: Portfolio of mortgages and personal loans

Credito Bank operates in South Zone, a region in which clothing manufacture is a significant industry. The bank provides personal loans and mortgages in the region. The average loan to value ratio for all its mortgage loans is 75%.

All loan applicants are required to provide information regarding the industry in which they are employed. If the application is for a mortgage, the customer must provide the postcode of the property which is to serve as collateral for the mortgage loan.

Credito Bank applies the expected credit loss impairment model in IFRS 9. The bank tracks the probability of customer default by reference to overdue status records. In addition, it is required to consider forward-looking information as far as that information is available.

Credito Bank has become aware that a number of clothing manufacturers are losing revenue and profits as a result of competition from abroad, and that several are expected to close.

Required

How should Credito Bank apply IFRS 9 to its portfolio of mortgages in the light of the changing situation in the clothing industry?

Solution

Credito Bank should segment the mortgage portfolio to identify borrowers who are employed by suppliers and service providers to the clothing manufacturers. This segment of the portfolio may be regarded as the credit quality being significantly deteriorated, that is having a significant increase in credit risk. Lifetime credit losses must be recognised.

In estimating lifetime credit losses for the mortgage loans portfolio, Credito Bank will take into account amounts that will be recovered from the sale of the property used as collateral. This may mean that the lifetime credit losses on the mortgages are very small even though the credit quality of the loans has significantly deteriorated.



Question

Particular defaults identified

Later in the year, more information emerged, and Credito Bank was able to identify the particular loans that defaulted or were about to default.

Required

How should Credito Bank treat these loans?

Answer

Objective evidence of impairment of these loans now exists. Lifetime credit losses should continue to be recognised, and interest revenue should switch to a net interest basis, that is on the carrying amount net of allowance for credit losses.

4.13.14 Undrawn facilities

Under IFRS 9, the expected credit loss model also applies to the undrawn portions of overdraft, credit card and other approved but undrawn facilities.

Stage	Apply to	Recognise
No significant increase in credit risk	Expected portion to be drawn down within the next 12 months	12 months expected credit losses
Significant increase in credit risk	Expected portion to be drawn down over the remaining life of the facility	Lifetime credit losses



Question

Undrawn overdraft facilities

Debita Bank applies the expected credit loss impairment model of IFRS 9. At 30 September 20X4, the bank approved a total of \$10m overdraft facilities which have not yet been drawn.

Debita Bank considers that \$8m has no significant increase in credit risk. Of that \$8m, \$4m is expected to be drawn down within the next 12 months, with a 3% probability of default over the next 12 months.

Debita Bank considers that the credit quality has significantly deteriorated on \$2m of overdraft facilities and \$2m is expected to be drawn down over the remaining life of the facilities, with a probability of default of 10%.

Required

Calculate the additional allowance required in respect of the undrawn overdraft facilities, taking account of the above information.

Answer

Stage		Expected credit loss
		\$
Credit quality not significantly deteriorated	$\$4m \times 3\%$	120,000
Credit quality significantly deteriorated	$\$2m \times 10\%$	<u>200,000</u>
		<u>320,000</u>

Under the IFRS 9 model, Debita bank would recognise an additional allowance of \$320,000 for the undrawn portion of its overdraft facilities.

4.13.15 Recognition of impairment

Credit losses are recognised in **profit or loss** and held in a **separate allowance account** (although this would not be required to be shown separately on the face of the statement of financial position). Where



the expected credit losses relate to a **loan commitment or financial guarantee contract** a **provision** rather than allowance would be made (IFRS 9: para. 5.5.5).

4.13.16 Adjustment of loss allowance

Entities must 'recognise in profit or loss, as an impairment gain or loss, the amount of expected credit losses (or reversal) that is required to adjust the loss allowance at the reporting date to the amount that is required to be recognised in accordance with [IFRS 9]' (IFRS 9: para. 5.5.8).

4.13.17 Simplified approach for trade and lease receivables

For trade receivables that **do not have an IFRS 15 financing element**, the loss allowance is measured at the **lifetime expected credit losses**, from initial recognition.

For **other** trade receivables and for lease receivables, the entity can **choose** (as a separate accounting policy for trade receivables and for lease receivables) to apply the expected credit loss model or to recognise an allowance for lifetime expected credit losses from initial recognition.

4.13.18 Example: Trade receivable provision matrix

On 1 June 20X4, Kredco sold goods on credit to Detco for \$200,000. Detco has a credit limit with Kredco of 60 days. Kredco applies IFRS 9, and uses a pre-determined matrix for the calculation of allowances for receivables as follows.

<i>Days overdue</i>	<i>Expected loss provision</i>
Nil	1%
1 to 30	5%
31 to 60	15%
61 to 90	20%
90 +	25%

Detco had not paid by 31 July 20X4, and so failed to comply with its credit term, and Kredco learned that Detco was having serious cash flow difficulties due to a loss of a key customer. The finance controller of Detco has informed Kredco that they will receive payment.

Ignore sales tax.

Required

Show the accounting entries on 1 June 20X4 and 31 July 20X4 to record the above, in accordance with the expected credit loss model in IFRS 9.

Solution

On 1 June 20X4

The entries in the books of Kredco will be:

DEBIT	Trade receivables	\$200,000	
CREDIT	Revenue		\$200,000

Being initial recognition of sales

An expected credit loss allowance, based on the matrix above, would be calculated as follows:

DEBIT	Expected credit losses	\$2,000	
CREDIT	Allowance for receivables		\$2,000

Being expected credit loss: \$200,000 × 1%

On 31 July 20X4

Applying Kredco's matrix, Detco has moved into the 5% bracket, because it has exhausted its 60-day credit limit. (Note that this does not equate to being 60 days overdue!) Despite assurances that Kredco will

receive payment, the company should still increase its credit loss allowance to reflect the increased credit risk. Kredco will therefore record the following entries on 31 July 20X4

DEBIT	Expected credit losses	\$8,000	
CREDIT	Allowance for receivables		\$8,000

Being expected credit loss: $\$200,000 \times 5\% = \$2,000$



Question

Trade receivables provision matrix

Redblack Co has a customer base consisting of a large number of small clients. At 30 June 20X4, it has a portfolio of trade receivables of \$60m. Redblack applies IFRS 9, using a provision matrix to determine the expected credit losses for the portfolio. The provision matrix is based on its historical observed default rates, adjusted for forward looking estimates. The historical observed default rates are updated at every reporting date.

At 30 June 20X4, Redblack estimates the following provision matrix.

	Expected default rate	Gross carrying amount	Credit loss allowance Default rate \times gross carrying amount
		\$'000	\$'000
Current	0.3%	30,000	90
1 to 30 days overdue	1.6%	15,000	240
31 to 60 days overdue	3.6%	8,000	288
61 to 90 days overdue	6.6%	5,000	330
More than 90 days overdue	10.6%	2,000	212
		<u>60,000</u>	<u>1,160</u>

At 30 June 20X5, Redblack has a portfolio of trade receivables of \$68m. The company revises its forward looking estimates and the general economic conditions are deemed to be less favourable than previously thought. The partially completed provision matrix is as follows.

	Expected default rate	Gross carrying amount	
		\$'000	
Current	0.5%	32,000	
1 to 30 days overdue	1.8%	16,000	
31 to 60 days overdue	3.8%	10,000	
61 to 90 days overdue	7%	7,000	
More than 90 days overdue	11%	3,000	
		<u>68,000</u>	

Required

Complete the provision matrix for Redblack at 30 June 20X5 and show the journal entries to record the credit loss allowance.

Answer

	Expected default rate	Gross carrying amount	Credit loss allowance Default rate \times gross carrying amount
		\$'000	\$'000
Current	0.5%	32,000	160
1 to 30 days overdue	1.8%	16,000	288
31 to 60 days overdue	3.8%	10,000	380
61 to 90 days overdue	7%	7,000	490
More than 90 days overdue	11%	3,000	330
		<u>68,000</u>	<u>1,648</u>



The credit loss allowance has increased by \$488,000 to \$1,648,000 as at 30 June 20X5. The journal entry at 30 June 20X5 would be:

DEBIT	Expected credit losses	\$488,000	
CREDIT	Allowance for receivables		\$488,000

Being expected credit loss

4.13.19 Purchased or originated credit-impaired financial assets

IFRS 9 requires that purchased or originated credit-impaired financial assets are treated differently because the asset is credit-impaired at initial recognition. For these assets, an entity **must 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.

4.13.20 Disclosures

IFRS 9 requires **extensive disclosures** with emphasis on **information that identifies and explains the amounts in the financial statements that arise from expected losses and the effect of deterioration and improvement in the credit risk** of financial instruments.

The disclosures must be provided either in the financial statements or by way of a cross reference to other statements, such as a risk report, available to users at the same time as the financial statements.

4.13.21 Possible effects

Possible effects of the new model include the following.

- It is likely that this model will result in **earlier recognition of credit losses** than under the current incurred loss model because it requires the recognition not only of credit losses that have already occurred, but also losses that are expected in the future. However, in the case of shorter term and higher-quality financial instruments the effects may not be significant.
- The new model will require significantly **more judgment** when considering information related to the past, present and future. It relies on more forward-looking information, which means that any losses would be accounted for earlier than happens under the current rules.
- Costs** of implementing the new model are likely to be material.
- There are differences between the IASB and the FASB approach which may lead to significant **differences** in the figures reported

5 Embedded derivatives

FAST FORWARD

- An **embedded derivative** is a derivative instrument that is combined with a non-derivative **host contract** to form a single hybrid instrument.
- Where the host contract is **an asset within the scope of IFRS 9** the hybrid contract is accounted for as **one instrument**.
- Otherwise**, IFRS 9 requires that the embedded derivative is **separated from the host contract** where certain conditions are met and accounted for separately.

Certain contracts that are not themselves derivatives (and may not be financial instruments) include derivative contracts that are 'embedded' within them. These non-derivatives are called **host contracts**.

An **embedded derivative** is a derivative instrument that is combined with a non-derivative host contract to form a single hybrid instrument.

(IFRS 9: Appendix A)

5.1 Examples of host contracts

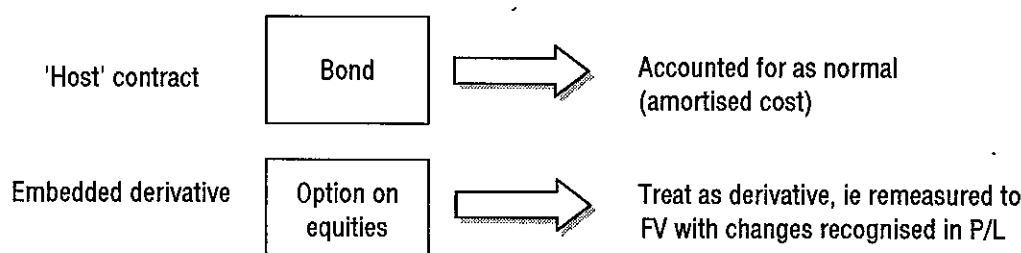
Possible examples include:

- (a) A lease
- (b) A debt or equity instrument
- (c) An insurance contract
- (d) A sale or purchase contract
- (e) A construction contract

5.2 Examples of embedded derivatives

Possible examples include:

- (a) A bond which is redeemable in five years' time with part of the redemption price being based on the increase in the FTSE 100 Index.



- (b) A construction contract priced in a foreign currency. The construction contract is a non-derivative contract, but the changes in foreign exchange rate is an embedded derivative.

5.3 Accounting treatment of embedded derivatives

5.3.1 Financial asset host contract

Where the host contract is a financial asset within the scope of the standard, the classification and measurement rules of the standard are applied to the entire hybrid contract (IFRS 9: para. 4.3.2).

This is a simplification of the IAS 39 rules, and different from the treatment of financial liability host contracts (see below).

5.3.2 Other host contracts

Where the host contract is not a financial asset within the scope of IFRS 9, the standard requires that an embedded derivative be **separated from its host contract** and accounted for as a derivative when the following conditions are met.

- (a) The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract.
- (b) A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative.
- (c) The hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in the profit or loss (a derivative embedded in a financial liability need not be separated out if the entity holds the combined instrument at fair value through profit or loss).

(IFRS 9: para. 4.3.3)

6 Hedge accounting

FAST FORWARD

- **Hedge accounting** means designating one or more instruments so that their change in fair value is **offset** by the change in fair value or cash flows of another item.
- **Hedge accounting** is required in certain circumstances, provided the **qualifying criteria are met**.
- There are three types of hedge: **fair value** hedge; **cash flow** hedge; hedge of a **net investment in a foreign operation**. Only the first two are examinable.
- The accounting treatment of a hedge **depends on its type**.

6.1 Introduction

IFRS 9 **requires hedge accounting** where there is a **designated hedging relationship** between a hedging instrument and a hedged item. It is **prohibited otherwise**.

Key terms

Hedging, for accounting purposes, means designating one or more hedging instruments so that their change in fair value is an offset, in whole or in part, to the change in fair value or cash flows of a 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.

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. (A non-derivative financial asset or liability may be designated as a hedging instrument for hedge accounting purposes only if it hedges the risk of changes in foreign currency exchange rates.)

Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

(IFRS 9: Appendix A)

In simple terms, entities hedge to reduce their exposure to risk and uncertainty, such as changes in prices, interest rates or foreign exchange rates. Hedge accounting recognises hedging relationships by allowing (for example) losses on a hedged item to be offset against gains on a hedging instrument.

Generally only assets, liabilities etc that involve external parties can be designated as hedged items. The foreign currency risk of an intragroup monetary item (eg payable/receivable between two subsidiaries) may qualify as a hedged item in the group financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation. This can happen (per IAS 21) when the transaction is between entities with different functional currencies.

In addition, the foreign currency risk of a highly probable group transaction may qualify as a hedged item if it is in a currency other than the functional currency of the entity and the foreign currency risk will affect profit or loss.

6.2 IFRS 9's model for hedge accounting

IFRS 9 contains a **principles-based model** for hedge accounting that aims to **align accounting with risk management activities**. This will combine the following.

- (a) A **management view**, that aims to use information produced internally for risk management purposes.
- (b) An **accounting view** that seeks to address the risk management issue of the timing of recognition of gains and losses.
- (c) An **objective-based assessment** for hedge effectiveness.

6.3 Conditions for hedge accounting

Adopting the hedge accounting provisions of IFRS 9 is mandatory where the hedging relations meets all of the following criteria:

- (a) The hedging relationship consists **only of eligible hedging instruments and eligible hedged items**.
- (b) It was **designated at its inception** as a hedge with formal documentation (including identification of the hedged item, the hedging instrument, the nature of the risk that is to be hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk).
- (c) The hedging relationship meets all of the following hedge effectiveness criteria
 - (i) There is an **economic relationship** between the hedged item and the hedging instrument, ie the hedging instrument and the hedged item have values that generally move in the opposite direction because of the same risk, which is the hedged risk;
 - (ii) The **effect of credit risk does not dominate the value** changes that result from that economic relationship, ie the gain or loss from credit risk does not frustrate the effect of changes in the underlyings on the value of the hedging instrument or the hedged item, even if those changes were significant; and
 - (iii) The **hedge ratio of the hedging relationship** (quantity of hedging instrument vs quantity of hedged item) is the same as that resulting from the quantity of the hedged item that the entity **actually hedges** and the quantity of the hedging instrument that the entity **actually uses** to hedge that quantity of hedged item. In other words, risk managers decide on the amount of hedging instrument they need in order to hedge a particular risk. This is known as the hedge ratio of the hedging relationship. IFRS 9 says that the hedge ratio used for accounting, based on the relationship between the actual amount hedged and the actual amount of hedging instrument used to do so, must be the same. This is intended to prevent under-hedging.

(IFRS 9: para. 6.4.1)

Practically however, hedge accounting is effectively **optional** in that an entity can choose whether to set up the hedge documentation at inception or not.

6.4 Example: Hedge accounting

Note. Hedge accounting is explained in more detail in the examples below. At its simplest, hedge accounting means offsetting the loss of value on one item (the hedged item) against the gain in value of another (the hedging instrument) so that only the net amount affects the profit figure for the year.

A company owns inventories of 20,000 gallons of oil which cost \$400,000 on 1 December 20X3.

In order to hedge the fluctuation in the market value of the oil the company signs a futures contract to deliver 20,000 gallons of oil on 31 March 20X4 at the futures price of \$22 per gallon.

The market price of oil on 31 December 20X3 is \$23 per gallon and the futures price for delivery on 31 March 20X4 is \$24 per gallon.

Required

Explain the impact of the transactions on the financial statements of the company:

- (a) Without hedge accounting
- (b) With hedge accounting

Solution

The futures contract was intended to protect the company from a fall in oil prices (which would have reduced the profit when the oil was eventually sold). However, oil prices have actually risen, so that the company has made a loss on the contract.

Without hedge accounting:

The futures contract is a derivative and therefore must be re-measured to fair value under IFRS 9. The loss on the futures contract is recognised in profit or loss:

DEBIT	Profit or loss ($20,000 \times 24 - 22$)	\$40,000	
CREDIT	Financial liability		\$40,000

With hedge accounting:

The loss on the futures contract is recognised in the profit or loss as before.

The inventories are revalued to fair value:

	\$
Fair value at 31 December 20X3 ($20,000 \times 23$)	460,000
Cost	(400,000)
Gain	<u>60,000</u>

The gain is also recognised in profit or loss:

DEBIT	Inventory	\$60,000	
CREDIT	Profit or loss		\$60,000

The net effect on the profit or loss is a gain of \$20,000 compared with a loss of \$40,000 without hedging.

The **standard** identifies three types of **hedging relationship**.

Key terms

Fair value hedge: a hedge of the exposure to changes in fair value of a recognised asset or liability, or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss.

Cash flow hedge: a hedge of the exposure to variability in cash flows that

- (a) Is attributable to a particular risk associated with all, or a component of, a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction; and
- (b) Could affect profit or loss.

Hedge of a net investment in a foreign operation: IAS 21 defines a net investment in a foreign operation as the amount of the reporting entity's interest in the net assets of that operation.

(IFRS 9: para. 6.5.2)

Exam focus point

Only fair value hedges and cash flow hedges are examinable in DiplIFR.

The hedge in the example above is a **fair value hedge** (it hedges exposure to changes in the fair value of a recognised asset: the oil).

6.5 Accounting treatment

6.5.1 Fair value hedges

(IFRS 9: para. 6.5.8)

Hedging instrument

The **gain or loss** resulting from **re-measuring** the hedging instrument at fair value is **recognised in profit or loss**. However, if the hedging instrument hedges an **equity instrument** for which an entity has elected

to present **changes in fair value in other comprehensive income**, then the **gain or loss** on the hedging instrument must be recognised in **other comprehensive income**.

Hedged item

The gain or loss on the hedged item attributable to the **hedged risk** should **adjust the carrying amount** of the hedged item and be **recognised in profit or loss**. If the hedged item is a **financial asset through other comprehensive income** (mandatory), the **gain or loss** on the hedged item is also **recognised through profit or loss**.

However, if the hedged item is an **investment in an equity instrument held at fair value through other comprehensive income**, the **gains and losses** on both the hedged investment and the hedging instrument will be **recognised in other comprehensive income**.

This ensures that hedges of investments of equity instruments held at fair value through other comprehensive income can be accounted for as hedges.

6.5.2 Example: Fair value hedge

On 1 July 20X6 Jules acquired 10,000 ounces of a material which it held in its inventory. This cost \$200 per ounce, so a total of \$2m. Jules was concerned that the price of this inventory would fall, so on 1 July 20X6 he sold 10,000 ounces in the futures market for \$210 per ounce for delivery on 30 June 20X7. On 1 July 20X6 the conditions for hedge accounting were all met.

At 31 December 20X6, the end of Jules' reporting period, the fair value of the inventory was \$220 per ounce while the futures price for 30 June 20X7 delivery was \$227 per ounce. On 30 June 20X7 the trader sold the inventory and closed out the futures position at the then spot price of \$230 per ounce.

The IFRS 9 hedge accounting criteria have been met.

Required

Set out the accounting entries in respect of the above transactions.

Solution

At 31 December 20X6 the increase in the fair value of the inventory was \$200,000 ($10,000 \times (\$220 - \$200)$) and the increase in the forward contract liability was \$170,000 ($10,000 \times (\$227 - \$210)$). The IFRS 9 hedge accounting criteria have been met, so hedge accounting was permitted.

	<i>Debit</i>	<i>Credit</i>
	\$	\$
31 December 20X6		
Profit or loss	170,000	
Financial liability		170,000
(To record the loss on the forward contract)		
Inventories	200,000	
Profit or loss		200,000
(To record the increase in the fair value of the inventories)		

At 30 June 20X7 the increase in the fair value of the inventory was another \$100,000 ($10,000 \times (\$230 - \$220)$) and the increase in the forward contract liability was another \$30,000 ($10,000 \times (\$230 - \$227)$).

	<i>Debit</i>	<i>Credit</i>
	\$	\$
30 June 20X7		
Profit or loss	30,000	
Financial liability		30,000
(To record the loss on the forward contract)		
Inventories	100,000	
Profit or loss		100,000
(To record the increase in the fair value of the inventories)		

	<i>Debit</i> \$	<i>Credit</i> \$
Profit or loss	2,300,000	
Inventories (To record the inventories now sold)		2,300,000
Cash	2,300,000	
Profit or loss – revenue (To record the revenue from the sale of inventories)		2,300,000
Financial liability	200,000	
Cash (To record the settlement of the net balance due on closing the financial liability)		200,000

Note that because the fair value of the material rose, Jules made a profit of only \$100,000 on the sale of inventories. Without the forward contract, the profit would have been \$300,000 (2,300,000 – 2,000,000). In the light of the rising fair value the trader might in practice have closed out the futures position earlier, rather than waiting until the settlement date.

6.5.3 Cash flow hedges

These hedge the risk of change in value of future cash flows from a recognised asset or liability (or highly probable forecast transaction) that could affect profit or loss, eg hedging a variable rate interest income stream. The hedging instrument is accounted for as follows:

- (a) The portion of the gain or loss on the hedging instrument that is effective (ie up to the value of the loss or gain on cash flow hedged) is recognised in other comprehensive income ('items that may be reclassified subsequently to profit or loss') and the cash flow hedge reserve.
- (b) Any excess is recognised immediately in profit or loss.

The amount that has been accumulated in the cash flow hedge reserve is then accounted for as follows:

- (a) If a hedged forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, the amount shall be removed from the cash flow reserve and be included directly in the initial cost or carrying amount of the asset or liability;
- (b) For all other cash flow hedges, the amount shall be reclassified from other comprehensive income to profit or loss in the same period(s) that the hedged expected future cash flows affect profit or loss.

(IFRS 9: para. 6.5.11)

6.5.4 Example: Cash flow hedge

Bets Co signs a contract on 1 November 20X1 to purchase an asset on 1 November 20X2 for €60,000,000. Bets reports in US\$ and hedges this transaction by entering into a forward contract to buy €60,000,000 on 1 November 20X2 at US\$1: €1.5.

Spot and forward exchange rates at the following dates are:

	<i>Spot</i>	<i>Forward (for delivery on 1.11.X2)</i>
1.11.X1	US\$1: €1.45	US\$1: €1.5
31.12.X1	US\$1: €1.20	US\$1: €1.24
1.11.X2	US\$1: €1.0	US\$1: €1.0 (actual)

The IFRS 9 hedge accounting criteria have been met.

Required

Show the double entries relating to these transactions at 1 November 20X1, 31 December 20X1 and 1 November 20X2.

Solution

Entries at 1 November 20X1

The value of the forward contract at inception is zero so no entries recorded (other than any transaction costs), but risk disclosures will be made.

The contractual commitment to buy the asset would be disclosed if material (IAS 16).

Entries at 31 December 20X1

Gain on forward contract:

	\$
Value of contract at 31.12.X1 ($\text{€}60,000,000/1.24$)	48,387,096
Value of contract at 1.11.X1 ($\text{€}60,000,000/1.5$)	40,000,000
Gain on contract	<u>8,387,096</u>

Compare to movement in value of asset (unrecognised):

Increase in \$ cost of asset	
($\text{€}60,000,000/1.20 - \text{€}60,000,000/1.45$)	\$8,620,690

As this is higher, the hedge is fully effective at this point:

DEBIT Financial asset (Forward a/c)	\$8,387,096	
CREDIT Equity		\$8,387,096

Entries at 1 November 20X2

Additional gain on forward contract

	\$
Value of contract at 1.11.X2 ($\text{€}60,000,000/1.0$)	60,000,000
Value of contract at 31.12.X1 ($\text{€}60,000,000/1.24$)	48,387,096
Gain on contract	<u>11,612,904</u>

Compare to movement in value of asset (unrecognised):

Increase in \$ cost of asset	
($\text{€}60,000,000/1.0 - \text{€}60,000,000/1.2$)	\$10,000,000

Therefore, the hedge is not fully effective during this period, but it still meets the IFRS 9 hedge accounting criteria (and hence hedge accounting can be used):

DEBIT Financial asset (Forward a/c)	\$11,612,904	
CREDIT Equity		\$10,000,000
CREDIT Profit or loss		\$1,612,904

Purchase of asset at market price

DEBIT Asset ($\text{€}60,000,000/1.0$)	\$60,000,000	
CREDIT Cash		\$60,000,000

Settlement of forward contract

DEBIT Cash	\$20,000,000	
CREDIT Financial asset (Forward a/c)		\$20,000,000

Realisation of gain on hedging instrument

The cumulative gain of \$18,387,096 recognised in equity is removed from equity (the cash flow hedge reserve) and included directly in the initial cost of the asset.

6.5.5 Discontinuing

Hedge accounting should be discontinued only when the hedging relationship no longer meets the criteria for hedge accounting (IFRS 9: para. 6.5.6).

6.5.6 Hedges of a group of items

IFRS 9 permits the designation of a group of assets as a hedged item provided that the following three conditions are met.

- (a) 'It consist of items [...] that are, individually, eligible hedged items;
 - (b) The items in the group are managed together on a group basis for risk management; and
 - (c) In the case of a cash flow hedge of a group of items whose variabilities in cash flows are not expected to be approximately proportional to the overall variability in cash flows of the group so that offsetting risk positions arise:
 - (i) It is a hedge of foreign currency risk, and
 - (ii) The designation of that net position specifies the reporting period in which the forecast transactions are expected to affect profit or loss, as well as their nature and volume'
- (IFRS 9: para. 6.6.1)

6.5.7 Accounting for hedges of credit risk using credit derivatives

IFRS 9 permits certain credit exposures to be designated at fair value through profit or loss if a credit derivative that is measured at fair value through profit or loss is used to manage the credit risk of all, or a part of, the exposure on a fair value basis (IFRS 9: para. 6.7.1).

A credit exposure may be a financial instrument within or outside the scope of IFRS 9, for example, loan commitments, that is managed for credit risk (IFRS 9: para. 6.7.1). The designation would be permitted if both of the following apply.

- (a) 'The name of the credit exposure [...] matches the reference entity of the credit derivative.
 - (b) The seniority of the financial instrument matches that of the instruments that can be delivered in accordance with the credit derivative'
- (IFRS 9: para. 6.7.1)

If the qualifying criteria are no longer met and the instrument is not otherwise required to be measured at fair value through profit or loss, the entity must discontinue measuring the financial instrument that gave rise to the credit risk at fair value through profit or loss (IFRS 9: para. 6.7.3).

7 Disclosure of financial instruments

Exam focus point

Skim through for background only – disclosures will not be tested in detail.

FAST FORWARD

IFRS 7 specifies the **disclosures** required for financial instruments. The standard requires qualitative and quantitative disclosures about exposure to risks arising from financial instruments and specifies minimum disclosures about credit risk, liquidity risk and market risk.

7.1 IFRS 7 Financial Instruments: Disclosures

The extent of disclosure required depends on the extent of the entity's use of financial instruments and of its exposure to risk.

IFRS 7 requires **qualitative and quantitative disclosures about exposure to risks** arising from financial instruments, and specifies minimum disclosures about **credit risk, liquidity risk and market risk**.

7.2 Nature and extent of risks arising from financial instruments

The disclosures required by IFRS 7 show the extent to which an entity is exposed to the following different types of risk, relating to both recognised and unrecognised financial instruments.

Credit risk	The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.
Currency risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.
Interest rate risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.
Liquidity risk	The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities.
Loans payable	Loans payable are financial liabilities, other than short-term trade payables on normal credit terms.
Market risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk , interest rate risk and other price risk .
Other price risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.
Past due	A financial asset is past due when a counterparty has failed to make a payment when contractually due.

(IFRS 13: Appendix A)

7.2.1 Qualitative disclosures

For each type of risk arising from financial instruments, an entity must disclose the **exposures to risk** and how they arise as well as its objectives, policies and processes for managing the risk and the methods used to measure the risk.

(IFRS 7: para. 34)

8 Fair value measurement

FAST FORWARD

IFRS 13 gives extensive guidance on how the fair value of assets and liabilities should be established.

8.1 Objective

IFRS 13 sets out to:

- (a) Define fair value
- (b) Set out in a single IFRS a framework for measuring fair value
- (c) Require disclosure about fair value measurements

(IFRS 13: para. 1)

8.2 Definitions

IFRS 13 defines fair value as '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' (IFRS 13: para. 9).

The price which would be received to sell the asset or paid to transfer (not settle) the liability is described as the 'exit price'. The market-based current exit price implies an exchange between unrelated, knowledgeable and willing parties.

8.3 Scope

IFRS 13 applies when another IFRS requires or permits fair value measurements or disclosures. The measurement and disclosure requirements do not apply in the case of:

- (a) Share-based payment transactions within the scope of IFRS 2 *Share-based Payment*;
 - (b) Leasing transactions within the scope of IFRS 16 *Leases*; and
 - (c) Net realisable value as in IAS 2 *Inventories* or value in use as in IAS 36 *Impairment of Assets*.
- (IFRS 13: para. 6)

8.4 Measurement

'Fair value is a **market-based measurement**, not an entity-specific measurement' (IFRS 13: para. 2, emphasis BPP's). It focuses on assets and liabilities and on exit (selling) prices. It also takes into account market conditions at the measurement date. In other words, it looks at the amount for which the holder of an asset could sell it and the amount which the holder of a liability would have to pay to transfer it. It can also be used to value an entity's own equity instruments.

Because it is a market-based measurement, fair value is measured using the assumptions that **market participants** would use when pricing the asset, taking into account any relevant characteristics of the asset (IFRS 13: para. 3).

It is assumed that the transaction to sell the asset or transfer the liability takes place either:

- (a) In the **principal market** for the asset or liability; or
 - (b) In the absence of a principal market, in the **most advantageous** market for the asset or liability.
- (IFRS 13: para. 16)

The principal market is the market which is the most liquid (has the greatest volume and level of activity) for that asset or liability (IFRS 13: Appendix A). In most cases the principal market and the most advantageous market will be the same.

IFRS 13 acknowledges that when market activity declines an entity must use a valuation technique to measure fair value (IFRS 13: para 38). In this case the emphasis must be on whether a transaction price is based on an **orderly transaction**, rather than a forced sale.

Fair value is **not adjusted for transaction costs**. Under IFRS 13, these are **not a feature of the asset or liability**, but may be taken into account when **determining the most advantageous market**.

(IFRS 13: paras. 25–26)

Fair value measurements are based on an asset or a liability's **unit of account**, which is specified by each IFRS where a fair value measurement is required. For most assets and liabilities, the unit of account is the individual asset or liability, but in some instances may be a group of assets or liabilities.

(IFRS 13: para. B2)

8.4.1 Example: Unit of account

A premium or discount on a large holding of the same shares (because the market's normal daily trading volume is not sufficient to absorb the quantity held by the entity) is not considered when measuring fair value: the quoted price per share in an active market is used.

However, a control premium is considered when measuring the fair value of a controlling interest, because the unit of account is the controlling interest. Similarly, any non-controlling interest discount is considered where measuring a non-controlling interest.

8.4.2 Example: Principal or most advantageous market

An asset is sold in two active markets, Market X and Market Y, at \$58 and \$57, respectively. Valor Co does business in both markets and can access the price in those markets for the asset at the measurement date as follows.

	Market X	Market Y
Price	\$ 58	\$ 57
Transaction costs	(4)	(3)
Transport costs (to transport the asset to that market)	(4)	(2)
	<u>50</u>	<u>52</u>

Remember that fair value is not adjusted for transaction costs. Under IFRS 13, these are not a feature of the asset or liability, but may be taken into account when determining the most advantageous market.

If Market X is the principal market for the asset (ie the market with the greatest volume and level of activity for the asset), the fair value of the asset would be \$54, measured as the price that would be received in that market (\$58) less transport costs (\$4) and ignoring transaction costs.

If neither Market X nor Market Y is the principal market for the asset, Valor must measure the fair value of the asset using the price in the most advantageous market. The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account both transaction costs and transport costs (ie the net amount that would be received in the respective markets).

The maximum net amount (after deducting both transaction and transport costs) is obtainable in Market Y (\$52, as opposed to \$50). But this is not the fair value of the asset. The fair value of the asset is obtained by deducting transport costs but not transaction costs from the price received for the asset in Market Y: \$57 less \$2 = \$55.

8.4.3 Non-financial assets

For **non-financial assets** the fair value measurement looks at how the asset can be used. It takes into account the ability of a market participant to generate economic benefits by using the asset in its **highest and best use**.

(IFRS 13: para. 31)

8.5 Valuation techniques

Valuation techniques must be those which are appropriate and for which sufficient data are available. Entities should maximise the use of relevant **observable inputs** and minimise the use of **unobservable inputs**.

(IFRS 13: para. 61)

The standard establishes a three-level hierarchy for the inputs that valuation techniques use to measure fair value:

- Level 1** 'Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date' (IFRS 13: para. 76).
- Level 2** 'Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly' (IFRS 13: para. 81), eg quoted prices for similar assets in active markets or for identical or similar assets in non-active markets or use of quoted interest rates for valuation purposes (IFRS 13: para. 82).
- Level 3** 'Unobservable inputs for the asset or liability' (IFRS 13: para. 86), ie using the entity's own assumptions about market exit value (IFRS 13: para. 89).

8.5.1 Valuation approaches

The IFRS identifies **three valuation approaches**:

- (a) **Income approach.** Valuation techniques that 'convert future amounts (eg cash flows or income and expenses) to a single current (ie discounted) amount' (IFRS 13: para. B10). The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts.
- (b) **Market approach.** A valuation technique that 'uses prices and other relevant information generated by market transactions involving identical or comparable (ie similar) assets, liabilities or a group of assets and liabilities, such as a business' (IFRS 13: para. B5).

- (c) **Cost approach.** A valuation technique that 'reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost)' (IFRS 13: para. B8).

Entities may use more than one valuation technique to measure fair value in a given situation (IFRS 13: para. 63).

8.5.2 Examples of inputs used to measure fair value

	Asset or liability	Input
Level 1	Equity shares in a listed company	Unadjusted quoted prices in an active market
Level 2	Licensing arrangement arising from a business combination	Royalty rate in the contract with the unrelated party at inception of the arrangement
	Cash generating unit	Valuation multiple (eg a multiple of earnings or revenue or a similar performance measure) derived from observable market data, eg from prices in observed transactions involving comparable businesses
	Finished goods inventory at a retail outlet	Price to customers adjusted for differences between the condition and location of the inventory item and the comparable (ie similar) inventory items
	Building held and used	Price per square metre for the derived from observable market data, eg prices in observed transactions involving comparable buildings in similar locations
Level 3	Cash generating unit	Financial forecast (eg of cash flows or profit or loss) developed using the entity's own data
	Three-year option on exchange-traded shares	Historical volatility, ie the volatility for the shares derived from the shares' historical prices
		Adjustment to a mid-market consensus (non-binding) price for the swap developed using data not directly observable or otherwise corroborated by observable market data

(IFRS 9: paras. B35–B36)

8.6 Measuring liabilities

Fair value measurement of a liability assumes that that liability is transferred at the measurement date to a market participant, who is then obliged to fulfill the obligation. The obligation is not settled or otherwise extinguished on the measurement date.

(IFRS 9: paras. 34, 42)

8.6.1 Entity's own credit risk

The fair value of a liability reflects the effect of **non-performance risk**, which includes but is not limited to **the entity's own credit risk**. This may be different for different types of liabilities.

(IFRS 9: para. 42)

8.6.2 Example: Entity's own credit risk

Black Co and Blue Co both enter into a legal obligation to pay \$20,000 cash to Green Co in seven years.

Black Co has a top credit rating and can borrow at 4%. Blue Co's credit rating is lower and it can borrow at 8%.

Black Co will receive approximately \$15,200 in exchange for its promise. This is the present value of \$20,000 in seven years at 4%.

Blue Co will receive approximately \$11,660 in exchange for its promise. This is the present value of \$20,000 in seven years at 8%.

8.7 IFRS 13 and business combinations

Fair value generally applies on a business combination. This topic is covered in Chapter 21, together with some further examples.

Chapter Roundup

- Financial instruments can be very complex, particularly **derivative instruments**, although **primary instruments** are more straightforward.
- The important definitions to learn are:
 - **Financial asset**
 - **Financial liability**
 - **Equity instrument**
- Financial instruments must be classified as **liabilities** or **equity** according to their **substance**.
The critical feature of a financial liability is the **contractual obligation to deliver cash** or another financial asset.
- **Compound instruments** are split into **equity** and **liability** components and presented accordingly in the statement of financial position.
- **All financial assets and liabilities** should be **recognised in the statement of financial position**, including derivatives.
- Financial assets should be derecognised when the **rights to the cash flows** from the asset **expire** or where **substantially all the risks and rewards of ownership** are transferred to another party.
- Financial liabilities should be derecognised when they are **extinguished**.
- IFRS 9 requires that financial assets are **classified as measured** at either:
 - **Amortised cost**,
 - **Fair value through other comprehensive income**, or
 - **Fair value through profit or loss**

There is an **option to designate** a financial asset **at fair value through profit or loss** to **reduce or eliminate an 'accounting mismatch'** (measurement or recognition inconsistency).

(IFRS 9: para. 5.2.1)

- **Financial assets** should initially be measured at **cost = fair value**, with some exceptions (see below).
- **Transaction costs increase this amount for financial assets** classified as measured at amortised cost, or at fair value through other comprehensive income and **decrease this amount for financial liabilities** classified as measured at amortised cost.
- **Subsequent measurement** of both financial assets and financial liabilities **depends on how the instrument is classified**: at amortised cost or fair value.
- Financial instruments at **fair value through profit or loss** are measured at **fair value**; gains and losses are recognised in **profit or loss**.
- Financial assets held within a business model whose objective is achieved by **both collecting contractual cash flows** and selling financial assets **must** be measured at **fair value** with gains and losses recognised in **other comprehensive income**.
- If an **investment in equity instruments is not held for trading**, the entity may make an **irrevocable election** to recognise changes in the fair value in **other comprehensive income**.
- Financial instruments at **amortised cost** are measured using the **effective interest method**.
- **Impairment of financial assets** is governed by an **expected loss model**, which recognises **expected credit losses** for all financial instruments subject to **impairment accounting**.
- An **embedded derivative** is a derivative instrument that is combined with a non-derivative **host contract** to form a single hybrid instrument.
- Where the host contract is **an asset within the scope of IFRS 9** the hybrid contract is accounted for as **one instrument**.
- **Otherwise**, IFRS 9 requires that the embedded derivative is **separated from the host contract** where certain conditions are met and accounted for separately.

- **Hedge accounting** means designating one or more instruments so that their change in fair value is **offset** by the change in fair value or cash flows of another item.
- **Hedge accounting** is required in certain circumstances, provided the **qualifying criteria** are met.
- There are three types of hedge: **fair value** hedge, **cash flow** hedge, hedge of a **net investment in a foreign operation**. Only the first two are examinable.
- The accounting treatment of a hedge **depends on its type**.
- **IFRS 7** specifies the **disclosures** required for financial instruments. The standard requires qualitative and quantitative disclosures about exposure to risks arising from financial instruments and specifies minimum disclosures about credit risk, liquidity risk and market risk.
- **IFRS 13** gives extensive guidance on how the fair value of assets and liabilities should be established.

Quick Quiz

- 1 Which issues are dealt with by IAS 32?
- 2 What items are not financial instruments according to IAS 32?
- 3 What is the critical feature used to identify a financial liability?
- 4 How should compound instruments be presented in the statement of financial position?
- 5 When should a financial asset be derecognised?
- 6 How are financial instruments initially measured?
- 7 How are financial assets measured under IFRS 9, subsequent to initial recognition?
- 8 When measuring expected credit losses under the IFRS 9 impairment model, entities should always consider the worst-case scenario. True or false?
- 9 How are embedded derivatives treated under IFRS 9?
- 10 What is hedge accounting?
- 11 Name the three types of hedging relationship identified by IFRS 9.
- 12 Fill in the blanks:
In applying IFRS 13, entities should maximise the use of _____ and minimise the use of _____.

Answers to Quick Quiz

- 1 Classification and presentation
- 2 Physical assets; prepaid expenses; non-contractual assets or liabilities; contractual rights not involving transfer of assets
- 3 The contractual obligation to deliver cash or another financial asset to the holder
- 4 By calculating the present value of the liability component and then deducting this from the instrument as a whole to leave a residual value for the equity component
- 5 An entity should derecognise a financial asset when:
 - (a) The contractual rights to the cash flows from the financial asset expire, or
 - (b) The entity transfers substantially all the risks and rewards of ownership of the financial asset to another party.
- 6 At cost = fair value
- 7 At amortised cost or at fair value through other comprehensive income or at fair value through profit or loss.
- 8 False. The probability-weighted outcome should reflect the possibility that a credit loss occurs and a possibility that it does not occur.
- 9 Where the host contract is a financial asset within the scope of IFRS 9, the classification and measurement rules of the standard are applied to the entire hybrid contract. Where the host contract is not a financial asset within the scope of IFRS 9, the standard requires that an embedded derivative be separated from its host contract and accounted for as a derivative when certain conditions are met.
- 10 Hedge accounting means designating one or more hedging instruments so that their change in fair value is offset, in whole or in part, against the change in fair value or cash flows of a hedged item.
- 11 Fair value hedge; cash flow hedge; hedge of a net investment in a foreign operation
- 12 In applying IFRS 13 entities should maximise the use of **relevant observable inputs** and minimise the use of **unobservable inputs**.

Now try the questions below from the Practice Question Bank

Number	Level	Marks	Time
Q12	Examination	20	39 mins
Q13	Examination	20	39 mins

Accounting for taxation

Topic list	Syllabus reference
1 Current tax	B10
2 Deferred tax	B10
3 Deferred taxation and business combinations	B10/D3(c)
4 Government sales tax	B10

Introduction

In almost all countries entities are taxed on the basis of their trading income. In some countries this may be called corporation or corporate tax, but we will follow the terminology of IAS 12 *Income Taxes* and call it income tax.

There are two aspects of income tax which must be accounted for: **current tax** and **deferred tax**. These will be discussed in Sections 1 and 2 respectively.

Study guide

B10	Tax in financial statements
(a)	Account for current tax liabilities and assets in accordance with IFRSs
(b)	Describe the general principles of government sales taxes (eg VAT or GST)
(c)	Outline the principles of accounting for deferred tax
(d)	Explain the effect of taxable temporary differences on accounting and taxable profits
(e)	Identify and account for the IASB requirements relating to deferred tax assets and liabilities
(f)	Calculate and record deferred tax amounts in the financial statements
D3	Business combinations – fair value adjustments
(c)	Prepare consolidated financial statements dealing with fair value adjustments (including their effect on consolidated goodwill) in respect of: <ul style="list-style-type: none"> – Deferred tax

1 Current tax

FAST FORWARD

Current tax is the amount payable to the tax authorities in relation to the trading activities of the period. It is generally straightforward.

1.1 Introduction

You may have assumed until now that accounting for income tax was a very simple matter for companies. You would calculate the amount of tax due to be paid on the company's taxable profits and with this amount you would:

DEBIT Tax charge (statement of profit or loss)
CREDIT Tax liability (statement of financial position)

Indeed, this aspect of corporate taxation – **current tax** – is ordinarily straightforward. Complexities arise, however, when we consider the future tax consequences of what is going on in the financial statements now. This is an aspect of tax called **deferred tax**, which we will look at in the next section.

1.2 IAS 12 *Income Taxes*

IAS 12 covers both current and deferred tax. The parts relating to current tax are fairly brief, because this is the simple and uncontroversial area of tax.

1.3 Definitions

These are some of the definitions given in IAS 12. We will look at the rest later.

Key terms

Accounting profit. Net profit or loss for a period before deducting tax expense.

Taxable profit (tax loss). The profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).

Tax expense (tax income). The aggregate amount included in the determination of net profit or loss for the period in respect of current tax and deferred tax.

Current tax. The amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

(IAS 12: para. 5)

1.4 Recognition of current tax liabilities and assets

IAS 12 requires any **unpaid tax** in respect of the current or prior periods to be recognised as a **liability** (IAS 12: para. 12).

Conversely, any **excess tax** paid in respect of current or prior periods over what is due should be recognised as an **asset** (IAS 12: para. 13).



Question

Current tax

In 20X8 Darton Co had taxable profits of \$120,000. In the previous year (20X7) income tax on 20X7 profits had been estimated as \$30,000. The corporate income tax rate is 30%.

Required

Calculate tax payable and the charge for 20X8 if the tax due on 20X7 profits was subsequently agreed with the tax authorities as:

- (a) \$35,000; or
- (b) \$25,000.

Any under or over payments are not settled until the following year's tax payment is due.

Answer

(a)		\$
	Tax due on 20X8 profits ($\$120,000 \times 30\%$)	36,000
	Underpayment for 20X7	5,000
	Tax charge and liability	<u>41,000</u>
(b)		\$
	Tax due on 20X8 profits (as above)	36,000
	Overpayment for 20X7	(5,000)
	Tax charge and liability	<u>31,000</u>

Alternatively, the rebate due could be shown separately as income in the statement of profit or loss and other comprehensive income and as an asset in the statement of financial position. An offset approach like this is, however, most likely.

Taking this a stage further, IAS 12 also requires recognition as an asset of the benefit relating to any tax loss that can be **carried back** to recover current tax of a previous period. This is acceptable because it is probable that the benefit will flow to the entity and it can be reliably measured (IAS 12: para. 13).

1.5 Example: Tax losses carried back

In 20X7 Eramu Co paid \$50,000 in tax on its profits. In 20X8 the company made tax losses of \$24,000. The local tax authority rules allow losses to be carried back to offset against current tax of prior years. The tax rate is 30%.

Required

Show the tax charge and tax liability for 20X8.

Solution

Tax repayment due on tax losses = $30\% \times \$24,000 = \$7,200$.

The double entry will be:

DEBIT	Tax receivable (statement of financial position)	\$7,200	
CREDIT	Tax repayment (statement of profit or loss)		\$7,200

The tax receivable will be shown as an asset until the repayment is received from the tax authorities.

1.6 Measurement

Measurement of current tax liabilities (assets) for the current and prior periods is very simple. They are measured at the **amount expected to be paid to (recovered from) the tax authorities**. The tax rates (and tax laws) used should be those enacted (or substantively enacted) by the year end.

1.7 Recognition of current tax

Normally, current tax is recognised as income or expense and included in the net profit or loss for the period, except in two cases (IAS 12: paras. 58, 61A).

- (a) Tax arising from a **business combination** which is an acquisition is treated differently.
- (b) A transaction or event which is recognised, in the same or a different period, outside profit or loss, either in other comprehensive income or directly in equity.

The rule in (b) is logical. If a transaction or event is charged or credited directly to equity, rather than to profit or loss, then the related tax should be also. 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 fundamental error.

1.8 Presentation

In the statement of financial position, **tax assets and liabilities** should be shown separately from other assets and liabilities (IAS 12: para. 77).

Current tax assets and liabilities can be **offset**, but this should happen only when (IAS 12: para. 71):

- (a) 'The entity has a **legally enforceable right** to set off the recognised amounts.
- (b) 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 for the year should be shown in the profit or loss section of the statement of profit or loss and other comprehensive income.

2 Deferred tax

FAST FORWARD

- Deferred tax is an accounting measure used to match the tax effects of transactions with their accounting impact. It is quite complex.
- Deferred tax is an **accounting device**. It does **not** represent tax payable to the tax authorities.
- The **tax base** of an asset or liability is the value of that asset or liability for tax purposes.
- Deferred tax is the tax attributable to **temporary differences**.

Exam focus point

Deferred tax is regularly examined in the DipIFR exam. In the examiner's report from June 2016, the examiner stated that although this topic is frequently examined, students still find it very challenging. Make sure that you study this topic carefully, attempting all the questions in this chapter, and the relevant questions in the DipIFR Practice & Revision Kit.

2.1 What is deferred tax?

Deferred tax is an **accounting adjustment**. It is not a tax which is currently payable to the tax authorities.

When a company recognises an asset or liability, it expects to **recover or settle the carrying amount** of that asset or liability. In other words, it expects to sell or use up assets, and to pay off liabilities. What

happens if that recovery or settlement is likely to make future tax payments larger (or smaller) than they would otherwise have been if the recovery or settlement had no tax consequences?

Similarly, some items of income or expense are included in accounting profit in one period, but included in taxable profit in a different period (IAS 12: para. 17). This is because the accounting profit is determined by applying the principles of IFRS, whereas taxable profit is determined by applying the tax rules established by the tax authorities. Without some form of adjustment, this difference may cause the tax charge in the statement of profit or loss and other comprehensive income to be misleading.

In both of these circumstances, IAS 12 requires companies to recognise a deferred tax liability (or deferred tax asset) (IAS 12: paras. 15 and 24). In these circumstances, IAS 12 requires companies to recognise a **deferred tax liability** (or **deferred tax asset**).

Before we go any further, let us be clear about the difference between current and deferred tax.

- (a) **Current tax** is the amount **actually payable** to the tax authorities in relation to the trading activities of the entity during the period.
- (b) **Deferred tax** is an **accounting measure**, used to match the tax effects of transactions with their accounting impact and thereby produce less distorted results.

2.2 Definitions

Here are the definitions relating to deferred tax given in IAS 12.

Key terms

Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of 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

Temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. Temporary differences may be either:

- **Taxable temporary differences**, which 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
- **Deductible temporary differences**, which 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

The **tax base** of an asset or liability is the amount attributed to that asset or liability for tax purposes.

(IAS 12: para. 5)

2.3 Tax base

Tax payable by an entity is calculated by the tax authorities using a tax computation. A tax computation is similar to a statement of profit or loss, except that it is constructed using tax rules instead of IFRS. Now imagine the tax authorities drawing up a statement of financial position for the same entity, but using tax rules instead of IFRS. In these 'tax accounts', assets and liabilities will be stated at their carrying amount for tax purposes, which is their tax base.

Different tax jurisdictions may have different tax rules. The tax rules determine the tax base.

Exam focus point

In the exam, the question will state the tax rules in a jurisdiction, or the tax base of certain assets or liabilities in that jurisdiction.

The table below gives some examples of tax rules and the resulting tax base.

Item	Carrying amount in the statement of financial position	Tax rule	Tax base (amount in 'tax accounts')
Item of property, plant and equipment	Carrying amount = cost – accumulated depreciation	Attracts tax relief in the form of tax depreciation	Tax written down value = cost – accumulated tax depreciation
Accrued income	Included in financial statements on an accruals basis ie when receivable	Chargeable for tax on a cash basis, ie when received	Nil
		Chargeable for tax on an accruals basis, ie when receivable	Same as carrying amount in statement of financial position
Accrued expenses and provisions	Included in financial statements on an accruals basis ie when payable	Attracts tax relief on a cash basis, ie when paid	Nil (Remember this is the carrying value in the tax accounts. As the cash has not been received, the income is not yet included in the tax accounts, so the tax base is nil)
		Attracts tax relief on an accruals basis, ie when payable	Same as carrying amount in statement of financial position
Income received in advance	When the cash is received, it will be included in the financial statements as deferred income ie a liability	Chargeable for tax on a cash basis, ie when received	Nil (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)



Question

Tax base 1

State the tax base of each of the following assets.

- A machine cost \$10,000. For tax purposes, depreciation of \$3,000 has already been deducted in the current and prior periods and the remaining cost will be deductible in future periods, either as depreciation or through a deduction on disposal. Revenue generated by using the machine is taxable, any gain on disposal of the machine will be taxable and any loss on disposal will be deductible for tax purposes.
- Interest receivable has a carrying amount of \$1,000. The related interest revenue will be taxed on a cash basis.
- Trade receivables have a carrying amount of \$10,000. The related revenue has already been included in taxable profit (tax loss).
- A loan receivable has a carrying amount of \$1m. The repayment of the loan will have no tax consequences.
- Dividends receivable from a subsidiary have a carrying amount of \$5,000. The dividends are not taxable.

Answer

- (a) The tax base of the machine is \$7,000.
- (b) The tax base of the interest receivable is nil.
- (c) The tax base of the trade receivables is \$10,000.
- (d) The tax base of the loan is \$1m.
- (e) The tax base of the dividend is \$5,000.

In the case of (e), in substance the entire carrying amount of the asset is deductible against the economic benefits. There is no taxable temporary difference. An alternative analysis is that the accrued dividends receivable have a tax base of nil and a tax rate of nil is applied to the resulting taxable temporary difference (\$5,000). Under both analyses, there is no deferred tax liability.



Question

Tax base 2

State the tax base of each of the following liabilities.

- (a) Current liabilities include accrued expenses with a carrying amount of \$1,000. The related expense will be deducted for tax purposes on a cash basis.
- (b) Current liabilities include interest revenue received in advance, with a carrying amount of \$10,000. The related interest revenue was taxed on a cash basis.
- (c) Current liabilities include accrued expenses with a carrying amount of \$2,000. The related expense has already been deducted for tax purposes.
- (d) Current liabilities include accrued fines and penalties with a carrying amount of \$100. Fines and penalties are not deductible for tax purposes.
- (e) A loan payable has a carrying amount of \$1m. The repayment of the loan will have no tax consequences.

Answer

- (a) The tax base of the accrued expenses is nil.
- (b) The tax base of the interest received in advance is nil.
- (c) The tax base of the accrued expenses is \$2,000.
- (d) The tax base of the accrued fines and penalties is \$100.
- (e) The tax base of the loan is \$1m.

Exam focus point

The June 2016 exam featured a whole 20 mark question on deferred tax, which included four marks each for defining and calculating examples of the tax base of an asset and of a liability. These should have been easy marks, however, the examiner commented that only a minority of candidates were able to correctly state the required definitions (Examiner's Report June 2016, p4).

2.4 Calculating deferred tax

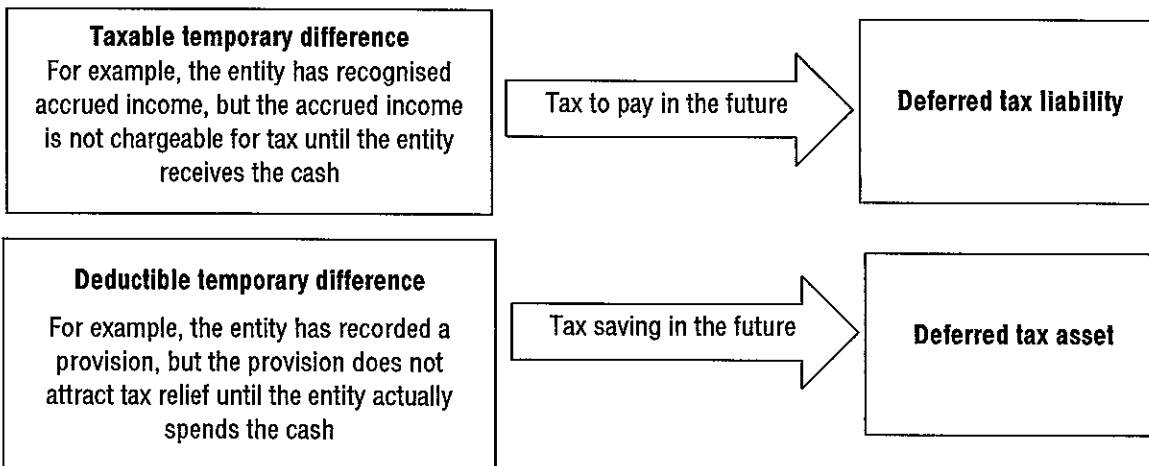
Deferred tax is calculated as follows

	\$
Carrying amount of asset/liability (statement of financial position)	X/(X)
Tax base	(X)/X
Temporary difference	X/(X)
Deferred tax (liability)/asset (temporary difference × tax rate)	(X)/X

Deferred tax is the tax attributable to **temporary differences**.

2.5 Temporary differences

There are two types of **temporary difference** (IAS 12: paras. 15, 24).



If an item is never taxable or tax deductible, its tax base is deemed to be its carrying amount so there is no temporary difference and no related deferred tax. This is a **permanent difference**.

2.5.1 Examples of temporary differences

The following tables summarise the temporary differences that you may already be familiar with from your earlier studies. Remember that the tax rule determines the tax base.

In the exam, make sure you apply the tax rules given in the question.

Property, plant and equipment	
Financial statements treatment	The asset is depreciated over its useful life as per IAS 16 and is carried at cost less accumulated depreciation.
Tax rule	Tax depreciation is granted on the asset. The tax depreciation is accelerated (ie it is more rapid than accounting depreciation).
Tax base	Tax written down value = cost – cumulative tax depreciation
Temporary difference	A temporary difference arises because accounting depreciation and tax depreciation are charged at different rates. In this example, the tax depreciation is at a quicker rate than the accounting depreciation. This results in a taxable temporary difference (and so a deferred tax liability) because the carrying amount of the asset will be higher than its tax written down value. If the tax depreciation was at a slower rate than the accounting depreciation, a deductible temporary difference arises and results in a deferred tax asset (IAS 12: para. 17b).

Accrued income/accrued expense	
Financial statements treatment	The accrued income or accrued expense is included in the financial statements when the item is accrued.
Tax rule	Income and expenses are taxed on a cash receipts/cash paid basis, ie they are chargeable to tax/attract tax relief when they are actually received/paid.
Tax base	Nil.
Temporary difference	<p>The temporary difference is the amount of the accrued income or expense.</p> <p>If it is accrued income, it will result in a deferred tax liability, as tax will be paid in the future when the income is actually received.</p> <p>If it is an accrued expense, it will result in a deferred tax asset, as the entity will get tax relief in the future when the expense is actually paid.</p>

Provisions and allowances for doubtful debts	
Financial statements treatment	<p>A provision is included in the financial statements when the criteria in IAS 37 are met.</p> <p>A doubtful debt allowance is recognised in accordance with IFRS 9.</p>
Tax treatment	<p>Expenses related to provisions attract tax relief on a cash paid basis, ie they attract tax relief when they are actually paid.</p> <p>Expenses related to doubtful debts attract tax relief when the debts become irrecoverable and are written off.</p>
Tax base	Nil.
Temporary difference	The temporary difference is the amount of the provision or allowance. This will result in a deferred tax asset as the entity will get tax relief in the future when the related expense is actually paid/debts become irrecoverable and are written off.

Development costs	
Financial statements treatment	Development costs are capitalised when the criteria in IAS 38 are met and are then amortised over their useful life.
Tax treatment	Development costs are tax deductible on a cash paid basis, ie in the period incurred.
Tax base	Nil, because the costs have already been deducted from taxable profits.
Temporary difference	A taxable temporary difference arises equal to the full carrying amount of the development costs, resulting in a deferred tax liability.

2.5.2 Example: Property, plant and equipment

A company buys an item of equipment on 1 January 20X1 for \$1,000,000. It has a useful life of ten years and an estimated residual value of \$100,000. The equipment is depreciated on a straight-line basis. For tax purposes, a tax expense can be claimed on a 20% reducing balance basis.

The rate of income tax can be taken as 30%.

Required

In respect of the above item of equipment, calculate the deferred tax charge/credit in the company's profit or loss for the year to 31 December 20X2 and the deferred tax balance in the statement of financial position at that date.

Solution

Movement in the deferred tax liability for the year ended 31 December 20X2

	\$'000
Deferred tax liability b/d	33
∴ Profit or loss charge	21
Deferred tax liability c/d	<u>54</u>

Workings

1 Deferred tax liability

	Carrying amount \$'000	Tax base \$'000	Temporary differences \$'000	Deferred tax liability @ 30% \$'000
20X1				
Cost	1,000	1,000	—	—
Depreciation c/d	(W2) <u>(90)</u> 910	(W3) <u>(200)</u> 800	110	(33)
20X2				
b/d	910	800		
Depreciation c/d	<u>(90)</u> 820	(W3) <u>(160)</u> 640	180	(54)

2 Depreciation

\$1,000,000 cost – \$100,000 residual value/10 years = \$90,000 per annum.

3 Tax depreciation

20X1: \$1,000,000 × 20% = \$200,000

20X2: \$800,000 Carrying amount b/d × 20% = \$160,000

2.5.3 Example: Development costs

During the year ended 31 March 20X4, Epsilon correctly capitalised development costs of \$1.6m in accordance with IAS 38. The development project began to generate economic benefits for Epsilon from 1 January 20X4. The directors of Epsilon estimated that the project would generate economic benefits for five years from that date. Amortisation is charged on a monthly pro-rata basis. The development expenditure was fully deductible against taxable profits for the year ended 31 March 20X4 and the rate of tax applicable is 25%.

Required

Discuss the deferred tax implications of the above in the financial statements of Epsilon for the year ended 31 March 20X4.

Solution

Amortisation of the development costs over their useful life of five years should commence on 1 January 20X4. Therefore at 31 March 20X4, the development costs have a carrying amount of \$1.52m (\$1.6m – (\$1.6m × 1/5 × 3/12)) in the financial statements.

The tax base of the development costs is nil since the relevant tax deduction has already been claimed.

The deferred tax liability will be \$380,000 (\$1.52m × 25%).



2.5.4 Revaluation of assets

Under IAS 16 assets may be revalued. If the revaluation does **not** affect current taxable profits, the tax base of the asset is not adjusted. Consequently, the taxable flow of economic benefits to the entity as the carrying value of the asset is recovered will differ from the amount that will be deductible for tax purposes. The gain (or loss) between the carrying amount of a revalued asset and its tax base is a temporary difference and gives rise to a **deferred tax liability (or deferred tax asset)** (IAS 12: para. 20).



Question

Revaluation of property, plant and equipment

A company purchased some land on 1 January 20X7 for \$400,000. On 31 December 20X8 the land was revalued to \$500,000. In the tax regime in which the company operates revaluations do not affect either the tax base of the asset or taxable profits.

The income tax rate is 30%.

Required

Prepare the accounting entry to record the deferred tax in relation to this revaluation for the year ended 31 December 20X8.

Answer

DEBIT	Other comprehensive income (and revaluation surplus)	\$30,000	
CREDIT	Deferred tax liability		\$30,000

Working: Deferred tax

	\$
Carrying amount of asset	500,000
Less tax base	(400,000)
Temporary difference	100,000
Deferred tax (liability) (30% × 100,000)	(30,000)

2.5.5 Impairment losses and inventory losses

If an item of property, plant or equipment suffers an impairment loss, the carrying amount of that asset is reduced.

If tax relief on the loss is only granted when the asset is sold, the reduction in value of the asset is ignored for tax purposes until the sale. The tax base of the asset does not change, resulting in a deductible temporary difference and a deferred tax asset.

Similarly, losses on inventory that are not tax deductible until the inventory is sold generate a deferred tax asset.

2.6 Deferred tax: Recognition

Under IAS 12, a deferred tax liability or asset is recognised for **all** taxable and deductible temporary differences, unless they arise from:

- (a) 'The **initial recognition of goodwill**; or
 - (b) The **initial recognition of an asset or liability** in a transaction which
 - (i) **Is not a business combination**
 - (ii) **At the time of the transaction, affects neither accounting profit nor taxable profit.**
- (IAS 12: paras. 15, 24)

Deferred tax is **recognised in the same section** of the statement of profit or loss and other comprehensive income **as the transaction was recognised** (IAS 12: paras. 58, 61a).

2.6.1 Example: Recognition of deferred tax

Charlton revalued a property from a carrying amount of \$2 million to its fair value of \$2.5 million during the reporting period. The property cost \$2.2 million and its tax base is \$1.8 million. The tax rate is 30%.

Required

Explain the deferred tax implications of the above information in Charlton's financial statements at the end of the reporting period.

Solution

The tax base is \$1.8 million and the carrying amount is \$2.5 million (being the historical carrying amount of \$2 million plus a revaluation surplus of \$500,000).

Therefore a taxable temporary difference of \$700,000 exists, giving rise to a deferred tax liability of \$210,000 ($30\% \times \$700,000$).

Of the taxable temporary difference:

- \$200,000 ($\$2\text{m} - \1.8m) arises due to the accelerated tax depreciation granted on the asset; and
- \$500,000 arises due to the revaluation.

Therefore deferred tax of \$150,000 ($30\% \times \$500,000$) should be charged to other comprehensive income, as this is where the revaluation gain is recognised, and the remainder should be charged to profit or loss.

2.6.2 Recognising deferred tax assets

Deferred tax assets are only recognised to the extent that 'it is **probable** that taxable profit will be available against which the deductible temporary difference can be utilised' (IAS 12: para. 24).

It is assumed that enough taxable profit will be available if there are **sufficient taxable temporary differences** which can be offset, in accordance with tax regulation, against the available deductible temporary difference (IAS 12: para. 28).

If an entity has a **history of recent losses**, then this is evidence that future taxable profit may not be available.

An entity may have unused tax losses or credits (ie which it can offset against taxable profits) at the end of a period. IAS 12 states that a deferred tax asset may be recognised in such circumstances '**to the extent that it is probable future taxable profit will be available against which the unused tax losses/credits can be utilised**' (IAS 12: para. 34).

For **all** unrecognised deferred tax assets, at each year end an entity should **reassess the availability of future taxable profits** and whether part or all of any unrecognised deferred tax assets should now be recognised. This may be due to an improvement in trading conditions which is expected to continue (IAS 12: para. 37).

2.7 Deferred tax: Measurement

Deferred tax assets and liabilities are measured at the tax rates expected to apply to the period when the asset is realised or liability settled, based on tax rates (and tax laws) that have been '**enacted (or substantively enacted) by the end of the reporting period**' (IAS 12: para. 47).

If tax rates change, the tax rate expected when the temporary difference will reverse is used (IAS 12: para. 47).

Deferred tax assets and liabilities **should not be discounted** because the complexities and difficulties involved will affect reliability (IAS 12: paras. 53, 54).

2.8 Deferred tax: Presentation

Deferred tax assets and liabilities can only be offset if (IAS 12: para. 74):

- (a) 'The entity has a **legally enforceable right** to set off **current tax assets against current tax liabilities**; and
- (b) The deferred tax assets and liabilities relate to income taxes levied by the **same taxation authority**.'

3 Deferred tax and business combinations

FAST FORWARD

Some temporary differences only arise in a **business combination**.

There are some temporary differences which only arise in a business combination. This is because, on consolidation, adjustments are made to the carrying amounts of assets and liabilities that are not always reflected in the tax base of those assets and liabilities.

The tax bases of assets and liabilities in the consolidated financial statements are determined by reference to the applicable tax rules. Usually tax authorities calculate tax on the profits of the individual entities, so the relevant tax bases to use will be those of the individual entities (IAS 12: para. 11).

Deferred tax calculation

	\$
Carrying amount of asset/liability (in the consolidated statement of financial position)	X/(X)
Tax base (usually subsidiary's tax base*)	(X)/X
Temporary difference	X/(X)
Deferred tax (liability)/asset	(X)/X

* The tax base depends on tax rules. Usually tax is charged on **individual entity profits**, *not* group profits.

Exam focus point

In the exam, the question will state the tax rules in a jurisdiction, or the tax base of certain assets or liabilities in that jurisdiction.

3.1 Fair value adjustments on consolidation

IFRS 3 requires assets acquired and liabilities assumed on acquisition of a subsidiary to be brought into the consolidated financial statements at their fair value rather than their carrying amount. However, this change in fair value is not usually reflected in the tax base, and so a temporary difference arises (IAS 12: para. 19).

The accounting entries to record the resulting deferred tax are:

- (a) Deferred tax liability due to fair value gain: reduces the fair value of the net assets of the subsidiary and therefore increases goodwill:

DEBIT	Goodwill	X	
CREDIT	Deferred tax liability		X

- (b) Deferred tax asset due to fair value loss: increases the fair value of the net assets of the subsidiary and therefore reduces goodwill:

DEBIT	Deferred tax asset	X	
CREDIT	Goodwill		X



Question

Fair value adjustments

On 1 April 20X5 Alpha purchased 100% of the ordinary shares of Beta. The fair values of the assets and liabilities acquired were considered to be equal to their carrying amounts, with the exception of equipment, which had a fair value of \$54 million. The tax base of the equipment on 1 April 20X5 was \$50 million.

The tax rate is 25% and the fair value adjustment does not affect the tax base of the equipment.

Required

Discuss how the above will affect the accounting for deferred tax under IAS 12 Income Taxes in the group financial statements of Alpha.

Answer

A taxable temporary difference arises for the group because on consolidation the carrying amount of the equipment has increased (to its fair value), but its tax base has not changed. The deferred tax on the fair value adjustment is calculated as:

	\$m
Carrying amount (in group financial statements)	54
Tax base	(50)
Temporary difference	4
Deferred tax liability ($4 \times 25\%$)	(1)

The deferred tax of \$1m is debited to goodwill, reducing the fair value adjustment (and net assets at acquisition) and increasing goodwill.

3.2 Undistributed profits of subsidiaries, branches, associates and joint ventures

A subsidiary's profits (or share of associate's/joint venture's profits) are recognised in the consolidated financial statements. If they are not taxable in the parent's tax regime until they are remitted to the parent as dividend income, a temporary difference arises (IAS 12: para. 38).

Under IAS 12, a resulting deferred tax liability is recognised **unless**:

- (a) 'The parent, investor or venturer is able to control the timing of the reversal of the temporary difference (eg by determining dividend policy); **and**
 - (b) It is probable that the temporary difference will not reverse in the foreseeable future.'
- (IAS 12: para. 39)

3.2.1 Example: Undistributed profits of subsidiary

Carrol has one subsidiary, Anchor. The retained earnings of Anchor at acquisition were \$2 million. The directors of Carrol have decided that over the next three years, they will realise earnings through future dividend payments from Anchor amounting to \$500,000 per year.

Tax is payable on any remittance of dividends and no dividends have been declared for the current year.

Required

Discuss the deferred tax implications of the above information for the Carrol Group.

Solution

Deferred tax should be recognised on the unremitted earnings of subsidiaries unless the parent is able to control the timing of dividend payments and it is unlikely that dividends will be paid for the foreseeable future. Carrol controls the dividend policy of Anchor and this means that there would normally be no need to recognise a deferred tax liability in respect of unremitted profits. However, the profits of Anchor will be distributed to Carrol over the next few years and tax will be payable on the dividends received. Therefore a deferred tax liability should be shown.

3.3 Unrealised profits on intragroup trading

When a group entity sells goods to another group entity, the selling entity recognises the profit made in its individual financial statements. If the related inventories are still held by the group at the year end, the profit is unrealised from the group perspective and adjustments are made in the group accounts to eliminate it. The same adjustment is not usually made to the tax base of the inventories (as tax is usually calculated on the individual entity profits, and not group profits) and a temporary difference arises.

3.3.1 Example: Unrealised profits on intragroup trading

P sells goods costing \$150 to its overseas subsidiary S for \$200. At the year end, S still holds the inventories. In the jurisdictions in which P and S operate, tax is charged on individual entity profits. P's rate of tax is 40%, whereas S's rate of tax is 50%.

P pays tax of \$20 ($\$50 \times 40\%$) on the profit generated by the sale.

S is entitled to a future tax deduction for the \$200 paid for the inventories. The tax base of the inventories is therefore \$200 from S's perspective.

From the perspective of the P group, the profit of \$50 generated by the sale is unrealised. In the consolidated financial statements, the unrealised profit is eliminated, so the carrying amount of the inventories from the group perspective is \$150.

Deferred tax is calculated as:

	\$
Carrying amount (in the group financial statements)	150
Tax base (cost of inventories to S)	(200)
Temporary difference (group unrealised profit)	(50)
Deferred tax asset ($50 \times 50\%$ (S's tax rate))	25

S's tax rate is used to calculate the deferred tax asset because S will receive the future tax deduction related to the inventories.

In the consolidated financial statements a deferred tax asset of \$25 should be recognised:

DEBIT	Deferred tax asset (in consolidated statement of financial position)	\$25
CREDIT	Deferred tax (in consolidated statement of profit or loss)	\$25

4 Government sales tax

Most countries have a sales tax – a tax on the sale of certain goods and services. It is **usually a tax on revenue, not on profits**. The basic principle is that the tax should be borne by the final consumer. Different countries have their own ways of applying the tax, so in order to explain and illustrate the principles, the UK system is explained.

In the UK, registered traders may deduct the tax which they suffer on supplies to them (input tax) from the tax which they charge to their customers (output tax) at the time this is paid to the government or taxing authority (Her Majesty's Revenue and Customs (HMRC)). Thus, at each stage of the manufacturing or service process, the net tax paid is on the value added at that stage.

4.1 Example: Value Added Tax (VAT)

A forester sells wood to a furniture maker for £100 plus VAT. The furniture maker uses this wood to make a table and sells the table to a shop for £150 plus VAT. The shop then sells the table to the final consumer for £300 plus VAT of 20%. VAT will be accounted for to the UK Government as follows.

	<i>Cost</i>	<i>Input tax</i> 20%	<i>Net sale price</i>	<i>Output tax</i> 20%	<i>Payable</i> <i>to HMRC</i>
	£	£	£	£	£
Forester	0	0	100	20.00	20.00
Furniture maker	100	20.00	150	30.00	10.00
Shop	150	30.00	300	60.00	30.00
					<u>60.00</u>

Because the traders involved account to the UK Government for VAT charged less VAT suffered, their profits for income tax or corporation tax purposes are based on sales and purchases net of VAT.

4.2 Taxable Supplies

VAT is chargeable on taxable supplies made by a taxable person in the course or furtherance of any business carried on by him. Supplies may be of goods or services.

Key term

A **taxable supply** is a supply of goods or services, other than an exempt supply.

A taxable supply is either standard-rated or zero-rated. The standard rate in the UK is 20%.

Certain supplies, which fall within the classification of standard rate supplies, are charged at a reduced rate of 5%. An example is the supply of domestic fuel.

Zero-rated supplies are taxable at 0%. A taxable supplier whose outputs are zero-rated but whose inputs are standard-rated will obtain repayments of the VAT paid on purchases.

An exempt supply is not chargeable to VAT. A person making exempt supplies is unable to recover VAT on inputs. The exempt supplier thus has to shoulder the burden of VAT. Of course, he may increase his prices to pass on the charge, but he cannot issue a VAT invoice which would enable a taxable customer to obtain a credit for VAT, since no VAT is chargeable on his supplies.

4.3 Supplies of goods

Goods are supplied if exclusive ownership of the goods passes to another person.

The following are treated as supplies of goods.

- The supply of any form of power, heat, refrigeration or ventilation, or of water
- The grant, assignment or surrender of a major interest (the freehold or a lease for over 21 years) in land
- Taking goods permanently out of the business for the non-business use of a taxable person or for other private purposes including the supply of goods by an employer to an employee for his private use
- Transfers under an agreement contemplating a transfer of ownership, such as a hire purchase agreement

4.4 Supplies of services

Apart from a few specific exceptions, **any supply which is not a supply of goods and which is done for a consideration is a supply of services**. A consideration is any form of payment in money or in kind, including anything which is itself a supply.

A supply of services also takes place if:

- Goods are lent to someone for use outside the business
- Goods are hired to someone
- Services bought for business purposes are used for private purposes

The European Court of Justice has ruled that restaurants supply services rather than goods.

4.5 Taxable persons

The term 'person' includes **individuals, partnerships** (which are treated as single entities, ignoring the individual partners) and **companies**. If a person is in business making taxable supplies, then the value of these supplies is called the taxable turnover. If a person's taxable turnover exceeds certain limits then he is a taxable person and should be registered for VAT.

Chapter Roundup

- Current tax is the amount payable to the tax authorities in relation to the trading activities of the period. It is generally straightforward.
- Deferred tax is an accounting measure used to match the tax effects of transactions with their accounting impact. It is quite complex.
- Deferred tax is an **accounting device**. It does **not** represent tax payable to the tax authorities.
- The **tax base** of an asset or liability is the value of that asset or liability for tax purposes.
- Deferred tax is the tax attributable to **temporary differences**.
- Some temporary differences only arise in a **business combination**.

Quick Quiz

- 1 How should current tax be measured?
 - A The total liability, including deferred tax
 - B The amount expected to be paid to (or recovered from) the tax authorities
 - C The amount calculated on profit at current tax rates
 - D The amount calculated on profit at future tax rates
- 2 A taxable temporary difference gives rise to a deferred tax liability. True/False?
- 3 How do temporary differences arise when investments are held in subsidiaries, associates and so on?
- 4 Give three examples of temporary differences.
- 5 An entity has a tax overprovision relating to the prior year of \$3,000. Taxable temporary differences have increased by \$6,000 and profit for the year is \$150,000. Tax is at 30%.
What is the charge to profit or loss?

Answers to Quick Quiz

- 1 B The amount expected to be paid to (or recovered from) the tax authorities.
- 2 True.
- 3 When the carrying amounts of the investment become different to the tax base of the investment.
- 4 Any three of:
 - Interest revenue received in arrears
 - Depreciation accelerated for tax purposes
 - Development costs capitalised in the statement of financial position
 - Prepayments
 - Sale of goods revenue recognised before the cash is received

5 \$43,800

	\$
Tax on profit ($150,000 \times 30\%$)	45,000
Overprovision	(3,000)
Deferred tax increase ($6,000 \times 30\%$)	1,800
	<u>43,800</u>

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q14	Introductory	20	39 mins

12

Foreign currency transactions

Topic list	Syllabus reference
1 Foreign currency translation	B11
2 IAS 21 <i>The Effects of Changes in Foreign Exchange Rates</i>	B11
3 Functional and reporting currency	B11

Introduction

In a global economy most companies trade overseas, buying and selling assets in foreign currencies. You need to be able to record transactions in foreign currency and translate monetary and non-monetary items at the reporting date.

Study guide

B11	The effects of changes in foreign currency exchange rates
(a)	Distinguish between reporting and functional currencies
(b)	Determine an entity's functional currency
(c)	Discuss the recording of transactions and translation of monetary/non-monetary items at the reporting date for individual entities in accordance with IFRSs

1 Foreign currency translation

FAST FORWARD

There are two distinct types of foreign currency transaction, **conversion** and **translation**. Translation is required at the end of an accounting period when a company still holds assets or liabilities in its statement of financial position which were obtained or incurred in a foreign currency.

If a company trades overseas, it will buy or sell assets in foreign currencies. For example, an Indian company might buy materials from Canada, and pay for them in Canadian dollars, and then sell its finished goods in Germany, receiving payment in euros, or perhaps in some other currency. If the company owes money in a foreign currency at the end of the accounting year or holds assets which were bought in a foreign currency then those liabilities or assets must be translated into the local currency (in this Text \$), in order to be shown in the books of account.

A company might have a subsidiary abroad (ie a foreign entity that it owns), and the subsidiary will trade in its own local currency. The subsidiary will keep books of account and prepare its annual accounts in its own currency. However, at the year end, the holding (parent) company must 'consolidate' the results of the overseas subsidiary into its group financial statements, so that somehow, the assets and liabilities and the annual profits of the subsidiary must be translated from the foreign currency into \$.

If foreign currency exchange rates remained constant, there would be no accounting problem. As you will be aware, however, foreign exchange rates are continually changing, and it is not inconceivable for example, that the rate of exchange between the Polish zloty and sterling might be Z6.2 to £1 at the start of the accounting year, and Z5.6 to £1 at the end of the year (in this example, a 10% increase in the relative strength of the zloty).

There are two distinct types of foreign currency transaction, conversion and translation.

1.1 Conversion gains and losses

Conversion is the process of exchanging amounts of one foreign currency for another. For example, suppose a local company buys a large consignment of goods from a supplier in Germany. The order is placed on 1 May and the agreed price is €124,250. At the time of delivery the rate of foreign exchange was €3.50 to \$1. The local company would record the amount owed in its books as follows.

DEBIT	Inventory account ($124,250 \div 3.5$)	\$35,500	
CREDIT	Payables account		\$35,500

When the local company comes to pay the supplier, it needs to obtain some foreign currency. By this time, however, if the rate of exchange has altered to €3.55 to \$1, the cost of raising €124,250 would be ($\div 3.55$) \$35,000. The company would need to spend only \$35,000 to settle a debt for inventories 'costing' \$35,500. Since it would be administratively difficult to alter the value of the inventories in the company's books of account, it is more appropriate to record a profit on conversion of \$500.

DEBIT	Payables account	\$35,500	
CREDIT	Cash		\$35,000
CREDIT	Profit on conversion		\$500

Profits (or losses) on conversion would be included in profit or loss for the year in which conversion (whether payment or receipt) takes place.

Suppose that another home company sells goods to a Chinese company, and it is agreed that payment should be made in Chinese Yuan at a price of Y116,000. We will further assume that the exchange rate at the time of sale is Y10.75 to \$1, but when the debt is eventually paid, the rate has altered to Y10.8 to \$1. The company would record the sale as follows.

DEBIT	Receivables account ($116,000 \div 10.75$)	\$10,800	
CREDIT	Sales account		\$10,800

When the Y116,000 are paid, the local company will convert them into \$, to obtain ($\div 10.8$) \$10,750. In this example, there has been a loss on conversion of \$50 which will be written off to profit or loss for the year:

DEBIT	Cash	\$10,750	
DEBIT	Loss on conversion	\$50	
CREDIT	Receivables account		\$10,800

There are **no accounting difficulties** concerned with foreign currency conversion gains or losses, and the procedures described above are uncontroversial.

1.2 Translation

Foreign currency translation, as distinct from conversion, does not involve the act of exchanging one currency for another. **Translation is required at the end of an accounting period when a company still holds assets or liabilities in its statement of financial position which were obtained or incurred in a foreign currency.**

These assets or liabilities might consist of any of the following:

- An individual home company holding individual **assets or liabilities** originating in a foreign currency 'deal'.
- An individual home company with a separate **branch** of the business operating abroad which keeps its own books of account in the local currency.
- A home company which wishes to consolidate the **results of a foreign subsidiary**.

There has been great **uncertainty** about the method which should be used to translate the following:

- Value of assets and liabilities from a foreign currency into \$ for the year end statement of financial position
- Profits of an independent foreign branch or subsidiary into \$ for the annual statement of profit or loss and other comprehensive income

Suppose, for example, that a Belgian subsidiary purchases a piece of property for €2,100,000 on 31 December 20X7. The rate of exchange at this time was €70 to \$1. During 20X8, the subsidiary charged depreciation on the building of €16,800, so that at 31 December 20X8, the subsidiary recorded the asset as follows.

Property at cost	€
	2,100,000
Less accumulated depreciation	16,800
Net carrying amount	<u>2,083,200</u>

At this date, the rate of exchange has changed to €60 to \$1.

The local holding (parent) company must translate the asset's value into \$, but there is a **choice of exchange rates**.

- Should the rate of exchange for translation be the rate which existed at the date of purchase, which would give a net carrying amount of $2,083,200 \div 70 = \$29,760$?
- Should the rate of exchange for translation be the rate existing at the end of 20X8 (the closing rate of €60 to \$1)? This would give a net carrying amount of \$34,720.

Similarly, should depreciation be charged to group profit or loss at the rate of €70 to \$1 (the historical rate), €60 to \$1 (the closing rate), or at an average rate for the year (say, €64 to \$1)?

2 IAS 21 *The Effects of Changes in Foreign Exchange Rates*

The questions discussed above are addressed by IAS 21 *The Effects of Changes in Foreign Exchange Rates*. We will examine those matters which affect single company accounts here.

2.1 Definitions

These are some of the definitions given by IAS 21.

Key terms

Foreign currency. A currency other than the functional currency of the entity.

Functional currency. The currency of the primary economic environment in which the entity operates.

Presentation currency. The currency in which the financial statements are presented.

Exchange rate. The ratio of exchange for two currencies.

Exchange difference. The difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Closing rate. The spot exchange rate at the year end date.

Spot exchange rate. The exchange rate for immediate delivery.

Monetary items. Units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.

(IAS 21: para. 8)

Each entity – whether an individual company, a parent of a group, or an operation within a group (such as a subsidiary, associate or branch) – should determine its **functional currency** and **measure its results and financial position in that currency**.

For most individual companies the functional currency will be the currency of the country in which they are located and in which they carry out most of their transactions. Determining the functional currency is much more likely to be an issue where an entity operates as part of a group. IAS 21 contains detailed guidance on how to determine an entity's functional currency and we will look at this in more detail in Section 3.

An entity can present its financial statements in any currency (or currencies) it chooses. IAS 21 deals with the situation in which financial statements are presented in a currency other than the functional currency.

Again, this is unlikely to be an issue for most individual companies. Their presentation currency will normally be the same as their functional currency (the currency of the country in which they operate).

2.2 Foreign currency transactions: initial recognition

IAS 21 states that a foreign currency transaction should be recorded, on initial recognition in the functional currency, by applying the exchange rate between the reporting currency and the foreign currency **at the date of the transaction** to the foreign currency amount.

An **average rate** for a period may be used if exchange rates do not fluctuate significantly.

2.3 Reporting at subsequent year ends

The following rules apply at each subsequent year end.

- (a) Report foreign currency **monetary items** using the **closing rate**

- (b) Report **non-monetary items** (eg non-current assets, inventories) which are carried at **historical cost** in a foreign currency using the **exchange rate at the date of the transaction** (historical rate)
- (c) Report **non-monetary items** which are carried at **fair value** in a foreign currency using the exchange rates that existed **when the values were measured**.

(IAS 21: para. 23)

2.4 Recognition of exchange differences

Exchange differences occur when there is a **change in the exchange rate** between the transaction date and the date of settlement of monetary items arising from a foreign currency transaction.

Exchange differences arising on the settlement of monetary items (receivables, payables, loans, cash in a foreign currency) or on translating an entity's monetary items at rates different from those at which they were translated initially, or reported in previous financial statements, should be **recognised in profit or loss** in the period in which they arise.

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.

In other words, where a monetary item has not been settled at the end of a period, it should be **restated using the closing exchange rate** and any gain or loss taken to profit or loss.



Question

Entries

White Cliffs Co, whose year end is 31 December, buys some goods from Rinka SA of France on 30 September. The invoice value is €40,000 and is due for settlement in equal instalments on 30 November and 31 January. The exchange rate moved as follows.

	€ = \$1
30 September	1.60
30 November	1.80
31 December	1.90
31 January	1.85

Required

State the accounting entries in the books of White Cliffs Co.

Answer

The purchase will be recorded in the books of White Cliffs Co using the rate of exchange ruling on 30 September.

DEBIT	Purchases	\$25,000	
CREDIT	Trade payables		\$25,000

Being the \$ cost of goods purchased for €40,000 ($€40,000 \div €1.60/\$1$)

On 30 November, White Cliffs must pay €20,000. This will cost $€20,000 \div €1.80/\$1 = \$11,111$ and the company has therefore made an exchange gain of $\$12,500 - \$11,111 = \$1,389$.

DEBIT	Trade payables	\$12,500	
CREDIT	Exchange gains: (P/L)		\$1,389
CREDIT	Cash		\$11,111

On 31 December, the year end, the outstanding liability will be recalculated using the rate applicable to that date: $\text{€}20,000 \div \text{€}1.90/\text{\$}1 = \$10,526$. A further exchange gain of \$1,974 has been made and will be recorded as follows.

DEBIT	Trade payables	\$1,974	
CREDIT	Exchange gains: (P/L)		\$1,974

The total exchange gain of \$3,363 will be included in the operating profit for the year ending 31 December.

On 31 January, White Cliffs must pay the second instalment of €20,000. This will cost them \$10,811 ($\text{€}20,000 \div \text{€}1.85/\text{\$}1$).

DEBIT	Trade payables	\$10,526	
	Exchange losses: (P/L)	\$285	
CREDIT	Cash		\$10,811

When a gain or loss on a non-monetary item is recognised in **other comprehensive income** (for example, where property is revalued), any **related exchange differences** should also be recognised in **other comprehensive income** (IAS 21: para. 30).

Exam focus point

The December 2015 paper included 7 marks for explaining the treatment of a non-current asset purchased from an overseas supplier.

3 Functional and reporting currency

FAST FORWARD

- The functional currency is the currency of the primary economic environment in which the entity operates.
- In order to determine the functional currency of a foreign operation it is necessary to consider the **relationship** between the foreign operation and its parent:
 - If the foreign operation carries out its business as though it were an **extension of the parent's operations**, it almost certainly has the **same functional currency** as the parent.
 - If the foreign operation is **semi-autonomous** it almost certainly has a **different functional currency** from the parent.

3.1 Determining functional currency

A holding or parent company with foreign operations must **translate the financial statements** of those operations into its own reporting currency before they can be consolidated into the group financial statements. There are two methods: **the method used depends upon whether** the foreign operation has the **same functional currency as the parent**.

IAS 21 states that an entity should consider the following factors in determining its functional currency:

- The currency that mainly **influences sales prices** for goods and services (often the currency in which prices are denominated and settled)
- The currency of the **country whose competitive forces and regulations** mainly determine the sales prices of its goods and services
- The currency that mainly **influences labour, material and other costs** of providing goods or services (often the currency in which prices are denominated and settled)

(IAS 21: para. 9)

Sometimes the functional currency of an entity is not immediately obvious. Management must then exercise judgement and may also need to consider (IAS 21: para. 10):

- (a) 'The currency in which **funds from financing activities** (raising loans and issuing equity) are generated
- (b) The currency in which **receipts from operating activities** are usually retained'

Where a parent has a foreign operation a number of factors are considered (IAS 21: para. 11):

- (a) Whether the activities of the foreign operation are carried out as an **extension of the parent**, rather than being carried out with a **significant degree of autonomy**
- (b) Whether **transactions with the parent** 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 parent** and are readily available for remittance to it
- (d) Whether the activities of the foreign operation are **financed from its own cash flows** or by **borrowing from the parent**

The translation method used has to reflect the economic reality of the relationship between the reporting entity (the parent) and the foreign operation.

3.1.1 Same functional currency as the reporting entity

In this situation, the foreign operation normally carries on its business as though it were an **extension of the reporting entity's operations**. For example, it may only sell goods imported from, and remit the proceeds directly to, the reporting entity.

Any **movement in the exchange rate** between the reporting currency and the foreign operation's currency will have an **immediate impact** on the reporting entity's cash flows from the foreign operations. In other words, changes in the exchange rate affect the **individual monetary items** held by the foreign operation, *not* the reporting entity's net investment in that operation.

3.1.2 Different functional currency from the reporting entity

In this situation, although the reporting entity may be able to exercise control, the foreign operation normally operates in a **semi-autonomous** way. It accumulates cash and other monetary items, generates income and incurs expenses, and may also arrange borrowings, all **in its own local currency**.

A change in the exchange rate will produce **little or no direct effect on the present and future cash flows** from operations of either the foreign operation or the reporting entity. Rather, the change in exchange rate affects the reporting entity's **net investment** in the foreign operation, not the individual monetary and non-monetary items held by the foreign operation.

Exam focus point

Practising examination questions is the best way of learning this topic.

3.2 Change in functional currency

The functional currency of an entity can be changed only if there is a change to the underlying transactions, events and conditions that are relevant to the entity. For example, an entity's functional currency may change if there is a change in the currency that mainly influences the sales price of goods and services.

Where there is a change in an entity's functional currency, the entity should translate all items into the new functional currency **prospectively** (ie from the date of the change) using the exchange rate at the date of the change (IAS 21: para. 35).

Chapter Roundup

- There are two distinct types of foreign currency transaction, **conversion** and **translation**. Translation is required at the end of an accounting period when a company still holds assets or liabilities in its statement of financial position which were obtained or incurred in a foreign currency.
- The functional currency is the currency of the primary economic environment in which the entity operates.
- In order to determine the functional currency of a foreign operation it is necessary to consider the **relationship** between the foreign operation and its parent:
 - If the foreign operation carries out its business as though it were an **extension of the parent's operations**, it almost certainly has the **same functional currency** as the parent.
 - If the foreign operation is **semi-autonomous** it almost certainly has a **different functional currency** from the parent.

Quick Quiz

- 1 What is the difference between conversion and translation?
- 2 Define 'monetary' items according to IAS 21.
- 3 How should foreign currency transactions be recognised initially in an individual entity's accounts?
- 4 When can an entity's functional currency be changed?
- 5 When can an entity's presentation currency be changed?

Answers to Quick Quiz

- 1 (a) Conversion is the process of exchanging one currency for another.
(b) Translation is the restatement of the value of one currency in another currency.
- 2 Money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.
- 3 Use the exchange rate at the date of the transaction. An average rate for a period can be used if the exchange rates did not fluctuate significantly.
- 4 Only if there is a change to the underlying transactions relevant to the entity.
- 5 Whenever the entity wants to. An entity chooses the presentation currency which it wants to use and can change it whenever it decides to.

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q15	Practice	10	20 mins

13

Other assets: agriculture, mineral resources and inventories

Topic list	Syllabus reference
1 IAS 41 <i>Agriculture</i>	B12
2 IFRS 6 <i>Exploration for and Evaluation of Mineral Resources</i>	B14
3 IAS 2 <i>Inventories</i>	B6

Introduction

In this chapter we deal with agriculture and biological assets (IAS 41), mineral resources (IFRS 6) and inventories (IAS 2). You will probably have encountered IAS 2 in your previous studies, so this material will be a revision for you. Nevertheless, make sure you are familiar with the requirements of IAS 2.

Study Guide

B12	Agriculture
(a)	Recognise the scope of international accounting standards for agriculture
(b)	Discuss the recognition and measurement criteria including the treatment of gains and losses, and the inability to measure fair value reliably
(c)	Identify and explain the treatment of government grants, and the presentation and disclosure of information relating to agriculture
(d)	Report on the transformation of biological assets and agricultural produce at the point of harvest and account for agriculture related government grants
B14	Exploration and evaluation expenditures
(a)	Outline the need for an accounting standard in this area and clarify its scope
(b)	Give examples of elements of cost that might be included in the initial measurement of exploration and evaluation assets
(c)	Describe how exploration and evaluation assets should be classified and reclassified
(d)	Explain when and how the exploration and evaluation assets should be tested for impairment
B5	Intangible assets and goodwill
(g)	Describe the method of accounting specified by the IASB for the exploration for and evaluation of mineral resources
B6	Inventories
	Measure and value inventories

1 IAS 41 Agriculture

FAST FORWARD

IAS 41 applies the requirements of IFRS to the treatment of biological assets.

Exam focus point

This is not a frequently-examined area, but IAS 41 has recently become more topical which increases the possibility of it coming up in an exam. Please give it proper attention and bear in mind that it fits well with IAS 20.

1.1 Introduction

The importance of the agricultural sector in a country's economy will vary. It is reasonable to assume, however, that although agriculture is important in first world countries, it is likely to be of greater significance to developing countries

IAS 41 has contributed to the international harmonisation of accounting standards, because agriculture in particular was characterised by a **great diversity in accounting treatments**. Cows, for instance, were accounted for as 'inventories' in Ireland but as 'non-current assets' in the UK. IAS 41 has helped to foster increased comparability between accounts produced in these different regions.



Question

Agriculture

If you work in agriculture, or if agriculture is important in your country, you may like to investigate the accounting treatment of items such as forestry activity or livestock activity in your country. Are there differences within your own country? How do these practices compare with other countries?

It is quite difficult to apply **traditional accounting methods** to agricultural activities, which explains why agriculture is excluded from many IFRSs.

- (a) When and how do you account for the **critical events** associated with biological transformation (growth, procreation, production and degeneration), which alter the substance of biological assets?
- (b) **Statement of financial position classification** is made difficult by the variety and characteristics of the living assets of agriculture.
- (c) The nature of the management of agricultural activities also causes problems, particularly determination of the **unit of measurement**, ie whether biological assets are a perpetual group of assets or a number of limited life assets.

IAS 41 seeks to improve and harmonise practice in accounting for agriculture, which demonstrates fundamental **differences in its nature and characteristics** to other business activities.

1.2 Definitions

Key terms

Agricultural activity is the management by an entity of the biological transformation and harvest of biological assets for sale or for conversion into agricultural produce or into additional biological assets.

Agricultural produce is the harvested product of an entity's biological assets.

A **biological asset** is a living animal or plant.

A **bearer plant** is 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.

Biological transformation comprises the processes of growth, degeneration, production and procreation that cause qualitative and quantitative changes in a biological asset.

A **group of biological assets** is an aggregation of similar living animals or plants.

Harvest is the detachment of produce from a biological asset or the cessation of a biological asset's life processes.

(IAS 41: para. 5)

Note the key parts of the definition of **agriculture**.

- (a) **Biological:** agriculture relates to 'life phenomena', living animals and plants with an innate capacity of biological transformation which are dependent upon a combination of natural resources (sunlight, water, etc).
- (b) **Transformation:** agriculture involves physical transformation, whereby animals and plants undergo a change in biological quantity (fat cover, density, etc) and/or quantity (progeny, live weight etc) over time, which is measured and monitored (increasingly objectively) as part of management control.
- (c) **Management:** biological transformation is managed.
 - (i) Conditions are stabilised or enhanced
 - (ii) The transparency of the relationship between inputs and outputs is determined by the degree of control (intensive versus extensive)
 - (iii) It is different from exploitation through extraction, where no attempt is made to facilitate the transformation
 - (iv) Biological assets are managed in groups of plant or animal classes, using individual assets to ensure the sustainability of the group
 - (v) Sustainability of an agricultural activity is a function of quality and quantity
- (d) **Produce:** agricultural produce is diverse and may require further processing before ultimate consumption.

- (e) **Harvest:** IAS 41 only applies up to the point of harvest and not to any further transformations or processes that occur after that point. For example, in the case of dairy farming, cows are biological assets from which milk is harvested as the agricultural produce. All of which would be accounted for under IAS 41. Any further processing after the milk is harvested, for example by turning the milk into cheese, would be outside the scope of IAS 41.

Bearer plants are specifically excluded from the scope of IAS 41, see Section 1.3.1.

1.3 Scope

FAST FORWARD

In relation to agriculture you should be able to discuss:

- Accounting for biological assets
- Transformation and changes in substance
- Unit of measurement and changes in the carrying amount

The standard applies to the three elements that form part of, or result from, agricultural activity (IAS 41: para. 1):

- Biological assets, except for bearer plants
- Agricultural produce at the point of harvest
- Government grants

The standard does not apply to agricultural land (IASs 16 and 40), intangible assets related to agricultural activity (IAS 38), bearer plants or associated government grants, or to right-of-use assets from agricultural land that has been leased (IAS 41: para. 2). After harvest, IAS 2 is applied.

1.4 Biological assets

Biological assets are the core income-producing assets of agricultural activities, held for their transformative capabilities. **Biological transformation** leads to various **different outcomes**.

- **Asset changes:**
 - Growth: increase in quantity and or quality
 - Degeneration: decrease in quantity and/or quality
- **Creation of new assets:**
 - Production: producing separable non-living products
 - Procreation: producing separable living animals

We can distinguish between the importance of these by saying that asset changes are **critical to the flow of future economic benefits** both in and beyond the current period, but the relative importance of new asset creation will depend on the purpose of the agricultural activity.

The IAS distinguishes therefore between two broad categories of agricultural production system.

- (a) **Consumable:** animals/plants themselves are harvested
(b) **Bearer:** animals/plants bear produce for harvest

A few further points are made.

- (a) Biological assets are usually managed in groups of animal or plant classes, with characteristics (eg male/female ratio) which allow **sustainability in perpetuity**.
(b) **Land often forms an integral part** of the activity itself in pastoral and other land-based agricultural activities.

1.4.1 Bearer plants

Bearer plants are excluded from the scope of IAS 41. Bearer plants include trees grown in plantations, such as grape vines, rubber trees and oil palms.

These plants are used solely to grow produce crops over several periods and are not in themselves consumed. When no longer productive they are usually scrapped.

Bearer plants should be accounted for under IAS 16 *Property, Plant and Equipment*. They are measured at accumulated costs until maturity and are then subject to depreciation and impairment charges. The IAS 16 revaluation model could also be applied. Agricultural produce from these plants continues to be recognised under IAS 41/IAS 2.

1.4.2 Recognition of biological assets

The recognition criteria are very **similar to those for other assets**, in that animals or plants should be recognised as assets in the following circumstances.

- (a) The entity **controls** the asset as a result of past events.
- (b) It is probable that the **future economic benefits** associated with the asset will flow to the entity.
- (c) The fair value or cost of the asset to the entity can be **measured reliably**.

(IAS 41: para.10)

The significant physical attributes of biological assets can be measured using various methods (which are used by markets to measure value) and generally indicate the source of future economic benefits. The **certainty** of the flow of rewards can be determined by formal ownership records, eg land title, branding. The availability of both cost and value for biological assets indicates the reliability aspect of the measurement criteria is fulfilled.

1.4.3 Measurement of biological assets

The IAS requires that at each year end **all biological assets should be measured at fair value** less estimated point-of-sale costs.

The IAS allows an alternative method of valuation, if a fair value cannot be determined because market-determined prices or values are not available. Then the biological asset can be measured at cost less accumulated depreciation and impairment losses.

This alternative basis is only allowed on **initial recognition**.

The **measurement basis** used to depict the fair value of a biological asset will differ depending on the existence of an active market, market efficiency and the use made of the asset. In summary, it is felt that **fair value**, when compared to historical cost, has greater relevance, reliability, comparability and understandability as a measure of future economic benefits.

1.4.4 Measuring fair value

The standard states that the primary indicator of fair value should be **net market value**. This is reasonable as efficient markets exist for most biological assets in most locations and net market value is usually considered as providing the best evidence of fair value where an active market exists. Markets will generally differentiate between differing **qualities and quantities**. Market value is not generally predicated on management's intended use, however, but recognises alternative uses.

IFRS 13 requires the fair value of a biological asset to be determined by reference to the **principal market** for the asset. This may or may not be the most favourable market.

An active and efficient market may not be available for a class of biological assets in a specific location, or there may be imperfections in the market. The standard goes into some detail about **how fair value should be measured** in such circumstances, but in summary the valuation techniques should be consistent with the objectives of measuring fair value and should attain an appropriate balance between relevance and reliability.

1.4.5 Recognition

In the **statement of financial position** the biological assets must be shown at fair value less estimated point of sale costs, incorporating the consequences of all biological transformations.

A gain or loss arising on initial recognition of a biological asset at fair value less estimated point of sale costs and from a change in fair value less estimated point of sale costs is included in profit or loss in the period in which it arises.

(IAS 41: para. 26)

Changes to fair value can arise due to both physical changes in the asset and price changes in the market. Entities are encouraged to make separate disclosure of these two elements in order to facilitate performance appraisal.

(IAS 41: para. B74)

There are **exceptions to this approach** in certain situations. For example, in some agricultural systems the predominant activity has a production cycle of less than a year (eg broiler chickens, mushroom growing, cereal crops). In such cases the total change in carrying amount is reported in profit or loss as a single item of income or expense.

(IAS 41: para. B76)

1.4.6 Presentation and disclosure

In the **statement of financial position** biological assets should be classified as a separate class of assets falling under neither current nor non-current classifications. This reflects the view of such assets as having an unlimited life on a collective basis; it is the total exposure of the entity to this type of asset that is important.

Biological assets should also be **sub-classified** (either in the statement of financial position or as a note to the financial statements).

- (a) Class of animal or plant
- (b) Nature of activities (consumable or bearer)
- (c) Maturity or immaturity for intended purpose

Where activities are **consumable**, the maturity criterion will be attainment of harvestable specifications, whereas in **bearer** activities, it will be attainment of sufficient maturity to sustain economic harvests.

1.5 Agricultural produce

This was defined in the key terms above. It is **recognised at the point of harvest** (eg detachment from the biological asset). Agricultural produce is either incapable of biological process or such processes remain dormant (eg stored grain). **Recognition ends** once the produce enters trading activities or production processes within integrated agribusinesses, although processing activities that are incidental to agricultural activities and that do not materially alter the form of the produce (eg drying or cleaning) are not counted as processing. Following harvest, the provisions of IAS 2 apply.

1.5.1 Measurement and presentation

Following the treatment of biological assets above, the IAS states that agricultural produce should be **measured at each reporting date at fair value** less estimated point-of-sale costs, to the extent that it is sourced from an entity's biological assets, which are also valued at fair value (IAS 41: para.13). This is logical when you consider that, until harvest, the agricultural produce was valued at fair value anyway as part of the biological asset.

The **change in the carrying amount** of the agricultural produce held at two reporting dates should be recognised as **income or expense** in profit or loss. This will be rare as such produce is usually sold or processed within a short time, so that produce held over two reporting dates is being held for a specific management purpose and the consequences of that should be reflected in the current period.

Agricultural produce that is harvested for **trading or processing activities** within integrated agricultural/agribusiness operations should be measured at **fair value** at the date of harvest and this amount is deemed cost for application of IAS 2 to consequential inventories.

1.5.2 Presentation in the statement of financial position

Agricultural produce should be classified as inventory in the statement of financial position and disclosed separately either in the statement of financial position or in the notes.

1.6 Government grants related to agriculture

FAST FORWARD

In relation to government grants you should be able to explain treatment, presentation and disclosure.

'An unconditional government grant related to a biological asset measured at its fair value less estimated point-of-sale costs should be recognised as income when, and only when, the grant becomes receivable' (IAS 41: para.34)

If a government grant requires an entity not to engage in specified agricultural activity (eg the EU's set aside grant), an entity should only recognise the grant as income when, and only when, the conditions are met (IAS 41: para. 35).

IAS 20 does not apply to a government grant on biological assets measured at fair value less estimated point-of-sale costs. However if a biological asset is measured at cost less accumulated depreciation and accumulated impairment losses then IAS 20 does apply.

Exam focus point

A useful article on IAS 41 is available on ACCA's website: www.accaglobal.com/gb/en/student/exam-support-resources/dipifr-study-resources/technical-articles.html

2 IFRS 6 *Exploration for and Evaluation of Mineral Resources*

FAST FORWARD

IFRS 6 requires that mineral resources on initial recognition are measured at cost.

- Subsequent measurement may be based on either the **cost model** or the **revaluation model**.
- Assets must be **assessed for impairment** in accordance with IAS 36.

2.1 Reasons for issuing IFRS 6

IFRS 6 is an interim standard. It is only a short-term solution to the problems of accounting in this area, and was issued so that entities had at least **some** guidance until a complete standard is issued in the future. Before IFRS, accounting practices varied greatly between national standard-setters, so it was important that, with more and more entities switching to IFRS, there was at least some IFRS guidance in the area. Since it had had to be specifically excluded from IAS 16 and IAS 38, the IASB developed and issued IFRS 6.

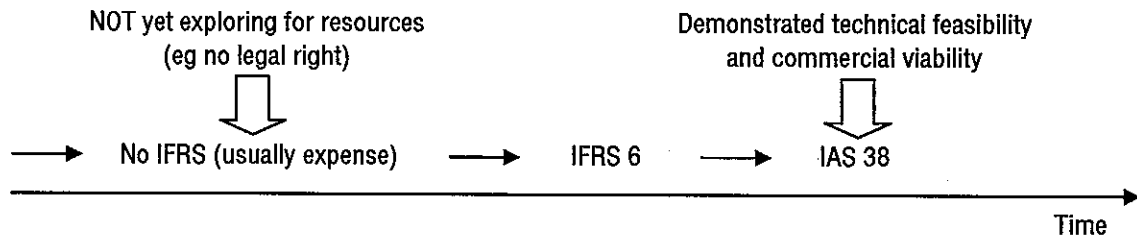
'Extractive activities' are included in the IASB's research pipeline. In 2010, discussion paper DP/2010/1 'Extractive Activities' was issued. Work has not progressed much further since then, however, in 2018, the IASB decided that its staff should aim to recommence work on this area in the near future.

IFRS 6 is related to IAS 38's distinction between research and development phases, where research costs are expensed and development costs are capitalised. The problem is that the exploration for and evaluation of mineral resources is not quite research and not quite development – hence the need for IFRS 6.

2.2 Scope

The scope of IFRS 6 is intentionally very narrow. Entities must apply IFRS 6 to all exploration and evaluation expenditure incurred, but it does not address other aspects of their accounting.

Moreover, IFRS 6 only applies **after** the entity has obtained legal rights to explore in a specific area, but **before** extraction has been demonstrated to be both technically feasible and commercially viable.



Key terms

Exploration and evaluation expenditures are expenditures incurred by an entity in connection with the exploration for and evaluation of mineral resources before the technical feasibility and commercial viability of extracting a mineral resource are demonstrable.

Exploration and evaluation assets are exploration and evaluation expenditures recognised as assets in accordance with the entity's accounting policy.

Exploration for and evaluation of mineral resources is the search for mineral resources, including minerals, oil, natural gas and similar non-regenerative resources after the entity has obtained legal rights to explore in a specific area, as well as the determination of the technical feasibility and commercial viability of extracting the mineral resource.

(IFRS 6: Appendix A)

2.3 Recognition

Expenditure is recognised as an asset for IFRS 6 until the technical feasibility and commercial viability of extracting resources can be demonstrated. Note that this also means that the entity must have the necessary technical and financial means to extract the resources.

An entity can then choose its own accounting policy as long as it is in line with IAS 8. Specifically, it must conform to IAS 8 paragraph 10, which states that **management should use its judgement** in developing an **accounting policy** that results in information that is **relevant** and **reliable**. After choosing their policy, entities must then **apply their policy consistently**.

Note that expenditure related to the **development** of mineral resources must not be recognised as exploration and evaluation assets under IFRS 6, as they come under IAS 38.

2.4 Measurement at recognition

At recognition, exploration and evaluation **assets must be measured at cost**.

The following are examples of expenditures an entity might incur in the initial measurement of exploration and evaluation assets:

- (a) Acquisition of rights to explore
- (b) Topographical geological, geochemical and geophysical studies
- (c) Exploratory drilling
- (d) Trenching
- (e) Sampling
- (f) Activities in relation to evaluating the technical feasibility and commercial viability of extracting a mineral resource

(IFRS 6: para. 9)

An entity should also recognise the cost of any obligations for removal and restoration, in line with IAS 37.

Exam focus point

The syllabus explicitly requires the ability to give examples of elements of cost that might be included in the initial recognition in the financial statements. It would be advisable to learn the above, non-exhaustive, list!

2.5 Example: Cost

Gold Diggers Co is a mining company currently exploring and evaluating the possibilities for extracting gold from the deserts of South Australia. It has incurred the following costs in the year ended 20X1.

	\$'000
Legal expenses relating to acquisition of land in which exploration is to take place	15,000
Legal expenses relating to acquisition of right to explore land	12,000
Exploratory drilling costs	123,000
General administrative overheads allocated to exploration of land in S Australia	25,000
Costs of extracting gold	152,000

Which of the above costs may be capitalised as exploration and evaluation assets in accordance with IFRS 6?

Solution

The following costs **can** be capitalised in accordance with IFRS 6:

	\$'000
Legal expenses relating to acquisition of right to explore land	12,000
Exploratory drilling costs	123,000

The following costs **cannot** be capitalised in accordance with IFRS 6 and should be expensed:

	\$'000
General administrative overheads allocated to exploration of land in S Australia (<i>Note 1</i>)	25,000
Costs of extracting gold (<i>Note 2</i>)	152,000

The following costs **cannot** be capitalised in accordance with IFRS 6, but can be capitalised in accordance with other standards:

	\$'000
Legal expenses relating to acquisition of land in which exploration is to take place (<i>Note 3</i>)	15,000

Notes

- 1 General administrative overheads do not relate to the exploration and evaluation of resources, and must be expensed.
- 2 The costs of extracting gold are incurred after the process of exploration and evaluation has ended, and are not therefore accounted for in accordance with IFRS 6. They are costs incurred in the ordinary course of the business, and will likely be expensed as they are unlikely to qualify as intangible assets under IAS 38.
- 3 The land is acquired before the process of exploration and evaluation begins (because by definition the entity cannot be exploring and evaluating resources on land it does not own). The legal expenses relating to the acquisition are therefore not accounted for in line with IFRS 6, but are instead capitalised as part of the carrying amount of the land in accordance with IAS 16.

2.6 Measurement after recognition

Entities must apply either the **cost model** or the **revaluation model** (taking the revaluation model either from IAS 16 or IAS 38).

2.7 Classification and reclassification

Exploration and evaluation assets are classified as **tangible or intangible according to the nature** of the assets acquired. For example, drilling rights would be intangible; vehicles or drilling rigs would be tangible. The classification must be applied consistently.

They should no longer be classified as exploration and evaluation assets when the technical feasibility and commercial viability of extracting a mineral resource are demonstrable. Any impairment loss on the assets must be recognised before classification.

2.8 Impairment

Exploration and evaluation assets must be **assessed for impairment when facts and circumstances suggest that the carrying amount of an asset may exceed its recoverable amount. Any resulting impairment loss must be measured, presented and disclosed in accordance with IAS 36.**

The following **factors** suggest exploration and evaluation assets should be tested for impairment:

- (a) The period for which the entity has **exploration rights has expired** or is due to expire in the near future and is not expected to be reviewed.
- (b) **Substantive expenditure** on further exploration in the specific area is **not budgeted** or planned.
- (c) Exploration in a specific area has **not** led to the discovery of **commercially viable quantities** of mineral resources, and the entity has decided to discontinue activities in this area.
- (d) Sufficient data indicates that whilst a development in a specific area may proceed, the **carrying value of the exploration and evaluation asset is unlikely to be recovered** from successful development and sale.

(IFRS 6: para. 20)

For impairment purposes, each cash generating unit or group of units to which an exploration and evaluation asset is allocated must not be larger than a segment as determined by IFRS 8 *Operating Segments*.

(IFRS 6: para. 21)

Exam focus point

A useful article on IFRS 6 is available on ACCA's website: www.accaglobal.com/gb/en/student/exam-support-resources/dipifr-study-resources/technical-articles.html

3 IAS 2 Inventories

FAST FORWARD

- Inventories can include any of the following:
 - Goods purchased and held for resale
 - Finished goods produced
 - Work in progress being produced
 - Raw materials
- The cost of inventories includes the cost of purchase and conversion plus other costs incurred in bringing the inventories to their present location and condition.
- The cost of inventories should be assigned using the **first-in, first-out (FIFO)** or **weighted average** cost. The use of **LIFO** is **prohibited** under IAS 2.
- Inventories should be measured at the **lower of cost and net realisable value (NRV)**.

3.1 IAS 2 Inventories

IAS 2 lays out the required accounting treatment for inventories. The major area of contention is the **cost value of inventory** to be recorded. This is recognised as an asset of the entity until the related revenues are recognised (ie the item is sold) at which point the inventory is recognised as an expense (ie cost of sales). Part or all of the cost of inventories may also be expensed if a write-down to **net realisable value** is necessary. The IAS also provides guidance on the cost formulas that are used to assign costs to inventories.

In other words, the fundamental accounting assumption of **accruals** requires costs to be matched with associated revenues. In order to achieve this, costs incurred for goods which remain unsold at the year end must be carried forward in the statement of financial position and matched against future revenues.

3.2 Scope

The following items are **excluded** from the scope of the standard:

- **Financial instruments** (ie shares, bonds)
- **Biological assets**

(IAS 2: para. 2)

3.3 Definitions

Key terms

Inventories are assets:

- Held for sale in the ordinary course of business;
- In the process of production for such sale; or
- In the form of materials or supplies to be consumed in the production process or in the rendering of services.

Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

(IAS 2: para. 6)

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.

(IFRS 13: para. 9)

Inventories can include any of the following.

- **Goods purchased and held for resale**, eg goods held for sale by a retailer, or land and buildings held for resale
- **Finished goods** produced
- **Work in progress** being produced
- Materials and supplies awaiting use in the production process (**raw materials**)

(IAS 2: para. 8)

3.4 Measurement of inventories

The **cost** of inventories will consist of all costs of:

- **Purchase**
- **Costs of conversion**
- **Other costs** incurred in bringing the inventories to their **present location and condition**

(IAS 2: para. 10)

The costs of **purchase** of inventories includes:

- **Purchase price** *plus*;
- **Import duties** and other taxes *plus*;
- Transport, handling and any other cost **directly attributable** to the acquisition of finished goods, services and materials *less*;
- **Trade discounts**, rebates and other similar amounts.

(IAS 2: para. 11)

Costs of **conversion** of inventories consist of two main parts.

- (a) Costs **directly related** to the units of production, eg direct materials, direct labour
- (b) Fixed and variable **production overheads** that are incurred in converting materials into finished goods, allocated on a systematic basis

(IAS 2: para. 12)

You may have come across the terms 'fixed production overheads' or 'variable production overheads' elsewhere in your studies. The standard defines them as follows.

Key terms

Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, eg the cost of factory management and administration.

Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, eg indirect materials and labour.

(IAS 2: para. 12)

Fixed production overheads must be allocated to items of inventory on the basis of the **normal capacity of the production facilities**. This is an important point.

- (a) **Normal capacity** is the expected achievable production based on the average over several periods/seasons, under normal circumstances.
- (b) The above figure should take account of the capacity lost through **planned maintenance**.
- (c) If it approximates to the normal level of activity then the **actual level of production** can be used.
- (d) **Low production or idle plant** will **not** result in a higher fixed overhead allocation to each unit.
- (e) **Unallocated overheads** must be recognised as an expense in the period in which they were incurred.
- (f) When production is **abnormally high**, the fixed production overhead allocated to each unit will be reduced, so avoiding inventories being stated at more than cost.
- (g) The allocation of variable production overheads to each unit is based on the **actual use** of production facilities.

(IAS 2: para. 13)

3.4.1 Other costs

Any other costs should only be recognised if they are incurred in bringing the inventories to their **present location and condition**.

The standard lists types of cost which **would not be included** in cost of inventories. Instead, they should be recognised as an **expense** in the period they are incurred.

- (a) **Abnormal amounts** of wasted materials, labour or other production costs
- (b) **Storage costs** (except costs which are necessary in the production process before a further production stage)
- (c) **Administrative overheads** not incurred to bring inventories to their present location and conditions
- (d) **Selling costs**

(IAS 2: para. 16)

3.5 Cost formulae

Where inventories consist of a large number of interchangeable (ie identical or very similar) items, the cost of inventories should be assigned by using the **first-in, first-out (FIFO)** or **weighted average** cost formulas. The LIFO formula (last in, first out) is **not permitted** by IAS 2.

Where individual items of inventory are segregated for a specific project, specific costs should be attributed to those items of inventory.

3.6 Net realisable value

Inventories should be measured at the **lower of cost and net realisable value (NRV)**.

In the case of inventories NRV could fall below cost when items are **damaged or become obsolete**, or where the **costs to completion have increased** in order to make the sale.

In fact we can identify the principal situations in which **NRV is likely to be less than cost**, ie where there has been:

- (a) **An increase in costs or a fall in selling price**
- (b) **A physical deterioration** in the condition of inventory

Important

- (c) **Obsolescence of products**
- (d) A decision as part of the company's marketing strategy to manufacture and sell products at a loss
- (e) **Errors in production or purchasing**

A write down of inventories would normally take place on an item by item basis, but similar or related items may be **grouped together**. This grouping together is acceptable for, say, items in the same product line, but it is not acceptable to write down inventories based on a whole classification (eg finished goods) or a whole business.

The assessment of NRV should take place **at the same time** as estimates are made of selling price, using the most reliable information available. Fluctuations of price or cost should be taken into account if they relate directly to **events after the reporting period**, which confirm conditions existing at the end of the period.

The reasons why inventory is held must also be taken into account. Some inventory, for example, may be held to satisfy a firm contract and its NRV will therefore be the **contract price**. Any additional inventory of the same type held at the period end will, in contrast, be assessed according to general sales prices when NRV is estimated.

Net realisable value must be reassessed at the end of each period and compared again with cost. If the NRV has risen for inventories held over the end of more than one period, then the previous write down must be **reversed** to the extent that the inventory is then valued at the lower of cost and the new NRV. This may be possible when selling prices have fallen in the past and then risen again.

On occasion a write down to NRV may be of such size, incidence or nature that it must be **disclosed separately**.

3.7 Recognition as an expense

The following treatment is required **when inventories are sold**.

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



Question

Inventory valuation

A company has inventory on hand at the end of the reporting period as follows:

	Units	Raw material cost	Attributable production overheads	Attributable selling costs	Expected selling
		\$	\$	\$	\$
Item A	300	160	15	12	185
Item B	250	50	10	10	75

Required

At what amount will inventories be stated in the statement of financial position in accordance with IAS 2?

Answer

	<i>Units</i>	<i>Cost</i>	<i>NRV</i>	<i>Lower</i>	<i>Total</i>
		\$	\$	\$	\$
Item A	300	175	173	173	51,900
Item B	250	60	65	60	15,000
					<u>66,900</u>

Chapter Roundup

- IAS 41 applies the requirements of IFRS to the treatment of biological assets.
- In relation to agriculture you should be able to discuss:
 - Accounting for biological assets
 - Transformation and changes in substance
 - Unit of measurement and changes in the carrying amount
- In relation to government grants you should be able to explain treatment, presentation and disclosure.
- IFRS 6 requires that mineral resources at initial recognition are measured at cost.
 - Subsequent measurement may be based on either the **cost model** or the **revaluation model**.
 - Assets must be **assessed for impairment** in accordance with IAS 36.
- Inventories can include any of the following:
 - Goods purchased and held for resale
 - Finished goods produced
 - Work in progress being produced
 - Raw materials
- The cost of inventories includes the cost of purchase and conversion plus other costs incurred in bringing the inventories to their present location and condition.
- The cost of inventories should be assigned using the **first-in, first-out (FIFO)** or **weighted average cost**. The use of **LIFO** is **prohibited** under IAS 2.
- Inventories should be measured at the **lower of cost and net realisable value (NRV)**.

Quick Quiz

- 1 What is a biological asset?
- 2 What is agricultural produce?
- 3 What are the two categories in the agricultural production system?
- 4 IAS 41 has abolished the concept of cost for measurement purposes. True/False?
- 5 An entity has just begun exploring a previously unexplored area of ocean for oil. It has discovered oil there and there is an active market to sell to. The entity is unsure, however, if it can raise the necessary funds to complete the exploration process. What is the required treatment of the exploration costs incurred?
- 6 Net realisable value = Selling price **less** **less**
- 7 Which inventory costing method is allowed under IAS 2?
 - (a) FIFO
 - (b) LIFO

Answers to Quick Quiz

- 1 A biological asset is a living animal or plant.
- 2 Agricultural produce is product harvested from biological assets.
- 3 Consumable and bearer
- 4 False. Cost is still allowed if fair value is not available at initial recognition.
- 5 The costs are recognised as expenses in profit and loss, as the entity does not have the financial resources to bring any asset to market and to receive future benefits from it.
- 6 Net realisable value = selling price **less** costs to completion **less** costs necessary to make the sale.
- 7 (a) FIFO. LIFO is not allowed.

Now try the questions below from the Practice Question Bank

Number	Level	Marks	Time
Q16	Examination	10	20 mins

Share-based payment

14

Topic list	Syllabus reference
1 IFRS 2 <i>Share-based Payment</i>	B13
2 Deferred tax implications	B13

Introduction

This chapter deals with IFRS 2 on share-based payments, a controversial area. The material in this chapter relates to equity settled and cash settled transactions.

Study guide

B13	Share-based payment
(a)	Understand the term 'share-based payment'
(b)	Discuss the key issue that measurement of the transaction should be based on fair value
(c)	Explain the difference between cash-settled share-based payment transactions and equity-settled share-based payment transactions
(d)	Identify the principles applied to measuring both cash and equity settled share-based payment transactions
(e)	Compute the amounts that need to be recorded in the financial statements when an entity carries out a transaction where the payment is share based

1 IFRS 2 *Share-based payment*

FAST FORWARD

- IFRS 2 requires entities to **recognise** the goods or services received as a result of **share-based payment transactions**.
- The required accounting treatment depends on the type of share-based payment:
 - Equity settled transactions: DEBIT Asset/Expense, CREDIT Equity
 - Cash settled transactions: DEBIT Asset/Expense, CREDIT Liability
- Transactions are **recognised when goods/services are obtained/received**
- If there are **vesting conditions** attached to the equity instruments granted, the share-based payment expense should be **spread over the vesting period**.
- Transactions are measured at fair value, using year-end estimates of instruments expected to vest and **fair values** of instruments at **grant date (equity-settled)** and at **year end (cash-settled)**.

Exam focus point

Share-based payment is a popular exam topic and is examined in some way or another in almost every sitting.

1.1 Background

Transactions whereby entities purchase goods or services from other parties, such as suppliers and employees, by **issuing shares or share options** to those other parties are **increasingly common**. Share schemes are a common feature of director and executive remuneration and in some countries the authorities may offer tax incentives to encourage more companies to offer shares to employees. Companies whose shares or share options are regarded as a valuable 'currency' commonly use share-based payment to obtain employee and professional services.

The use of share-based payment has increased in recent years. Until the issue of IFRS 2 *Share-based Payment* there was no IFRS on this topic, other than disclosures formerly required for 'equity compensation benefits' under IAS 19 *Employee Benefits*.

Improvements in accounting treatment were called for. In particular, the omission of expenses arising from share-based payment transactions with employees was believed to cause economic distortions and corporate governance concerns.

1.1.1 Objective and scope

IFRS 2 requires an entity to **reflect the effects of share-based payment transactions** in its profit or loss and financial position (IFRS 2: para. 1).

IFRS 2 applies to all share-based payment transactions. There are three types.

- (a) **Equity-settled share-based payment transactions**, in which the entity receives goods or services in exchange for equity instruments of the entity (including shares or share options) (IFRS 2: Appendix A)
- (b) **Cash-settled share-based payment transactions**, in which 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 (IFRS 2: Appendix A)
- (c) Transactions in which the entity receives or acquires 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 (IFRS 2: para. 2)

Exam focus point

Share-based payments with a choice of settlement are excluded from the DipIFR syllabus.

Key terms

1.1.2 Definitions

Share-based payment transaction. A transaction in which the entity:

- (a) Receives goods or services from the supplier of those goods or services (including an employee) in a **share-based payment arrangement**; or
- (b) Incurs an obligation to settle the transaction with the supplier in a **share-based payment arrangement** when another group entity receives those goods or services.

Share-based payment arrangement. An agreement between the entity (or another group entity or any shareholder of any group entity) and another party (including an employee) that entitles the other party to receive:

- (a) Cash or other assets of the entity 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; or
- (b) **Equity instruments** (including shares or **share options**) of the entity or another group 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.

Fair value. The amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction. (Note that this definition is different from that in IFRS 13 *Fair Value Measurement*, but the IFRS 2 definition applies.)

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 condition. A condition that determines whether the entity receives the services that entitle the counterparty to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement. A vesting condition is either a service condition or a performance condition.

Vesting period. The period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied.

1.2 Vesting conditions

Vesting conditions are the conditions that must be satisfied for the counterparty to become unconditionally entitled to receive payment under a share-based payment agreement (IFRS 2: Appendix A).

Vesting conditions can be market-based or non-market based.

Vesting conditions include **service conditions** and **performance conditions**. Other features, such as a requirement for employees to make regular contributions into a savings scheme, are not vesting conditions.

(IFRS 2: para. 15)

1.2.1 Service conditions

Service conditions are where the counterparty is required to complete a specified period of service (IFRS 2: Appendix A). This is the typical scenario in which an employee is required to complete a specified period of service.

The share-based payment is recognised over the required period of service (IFRS 2: para. 15).

1.2.2 Performance conditions (other than market conditions)

There may be performance conditions that must be satisfied before share-based payment vests, such as achieving a specific growth in profit or earnings per share.

The amount recognised as share-based payment is based on the **best available estimate** of the number of equity instruments expected to vest (ie expectation of whether the profit target will be met), revised as necessary **at each period end** (IFRS 2: para. 20).

A vesting period may vary in length depending on whether a performance condition is satisfied; for example where different growth targets are set for different years, and if the first target is met, the instruments vest at the end of the first year, and if not the next target for the following year comes into play (IFRS 2: para. 15).

In such circumstances, the share-based payment equity figure is accrued over the period based on the **most likely outcome** of which target will be met, revised **at each period end**.

1.2.3 Market-based and non-market based vesting conditions

Vesting conditions can be **market-based** (such as vesting dependent on achieving a target share price) or **non-market-based** (such as a specified service period or achieving a certain growth in profit).

A market-based vesting condition is taken into account by reflecting it in the measurement of the fair value of the share-based payment. This is at the grant date if equity-settled and at the year end if cash-settled. Market-based vesting conditions are **not taken into consideration** when calculating the number of equity instruments expected to vest.

A non-market condition is taken into account by reflecting it in the calculation of the number of options ultimately expected to vest.

Exam focus
point

Vesting conditions were tested for 7 marks in the June 2017 exam.

1.3 Recognition: The basic principle

An entity should 'recognise goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received' (IFRS 2: para. 7). Goods or services received or acquired in a share-based payment transaction **should be recognised as expenses unless they qualify for recognition as assets** (IFRS 2: para. 8). For example, services are normally recognised as expenses (because they are normally rendered immediately), while goods can often be recognised as assets (IFRS 2: para. 9).

If the goods or services were received or acquired in an **equity-settled** share-based payment transaction the entity should recognise a **corresponding increase in equity** (reserves) (IFRS 2: para. 7). The accounting entry is:

DR	Expense (or asset)	X
CR	Equity	X

If the goods or services were received or acquired in a **cash-settled** share-based payment transaction the entity should recognise a **liability** (IFRS 2: para. 7). The accounting entry is:

DR	Expense (or asset)	X
CR	Liability	X

Exam focus
point

The June 2016 examiner's report stated that many candidates referred in their answer to a credit to a 'share option reserve', but as it was not clear that this was part of equity (as 'reserve' could have referred to a liability) they were not awarded any marks. Ensure that you make it clear in your answer whether you are referring to a component of equity or to a liability.

1.4 Equity-settled share-based payment transactions

1.4.1 Measurement

The issue here is how to measure the 'cost' of the goods and services received and the equity instruments (eg the share options) granted in return.

The general principle in IFRS 2 is that when an entity recognises the goods or services received and the corresponding increase in equity, it should measure these at the **fair value of the goods or services received** (IFRS 2: para. 10). Where the transaction is with **parties other than employees**, there is a rebuttable presumption that the fair value of the goods or services received can be estimated reliably (IFRS 2: para. 13).

If the fair value of the goods or services received cannot be measured reliably, the entity should measure their value by reference to the **fair value of the equity instruments granted** (IFRS 2: para. 11).

Where the transaction is with a party other than an employee fair value should be measured at the date the entity obtains the goods or the counterparty renders service (IFRS 2: para. 13).

Where shares, share options or other equity instruments are granted to **employees** as part of their remuneration package, it is not normally possible to measure directly the services received. For this reason, the entity should measure the fair value of the employee services received by reference to the **fair**

value of the equity instruments granted. The fair value of those equity instruments should be measured at the **grant date**.

(IFRS 2: para. 12)

1.4.2 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** if available, taking into account the terms and conditions upon which those equity instruments were granted.

If market prices are not available, the entity should estimate the fair value of the equity instruments granted using a **valuation technique**. (These are beyond the scope of this exam.)

1.4.3 Transactions in which services are received

The issue here is **when** to recognise the transaction. When equity instruments are granted they may vest immediately, but often the counterparty has to meet specified conditions first. For example, an employee may have to complete a specified period of service. This means that the effect of the transaction normally has to be allocated over more than one accounting period.

If the equity instruments granted **vest immediately**, (ie the counterparty is not required to complete a specified period of service before becoming unconditionally entitled to the equity instruments) it is presumed that the services have already been received (in the absence of evidence to the contrary). The entity should **recognise the services received in full**, with a corresponding increase in equity, **on the grant date**.

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. For example if an employee is granted share options on condition that he or she completes three years' service, then the services to be rendered by the employee as consideration for the share options will be received in the future, over that three-year vesting period.

The entity should recognise an amount for the goods or services received during the vesting period based on the **best available estimate** of the **number of equity instruments expected to vest**. It should **revise** that estimate if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates. On **vesting date**, the entity should revise the estimate to **equal the number of equity instruments that actually vest**.

Once the goods and services received and the corresponding increase in equity have been recognised, the entity should make no subsequent adjustment to total equity after vesting date.

(IFRS 2: paras. 14–15)

1.5 Example: Equity-settled share-based payment transaction

On 1 January 20X1 an entity grants 100 share options to each of its 400 employees. Each grant is conditional upon the employee working for the entity until 31 December 20X3. The fair value of each share option is \$20.

During 20X1 20 employees leave and the entity estimates that 20% of the employees will leave during the three-year period.

During 20X2 a further 25 employees leave and the entity now estimates that 25% of its employees will leave during the three-year period.

During 20X3 a further ten employees leave.

Required

Calculate the remuneration expense that will be recognised in respect of the share-based payment transaction for each of the three years ended 31 December 20X3.

Solution

IFRS 2 requires the entity to recognise the remuneration expense, based on the fair value of the share options granted, as the services are received during the three-year vesting period.

In 20X1 and 20X2 the entity estimates the number of options expected to vest (by estimating the number of employees likely to leave) and bases the amount that it recognises for the year on this estimate.

In 20X3 it recognises an amount based on the number of options that actually vest. A total of 55 employees left during the three-year period and therefore 34,500 options $((400 - 55) \times 100)$ vested.

The amount recognised as an expense for each of the three years is calculated as follows:

		<i>Cumulative expense at year-end</i>	<i>Expense for year</i>
		\$	\$
20X1	$40,000 \times 80\% \times 20 \times 1/3$	213,333	213,333
20X2	$40,000 \times 75\% \times 20 \times 2/3$	400,000	186,667
20X3	$34,500 \times 20$	690,000	290,000



Question

Share based payment 1

On 1 January 20X3 an entity grants 250 share options to each of its 200 employees. The only condition attached to the grant is that the employees should continue to work for the entity until 31 December 20X6. Five employees leave during the year.

The market price of each option was \$12 at 1 January 20X3 and \$15 at 31 December 20X3.

Required

Show how this transaction will be reflected in the financial statements for the year ended 31 December 20X3.

Answer

The remuneration expense for the year is based on the fair value of the options granted at the grant date (1 January 20X3). As five of the 200 employees left during the year it is reasonable to assume that 20 employees will leave during the four-year vesting period and that therefore 45,000 options (250×180) will actually vest.

Therefore, the entity recognises a remuneration expense of \$135,000 $(45,000 \times 12 \times 1/4)$ in profit or loss and a corresponding increase in equity of the same amount.



Question

Share based payment 2

J&B granted 200 options on its \$1 ordinary shares to each of its 800 employees on 1 January 20X1. Each grant is conditional upon the employee being employed by J&B until 31 December 20X3.

J&B estimated at 1 January 20X1 that:

- The fair value of each option was \$4 (before adjustment for the possibility of forfeiture).
- Approximately 50 employees would leave during 20X1, 40 during 20X2 and 30 during 20X3 thereby forfeiting their rights to receive the options. The departures were expected to be evenly spread within each year.

The exercise price of the options was \$1.50 and the market value of a J&B share on 1 January 20X1 was \$3.

In the event, only 40 employees left during 20X1 (and the estimate of total departures was revised down to 95 at 31 December 20X1), 20 during 20X2 (and the estimate of total departures was revised to 70 at 31 December 20X2) and none during 20X3, spread evenly during each year.

Required

The directors of J&B have asked you to illustrate how the scheme is accounted for under IFRS 2 *Share-based Payment*.

- Show the double entries for the charge to profit or loss for employee services over the three years and for the share issue, assuming all employees entitled to benefit from the scheme exercised their rights and the shares were issued on 31 December 20X3.
- Explain how your solution would differ had J&B offered its employees cash based on the share value rather than share options.

Answer

(a) Accounting entries

<i>31.12.X1</i>		\$	\$
DEBIT	Profit or loss (Staff costs)	188,000	
CREDIT	Equity reserve $((800 - 95) \times 200 \times \$4 \times 1/3)$		188,000
<i>31.12.X2</i>			
DEBIT	Profit or loss (Staff costs) (W1)	201,333	
CREDIT	Equity reserve		201,333
<i>31.12.X3</i>			
DEBIT	Profit or loss (Staff costs) (W2)	202,667	
CREDIT	Equity reserve		202,667
<i>Issue of shares:</i>			
DEBIT	Cash $(740 \times 200 \times \$1.50)$	222,000	
DEBIT	Equity reserve	592,000	
CREDIT	Share capital $(740 \times 200 \times \$1)$		148,000
CREDIT	Share premium (balancing figure)		666,000

Workings

1	<i>Equity reserve at 31.12.X2</i>	
	Equity b/d	\$ 188,000
	∴ P/L charge	201,333
	Equity c/d $((800 - 70) \times 200 \times \$4 \times 2/3)$	<u>389,333</u>
2	<i>Equity reserve at 31.12.X3</i>	
	Equity b/d	389,333
	∴ P/L charge	202,667
	Equity c/d $((800 - 40 - 20) \times 200 \times \$4 \times 3/3)$	<u>592,000</u>

(b) Cash-settled share-based payment

If J&B had offered cash payments based on the value of the shares at vesting date rather than options, in each of the three years an accrual would be shown in the statement of financial position representing the expected amount payable based on the following:

No. of employees estimated at the year end to be entitled to rights at the vesting date	×	Number of rights each	×	Fair value of each right at year end	×	Cumulative proportion of vesting period elapsed
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The movement in the accrual would be charged to profit or loss representing further entitlements received during the year and adjustments to expectations accrued in previous years.

The accrual would continue to be adjusted (resulting in a profit or loss charge) for changes in the fair value of the right over the period between when the rights become fully vested and are subsequently exercised. It would then be reduced for cash payments as the rights are exercised.

1.6 Changes to exercise price

If there is a downturn in the equity markets, leading an entity to reduce the exercise price of the share options, this would cause the fair value of the share-based payment to increase. IFRS 2 requires that this increase in value must be recognised over the remaining period until the options vest.

(IFRS 2: para. 26)

Exam focus point

Repricing of share options was examined in the June 2016 exam. The examiner's report commented that many students found this question difficult, so make sure you carefully study the example given below.

1.6.1 Example: Change in exercise price

At the beginning of year 1, Cello Co grants 100 share options to each of its 500 employees. Each grant is conditional upon the employee remaining in service over the next three years. Cello Co estimates that the fair value of each option is \$15. On the basis of a weighted average probability, Cello Co estimates that 100 employees will leave during the three-year period and therefore forfeit their rights to the share options.

Suppose that 40 employees leave during year 1. Also suppose that by the end of year 1, Cello Co's share price has dropped, and the company reprices its share options, and that the repriced share options vest at the end of year 3. Cello Co estimates that a further 70 employees will leave during years 2 and 3, and hence the total expected employee departures over the three-year vesting period is 110 employees.

During year 2, a further 35 employees leave, and Cello Co estimates that a further 30 employees will leave during year 3, to bring the total expected employee departures over the three-year vesting period to 105 employees.

During year 3, a total of 28 employees leave, and hence a total of 103 employees ceased employment during the vesting period. For the remaining 397 employees, the share options vested at the end of year 3.

Cello Co estimates that, at the date of repricing, the fair value of each of the original share options granted (ie immediately before taking into account the repricing) is \$5 and that the fair value of each repriced share option is \$8.

The incremental value is \$3 per share option (\$8 – \$5). This amount is recognised over the remaining two years of the vesting period, along with remuneration expense based on the original option value of \$15.

The amounts recognised in years 1–3 are as follows:

Year	Calculation	Remuneration expense for period \$	Cumulative remuneration expense \$
1	$(500 - 110) \text{ employees} \times 100 \text{ options} \times \$15 \times 1/3$	195,000	195,000
2	$(500 - 105) \text{ employees} \times 100 \text{ options} \times (\$15 \times 2/3 + \$3 \times 1/2) - \$195,000$	259,250	454,250
3	$(500 - 103) \text{ employees} \times 100 \text{ options} \times (\$15 + \$3) - \$454,250$	260,350	714,600

1.7 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 re-pricing 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.

As well as the entity, two other parties may cancel an equity instrument:

- Cancellations by the counterparty (eg the employee)
- Cancellations by a third party (eg a shareholder)

Cancellations by the employee must be treated in the same way as cancellations by the employer, resulting in an **accelerated charge to profit or loss of the unamortised balance of the options granted**.

(IFRS 2: paras. 28–28A)

1.7.1 Example: Cancellation and reissuance

On 1 January 20X1, Piper made an award of 3,000 share options to each of its 1,000 employees. The employees had to remain in Piper's employ until 31 December 20X3 in order to be entitled to the share options. At the date of the award and at 31 December 20X1, management estimated that 100 employees would leave the company before the vesting date. Piper accounted for the options correctly in its financial statements for the year ended 31 December 20X1. The fair value of each option on 1 January 20X1 was \$5.

The share price of Piper fell substantially during 20X1. On 1 January 20X2 the fair value of the share options had fallen to \$1 each and 975 of the employees who were awarded options remained in the company's employ. During the year ended 31 December 20X2 35 of those employees left and the company estimated that a further 40 would leave each year before 31 December 20X4.

Required

Discuss, with suitable calculations, the accounting treatment of the share options in Piper's financial statements for the year ended 31 December 20X2 if on 1 January 20X2:

- The original options were cancelled and \$4m is paid to employees as compensation.
- Piper's management cancelled the share options and replaced them with new share options, vesting on 31 December 20X4, the fair value of each replacement option on 1 January 20X2 being \$7. No compensation was paid.

Solution

(a) Original options were cancelled and compensation paid

At 1 January 20X2, the original equity instruments are one third vested so $\$4.5\text{m} ((1,000 - 100) \times 3,000 \times \$5 \times 1/3)$ of the grant date fair value has already been charged to profit or loss and recognised in equity.

Cancellation is treated as an acceleration of vesting so the amount that would have been charged over the remaining two-year vesting period is recognised immediately in profit or loss:

	\$m
Equity b/d at 1 January 20X2	4.5
∴ P/L charge	9.0
Equity c/d at 1 January 20X2 $((1,000 - 100 = 900) \times 3,000 \times \$5)$	<u>13.5</u>

DR Profit or loss	\$9.0m	
CR Equity		\$9.0m

The settlement made is treated as a repurchase of an equity interest. The amount representing the repurchase of equity instruments granted (measured at the date of the cancellation) is charged directly to equity and the excess to profit or loss:

DR Equity $(900 \times 3,000 \times \$1)$	\$2.7m	
DR Profit or loss (remainder)	\$1.3m	
CR Cash		\$4m

Note.

* Interpretative guidance issued by Ernst & Young indicates that actual employees in service at the date of the cancellation (ie 975 employees here) could also be used as IFRS 2 paragraph 28(a) is unclear.

(b) Original options cancelled and replaced with new options

The replacement share options are treated as a modification of the original grant. Therefore the excess of the fair value of the new options over the fair value of the cancelled options is charged to profit or loss over the new vesting period.

This amount is calculated as follows:

Fair value of replacement equity instruments at 1 January 20X2	\$ 7
Less: Net fair value of cancelled equity instruments at 1 January 20X2 (\$1 fair value as no payment made to employees on cancellation)	(1) <u>6</u>

The original fair value continues to be charged over the remainder of the **original** vesting period, consistent with the treatment of modified instruments in IFRS 2 paragraph B43(a).

The charge recognised in profit or loss in 20X2 is calculated as follows:

	\$m
Equity b/d at 1 January 20X2 (see (a))	4.5
∴ P/L charge	<u>9.26</u>
Equity c/d at 31 December 20X2	
$[(975 - 35 - 40 - 40 = 860^{**}) \times 3,000 \times \$5 \times 2/3] + (860^{**} \times 3,000 \times \$6 \times 1/3)$	<u>13.76</u>
DR Profit or loss	\$9.26m
CR Equity	\$9.26m

** Based on the number of employees whose awards are finally expected to vest for both elements.

1.8 Cash-settled share-based payment transactions

Examples of this type of transaction include:

- (a) **Share appreciation rights** granted to employees: the employees become entitled to a future cash payment (rather than an equity instrument), based on the increase in the entity's share price from a specified level over a specified period of time; or
- (b) An entity might grant to its employees a right to receive a future cash payment by granting to them a **right to shares that are redeemable**.

The basic principle is that the entity 'measure[s] the goods or services acquired and the liability incurred at the **fair value of the liability**' (IFRS 2: para. 30, emphasis BPP's).

The entity should **remeasure** the fair value of the liability at **each reporting date** until the liability is settled **and at the date of settlement**. Any **changes** in fair value are recognised in **profit or loss** for the period.
(IFRS 2: para. 30)

The entity should recognise the services received, and a liability to pay for those services, **as the employees render service**. For example, if share appreciation rights do not vest until the employees have completed a specified period of service, the entity should recognise the services received and the related liability, over that period.
(IFRS 2: para. 32)

1.9 Example: Cash-settled share-based payment transaction

On 1 January 20X1 an entity grants 100 cash share appreciation rights (SARS) to each of its 500 employees, on condition that the employees continue to work for the entity until 31 December 20X3.

During 20X1 35 employees leave. The entity estimates that a further 60 will leave during 20X2 and 20X3.

During 20X2 40 employees leave and the entity estimates that a further 25 will leave during 20X3.

During 20X3 22 employees leave.

At 31 December 20X3 150 employees exercise their SARs. Another 140 employees exercise their SARs at 31 December 20X4 and the remaining 113 employees exercise their SARs at the end of 20X5.

The fair values of the SARs for each year in which a liability exists are shown below, together with the intrinsic values at the dates of exercise.

	<i>Fair value</i>	<i>Intrinsic value</i>
	\$	\$
20X1	14.40	
20X2	15.50	
20X3	18.20	15.00
20X4	21.40	20.00
20X5		25.00

Required

Calculate the amount to be recognised in the profit or loss for each of the five years ended 31 December 20X5 and the liability to be recognised in the statement of financial position at 31 December for each of the five years.

Solution

For the three years to the vesting date of 31 December 20X3 the expense is based on the entity's estimate of the number of SARs that will actually vest (as for an equity-settled transaction). However, the fair value of the liability is **re-measured** at each year-end.

The intrinsic value of the SARs at the date of exercise is the amount of cash actually paid.

	<i>Liability at year-end</i>		<i>Expense for year</i>
	\$	\$	\$
20X1 Expected to vest (500 – 95): 405 × 100 × 14.40 × 1/3	<u>194,400</u>		194,400
20X2 Expected to vest (500 – 100): 400 × 100 × 15.50 × 2/3	<u>413,333</u>		218,933
20X3 Exercised: 150 × 100 × 15.00		225,000	
Not yet exercised (500 – 97 – 150): 253 × 100 × 18.20	<u>460,460</u>	<u>47,127</u>	
			272,127
20X4 Exercised: 140 × 100 × 20.00		280,000	
Not yet exercised (253 – 140): 113 × 100 × 21.40	<u>241,820</u>	<u>(218,640)</u>	
			61,360
	\$	\$	\$
20X5 Exercised: 113 × 100 × 25.00		282,500	
	<u>Nil</u>	<u>(241,820)</u>	
			<u>40,680</u>
			<u>787,500</u>

See Section 1.2.2 for a definition of intrinsic value.



1.10 Amendment to IFRS 2: Classification and Measurement of Share-based Payment Transactions

This amendment was issued in June 2016. It addresses the following three issues (IFRS 2: paras. 33A–33D).

- (a) Accounting for cash-settled **share-based payment transactions that include a performance condition (vesting condition)**. The amendment clarifies that the accounting in the case of **cash-settled share-based payments** should follow the **same approach as used for equity-settled share-based payments**.
- (b) **Classification of share-based payment transactions with net settlement features**, for example, where an employer settles a share-based payment transaction by issuing a net number of shares to the employee and paying cash to the tax authority. An exception is added to IFRS 2 so that a share-based payment where the entity settles the share-based payment arrangement net would be **classified as equity-settled in its entirety provided the share-based payment would have been classified as equity-settled had it not included the net settlement feature**.
- (c) Accounting for modifications of share-based payment transactions from cash-settled to equity-settled. The amendment requires the following approach.
 - (i) The **original liability** recognised in respect of the cash-settled share-based payment should be **derecognised** and the **equity-settled share-based payment should be recognised at the modification date fair value to the extent services have been rendered up to the modification date**.
 - (ii) The **difference**, if any, between the carrying amount of the liability as at the modification date and the amount recognised in equity at the same date would **be recognised in profit or loss immediately**.

2 Deferred tax implications

FAST FORWARD

Since the accounting value of share-based payment is zero (it is expensed), any **future tax deductions** (eg if there is no tax deduction until the share-based payment vests) will generate a **deferred tax asset**.

2.1 Issue

An entity may receive a tax deduction that differs from related cumulative remuneration expense, and may arise in a later accounting period (IAS 12: para. 68A).

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 and receives the tax deduction at the share price on the exercise date.

2.2 Measurement

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 (estimated amount tax authorities will permit as a deduction in future periods, based on year end information)	(X)
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, IFRS 2 states that this indicates that the tax deduction relates also to an equity item.

IFRS 2 requires that the excess is therefore recognised directly in equity (it is **not** reported in other comprehensive income) (IAS 12: paras. 68A–68C).

2.3 Example: Deferred tax implications of share-based payment

On 1 January 20X2, Bruce granted 5,000 share options to an employee vesting two years later on 31 December 20X3. The fair value of each option measured at the grant date was \$3.

Tax law in the jurisdiction in which the entity operates allows a tax deduction of the intrinsic value of the options on exercise. The intrinsic value of the share options was \$1.20 at 31 December 20X2 and \$3.40 at 31 December 20X3 on which date the options were exercised.

Assume a tax rate of 30%.

Required

Show the deferred tax accounting treatment of the above transaction at 31 December 20X2, 31 December 20X3 (before exercise), and on exercise.

Solution

	31/12/20X2	31/12/20X3 before exercise
Carrying amount of share-based payment expense	0	0
Less: Tax base of share-based payment expense (5,000 × \$1.2 × ½)/(5,000 × \$3.40)	(3,000)	(17,000)
Temporary difference	<u>(3,000)</u>	<u>(17,000)</u>
Deferred tax asset @ 30%	900	5,100
Deferred tax (Cr P/L) (5,100 – 900 – (Working) 600)	<u>900</u>	<u>3,600</u>
Deferred tax (Cr Equity) (Working)	0	600

On exercise, the deferred tax asset is replaced by a current tax one. The double entry is:

DEBIT Deferred tax (in P/L)	4,500	} reversal
DEBIT Deferred tax (in equity)	600	
CREDIT Deferred tax asset	5,100	
DEBIT Current tax asset	5,100	
CREDIT Current tax (in P/L)	4,500	
CREDIT Current tax (in equity)	600	

Working

Accounting expense recognised (5,000 × \$3 × ½)/(5,000 × \$3)	7,500	15,000
Tax deduction	<u>(3,000)</u>	<u>(17,000)</u>
Excess temporary difference	0	<u>(2,000)</u>
Excess deferred tax asset to equity @ 30%	0	600

**Exam focus
point**

ACCA's website contains many useful articles, including the following relating to topics covered in this chapter:

- *Share-based payment*
- *IFRS 2*

Available at www.accaglobal.com/gb/en/student/exam-support-resources/dipifr-study-resources/technical-articles.html

Chapter Roundup

- IFRS 2 requires entities to **recognise** the goods or services received as a result of **share-based payment transactions**.
- The required accounting treatment depends on the type of share-based payment:
 - Equity settled transactions: DEBIT Asset/Expense, CREDIT Equity
 - Cash settled transactions: DEBIT Asset/Expense, CREDIT Liability
- Transactions are **recognised when goods/services are obtained/received**
- If there are **vesting conditions** attached to the equity instruments granted, the share-based payment expense should be **spread** over the **vesting period**.
- Transactions are measured at fair value, using year-end estimates of instruments expected to vest and **fair values** of instruments at **grant date (equity-settled)** and at **year end (cash-settled)**.
- Since the accounting value of share-based payment is zero (it is expensed), any **future tax deductions** (eg if there is no tax deduction until the share-based payment vests) will generate a **deferred tax asset**.

Quick Quiz

- 1 What is a cash-settled share-based payment transaction?
- 2 What is the grant date?
- 3 If an entity has entered into an equity-settled share-based payment transaction, what should it recognise in its financial statements?
- 4 Where an entity has granted share options to its employees in return for services, how is the transaction measured?
- 5 Why does remeasurement at each year end occur only in the case of cash-settled share-based payments?

Answers to Quick Quiz

- 1 A transaction in which 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.
- 2 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.
- 3 The goods or services received and a corresponding increase in equity.
- 4 By reference to the fair value of the equity instruments granted, measured at grant date.
- 5 The amount of cash that will be paid to settle a cash-settled share-based payment changes as the underlying value of the equity instrument changes. Accordingly the liability is remeasured at each year end based on the latest values so as to give an up-to-date estimate of the amount that will be paid.

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q17	Examination	20	39 mins

Presentation of financial statements and additional disclosures

15

Presentation of published financial statements

Topic list	Syllabus reference
1 IAS 1 <i>Presentation of Financial Statements</i>	C1
2 Statement of financial position	C1
3 The current/non-current distinction	C1
4 Statement of profit or loss and other comprehensive income	C1
5 Changes in equity	C1
6 Notes to the financial statements	C1
7 Fair presentation and compliance with IFRS	C1

Introduction

We begin in this chapter by looking at the overall **content and format** of company financial statements. These are governed by IAS 1 *Presentation of Financial Statements*.

Study guide

C1	Presentation of the statement of financial position and statement of profit or loss and other comprehensive income
(a)	State the objectives of IFRSs governing presentation of financial statements
(b)	Describe the structure and content of statements of financial position and statements of profit or loss and other comprehensive income including continuing operations
(e)	Discuss 'fair presentation' and the accounting concepts/principles

1 IAS 1 *Presentation of Financial Statements*

FAST FORWARD

IAS 1 covers the **form and content** of financial statements. The main components are:

- Statement of financial position
- Statement of profit or loss and other comprehensive income
- Statement of changes in equity
- Statement of cash flows
- Notes to the financial statements

1.1 Profit or loss for the year

The statement of profit or loss and other comprehensive income is the most significant indicator of a company's financial performance. So it is important to ensure that it is not misleading.

IAS 1 stipulates that all items of income and expense recognised in a period shall be included in profit or loss unless an IFRS requires or permits otherwise (IAS 1: para. 88).

Circumstances where items may be excluded from profit or loss for the current year include the correction of errors and the effect of changes in accounting policies (IAS 1: para. 89). These are covered in IAS 8.

1.2 How items are disclosed

IAS 1 specifies disclosures of certain items in certain ways.

- Some items must appear as line items in the statement of financial position or statement of profit or loss and other comprehensive income
- Other items can appear in a **note to the financial statements** instead
- **Recommended formats** are given which entities may or may not follow, depending on their circumstances

Obviously, disclosures specified by **other standards** must also be made, and we will mention the necessary disclosures when we cover each statement in turn. Disclosures in both IAS 1 and other standards must be made either as separate line items in the statement or in the notes unless otherwise stated, ie disclosures cannot be made in an accompanying commentary or report.

1.3 Identification of financial statements

As a result of the above point, it is most important that entities **distinguish the financial statements** very clearly from any other information published with them (IAS 1: para. 49). This is because all IFRSs apply **only** to the financial statements (ie the main statements and related notes), so readers of the annual report must be able to differentiate between the parts of the report which are prepared under IFRSs, and other parts which are not (IAS 1: para. 50).

The entity should **identify each** financial statement and the notes very clearly. IAS 1 also requires 'an entity [to] display the following information prominently, and repeat it when necessary for the information presented to be understandable:

- (a) The name of the reporting entity or other means of identification, and any change in that information from the end of the preceding reporting period;
- (b) Whether the financial statements are of an individual entity or a group of entities;
- (c) The date of the end of the reporting period or the period covered by the set of financial statements or notes;
- (d) The presentation currency, as defined in IAS 21; and
- (e) The level of rounding used in presenting amounts in the financial statements' (IAS 1: para. 51).

Judgement must be used to determine the best method of presenting this information. In particular, the standard suggests that the approach to this will be very different when the financial statements are communicated electronically (IAS 1: para. 52).

The **level of rounding** is important, as presenting figures in thousands or millions of units makes the figures more understandable. The level of rounding must be disclosed, however, and it should not obscure necessary details or make the information less relevant.

(IAS 1: para. 53)

1.4 Reporting period

It is normal for entities to present financial statements **annually** and IAS 1 states that they should be prepared at least as often as this. If (unusually) the end of an entity's reporting period is changed, for whatever reason, the period for which the statements are presented will be less or more than one year. In such cases the entity should also disclose:

- (a) The **reason(s) why** a period other than one year is used; and
- (b) The fact that the comparative figures given **are not in fact comparable**.

(IAS 1: para. 36)

For practical purposes, some entities prefer to use a period which **approximates to a year**, eg 52 weeks, and the IAS allows this approach as it will produce statements not materially different from those produced on an annual basis.

(IAS 1: para. 37)

1.5 Timeliness

If the publication of financial statements is delayed too long after the reporting period, their usefulness will be severely diminished. An entity with consistently complex operations cannot use this as a reason for its failure to report on a timely basis. Local legislation and market regulation imposes specific deadlines on certain entities.

IAS 1 looks at the statement of financial position and statement of profit or loss and other comprehensive income. We will not give all the detailed disclosures as some are outside the scope of your syllabus. Instead we will look at a '**proforma**' set of financial statements based on the Standard.

2 Statement of financial position

FAST FORWARD

IAS 1 suggests a format for the statement of financial position. Certain items are specified for **disclosure as line items in the financial statements**.

IAS 1 discusses the distinction between current and non-current items in some detail, as we shall see in the next section. First of all we can look at the **suggested format** of the statement of financial position (given in the Implementation Guidance to the Standard) and then look at further disclosures required.

2.1 Statement of financial position example

The example given by IAS 1 is as follows (IAS 1: Implementation Guidance Part 1).

XYZ GROUP – STATEMENT OF FINANCIAL POSITION AT 31 DECEMBER

	20X7 \$'000	20X6 \$'000
Assets		
Non-current assets		
Property, plant and equipment	350,700	360,020
Goodwill	80,800	91,200
Other intangible assets	227,470	227,470
Investments in associates	100,150	110,770
Investments in equity instruments	142,500	156,000
	<u>901,620</u>	<u>945,460</u>
Current assets		
Inventories	135,230	132,500
Trade receivables	91,600	110,800
Other current assets	25,650	12,540
Cash and cash equivalents	312,400	322,900
	<u>564,880</u>	<u>578,740</u>
Total assets	<u>1,466,500</u>	<u>1,524,200</u>
Equity and liabilities		
Equity attributable to owners of the parent		
Share capital	650,000	600,000
Retained earnings	243,500	161,700
Other components of equity	10,200	21,200
	<u>903,700</u>	<u>782,900</u>
Non-controlling interest	70,050	48,600
Total equity	<u>973,750</u>	<u>831,500</u>
Non-current liabilities		
Long-term borrowings	120,000	160,000
Deferred tax	28,800	26,040
Long-term provisions	28,850	52,240
Total non-current liabilities	<u>177,650</u>	<u>238,280</u>
Current liabilities		
Trade and other payables	115,100	187,620
Short-term borrowings	150,000	200,000
Current portion of long-term borrowings	10,000	20,000
Current tax payable	35,000	42,000
Short-term provisions	5,000	4,800
Total current liabilities	<u>315,100</u>	<u>454,420</u>
Total liabilities	<u>492,750</u>	<u>692,700</u>
Total equity and liabilities	<u>1,466,500</u>	<u>1,524,200</u>

IAS 1 specifies various items which must appear as **line items in the statement of financial position** as a minimum disclosure.

- (a) Property, plant and equipment (Chapter 4)
- (b) Investment property (Chapter 4)
- (c) Intangible assets (Chapter 7)
- (d) Financial assets (excluding amounts shown under (e), (h) and (i)) (Chapter 10)
- (e) Investments accounted for using the equity method (Chapter 23)
- (f) Biological assets (Chapter 13)
- (g) Inventories (Chapter 13)
- (h) Trade and other receivables
- (i) Cash and cash equivalents
- (j) Assets classified as held for sale under IFRS 5 (Chapter 16)

- (k) Trade and other payables
- (l) Provisions (Chapter 8)
- (m) Financial liabilities (other than (j) and (k))
- (n) Current tax liabilities and assets as in IAS 12 (Chapter 11)
- (o) Deferred tax liabilities and assets (Chapter 11)
- (p) Liabilities included in disposal groups under IFRS 5
- (q) Non-controlling interests (Chapter 21 and 22)
- (r) Issued capital and reserves

(IAS 1: para. 54)

We will look at these items in the chapters marked.

Any **other line items**, headings or sub-totals should be shown as line items in the statement of financial position when it is necessary for an understanding of the entity's financial position (IAS 1: para. 55).

The example shown above is for illustration only (although we will follow the format in this Study Text). The standard, however, does not prescribe the order or format in which the items listed should be presented. It simply states that they **must be presented separately** because they are so different in nature or function from each other.

(IAS 1: para. 57)

Whether additional items are presented separately depends on judgements based on the assessment of the following factors.

- (a) **Nature and liquidity of assets and their materiality.** Thus goodwill and assets arising from development expenditure will be presented separately, as will monetary/non-monetary assets and current/non-current assets.
- (b) **Function within the entity.** Operating and financial assets, inventories, receivables and cash and cash equivalents are therefore shown separately.
- (c) **Amounts, nature and timing of liabilities.** Interest-bearing and non-interest-bearing liabilities and provisions will be shown separately, classified as current or non-current as appropriate.

(IAS 1: para. 58)

The standard also requires separate presentation where **different measurement bases** are used for assets and liabilities which differ in nature or function. According to IAS 16, for example, it is permitted to carry certain items of property, plant and equipment at cost or at a revalued amount.

(IAS 1: para. 59)

2.2 Information presented either as a line item in the statement of financial position or by note

Further **sub-classification** of the line items listed above should be disclosed either as line items in the statement of financial position or in the notes. The classification will depend upon the nature of the entity's operations. As well as each item being sub-classified by its nature, any amounts payable to or receivable from any **group company or other related party** should also be disclosed separately.

The sub-classification details will in part depend on the requirements of IFRSs. The size, nature and function of the amounts involved will also be important and the factors listed above should be considered. **Disclosures** will vary from item to item and IAS 1 gives the following examples (IAS 1: para. 78).

- (a) **Property, plant and equipment** are classified by class as described in IAS 16, *Property, Plant and Equipment*.
- (b) **Receivables** are analysed between amounts receivable from trade customers, other members of the group, receivables from related parties, prepayments and other amounts.
- (c) **Inventories** are sub-classified, in accordance with IAS 2 *Inventories*, into classifications such as merchandise, production supplies, materials, work in progress and finished goods.
- (d) **Provisions** are analysed showing separately provisions for employee benefit costs and any other items classified in a manner appropriate to the entity's operations.
- (e) **Equity capital and reserves** are analysed showing separately the various classes of paid in capital, share premium and reserves.

The standard then lists some **specific disclosures** which must be made, 'either in the statement of financial position or the statement of changes in equity, or in the notes:

- (a) For each class of share capital:
 - (i) The number of shares authorised;
 - (ii) The number of shares issued and fully paid, and issued but not fully paid;
 - (iii) Par value per share, or that the shares have no par value;
 - (iv) A reconciliation of the number of shares outstanding at the beginning and at the end of the period;
 - (v) The rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital;
 - (vi) Shares in the entity held by the entity or by its subsidiaries or associates; and
 - (vii) Shares reserved for issue under options and contracts for the sale of shares, including terms and amounts; and
- (b) a description of the nature and purpose of each reserve within equity' (IAS 1: para. 79).

Some types of entity have no share capital, eg partnerships. Such entities should disclose information which is **equivalent** to that listed above. This means disclosing the movement during the period in each category of equity interest and any rights, preferences or restrictions attached to each category of equity interest.

(IAS 1: para. 80)

3 The current/non-current distinction

FAST FORWARD

You should appreciate the distinction between current and non-current assets and liabilities and their different treatments.

3.1 The current/non-current distinction

An entity must present **current** and **non-current** assets as separate classifications in the statement of financial position. A presentation based on liquidity should only be used where it provides more relevant and reliable information, in which case all assets and liabilities must be presented broadly **in order of liquidity**.

(IAS 1: para. 60)

In either case, the entity should disclose any portion of an asset or liability which is expected to be recovered or settled **after more than 12 months** (IAS 1: para. 61). For example, for an amount receivable which is due in instalments over 18 months, the portion due after more than 12 months must be disclosed.

The standard emphasises how helpful information on the **operating cycle** is to users of financial statements. Where there is a clearly defined operating cycle within which the entity supplies goods or services, then information disclosing those net assets that are continuously circulating as **working capital** is useful.

This distinguishes them from those net assets used in the long-term operations of the entity. Assets that are expected to be realised and liabilities that are due for settlement within the operating cycle are therefore highlighted.

The liquidity and solvency of an entity is also indicated by information about the **maturity dates** of assets and liabilities. IFRS 7 *Financial Instruments: Disclosures* requires disclosure of maturity dates of both financial assets and financial liabilities. (Financial assets include trade and other receivables; financial liabilities include trade and other payables.)

3.2 Current assets

Key term

An asset should be classified as a **current asset** 'when:

- (a) It expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;
- (b) It holds the asset primarily for the purpose of trading;
- (c) It expects to realise the asset within twelve months after the reporting period; or
- (d) The asset is cash or a cash equivalent (as defined in IAS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

An entity shall classify all other assets as non-current'.

(IAS 1: para. 66)

Non-current assets includes tangible, intangible, operating and financial assets of a long-term nature. Other terms with the same meaning can be used (eg 'fixed', 'long-term').

The term 'operating cycle' has been used several times above and the standard defines it as follows.

Key term

The **operating cycle** of an entity is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents.

(IAS 1: para. 68)

'Current assets include assets (such as inventories and trade receivables) that are sold, consumed or realised as part of the normal operating cycle even when they are not expected to be realised within twelve months after the reporting period' (IAS 1: para. 68).

Current assets will also include **marketable securities** if they are expected to be realised within 12 months after the reporting period. If expected to be realised later, they should be included in non-current assets (IAS 1: para. 68).

3.3 Current liabilities

Key term

A liability should be classified as a **current liability** 'when:

- (a) It expects to settle the liability in its normal operating cycle;
- (b) It holds the liability primarily for the purpose of trading;
- (c) The liability is due to be settled within twelve months after the reporting period; or
- (d) It does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period [...].

An entity shall classify all other liabilities as non-current.'

(IAS 1: para. 69)

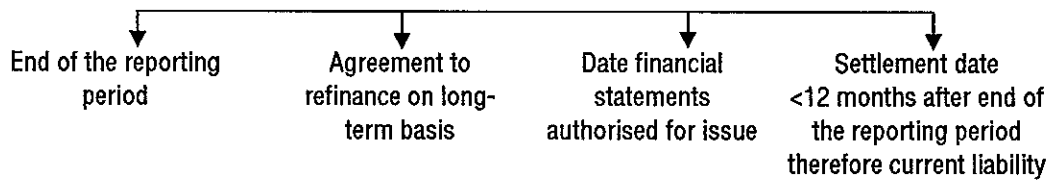
The categorisation of current liabilities is very similar to that of current assets. Thus, some current liabilities are part of the **working capital** used in the normal operating cycle of the business (ie trade payables and accruals for employee and other operating costs). Such items will be classed as current liabilities **even where they are due to be settled more than 12 months after the end of the reporting period.**

(IAS 1: para. 70)

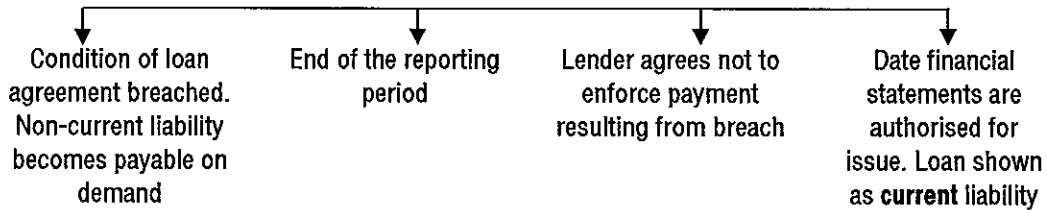
There are also current liabilities which are not settled as part of the normal operating cycle, but which are due to be settled within 12 months of the end of the reporting period. These include bank overdrafts, income taxes, other non-trade payables and the current portion of interest-bearing liabilities. Any interest-bearing liabilities that are used to finance working capital on a long-term basis, and that are not due for settlement within 12 months, should be classed as **non-current liabilities.**

(IAS 1: para. 71)

A **non-current financial liability** due to be settled **within 12 months** of the end of the reporting period should be classified as a **current liability**, even if 'an agreement to refinance, or to reschedule payments, on a long-term basis is completed after [the end of] the reporting period and before the financial statements are authorised for issue' (IAS 1: para. 72).



A **non-current financial liability** that is payable on **demand** because the entity **breached a condition** of its loan agreement should be classified as **current** at the end of the reporting period even if the **lender** has agreed **after the end of the reporting period**, and **before** the financial statements are **authorised for issue**, **not to demand payment** as a consequence of the breach.



However, the liability is classified as **non-current** 'if the **lender** has **agreed by the end of the reporting period** to provide a **period of grace ending at least twelve months after the end of the reporting period** within which the entity can rectify the breach and during that time the lender cannot demand immediate repayment' (IAS 1: para. 75).

4 Statement of profit or loss and other comprehensive income

4.1 Format

IAS 1 allows income and expense items to be presented either:

- (a) In a single statement of profit or loss and other comprehensive income; or
- (b) In two statements: a separate statement of profit or loss and statement of other comprehensive income.

The format for a single statement of profit or loss and other comprehensive income is shown as follows in the standard. The section down to 'profit for the year' can be shown as a separate 'statement of profit or loss' with an additional 'statement of other comprehensive income'. Note that not all of the items shown under 'other comprehensive income' are included in your syllabus.

Exam focus point

In the examinations, if a 'statement of profit or loss and other comprehensive income' is referred to, this will always relate to the single statement format. If a 'statement of profit or loss' is referred to, this relates to the statement from 'revenue' to 'profit for the year'. Exams may refer to 'other comprehensive income' which relates to the 'other comprehensive income' section of the statement. In practice, the item of 'other comprehensive income' you are most likely to meet is a revaluation gain. Where we have used 'statement of profit or loss' in this Study Text, this can be taken to refer to the profit or loss section of the full statement or separate statement of profit or loss.

XYZ GROUP – STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X7

	20X7 \$'000	20X6 \$'000
Revenue	390,000	355,000
Cost of sales	(245,000)	(230,000)
Gross profit	145,000	125,000
Other income	20,667	11,300
Distribution costs	(9,000)	(8,700)
Administrative expenses	(20,000)	(21,000)
Other expenses	(2,100)	(1,200)
Finance costs	(8,000)	(7,500)
Share of profit of associates	35,100	30,100
Profit before tax	161,667	128,000
Income tax expense	(40,417)	(32,000)
Profit for the year from continuing operations	121,250	96,000
Loss for the year from discontinued operations	–	(30,500)
Profit for the year	121,250	65,500
<i>Other comprehensive income:</i>		
<i>Items that will not be reclassified to profit or loss:</i>		
Gains on property revaluation	933	3,367
Investments in equity instruments	(24,000)	26,667
Remeasurement gains (losses) on defined benefit pension plans	(667)	1,333
Share of gain(loss) on property revaluation of associates	400	(700)
Income tax relating to items that will not be reclassified	5,834	(7,667)
	(17,500)	23,000
<i>Items that may be reclassified subsequently to profit or loss</i>		
Exchange differences on translating foreign operations	5,334	10,667
Cash flow hedges	(667)	(4,000)
Income tax relating to items that may be reclassified	(1,167)	(1,667)
	3,500	5,000
Other comprehensive income for the year, net of tax	(14,000)	28,000
Total comprehensive income for the year	107,250	93,500
Profit attributable to:		
Owners of the parent	97,000	52,400
Non-controlling interest	24,250	13,100
	<u>121,250</u>	<u>65,500</u>
Total comprehensive income attributable to		
Owners of the parent	85,800	74,800
Non-controlling interest	21,450	18,700
	<u>107,250</u>	<u>93,500</u>
Earnings per share (in currency units)	0.46	0.30

(IAS 1: Implementation Guidance Part 1)

Items of other comprehensive income are split into those which can be reclassified to profit or loss and those which can not be reclassified.

Companies are given the option of presenting this information in two statements as follows:

XYZ GROUP – STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X7

	20X7	20X6
	\$'000	\$'000
Revenue	390,000	355,000
Cost of sales	(245,000)	(230,000)
Gross profit	145,000	125,000
Other income	20,667	11,300
Distribution costs	(9,000)	(8,700)
Administrative expenses	(20,000)	(21,000)
Other expenses	(2,100)	(1,200)
Finance costs	(8,000)	(7,500)
Share of profit of associates	35,100	30,100
Profit before tax	161,667	128,000
Income tax expense	(40,417)	(32,000)
Profit for the year from continuing operations	121,250	96,000
Loss for the year from discontinued operations	–	(30,500)
<i>Profit for the year</i>	<u>121,250</u>	<u>65,500</u>
Profit attributable to:		
Owners of the parent	97,000	52,400
Non-controlling interest	24,250	13,100
	<u>121,250</u>	<u>65,500</u>

XYZ GROUP STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X7 (TWO STATEMENT FORMAT)

	20X7	20X6
	\$'000	\$'000
Profit for the year	<u>121,250</u>	<u>65,500</u>
<i>Other comprehensive income:</i>		
<i>Items that will not be reclassified to profit or loss:</i>		
Gains on property revaluation	933	3,367
Remeasurements of defined benefit pension plans	(667)	1,333
Share of other comprehensive income of associates	400	(700)
Income tax relating to items that will not be reclassified	(166)	(1,000)
	<u>500</u>	<u>3,000</u>
<i>Items that may be reclassified subsequently to profit or loss:</i>		
Exchange differences on translating foreign operations	5,334	10,667
Investments in equity instruments	(24,000)	26,667
Cash flow hedges	(667)	(4,000)
Income tax relating to items that may be reclassified	4,833	(8,334)
	<u>14,500</u>	<u>25,000</u>
Other comprehensive income for the year, net of tax	<u>(14,000)</u>	<u>28,000</u>
<i>Total comprehensive income for the year</i>	<u>107,250</u>	<u>93,500</u>
Total comprehensive income attributable to		
Owners of the parent	85,800	74,800
Non-controlling interest	21,450	18,700
	<u>107,250</u>	<u>93,500</u>

(IAS 1: Implementation Guidance Part 1)

4.2 Examples of separate statements of profit or loss

IAS 1 offers two possible formats for the statement of profit or loss or separate profit or loss section – by **function** or by **nature**. Classification by function is more common.

XYZ GROUP

STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X8

Illustrating the classification of expenses by function

	20X8 \$'000	20X7 \$'000
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the year	<u>X</u>	<u>X</u>
Profit attributable to:		
Owners of the parent	X	X
Non-controlling interest	<u>X</u>	<u>X</u>

Illustrating the classification of expenses by nature

	20X8 \$'000	20X7 \$'000
Revenue	X	X
Other operating income	X	X
Changes in inventories of finished goods and work in progress	(X)	X
Work performed by the entity and capitalised	X	X
Raw material and consumables used	(X)	(X)
Employee benefits expense	(X)	(X)
Depreciation and amortisation expense	(X)	(X)
Impairment of property, plant and equipment	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the year	<u>X</u>	<u>X</u>
Profit attributable to:		
Owners of the parent	X	X
Non-controlling interest	<u>X</u>	<u>X</u>

(Adapted from IAS 1: Implementation Guidance Part 1)

Note. The usual method of presentation is expenses by function and this is the format likely to appear in your exam.

4.3 Information presented in the statement of profit or loss

The standard lists the following as the **minimum** to be disclosed as line items in the statement of profit or loss (IAS 1: para. 82).

- (a) Revenue
- (b) Gains and losses arising from the derecognition of financial assets measured at amortised cost
- (c) Finance costs
- (d) Impairment losses determined in accordance with IFRS 9
- (e) Share of the profit or loss of associates and joint ventures accounted for using the equity method
- (f) If a financial asset is reclassified out of the amortised cost measurement category so that it is measured at fair value through profit or loss, any gain or loss arising from a difference between the previous amortised cost of the financial asset and its fair value at the reclassification date (as defined in IFRS 9)
- (g) If a financial asset is reclassified out of the fair value through other comprehensive income measurement category so that it is measured at fair value through profit or loss, any cumulative gain or loss previously recognised in other comprehensive income that is reclassified to profit or loss
- (h) Tax expense
- (i) A single amount for the total of discontinued operations

The statement of profit or loss and other comprehensive income must present the following totals (IAS 1: para. 81A):

- (a) 'Profit or loss;
- (b) Total other comprehensive income;
- (c) Comprehensive income for the period, being the total of profit or loss and other comprehensive income.'

The following items must be disclosed as 'allocation of profit or loss and other comprehensive income for the period:

- (a) Profit or loss for the period attributable to:
 - (i) Non-controlling interests, and
 - (ii) Owners of the parent.
- (b) Comprehensive income for the period attributable to:
 - (i) Non-controlling interests, and
 - (ii) Owners of the parent.'

Income and expense items should not be offset unless required or permitted by an IFRS (IAS 1: para. 32).

4.4 Information presented either in the statement or in the notes

An analysis of expenses must be shown either in the profit or loss section (as above, which is encouraged by the standard) or by note, using a classification based on **either** the nature of the expenses or their function. This **sub-classification of expenses** indicates a range of components of financial performance; these may differ in terms of stability, potential for gain or loss and predictability.

(IAS 1: paras. 99–106)

4.4.1 Nature of expense method

Expenses are not reallocated amongst various functions within the entity, but are aggregated in the statement of profit or loss **according to their nature** (eg purchase of materials, depreciation, wages and salaries, transport costs). This is by far the easiest method, especially for smaller entities.

(IAS 1: para. 102)

4.4.2 Function of expense/cost of sales method

You are likely to be more familiar with this method. Expenses are classified according to their function as part of cost of sales, distribution or administrative activities. This method often gives **more relevant information** for users, but the allocation of expenses by function requires the use of judgement and can be arbitrary (IAS 1: para. 103). Consequently, perhaps, when this method is used, entities should 'disclose **additional information** on the nature of expenses, including depreciation and amortisation expense and employee benefits expense' (IAS 1: para. 104).

Which of the above methods is chosen by an entity will 'depend[...] on **historical and industry factors**, and also the **nature of the entity**' (IAS 1: para. 105). Under each method, there should be given an indication of costs which are likely to vary (directly or indirectly) with the level of sales or production. The choice of method should fairly reflect the main elements of the entity's performance. **This is the method you should expect to see in your exam.**

4.5 Dividends

IAS 1 also requires disclosure of the amount of **dividends paid** during the period covered by the financial statements. This is shown either in the statement of changes in equity or in the notes. (IAS 1: para. 107)

4.6 Further points

- (a) All requirements previously set out in other Standards for the presentation of particular line items in the statement of financial position and statement of profit or loss and other comprehensive income are now dealt with in IAS 1. These line items are: biological assets; liabilities and assets for current tax and deferred tax; and pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to discontinued operations.
- (b) An entity must disclose, in the summary of significant accounting policies and/or other notes, the **judgements** made by management in **applying the accounting policies** that have the **most significant effect** on the amounts of items recognised in the financial statements (IAS 1: para. 122).
- (c) An entity must disclose in the notes information regarding **key assumptions** about the **future**, and other sources of **measurement uncertainty**, that have a **significant risk of causing a material adjustment** to the carrying amounts of assets and liabilities within the **next financial year** (IAS 1: para. 125).

5 Changes in equity

FAST FORWARD

IAS 1 requires a statement of changes in equity. This shows the movement in the equity section of the statement of financial position. A full set of financial statements includes a statement of changes in equity.

5.1 Format

This is the format of the statement of changes in equity as per IAS 1.

XYZ GROUP – STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20X7

	Share capital	Retained earnings	Investments In equity instruments	Revaluation surplus	Total	Non- controlling interest	Total equity
Balance at 1 January 20X6	\$'000 600,000	\$'000 118,100	\$'000 1,600	\$'000 –	\$'000 719,700	\$'000 29,800	\$'000 749,500
Changes in accounting policy	–	400	–	–	400	100	500
Restated balance	600,000	118,500	1,600	–	720,100	29,900	750,000

	Share capital	Retained earnings	Investments in equity instruments	Revaluation surplus	Total	Non-controlling interest	Total equity
Changes in equity							
Dividends	–	(10,000)	–	–	(10,000)	–	(10,000)
Total comprehensive income for the year	–	53,200	16,000	1,600	70,800	18,700	89,500
Balance at 31 December 20X6	600,000	161,700	17,600	1,600	780,900	48,600	829,500
Changes in equity for 20X7							
Issue of share capital	50,000	–	–	–	50,000	–	50,000
Dividends	–	(15,000)	–	–	(15,000)	–	(15,000)
Total comprehensive income for the year	–	96,600	(14,400)	800	83,000	21,450	104,450
Transfer to retained earnings	–	200	–	(200)	–	–	–
Balance at 31 December 20X7	650,000	243,500	3,200	2,200	898,900	70,050	968,950

(Adapted from IAS 1: Implementation Guidance Part 1)

Note that where there has been a change of accounting policy necessitating a retrospective restatement, the adjustment is disclosed for each period. So, rather than just showing an adjustment to the balance b/f on 1.1.X7, the balances for 20X6 are restated.

6 Notes to the financial statements

FAST FORWARD

Some items need to be disclosed by way of a note.

6.1 Contents of notes

The notes to the financial statements will **amplify** the information given in the statement of financial position, statement of profit or loss and other comprehensive income and statement of changes in equity. We have already noted above the information which the IAS allows to be shown by note rather than in the statements. To some extent, then, the contents of the notes will be determined by the level of detail shown in the **primary statements**.

6.2 Structure

The notes to the financial statements should perform the following functions.

- Present information about the **basis on which the financial statements were prepared** and which **specific accounting policies** were chosen and applied to significant transactions/events
- Disclose any information, not shown elsewhere in the financial statements, which is **required by IFRSs**
- Show any additional information that is relevant to understanding which is not shown elsewhere in the financial statements

(IAS 1: para. 112)

The way the notes are presented is important. They should be given in a **systematic manner** and **cross referenced** back to the related figure(s) in the statement of financial position, statement of profit or loss and other comprehensive income, or statement of cash flows.

(IAS 1: para. 113)

Notes to the financial statements will amplify the information shown therein by giving the following.

- More **detailed analysis** or breakdowns of figures in the statements
- Narrative information** explaining figures in the statements
- Additional information**, eg contingent liabilities and commitments

6.3 Presentation of accounting policies

IAS 1 (para. 117) requires the disclosure of an entity's significant accounting policies, including the measurement bases used.

This information may be shown in the notes or sometimes as a **separate component** of the financial statements.

The information on measurement bases used is obviously fundamental to an understanding of the financial statements. Where **more than one basis is used**, it should be stated to which categories of assets or liabilities each basis has been applied.

(IAS 1: para. 118)

Note. Accounting policies are covered in Chapter 16.

6.4 Other disclosures

IAS 1 lists the following disclosures which must also be given in the notes:

- (a) 'The amount of dividends proposed or declared before the financial statements were authorised for issue but not recognised as a distribution to owners during the period, and the related amount per share; and
- (b) The amount of any cumulative preference dividends not recognised' (IAS 1: para. 137).

And finally, if this information is not shown elsewhere in annual report, the notes should include disclosure of:

- (a) 'The domicile and legal form of the entity, its country of incorporation and the address of the registered office (or, [if different], principal place of business [...]);
- (b) A description of the nature of the entity's operations and its principal activities;
- (c) The name of the parent entity and the ultimate parent entity of the group; and
- (d) If it is a limited life entity, information regarding the length of its life' (IAS 1: para. 138).



Question

Financial statements

The accountant of Wislon Co has prepared the following list of account balances as at 31 December 20X7.

	\$'000
50c ordinary shares (fully paid)	450
10% loan notes (secured)	200
Retained earnings 1.1.X7	242
General reserve 1.1.X7	171
Land and buildings 1.1.X7 (cost)	430
Plant and machinery 1.1.X7 (cost)	830
Accumulated depreciation	
Buildings 1.1.X7	20
Plant and machinery 1.1.X7	222
Inventory 1.1.X7	190
Sales	2,695
Purchases	2,152
Ordinary dividend	15
Loan note interest	10
Wages and salaries	254
Light and heat	31
Sundry expenses	113
Suspense account	135
Trade accounts receivable	179
Trade accounts payable	195
Cash	126

Notes:

- (a) Sundry expenses include \$9,000 paid in respect of insurance for the year ending 1 September 20X8. Light and heat does not include an invoice of \$3,000 for electricity for the three months ending 2 January 20X8, which was paid in February 20X8. Light and heat also includes \$20,000 relating to salesmen's commission.

- (b) The suspense account is in respect of the following items.

	\$'000
Proceeds from the issue of 100,000 ordinary shares	120
Proceeds from the sale of plant	300
	<u>420</u>
Less consideration for the acquisition of Mary & Co	285
	<u>135</u>

- (c) The net assets of Mary & Co were purchased on 3 March 20X7. Assets were valued as follows

	\$'000
Equity investments	231
Inventory	34
	<u>265</u>

All the inventory acquired was sold during 20X7. The equity investments were still held by Wislon at 31.12.X7. Goodwill has not been impaired in value.

- (d) The property was acquired some years ago. The buildings element of the cost was estimated at \$100,000 and the estimated useful life of the assets was 50 years at the time of purchase. As at 31 December 20X7 the property is to be revalued at \$800,000.
- (e) The plant which was sold had cost \$350,000 and had a carrying amount of \$274,000 as on 1.1.X7. \$36,000 depreciation is to be charged on plant and machinery for 20X7.
- (f) The management wish to provide for:
- Loan note interest due
 - A transfer to general reserve of \$16,000
 - Audit fees of \$4,000
- (g) Inventory as at 31 December 20X7 was valued at \$220,000 (cost).
- (h) Taxation is to be ignored.

Required

Prepare the financial statements of Wislon Co as at 31 December 20X7. You do not need to produce notes to the statements.

Answer

- (a) Normal adjustments are needed for accruals and prepayments (insurance, light and heat, loan note interest and audit fees). The loan note interest accrued is calculated as follows.

	\$'000
Charge needed in profit or loss ($10\% \times \$200,000$)	20
Amount paid so far, as shown in list of account balances	10
Accrual: presumably six months' interest now payable	<u>10</u>

The accrued expenses shown in the statement of financial position comprise:

	\$'000
Loan note interest	10
Light and heat	3
Audit fee	4
	<u>17</u>

- (b) The misposting of \$20,000 to light and heat is also adjusted, by reducing the light and heat expense, but charging \$20,000 to salesmen's commission.

- (c) Depreciation on the building is calculated as $\frac{\$100,000}{50} = \$2,000$.

The carrying amount of the building is then $\$430,000 - \$20,000 - \$2,000 = \$408,000$ at the end of the year. When the property is revalued a reserve of $\$800,000 - \$408,000 = \$392,000$ is then created.

- (d) The profit on disposal of plant is calculated as proceeds \$300,000 (per suspense account) less carrying amount \$274,000, ie \$26,000. The cost of the remaining plant is calculated at $\$830,000 - \$350,000 = \$480,000$. The depreciation provision at the year end is:

	\$'000
Balance 1.1.X7	222
Charge for 20X7	36
Less depreciation on disposals (350 – 274)	(76)
	<u>182</u>

- (e) Goodwill arising on the purchase of Mary & Co is:

	\$'000
Consideration (per suspense account)	285
Assets at valuation	<u>265</u>
Goodwill	<u>20</u>

This is shown as an asset in the statement of financial position. The equity investments, being owned by Wislon at the year end, are also shown on the statement of financial position, whereas Mary's inventory, acquired and then sold, is added to the purchases figure for the year.

- (f) The other item in the suspense account is dealt with as follows.

	\$'000
Proceeds of issue of 100,000 ordinary shares	120
Less nominal value 100,000 × 50c	<u>50</u>
Excess of consideration over par value (= share premium)	<u>70</u>

- (g) The transfer to general reserve increases it to $\$171,000 + \$16,000 = \$187,000$.

We can now prepare the financial statements.

WISLON CO

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X7

	\$'000
Revenue	2,695
Cost of sales (W1)	<u>(2,156)</u>
Gross profit	539
Other income (profit on disposal of plant)	26
Administrative expenses (W2)	<u>(437)</u>
Finance costs	<u>(20)</u>
Profit for the year	108
Other comprehensive income:	
Gain on property revaluation	<u>392</u>
Total comprehensive income for the year	<u>500</u>

Workings

WISLON CO

	\$'000	\$'000
2019	1,000	1,000
2018	1,000	1,000
2017	1,000	1,000
2016	1,000	1,000
2015	1,000	1,000
2014	1,000	1,000
2013	1,000	1,000
2012	1,000	1,000
2011	1,000	1,000
2010	1,000	1,000
2009	1,000	1,000
2008	1,000	1,000
2007	1,000	1,000
2006	1,000	1,000
2005	1,000	1,000
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1927	1,000	1,000
1926	1,000	1,000
1925	1,000	1,000
1924	1,000	1,000
1923	1,000	1,000
1922	1,000	1,000
1921	1,000	1,000
1920	1,000	1,000
1919	1,000	1,000
1918	1,000	1,000
1917	1,000	1,000
1916	1,000	1,000

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WISLON CO
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X7

	Share capital \$'000	Share premium \$'000	Retained earnings \$'000	General reserve \$'000	Revaluation Surplus \$'000	Total \$'000
Balance at 1.1.X7	450	—	242	171	—	863
Issue of share capital	50	70				120
Dividends			(15)			(15)
Total comprehensive income for the year			108		392	500
Transfer to reserve			(16)	16		
Balance at 31.12.X7	<u>500</u>	<u>70</u>	<u>319</u>	<u>187</u>	<u>392</u>	<u>1,468</u>

Note that the total comprehensive income is analysed into its components.

7 Fair presentation and compliance with IFRS

Most importantly, financial statements should '**present fairly** the financial position, financial performance and cash flows of an entity' (IAS 1: para. 15, emphasis BPP's). **Compliance with IFRS** is presumed to result in fair presentation (IAS 1: para. 15).

The following points made by IAS 1 expand on this principle (IAS 1: paras. 17–18):

- (a) **Compliance with IFRS** should be disclosed
- (b) **All relevant IFRS** must be followed if compliance with IFRS is disclosed
- (c) Use of an **inappropriate accounting treatment** cannot be rectified either by disclosure of accounting policies or notes/explanatory material

IAS 1 states what is also expected for a fair presentation (IAS 1: para. 17):

- (a) Selection and application of appropriate **accounting policies**
- (b) **Presentation of information** in a manner which provides relevant, reliable, comparable and understandable information
- (c) **Additional disclosures** where required

7.1 Departure from IFRS requirement

There may be extremely rare circumstances in which management concludes that compliance with a requirement of an IFRS would be 'so misleading that it would conflict with the objective of financial statements [...]' (IAS 1: para. 19). In those circumstances, and provided it is permissible under the applicable regulatory framework, **departure from the specific requirement of the IFRS** is required to achieve a fair presentation. This is usually referred to as the 'true and fair override' or the 'fair presentation override'.

The following should be disclosed in such an event (IAS 1: para. 20):

- (a) Management confirmation that the financial statements fairly present the entity's financial position, performance and cash flows
- (b) Statement that all IFRS have been complied with **except** departure from one IFRS to achieve a fair presentation
- (c) Details of the nature of the departure, why the IFRS treatment would be misleading, and the treatment adopted
- (d) Financial impact of the departure

In some countries, departure from an IFRS is **not permitted** by the applicable regulatory framework under any circumstance. In such cases the entity needs to 'reduce the perceived misleading aspects of compliance by **disclosing**:'

- (a) The title of the Standard, the nature of the requirement, and the reason why management has [reached its conclusion]; and
- (b) For each period, the adjustment to each item in the financial statements that management has concluded would be necessary to achieve a fair presentation' (IAS 1: para. 23).

Chapter Roundup

- IAS 1 covers the **form and content** of financial statements. The main components are:
 - Statement of financial position
 - Statement of profit or loss and other comprehensive income
 - Statement of changes in equity
 - Statement of cash flows
 - Notes to the financial statements
- IAS 1 suggests a format for the statement of financial position. Certain items are specified for **disclosure as line items in the financial statements**.
- You should appreciate the distinction between current and non-current assets and liabilities and their different treatments.
- IAS 1 offers **two** possible formats for the statement of profit or loss or separate profit or loss section – by **function or by nature**. Classification by function is more common.
- IAS 1 requires a statement of changes in equity. This shows the movement in the equity section of the statement of financial position. A full set of financial statements includes a statement of changes in equity.
- Some items need to be disclosed by way of a note.

Quick Quiz

- 1 Which of the following are examples of current assets?
 - (a) Property, plant and equipment
 - (b) Prepayments
 - (c) Cash equivalents
 - (d) Manufacturing licences
 - (e) Retained earnings
- 2 Provisions must be disclosed in the statement of financial position. True/False?
- 3 Which of the following must be disclosed as line items in the statement of profit or loss?
 - (a) Tax expense
 - (b) Analysis of expenses
 - (c) Profit or loss
- 4 Where are revaluation gains shown in the financial statements?
- 5 An entity has headings of cost of sales, distribution costs and administrative expenses on its statement of profit or loss. Are these expenses analysed by nature or function?

Answers to Quick Quiz

- 1 (b) and (c) only
- 2 True
- 3 (a) and (c) only. (b) may be shown in the notes.
- 4 In other comprehensive income and in the statement of changes in equity.
- 5 Function

Now try the questions below from the Practice Question Bank

Number	Level	Marks	Time
Q18	Intermediate	40	78 mins
Q19	Introductory	6	12 mins

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Reporting financial performance

Topic list	Syllabus reference
1 IAS 8 <i>Accounting Policies, Changes in Accounting Estimates and Errors</i>	C4
2 Changes in accounting policies	C4
3 Errors	C4
4 IFRS 5 <i>Non-current Assets Held for Sale and Discontinued Operations</i>	C1, B2
5 IAS 10 <i>Events After the Reporting Period</i>	C3

Introduction

IAS 8 deals with accounting policies. It also looks at certain circumstances and transactions which require different treatment to normal profit or loss items.

IFRS 5 on assets held for sale and discontinued operations is an important standard which gives users additional information regarding the sources of the entity's profit and losses.

IAS 10 sets out the treatment for events occurring after the accounting year end.

Study guide

C1	Presentation of the statement of financial position, and statement of profit or loss and other comprehensive income
(c)	Discuss the importance of identifying and reporting the results of discontinued operations
(d)	Define and account for non-current assets held for sale and discontinued operations
B2	Property, plant and equipment
(h)	Describe the criteria that need to be present before non-current assets are classified as held for sale, either individually or in a disposal group
(i)	Apply the requirements of International Financial Reporting Standards for non-current assets and disposal groups that are held for sale
C3	Events after the reporting period
(a)	Distinguish between and account for adjusting and non-adjusting events after the reporting period
C4	Accounting policies, changes in accounting estimates and errors
(a)	Identify items requiring separate disclosure, including their accounting treatment and required disclosures
(b)	Recognise the circumstances where a change in accounting policy is justified
(c)	Define prior period adjustments and 'errors'
(d)	Account for the correction of errors and changes in accounting policies

1 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*

FAST FORWARD

IAS 8 deals with changes in accounting estimates, changes in accounting policies and errors.

1.1 Definitions

The following definitions are given in the standard.

Key terms

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

A **change in accounting estimate** is an adjustment of the carrying amount of an asset or a liability or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

Material. 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.

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 authorised for issue, and
- Could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

Key terms (cont'd)

Retrospective application is applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.

Retrospective restatement is correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred.

Prospective application of a change in accounting policy and of recognising the effect of a change in an accounting estimate, respectively, are:

- Applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed; and
- Recognising the effect of the change in the accounting estimate in the current and future periods affected by the change.

Impracticable. Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. It is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if one of the following apply.

- The effects of the retrospective application or retrospective restatement are not determinable.
- The retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period.
- The retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that provides evidence of circumstances that existed on the date(s) at which those amounts are to be recognised, measured or disclosed; and would have been available when the financial statements for that prior period were authorised for issue, from other information.

(IAS 8: para. 5)

1.2 Accounting policies

Accounting policies are determined by **applying the relevant IFRS** and considering any relevant Implementation Guidance issued by the IASB for that IFRS.

Where there is no applicable IFRS or Interpretation management should use its **judgement** in developing and applying an accounting policy that results in information that is **relevant** and **reliable**. Management should refer to:

- (a) The requirements and guidance in IFRSs dealing with **similar** and **related issues**
- (b) The definitions, recognition criteria and measurement concepts for assets, liabilities and expenses in the **Conceptual Framework**

(IAS 8: para.11)

Management may also consider the most recent pronouncements of **other standard setting bodies** that use a similar conceptual framework to develop standards, other accounting literature and accepted industry practices if these do not conflict with the sources above.

An entity must select and apply its accounting policies for a period **consistently** for similar transactions, other events and conditions, unless an IFRS specifically requires or permits categorisation of items for which different policies may be appropriate. If an IFRS requires or permits categorisation of items, an appropriate accounting policy must be selected and applied consistently to each category.

2 Changes in accounting policies

FAST FORWARD

Changes in accounting policy are applied **retrospectively**.

2.1 Accounting for changes of policy

The same accounting policies are usually adopted from period to period, to allow users to analyse trends over time in profit, cash flows and financial position. **Changes in accounting policy will therefore be rare** and should be made only if:

- (a) The change is required by an IFRS; or
- (b) The change will result in a **more appropriate presentation** of events or transactions in the financial statements of the entity, providing more reliable and relevant information.

(IAS 8: para. 14)

The standard highlights two types of event which do **not** constitute changes in accounting policy.

- (a) Adopting an accounting policy for a **new type of transaction** or event not dealt with previously by the entity.
- (b) Adopting a **new accounting policy** for a transaction or event which has not occurred in the past or which was not material.

(IAS 8: para. 16)

In the case of tangible non-current assets, if a policy of revaluation is adopted for the first time then this is treated, not as a change of accounting policy under IAS 8, but as a revaluation under IAS 16 Property, plant and equipment (see Chapter 4). The following paragraphs do not therefore apply to a change in policy to adopt revaluations.

A change in accounting policy **must be applied retrospectively**. **Retrospective application** means that the new accounting policy is applied to transactions and events as if it had always been in use. In other words, at the earliest date such transactions or events occurred, the policy is applied from that date (IAS 8: para. 22).

Prospective application is **no longer allowed** under IAS 8 unless it is **impracticable** (see Key Terms) to determine the cumulative effect of the change.

2.2 Worked example: Change of accounting policy

A company has always valued inventory on a FIFO (first in, first out) basis. In 20X9 it decides to switch to the weighted average method of valuation. Gross profit in the 20X8 financial statements was calculated as follows:

		\$'000
Revenue		869
Cost of sales:		
Opening inventory	135	
Purchases	246	
Closing inventory	<u>(174)</u>	<u>(207)</u>
Gross profit		<u>662</u>

In order to prepare comparative figures for 20X8 showing the change of accounting policy, it is necessary to recalculate the amounts for 20X7, so that the opening inventory for 20X8 is valued on a weighted average basis.

It is established that opening inventory for 20X8 based on the weighted average method would be \$122,000 and closing inventory would be \$143,000. So the 20X8 gross profit now becomes:

		\$'000
Revenue		869
Cost of sales:		
Opening inventory	122	
Purchases	246	
Closing inventory	<u>(143)</u>	<u>(225)</u>
		<u>644</u>

This shows \$18,000 lower gross profit for 20X8 which will reduce net profit and retained earnings by the same amount. The opening inventory for 20X9 will be \$143,000 rather than \$174,000 and the statement of changes in equity for 20X9 will show an \$18,000 adjustment to opening retained earnings.

2.3 Adoption of an IFRS

Where a new IFRS is adopted, resulting in a change of accounting policy, IAS 8 requires any transitional provisions in the new IFRS itself to be followed. If none are given in the IFRS which is being adopted, then you should follow the general principles of IAS 8.

2.4 Disclosure

Certain **disclosures** are required when a change in accounting policy has a material effect on the current period or any prior period presented, or when it may have a material effect in subsequent periods.

- (a) The nature of the change
- (b) The reasons why applying the new accounting policy provides reliable and more relevant information
- (c) For the current period and each prior period presented the amount of the adjustment:
 - (i) For each financial statement line item affected; and
 - (ii) If IAS 33 applies to the entity, for basic and diluted earnings per share
- (d) The amount of the adjustment relating to periods before those presented
- (e) If retrospective application is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

(IAS 8: para. 29)

An entity should also disclose information relevant to assessing the **impact of new IFRS** on the financial statements where these have **not yet come into force** (IAS 8: para. 28).

Disclosure is important to maintain the principle of **comparability**. Users should be able to compare the financial statements of an entity over time and to compare the financial statements of entities in the same line of business. Changes of accounting policy affect comparability, so it is important that they are disclosed.

2.5 Changes in accounting estimates

FAST FORWARD

Changes in accounting estimate are **not** applied retrospectively.

Estimates arise in relation to business activities because of the **uncertainties inherent within them**. Judgements are made based on the most up to date information and the use of such estimates is a necessary part of the preparation of financial statements. It does not undermine their reliability. Here are some examples of accounting estimates.

- (a) A necessary **irrecoverable debt allowance**
- (b) **Useful lives** of depreciable assets
- (c) Provision for obsolescence of inventory

(IAS 8: para. 32)

The rule here is that the **effect of a change in an accounting estimate** should be included in the determination of net profit or loss in one of:

- (a) The period of the change, if the change affects that period only
- (b) The period of the change and future periods, if the change affects both

Changes may occur in the circumstances which were in force at the time the estimate was calculated, or perhaps additional information or subsequent developments have come to light.

An example of a change in accounting estimate which affects only the **current period** is the bad debt estimate. However, a revision in the life over which an asset is depreciated would affect both the **current and future periods**, in the amount of the depreciation expense.

Reasonably enough, the effect of a change in an accounting estimate should be included in the **same expense classification** as was used previously for the estimate. This rule helps to ensure **consistency** between the financial statements of different periods.

The **materiality** of the change is also relevant. The nature and amount of a change in an accounting estimate that has a material effect in the current period (or which is expected to have a material effect in subsequent periods) should be disclosed. If it is not possible to quantify the amount, this impracticability should be disclosed.

3 Errors

FAST FORWARD

Prior period errors must be corrected **retrospectively**.

3.1 Introduction

Errors discovered during a current period which **relate to a prior period** may arise through:

- (a) Mathematical mistakes
- (b) Mistakes in the application of accounting policies
- (c) Misinterpretation of facts
- (d) Oversights
- (e) Fraud

A more formal definition is given in the Key Terms in Section 1.1.

Most of the time these errors can be **corrected through net profit or loss for the current period**. Where they are **material** prior period errors, however, this is not appropriate. The standard considers two possible treatments.

3.2 Accounting treatment

Material prior period errors: correct retrospectively.

This involves:

- (a) Either restating the comparative amounts for the prior period(s) in which the error occurred,
- (b) Or, when the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for that period

(IAS 8: para. 42)

so that the financial statements are presented **as if the error had never occurred**.

Only where it is **impracticable** to determine the cumulative effect of an error on prior periods can an entity correct an error **prospectively**.

Various **disclosures** are required.

- (a) **Nature** of the prior period error
- (b) For each prior period, to the extent practicable, the **amount** of the correction.
 - (i) For each financial statement line item affected
 - (ii) If IAS 33 applies, for basic and diluted earnings per share
- (c) The amount of the correction at the **beginning of the earliest prior period** presented
- (d) If **retrospective restatement is impracticable** for a particular prior period, the **circumstances** that led to the existence of that condition and a description of how and from when the error has been corrected.

(IAS 8: para. 49)

Subsequent periods need not repeat these disclosures.

If you have to deal with a change of accounting policy or an error in an accounts preparation question, remember to adjust the balance of retained earnings brought forward.



Question

Error

During 20X7 Global discovered that certain items had been included in inventory at 31 December 20X6, valued at \$4.2m, which had in fact been sold before the year end. The following figures for 20X6 (as reported) and 20X7 (draft) are available.

	20X6	20X7 (draft)
	\$'000	\$'000
Sales	47,400	67,200
Cost of goods sold	(34,570)	(55,800)
Profit before taxation	12,830	11,400
Income taxes	(3,880)	(3,400)
Profit for the period	<u>8,950</u>	<u>8,000</u>

Retained earnings at 1 January 20X6 were \$13m. The cost of goods sold for 20X7 includes the \$4.2m error in opening inventory. The income tax rate was 30% for 20X6 and 20X7. No dividends have been declared or paid.

Required

Show the statement of profit or loss for 20X7, with the 20X6 comparative, and retained earnings.

Answer

STATEMENT OF PROFIT OR LOSS

	20X6	20X7
	\$'000	\$'000
Sales	47,400	67,200
Cost of goods sold (W1)	(38,770)	(51,600)
Profit before tax	8,630	15,600
Income tax (W2)	(2,620)	(4,660)
Profit for the year	<u>6,010</u>	<u>10,940</u>

RETAINED EARNINGS

	20X6	20X7
	\$'000	\$'000
Opening retained earnings	13,000	21,950
As previously reported (13,000 + 8,950)		
Correction of prior period error (4,200 – 1,260)	–	(2,940)
As restated	13,000	19,010
Profit for the year	6,010	10,940
Closing retained earnings	<u>19,010</u>	<u>29,950</u>

Workings

1	Cost of goods sold	20X6	20X7
		\$'000	\$'000
	As stated in question	34,570	55,800
	Inventory adjustment	4,200	(4,200)
		<u>38,770</u>	<u>51,600</u>
2	Income tax	20X6	20X7
		\$'000	\$'000
	As stated in question	3,880	3,400
	Inventory adjustment (4,200 × 30%)	(1,260)	1,260
		<u>2,620</u>	<u>4,660</u>

4 IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

FAST FORWARD

IFRS 5 requires assets 'held for sale' to be presented separately in the statement of financial position. It sets out the criteria for recognising a **discontinued operation**.

Exam focus point

IFRS 5 is examined quite frequently. It often crops up as a discursive part of a question.

4.1 Background

IFRS 5 is the result of a short-term convergence project with the US Financial Accounting Standards Board (FASB).

IFRS 5 requires assets and groups of assets that are 'held for sale' to be **presented separately** in the statement of financial position and the results of discontinued operations to be presented separately in the statement of profit or loss and other comprehensive income. This is required so that users of financial statements will be better able to make **projections** about the financial position, profits and cash flows of the entity.

Key terms

Disposal group. A group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. (In practice a disposal group could be a subsidiary, a cash-generating unit or a single operation within an entity.)

Cash-generating unit. The smallest identifiable group of assets for which independent cash flows can be identified and measured.

(IFRS 5: Appendix A)

IFRS 5 does not apply to certain assets covered by other accounting standards:

- (a) Deferred tax assets (IAS 12)
- (b) Assets arising from employee benefits (IAS 19)
- (c) Financial assets (IFRS 9)
- (d) Investment properties accounted for in accordance with the fair value model (IAS 40)
- (e) Agricultural and biological assets (IAS 41)
- (f) Insurance contracts (IFRS 17, not examinable in this syllabus)

(IFRS 5: para. 5)

4.2 Classification of assets held for sale

A non-current asset (or disposal group) should be classified as **held for sale** if its carrying amount will be recovered **principally through a sale transaction** rather than **through continuing use**. A number of detailed criteria must be met:

- (a) The asset must be **available for immediate sale** in its present condition.
- (b) Its sale must be **highly probable** (ie significantly more likely than not).

(IFRS 5: para. 7)

For the sale to be highly probable, the following must apply.

- (a) Management must be **committed** to a plan to sell the asset.
- (b) There must be an active programme to **locate a buyer**.
- (c) The asset must be marketed for sale at a **price that is reasonable** in relation to its current fair value.
- (d) The sale should be expected to take place **within one year** from the date of classification.
- (e) It is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

(IFRS 5: para. 8)

An asset (or disposal group) can still be classified as held for sale, even if the sale has not actually taken place within one year. However, the delay must have been **caused by events or circumstances beyond the entity's control** and there must be sufficient evidence that the entity is still committed to sell the asset or disposal group. Otherwise the entity must cease to classify the asset as held for sale (IFRS 5: para. 9).

If 'an entity acquires a disposal group (eg a subsidiary) exclusively with a view to its subsequent disposal it can classify the asset as held for sale only if the sale is expected to take place within one year and it is highly probable that all the other criteria will be met within a short time (normally three months)' (IFRS 5: para. 11).

An asset that is to be **abandoned** should not be classified as held for sale. This is because its carrying amount will be recovered principally through continuing use. However, a disposal group to be abandoned may meet the definition of a discontinued operation and therefore separate disclosure may be required (see section 4.6 below) (IFRS 5: para. 13).



Question

Held for sale

On 1 December 20X3, a company became committed to a plan to sell a manufacturing facility and has already found a potential buyer. The company does not intend to discontinue the operations currently carried out in the facility. At 31 December 20X3 there is a backlog of uncompleted customer orders. The company will not be able to transfer the facility to the buyer until after it ceases to operate the facility and has eliminated the backlog of uncompleted customer orders. This is not expected to occur until spring 20X4.

Required

Can the manufacturing facility be classified as 'held for sale' at 31 December 20X3?

Answer

The facility will not be transferred until the backlog of orders is completed; this demonstrates that the facility is not available for immediate sale in its present condition. The facility cannot be classified as 'held for sale' at 31 December 20X3. It must be treated in the same way as other items of property, plant and equipment: it should continue to be depreciated and should not be separately disclosed.

4.3 Measurement of assets held for sale

Key terms

Fair value. 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
(IFRS 3: para. 9)

Costs of disposal. The incremental costs directly attributable to the disposal of an asset (or disposal group), excluding finance costs and income tax expense

Recoverable amount. The higher of an asset's fair value less costs of disposal and its value in use

Value in use. 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
(IFRS 5: Appendix A)

A non-current asset (or disposal group) that is held for sale should be measured at the **lower of its carrying amount and fair value less costs of disposal**. Fair value less costs of disposal is equivalent to net realisable value.

An impairment loss should be recognised where fair value less costs of disposal is lower than carrying amount. Note that this is an exception to the normal rule. IAS 36 *Impairment of Assets* requires an entity to recognise an impairment loss only where an asset's recoverable amount is lower than its carrying value. Recoverable amount is defined as the higher of fair value less costs of disposal and value in use.

IAS 36 does not apply to assets held for sale. An impairment loss on an asset held under IFRS 5 is charged to **profit or loss**.

Non-current assets held for sale **should not be depreciated**, even if they are still being used by the entity.

A non-current asset held for sale should be **remeasured** at the lower of its carrying amount and fair value less costs of disposal at each reporting date at which it is still classified as held for sale. Any impairment (arising for instance from an increase in costs of disposal) is recognised and charged to profit or loss. If the fair value less costs of disposal of the asset increases, then the carrying amount of the asset can be increased and the resulting gain should be recognised in profit or loss, effectively reversing the impairment loss. However, this gain should not be in excess of impairment losses previously recognised under IFRS 5 or under IAS 36 (before the asset was classified as held for sale) (IFRS 5: para. 21).

A non-current asset (or disposal group) that is **no longer classified as held for sale** (for example, because the sale has not taken place within one year) is measured at the **lower of**:

- (a) Its **carrying amount** before it was classified as held for sale, adjusted for any depreciation that would have been charged had the asset not been held for sale
- (b) Its **recoverable amount** at the date of the decision not to sell

(IFRS 5: para. 27)

4.4 Presentation of a non-current asset or disposal group classified as held for sale

Non-current assets and disposal groups classified as held for sale should be **presented separately** from other assets in the statement of financial position. The liabilities of a disposal group should be presented separately from other liabilities in the statement of financial position.

- (a) Assets and liabilities held for sale **should not be offset**.
- (b) The **major classes** of assets and liabilities held for sale should be **separately disclosed** either on the face of the statement of financial position or in the notes.
- (c) IFRS 5 requires non-current assets or disposal groups held for sale to be shown as a separate component of **current assets/current liabilities**.

(IFRS 5: para. 38)

For example (taken from IFRS 5, Implementation Guidance)

ASSETS

Non-current assets

AAA

X

Current assets

BBB

X

CCC

X

X

Non-current assets classified as held for sale

X

X

Total assets

X

EQUITY AND LIABILITIES

Equity

DDD

X

Non-current liabilities

EEE

X

Current liabilities

FFF

X

GGG

X

Liabilities directly associated with non-current assets classified as held for sale

X

X

Total equity and liabilities

X

4.5 Additional disclosures

In the period in which a non-current asset (or disposal group) has been either classified as held for sale or sold the following should be disclosed.

- (a) A **description** of the non-current asset (or disposal group)
- (b) A description of the **facts and circumstances** of the disposal
- (c) Any **gain or loss** recognised when the item was classified as held for sale

(IFRS 5: para. 41)

Where an asset previously classified as held for sale is **no longer held for sale**, the entity should disclose a description of the facts and circumstances leading to the decision and its effect on results.

Exam focus point

The December 2015 paper included 10 marks for explaining the accounting requirements for assets held for sale.

4.6 Presenting discontinued operations

Key terms

Discontinued operation: a component of an entity that has either been disposed of, or is classified as held for sale, and:

- (a) Represents a separate major line of business or geographical area of operations
- (b) Is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations, or
- (c) Is a subsidiary acquired exclusively with a view to resale.

Component of an entity: operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

(IFRS 5, Appendix A)

An entity should **present and disclose information** that enables users of the financial statements to evaluate the financial effects of **discontinued operations** and disposals of non-current assets or disposal groups.

This allows users to distinguish between operations which will continue in the future and those which will not, and makes it more possible to predict future results.

An entity should disclose a **single amount** in the statement of profit or loss comprising the total of:

- (a) The **post-tax profit or loss** of discontinued operations and
- (b) The post-tax gain or loss recognised on the **measurement to fair value less costs of disposal** or on the disposal of the assets or disposal group(s) constituting the discontinued operation.

An entity should also disclose an **analysis** of this single amount into:

- (a) The revenue, expenses and **pre-tax profit or loss** of discontinued operations
- (b) The related income tax expense
- (c) The gain or loss recognised on the measurement to fair value less costs of disposal or on the disposal of the assets of the discontinued operation
- (d) The related income tax expense

(IFRS 5: para. 33)

This may be presented either in the statement of profit or loss or in the notes. If it is presented in the statement of profit or loss it should be presented in a section identified as relating to discontinued operations, ie separately from continuing operations. This analysis is not required where the discontinued operation is a newly acquired subsidiary that has been classified as held for sale.

An entity should disclose the **net cash flows** attributable to the operating, investing and financing activities of discontinued operations. These disclosures may be presented either as separate line items in the statement of cash flows or in the notes.

Gains and losses on the remeasurement of a disposal group that is not a discontinued operation but is held for sale should be included in profit or loss from continuing operations.

As mentioned in section 4.2, a disposal group that is to be abandoned may meet the definition of a discontinued operation.

Exam focus point

The December 2013 paper included seven marks in question four for explaining and showing how to report the disposal of the 'trade and assets of a business [which the entity] had acquired'.

4.7 Illustration

The following illustration is taken from the implementation guidance to IFRS 5. Profit for the period from discontinued operations would be analysed in the notes.

XYZ GROUP

STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X2

	20X2 \$'000	20X1 \$'000
Continuing operations		
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the year from continuing operations	X	X
Discontinued operations		
Profit for the year from discontinued operations	X	X
Profit for the year	X	X
Profit attributable to:		
Owners of the parent	X	X
Non-controlling interest	X	X

Note that if there were items of 'other comprehensive income' this would be shown as a full 'statement of profit or loss and other comprehensive income' as per the format in IAS 1.



Question

Closure

On 20 October 20X3 the directors of a parent company made a public announcement of plans to close a steel works. The closure means that the group will no longer carry out this type of operation, which until recently has represented about 10% of its total revenue. The works will be gradually shut down over a period of several months, with complete closure expected in July 20X4. At 31 December output had been significantly reduced and some redundancies had already taken place. The cash flows, revenues and expenses relating to the steel works can be clearly distinguished from those of the subsidiary's other operations.

Required

How should the closure be treated in the financial statements for the year ended 31 December 20X3?

Because the steel works is being closed, rather than sold, it cannot be classified as 'held for sale'. In addition, the steel works is not a discontinued operation. Although at 31 December 20X3 the group was firmly committed to the closure, this has not yet taken place nor can its assets be classified as held for sale, therefore the steel works must be included in continuing operations. Information about the planned closure could be disclosed in the notes to the financial statements.

5 IAS 10 Events After the Reporting Period

FAST FORWARD

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

The standard gives the following definition.

Key term

Events occurring after the reporting period are those events, both favourable and unfavourable, that occur between the end of the reporting period and the date on which the financial statements are authorised for issue. Two types of events can be identified.

- Those that provide evidence of conditions that existed at the end of the reporting period – **adjusting**
- Those that are indicative of conditions that arose after the reporting period – **non-adjusting**
(IAS 10: para. 3)

The financial statements are significant indicators of a company's success or failure. It is important, therefore, that they include all the information necessary for an understanding of the company's position.

Between the end of the reporting period and the date the financial statements are authorised (ie for issue outside the organisation), **events may occur** which show that assets and liabilities at the end of the reporting period should be adjusted, or that disclosure of such events should be given.

5.1 Events requiring adjustment

The standard requires adjustment of assets and liabilities in certain circumstances.

An entity shall adjust the amounts recognised in its financial statements to reflect **adjusting events** after the reporting period (IAS 10: para. 8).

An entity shall not adjust the amounts recognised in its financial statements to reflect non-adjusting events after the reporting period (IAS 10: para. 10).

An **example** of additional evidence which becomes available after the reporting period is where a **customer goes bankrupt, thus confirming that the trade account receivable balance at the year end is uncollectible**. In relation to **going concern**, the standard states that, where operating results and the financial position have deteriorated after the reporting period, it may be necessary to reconsider whether the going concern assumption is appropriate in the preparation of the financial statements.

Examples of **adjusting events** would be:

- Evidence of a permanent diminution in property value prior to the year end
- Sale of inventory after the reporting period for less than its carrying value at the year end
- Insolvency of a customer with a balance owing at the year end
- Amounts received or paid in respect of legal or insurance claims which were in negotiation at the year end
- Determination after the year end of the sale or purchase price of assets sold or purchased before the year end

- Evidence of a permanent diminution in the value of a long-term investment prior to the year end
 - Discovery of error or fraud which shows that the financial statements were incorrect
- (IAS 10: para. 9)

5.2 Events not requiring adjustment

The standard then looks at events which do **not** require adjustment.

The standard gives the following examples of events which do **not** require adjustments:

- Acquisition of, or disposal of, a subsidiary after the year end
- Announcement of a plan to discontinue an operation
- Major purchases and disposals of assets
- Destruction of a production plant by fire after the reporting period
- Announcement or commencing implementation of a major restructuring
- Share transactions after the reporting period
- Litigation commenced after the reporting period

(IAS 10: para. 22)

But note that, while they may be non-adjusting, some events after the reporting period will require **disclosure**.

The **example** given by the standard of such an event is where the **value of an investment falls between the end of the reporting period and the date the financial statements are authorised** for issue. The fall in value represents circumstances during the current period, not conditions existing at the end of the previous reporting period, so it is not appropriate to adjust the value of the investment in the financial statements. Disclosure is an aid to users, however, indicating 'unusual changes' in the state of assets and liabilities after the reporting period.

The rule for **disclosure** of events occurring after the reporting period which relate to conditions that arose after that date, is that disclosure should be made if non-disclosure would hinder the user's ability to make **proper evaluations** and decisions based on the financial statements. An example might be the acquisition of another business.

Chapter Roundup

- IAS 8 deals with changes in accounting estimates, changes in accounting policies and errors.
- Changes in accounting policy are applied **retrospectively**.
- Changes in accounting estimate are **not** applied retrospectively.
- Prior period errors must be corrected **retrospectively**.
- IFRS 5 requires assets 'held for sale' to be presented separately in the statement of financial position. It sets out the criteria for recognising a **discontinued operation**.
- IAS 10 sets out the criteria for recognising **events occurring after the reporting date**.

Quick Quiz

- 1 How should a prior period error be corrected under IAS 8?
- 2 Give the circumstances when a change in accounting policy might be required.
- 3 When can a non-current asset be classified as held for sale?
- 4 How should an asset held for sale be measured?
- 5 How does IFRS 5 define a discontinued operation?

Answers to Quick Quiz

- 1 By adjusting the opening balance of retained earnings (Section 3.2)
- 2 (a) The change is required by an IFRS; or
(b) The change will result in a **more appropriate presentation** of events or transactions in the financial statements of the entity, providing more reliable and relevant information.
- 3 (a) The asset must be **available for immediate sale** in its present condition.
(b) Its sale must be **highly probable** (ie significantly more likely than not).
- 4 At the lower of carrying amount and fair value less costs of disposal
- 5 See Key Term Section 4.6

Earnings per share

17

Topic list	Syllabus reference
1 IAS 33 <i>Earnings per Share</i>	C2
2 Basic EPS	C2
3 Effect on EPS of changes in capital structure	C2
4 Diluted EPS	C2
5 Presentation, disclosure and other matters	C2

Introduction

Earnings per share (EPS) is widely used by investors as a measure of a company's performance and is of particular importance in:

- (a) **Comparing the results** of a company over a **period of time**.
- (b) **Comparing the performance** of one company's equity against the performance of **another company's equity**, and also against the returns obtainable from loan stock and other forms of investment.

The purpose of any earnings measure is to achieve as far as possible clarity of meaning, comparability between one company and another, one year and another, and attributability of profits to the equity shares. IAS 33 *Earnings per Share* goes some way to ensuring that all these aims are achieved.

Study guide

C2	Earnings per share
(a)	Recognise the importance of comparability in relation to the calculation of earnings per share (EPS) and its importance as a stock market indicator
(b)	Explain why the trend of EPS may be a more accurate indicator of performance than a company's profit trend
(c)	Define earnings
(d)	Calculate the EPS in the following circumstances <ul style="list-style-type: none"> – Basic EPS – Where there has been a bonus issue of shares/stock split during the year, and – Where there has been a rights issue of shares during the year
(e)	Explain the relevance to existing shareholders of the diluted EPS, and describe the circumstances that will give rise to a future dilution of the EPS
(f)	Compute the diluted EPS in the following circumstances: <ul style="list-style-type: none"> – Where convertible debt or preference shares are in issue – Where share options and warrants exist
(g)	Identify anti-dilutive circumstances

1 IAS 33 *Earnings per Share*

FAST FORWARD

Earnings per share is a measure of the amount of profits earned by a company for each ordinary share. Earnings are profits after tax and preference dividends

Exam focus point

IAS 33 is a fairly straightforward standard. You would be advised to make sure that you follow all the calculations and discussion points through so that you can tackle any questions that do come up.

1.1 Objective

The objective of IAS 33 is to improve the **comparison** of the performance of different entities in the same period and of the same entity in different accounting periods by prescribing methods for determining the number of shares to be included in the calculation of earnings per share and other amounts per share and by specifying their presentation.

1.2 Definitions

The following definitions are given in IAS 33 and IAS 32.

Key terms

Ordinary shares. An equity instrument that is subordinate to all other classes of equity instruments.

Potential ordinary share. A financial instrument or other contract that may entitle its holder to ordinary shares.

Options, warrants and their equivalents. Financial instruments that give the holder the right to purchase ordinary shares.

(IAS 33: para. 5)

Financial instrument. Any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

Equity instrument. Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

(IAS 32: para. 32)

1.2.1 Ordinary shares

There may be more than one class of ordinary shares, but ordinary shares of the same class will have the same rights to receive dividends. Ordinary shares participate in the net profit for the period **only after other types of shares**, eg preference shares.

1.2.2 Potential ordinary shares

IAS 33 identifies the following examples of financial instruments and other contracts generating potential ordinary shares.

- (a) **Debt or equity instruments**, including preference shares, that are convertible into ordinary shares (IAS 33: para. 7)
- (b) **Share warrants and options** (IAS 33: para. 7)
- (c) **Employee plans** that allow employees to receive ordinary shares as part of their remuneration and other share purchase plans (IAS 33: para. 48)
- (d) Shares that would be issued upon the satisfaction of **certain conditions** resulting from contractual arrangements, such as the purchase of a business or other assets (IAS 33: para. 7)

1.3 Scope

IAS 33 has the following scope restrictions.

- (a) Only companies with (potential) ordinary shares which are **publicly traded** need to present EPS (including companies in the process of being listed).
- (b) EPS need only be presented on the basis of **consolidated results** where the parent's results are shown as well.
- (c) Where companies **choose** to present EPS, even when they have no (potential) ordinary shares which are traded, they must do so in accordance with IAS 33.

(IAS 33: para. 2)

2 Basic EPS

FAST FORWARD

Basic EPS is calculated by dividing the net profit or loss for the period attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the period.

2.1 Measurement

Basic EPS should be calculated by dividing the **net profit** or loss for the period attributable to ordinary shareholders by the **weighted average number of ordinary shares** outstanding during the period.

$$\text{Basic EPS} = \frac{\text{Net profit/(loss) attributable to ordinary shareholders}}{\text{Weighted average number of ordinary shares outstanding during the period}}$$

The **net profit or loss attributable to ordinary shareholders** is the consolidated profit after:

- Income taxes
- Non-controlling interests
- Preference dividends (on preference shares which have been classified as equity)

Preference dividends on preference shares which have been classified as a financial liability do not need to be deducted as they will already have been reported in the profit figure as a finance cost.

The **number of ordinary shares** used should be the weighted average number of ordinary shares during the period. This figure (for all periods presented) should be **adjusted** for events, other than the conversion of potential ordinary shares, that have changed the number of shares outstanding without a corresponding change in resources.

The **time-weighting factor** is the number of days the shares were outstanding compared with the total number of days in the period; a reasonable approximation is usually adequate.

2.2 Example: Weighted average number of shares

Justina Co, a listed company, has the following share transactions during 20X7.

Date	Details	Shares issued
1 January 20X7	Balance at beginning of year	170,000
31 May 20X7	Issue of new shares for cash	80,000
31 December 20X7	Balance at year end	<u>250,000</u>

Required

Calculate the weighted average number of shares outstanding for 20X7.

Solution

The weighted average number of shares can be calculated in two ways:

- (a) $(170,000 \times 5/12) + (250,000 \times 7/12) = 216,666$ shares
 (b) $(170,000 \times 12/12) + (80,000 \times 7/12) = 216,666$ shares

2.3 Consideration

Shares are usually included in the weighted average number of shares from the **date consideration is receivable** which is usually the date of issue. The treatment for the issue of ordinary shares in different circumstances is as follows.

Ordinary shares issued as **purchase consideration** in an acquisition should be included as of the date of acquisition because the acquired entity's results will also be included from that date.

If ordinary shares are **partly paid**, they are treated as a fraction of an ordinary share to the extent they are entitled to dividends relative to fully paid ordinary shares.

Contingently issuable shares (including those subject to recall) are included in the computation when all necessary conditions for issue have been satisfied.



Question

Basic EPS

Flame Co is a company with a called up and paid up capital of 100,000 ordinary shares of \$1 each and 20,000 10% redeemable preference shares of \$1 each.

The gross profit was \$200,000 and trading expenses were \$50,000. Flame Co paid the required preference share dividend and an ordinary dividend of 42c per share. The tax charge for the year was estimated at \$40,000.

Calculate basic EPS for the year.

Answer

FLAME CO
TRADING RESULTS FOR YEAR TO 31 DECEMBER

	\$
Gross profit	200,000
Expense (50,000 + 2,000 preference dividend)	<u>(52,000)</u>
Profit before tax	148,000
Income tax expense	<u>(40,000)</u>
Profit for the year	<u>108,000</u>

EARNINGS PER SHARE

$$\frac{108,000}{100,000} = 108\text{c}$$

3 Effect on EPS of changes in capital structure

FAST FORWARD

You should know how to calculate **basic EPS** and how to deal with related complications (issue of shares for cash, bonus issues, rights issues).

3.1 Introduction

We looked at the effect of issues of new shares on basic EPS above. In these situations, the corresponding figures for EPS for the previous year will be comparable with the current year because, as the weighted average number of shares has risen, there has been a **corresponding increase in resources**. Money has been received when shares were issued. It is assumed that shares are issued at full market price.

3.2 Example: Earnings per share with a new issue

On 30 September 20X2, Boffin Co made an issue at full market price of 1,000,000 ordinary shares. The company's accounting year runs from 1 January to 31 December. Relevant information for 20X1 and 20X2 is as follows.

	20X2	20X1
Shares in issue as at 31 December	9,000,000	8,000,000
Profits after tax and preference dividend	\$3,300,000	\$3,280,000

Required

Calculate the EPS for 20X2 and the corresponding figure for 20X1.

Solution

	20X2	20X1
Weighted average number of shares		
8 million \times 9/12	6,000,000	
9 million \times 3/12	<u>2,250,000</u>	
	<u>8,250,000</u>	<u>8,000,000</u>
Earnings	\$3,300,000	\$3,280,000
EPS	40 cents	41 cents

In spite of the increase in total earnings by \$20,000 in 20X2, the EPS is not as good as in 20X1, because there was extra capital employed for the final three months of 20X2.

There are other events, however, which change the number of shares outstanding, **without a corresponding change in resources**. In these circumstances it is necessary to make adjustments so that the current and prior period EPS figures are comparable.

Four such events are considered by IAS 33, para.13.

- (a) **Capitalisation or bonus issue** (sometimes called a stock dividend)
- (b) Bonus element in any other issue, eg a **rights issue** to existing shareholders
- (c) **Share split**
- (d) **Reverse share split** (consolidation of shares)

3.3 Capitalisation/bonus issue and share split/reverse share split

These two types of event can be considered together as they have a similar effect. In both cases, ordinary shares are issued to existing shareholders for **no additional consideration**. The number of ordinary shares has increased without an increase in resources.

This problem is solved by **adjusting the number of ordinary shares outstanding before the event** for the proportionate change in the number of shares outstanding as if the event had occurred at the beginning of the earliest period reported.

3.4 Example: Earnings per share with a bonus issue

Greymatter Co had 400,000 shares in issue, until on 30 September 20X2 it made a bonus issue of 100,000 shares. Calculate the EPS for 20X2 and the corresponding figure for 20X1 if total earnings were \$80,000 in 20X2 and EPS for 20X1 was 18.75c. The company's accounting year runs from 1 January to 31 December.

Solution

	20X2
Earnings	<u>\$80,000</u>
Shares at 1 January	400,000
Bonus issue	<u>100,000</u>
	<u>500,000</u> shares
EPS	16c

The number of shares for 20X1 must also be adjusted if the figures for EPS are to remain comparable.

The EPS for 20X1 is therefore restated as:

$$18.75c \times \frac{400}{500} = 15c$$

3.5 Rights issue

A rights issue of shares is an issue of new shares to existing shareholders **at a price below the current market value**. The offer of new shares is made on the basis of x new shares for every y shares currently held; eg a 1 for 3 rights issue is an offer of 1 new share at the offer price for every 3 shares currently held. This means that there is a bonus element included.

To arrive at figures for EPS when a rights issue is made, we need to calculate first of all the **theoretical ex-rights value**. This is a weighted average value per share, and is perhaps explained most easily with a numerical example.

3.6 Example: Theoretical ex-rights value

Suppose that Egghead Co has 10,000,000 shares in issue. It now proposes to make a 1 for 4 rights issue at a price of \$3 per share. The market value of existing shares on the final day before the issue is made is \$3.50 (this is the 'with rights' value). What is the theoretical ex-rights value per share?

Solution

	\$
Before issue 4 shares, value \$3.50 each	14.00
Rights issue 1 share, value \$3	<u>3.00</u>
Theoretical value of 5 shares	<u>17.00</u>

$$\text{Theoretical ex-rights value} = \frac{\$17.00}{5} = \$3.40 \text{ per share}$$

Note that this calculation can alternatively be performed using the total value and number of outstanding shares.

3.7 Procedures

The procedures for calculating the EPS for the current year and a corresponding figure for the previous year are as follows.

- (a) The **EPS for the corresponding previous period** should be multiplied by the following fraction.
(Note. The market price on the last day of quotation is taken as the fair value immediately prior to exercise of the rights, as required by the standard.)

Formula to learn

$$\frac{\text{Theoretical ex-rights fair value per share}}{\text{Fair value per share immediately before the exercise of rights (cum rights price)}}$$

- (b) To obtain the **EPS for the current year** you should:
- (i) Multiply the number of shares before the rights issue by the fraction of the year before the date of issue and by the following fraction:

Formula to learn

$$\frac{\text{Fair value per share immediately before the exercise of rights (cum rights price)}}{\text{Theoretical ex-rights fair value per share}}$$

- (ii) Multiply the number of shares after the rights issue by the fraction of the year after the date of issue and add to the figure arrived at in (i).

The total earnings should then be divided by the total number of shares so calculated.

3.8 Example: Earnings per share with a rights issue

Brains Co had 100,000 shares in issue, but then makes a 1 for 5 rights issue on 1 October 20X2 at a price of \$1. The market value on the last day of quotation with rights was \$1.60.

Calculate the EPS for the year ended 31 December 20X2 and the corresponding figure for 20X1 given total earnings of \$50,000 in 20X2 and \$40,000 in 20X1.

Solution

Calculation of theoretical ex-rights value:

	\$
Before issue 5 shares, value × \$1.60	8.00
Rights issue 1 share, value × \$1.00	1.00
Theoretical value of 6 shares	<u>9.00</u>

$$\text{Theoretical ex-rights value} = \frac{\$9}{6} = \$1.50$$

EPS for 20X1

EPS as calculated before taking into account the rights issue = 40c (\$40,000 divided by 100,000 shares).

$$\text{EPS} = \frac{1.50}{1.60} \times 40\text{c} = 37\frac{1}{2}\text{c}$$

(Remember: This is the corresponding value for 20X1 which will be shown in the financial statements for Brains Co at the end of 20X2.)

EPS for 20X2

Number of shares before the rights issue was 100,000. 20,000 shares were issued.

Stage 1:	$100,000 \times \frac{9}{12} \times \frac{1.60}{1.50}$	80,000
Stage 2:	$120,000 \times \frac{3}{12}$	<u>30,000</u>
		<u>110,000</u>

$$\text{EPS} = \frac{\$50,000}{110,000} = 45\frac{1}{2}\text{c}$$

The figure for total earnings is the actual earnings for the year.



Question

Rights issue

Marcoli Co has produced the following net profit figures for the years ending 31 December.

	\$m
20X6	1.1
20X7	1.5
20X8	1.8

On 1 January 20X7 the number of shares outstanding was 500,000. During 20X7 the company announced a rights issue with the following details.

Rights:	1 new share for each 5 outstanding (100,000 new shares in total)
Exercise price:	\$5.00
Last date to exercise rights:	1 March 20X7

The market (fair) value of one share in Marcoli immediately prior to exercise on 1 March 20X7 = \$11.00.

Required

Calculate the EPS for 20X6, 20X7 and 20X8.

Answer

Computation of theoretical ex-rights value

This computation uses the total fair value and number of shares.

$$\frac{\text{Fair value of all outstanding shares} + \text{total received from exercise of rights}}{\text{No. shares outstanding prior to exercise} + \text{no shares issued in exercise}}$$

$$= \frac{(\$11.00 \times 500,000) + (\$5.00 \times 100,000)}{500,000 + 100,000} = \$10.00$$

Computation of EPS

		20X6	20X7	20X8
		\$	\$	\$
20X6	EPS as originally reported			
	$\frac{\$1,100,000}{500,000}$	2.20		
20X6	EPS restated for rights issue			
	$\frac{\$1,100,000}{500,000} \times \frac{10}{11}$ (or $2.20 \times \frac{10}{11}$)	2.00		
20X7	EPS including effects of rights issue			
	$\frac{\$1,500,000}{(500,000 \times 2/12 \times 11/10) + (600,000 \times 10/12)}$		2.54	
20X8	EPS = $\frac{\$1,800,000}{600,000}$			3.00

Exam focus point

You should know how to deal with the effect on EPS of bonus and rights issues and be able to calculate diluted EPS.

4 Diluted EPS

FAST FORWARD

Diluted EPS is calculated by adjusting the net profit due to continuing operations attributable to ordinary shareholders and the weighted average number of shares outstanding for the effects of all dilutive potential ordinary shares.

4.1 Introduction

At the end of an accounting period, a company may have in issue some **securities** which do not (at present) have any 'claim' to a share of equity earnings, but **may give rise to such a claim in the future**. These securities include:

- (a) A **separate class of equity shares** which at present is not entitled to any dividend, but will be entitled after some future date
- (b) **Convertible loan stock** or **convertible preferred shares** which give their holders the right at some future date to exchange their securities for ordinary shares of the company, at a pre-determined conversion rate
- (c) **Options or warrants**

In such circumstances, the future number of ordinary shares in issue might increase, which in turn results in a fall in the EPS. In other words, a **future increase** in the **number of ordinary shares will cause a dilution or 'watering down' of equity**, and it is possible to calculate a **diluted earnings per share** (ie the EPS that would have been obtained during the financial period if the dilution had already taken place). This will indicate to investors the possible effects of a future dilution.

4.2 Earnings

The earnings calculated for basic EPS should be based on **continuing operations** and adjusted by the **post-tax** (including deferred tax) effect of:

- (a) Any **dividends** on dilutive potential ordinary shares that were deducted to arrive at earnings for basic EPS
- (b) **Interest recognised** in the period for the dilutive potential ordinary shares (convertible debt)
- (c) Any **other changes in income or expenses** (fees or discount) that would result from the conversion of the dilutive potential ordinary shares

The conversion of some potential ordinary shares may lead to changes in **other income or expenses**. For example, the reduction of interest expense related to potential ordinary shares and the resulting increase in net profit for the period may lead to an increase in the expense relating to a non-discretionary employee profit-sharing plan. When calculating diluted EPS, the net profit or loss for the period is adjusted for any such consequential changes in income or expense.

4.3 Per share

The number of ordinary shares is the weighted average number of ordinary shares calculated for basic EPS plus the weighted average number of ordinary shares that would be issued on the conversion of all the **dilutive potential ordinary shares** into ordinary shares.

It should be assumed that dilutive ordinary shares were converted into ordinary shares at the **beginning of the period** or, if later, at the actual date of issue. There are two other points.

- (a) The computation assumes the most **advantageous conversion rate** or exercise rate from the standpoint of the holder of the potential ordinary shares.
- (b) **Contingently issuable** (potential) ordinary shares are treated as for basic EPS; if the conditions have not been met, the number of contingently issuable shares included in the computation is

based on the number of shares that would be issuable if the end of the reporting period was the end of the contingency period. Restatement is not allowed if the conditions are not met when the contingency period expires.

4.4 Example: Diluted EPS

In 20X7 Farrah Co had a basic EPS of 105c based on earnings of \$105,000 and 100,000 ordinary \$1 shares. It also had in issue \$40,000 15% convertible loan stock which is convertible in two years' time at the rate of 4 ordinary shares for every \$5 of stock. The rate of tax is 30%.

Required

Calculate the diluted EPS.

Solution

Diluted EPS is calculated as follows.

- Step 1** **Number of shares:** the additional equity on conversion of the loan stock will be $40,000 \times \frac{4}{5} = 32,000$ shares
- Step 2** **Earnings:** Farrah Co will save interest payments of \$6,000 ($40,000 \times 15\%$) but this increase in profits will be taxed. Hence the earnings figure may be recalculated:
 $(105,000 + (6,000 \times 70\%)) = \$109,200$
- Step 3** **Calculation:** Diluted EPS = $\frac{\$109,200}{132,000} = 82.7c$
- Step 4** **Dilution:** the dilution in earnings would be $105c - 82.7c = 22.3c$ per share.



Question

Diluted EPS

Ardent Co has 5,000,000 ordinary shares of 25 cents each in issue, and also had in issue in 20X4:

- (a) \$1,000,000 of 14% convertible loan stock, convertible in three years' time at the rate of 2 shares per \$10 of stock;
- (b) \$2,000,000 of 10% convertible loan stock, convertible in one year's time at the rate of 3 shares per \$5 of stock.

The total earnings in 20X4 were \$1,750,000.

The rate of income tax is 35%.

Required

Calculate the basic EPS and diluted EPS.

Answer

- (a) Basic EPS = $\frac{\$1,750,000}{5 \text{ million}} = 35 \text{ cents}$
- (b) We must decide which of the potential ordinary shares (ie the loan stocks) are dilutive (ie would decrease the EPS if converted).

$$\text{For the 14\% loan stock, incremental EPS} = \frac{0.65 \times \$140,000}{200,000 \text{ shares}} = 45.5c$$

$$\text{For the 10\% loan stock, incremental EPS} = \frac{0.65 \times \$200,000}{1.2m \text{ shares}} = 10.8c$$

The effect of converting the 14% loan stock is therefore to **increase** the EPS figure, since the incremental EPS of 45.5c is greater than the basic EPS of 35c. The 14% loan stock is not dilutive and is therefore excluded from the diluted EPS calculation.

The 10% loan stock is dilutive.

$$\text{Diluted EPS} = \frac{\$1.75\text{m} + \$0.13\text{m}}{5\text{m} + 1.2\text{m}} = 30.3\text{c}$$

Note:

The calculation of DEPS should always be based on the **maximum** number of shares that can be issued. For instance, if the 14% loan stock above had the following conversion rights:

20X5: 4 shares per \$10

20X6: 3 shares per \$10

20X7: 2 shares per \$10

DEPS would be calculated at 4 shares per \$10.

4.5 Treatment of options

It should be assumed that options are exercised and that the assumed proceeds would have been received from the issue of shares at **fair value**. Fair value for this purpose is calculated on the basis of the average price of the ordinary shares during the period. Options are brought into the dilution calculation in the year in which they are issued, **weighted as appropriate**. For instance, if the year end is 31 December 20X6 and options had been granted on 1 July 20X6, the number of dilutive shares under the options will be $\times 6/12$.

Options and other share purchase arrangements are dilutive when they would result in the issue of ordinary shares for **less than fair value**. The amount of the dilution is fair value less the issue price. In order to calculate diluted EPS, each transaction of this type is treated as consisting of two parts.

- A contract to issue a certain number of ordinary shares at their **average market price** during the period. These shares are fairly priced and are assumed to be neither dilutive nor antidilutive. They are **ignored** in the computation of diluted earnings per share.
- A contract to issue the remaining ordinary shares for **no consideration**. Such ordinary shares generate no proceeds and have no effect on the net profit attributable to ordinary shares outstanding. Therefore such shares are **dilutive** and they are added to the number of ordinary shares outstanding in the computation of diluted EPS.

To the extent that **partly paid shares** are not entitled to participate in dividends during the period, they are considered the equivalent of **warrants** or **options**.



Question

EPS

Brand Co has the following results for the year ended 31 December 20X7.

Net profit for year	\$1,200,000
Weighted average number of ordinary shares outstanding during year	500,000 shares
Average fair value of one ordinary share during year	\$20.00
Weighted average number of shares under option during year	100,000 shares
Exercise price for shares under option during year	\$15.00

Required

Calculate both basic and diluted earnings per share.

	Per share	Earnings \$	Shares
Net profit for year		1,200,000	
Weighted average shares outstanding during 20X7			500,000
Basic earnings per share	2.40		
Number of shares under option			100,000
Number of shares that would have been issued at fair value: $(100,000 \times \$15.00/\$20.00)$			(75,000) *
Diluted earnings per share	2.29	<u>1,200,000</u>	<u>525,000</u>

* The earnings have not been increased as the total number of shares has been increased only by the number of shares (25,000) deemed for the purpose of the computation to have been issued for no consideration.

4.6 Dilutive potential ordinary shares

According to IAS 33, 'potential ordinary shares should be treated as dilutive when, and only when, their conversion to ordinary shares would **decrease net profit per share** from continuing operations' (IAS 33: para. 41). This point was illustrated in the question above.

4.7 Restatement

If the number of ordinary or potential ordinary shares outstanding **increases** as a result of a capitalisation, bonus issue or share split, or decreases as a result of a reverse share split, the calculation of basic and diluted EPS for all periods presented should be **adjusted retrospectively**.

If these changes occur **after the reporting date** but before the financial statements are authorised for issue, the calculations per share for the financial statements and those of any prior period should be based on the **new number of shares** (and this should be disclosed).

In addition, basic and diluted EPS of all periods presented should be adjusted for the effects of **material errors**, and adjustments resulting from **changes in accounting policies**, dealt with in accordance with IAS 8.

An entity **does not restate diluted EPS** of any prior period for changes in the assumptions used or for the conversion of potential ordinary shares into ordinary shares outstanding.

Entities are encouraged to disclose a description of ordinary share transactions or potential ordinary share transactions, other than capitalisation issues and share splits, which occur **after the reporting date** when they are of such importance that non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions (see IAS 10). Examples of such transactions include the following:

- Issue of shares for cash
 - Issue of shares when the proceeds are used to repay debt or preferred shares outstanding at the reporting date
 - Redemption of ordinary shares outstanding
 - Conversion or exercise of potential ordinary shares, outstanding at the reporting date, into ordinary shares
 - Issue of warrants, options or convertible securities
 - Achievement of conditions that would result in the issue of contingently issuable shares
- (IAS 33: para. 71)

EPS amounts are not adjusted for such transactions occurring after the reporting date because such transactions **do not affect the amount of capital used** to produce the net profit or loss for the period.

5 Presentation, disclosure and other matters

FAST FORWARD

IAS 33 contains a number of requirements on presentation and disclosure.

5.1 Presentation

Basic and diluted EPS should be presented by an entity in the statement of profit or loss and other comprehensive income for each class of ordinary share that has a different right to share in the net profit for the period. The basic and diluted EPS should be presented with **equal prominence** for all periods presented.

Disclosure must still be made where the EPS figures (basic and/or diluted) are **negative** (ie a loss per share).

If the entity has reported **discontinued operations** in accordance with IFRS 5 at the reporting date, then basic and diluted EPS should be presented using earnings from:

- (a) Both continuing and discontinued operations
- (b) Continuing operations only
- (c) Discontinued operations only.

EPS from discontinued operations can be presented either in the statement of profit or loss and other comprehensive income or in the notes (IAS 33: para. 68).

5.2 Disclosure

An entity should disclose the following.

- (a) The amounts used as the **numerators** in calculating basic and diluted EPS, and a **reconciliation** of those amounts to the net profit or loss for the period
- (b) The weighted average number of ordinary shares used as the **denominator** in calculating basic and diluted EPS, and a **reconciliation** of these denominators to each other

(IAS 33: para. 79)

5.3 Alternative EPS figures

An entity may present **alternative EPS figures** if it wishes. However, IAS 33 lays out certain rules where this takes place.

- (a) The weighted average number of shares as calculated under IAS 33 **must** be used.
- (b) A **reconciliation** must be given if necessary between the component of profit used in the alternative EPS and the line item for profit reported in the statement of profit or loss and other comprehensive income.
- (c) Basic and diluted EPS must be shown with **equal prominence**.

(IAS 33: para. 73)

5.4 Significance of earnings per share

Earnings per share (EPS) is one of the most frequently quoted statistics in financial analysis. Because of the widespread use of the price earnings (**P/E**) **ratio** as a yardstick for investment decisions, it became increasingly important. It is certainly true that EPS gives a more accurate picture of the actual return to investors than reported profits, which do not show the dilutive effect of share issues.

Reported and forecast EPS can, through the P/E ratio, have a **significant effect on a company's share price**. Thus, a share price might fall if it looks as if EPS is going to be low.

There are a number of reasons why EPS should not be used to determine the value of a company's shares. IAS 33 concentrates on the **denominator** of EPS – ie the number of shares. However, it is more difficult to regulate the **numerator** – earnings. Reported earnings can be affected by a number of factors – choice of

accounting policy, asset valuation, taxation issues. Directors who want to present favourable EPS can find ways to boost reported earnings, as happened with Enron.

EPS has also served as a means of assessing the **stewardship and management** role performed by company directors and managers. Remuneration packages might be linked to EPS growth, thereby increasing the pressure on management to improve EPS. The danger of this, however, is that management effort may go into distorting results to produce a favourable EPS.

It should also be noted that EPS takes no account of other issues that affect whether a company is worth investing in, such as its risk profile and its investment requirements. Nevertheless, the market is sensitive to EPS.

Chapter Roundup

- **Earnings per share** is a measure of the amount of profits earned by a company for each ordinary share. Earnings are profits after tax and preference dividends.
- **Basic EPS** is calculated by dividing the net profit or loss for the period attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the period.
- You should know how to calculate **basic EPS** and how to deal with related complications (issue of shares for cash, bonus issues, rights issues).
- **Diluted EPS** is calculated by adjusting the net profit due to continuing operations attributable to ordinary shareholders and the weighted average number of shares outstanding for the effects of all dilutive potential ordinary shares.
- **IAS 33** contains a number of requirements on presentation and disclosure.

Quick Quiz

- 1 How is basic EPS calculated?
- 2 Give the formula for the 'bonus element' of a rights issue.
- 3 Define 'dilutive potential ordinary share'.
- 4 Which numerator is used to decide whether potential ordinary shares are dilutive?
- 5 Why is the numerator adjusted for convertible bonds when calculating diluted EPS?

Answers to Quick Quiz

- 1
$$\frac{\text{Net profit / (loss) attributable to ordinary shareholders}}{\text{Weighted average number of ordinary shares outstanding during the period}}$$
- 2
$$\frac{\text{Actual cum – rights price}}{\text{Theoretical ex – rights price}}$$
- 3 See Para 4.1
- 4 Net profit from continuing operations only.
- 5 Because the issue of shares will affect earnings (the interest will no longer have to be paid).

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q20	Examination	10	20 mins

18

Related party disclosures and segment reporting

Topic list	Syllabus reference
1 IAS 24 <i>Related Party Disclosures</i>	C5
2 IFRS 8 <i>Operating Segments</i>	C6

Introduction

In this chapter we look at two standards.

IAS 24 requires disclosure on related party transactions during the period in order to give a better indication of performance.

IFRS 8 on segment reporting requires quoted entities to provide additional information on their results in order for more detailed analysis to be possible.

Study Guide

C5	Related party disclosures
(a)	Define and apply the definition of related parties in accordance with IFRSs
(b)	Describe the potential to mislead users when related party transactions are accounted for
(c)	Explain the disclosure requirements for related party transactions
C6	Operating segments
(a)	Discuss the usefulness and problems associated with the provision of segment information
(b)	Define an operating segment
(c)	Identify reportable segments (including applying the aggregation criteria and quantitative thresholds)

1 IAS 24 *Related Party Disclosures*

FAST FORWARD

IAS 24 is primarily a disclosure standard. It is concerned to improve the quality of information provided by published accounts and also to strengthen their stewardship roles.

In the absence of information to the contrary, it is assumed that a reporting entity has **independent discretionary power** over its resources and transactions and pursues its activities independently of the interests of its individual owners, managers and others. Transactions are presumed to have been undertaken on an **arm's length basis**, ie on terms such as could have obtained in a transaction with an external party, in which each side bargained knowledgeably and freely, unaffected by any relationship between them.

These assumptions may not be justified when **related party relationships** exist, because the requisite conditions for competitive, free market dealings may not be present. While the parties may endeavour to achieve arm's length bargaining the very nature of the relationship may preclude this occurring.

1.1 Objective

This is the related parties issue and IAS 24 tackles it by ensuring that financial statements contain the disclosures necessary to draw attention to the possibility that the reported financial position and results may have been affected by the existence of related parties and by material transactions with them. In other words, this is a standard which is primarily concerned with **disclosure**.

1.2 Scope

The standard requires disclosure of related party transactions and outstanding balances in the **separate financial statements** of a parent, venturer or investor presented in accordance with IAS 27 as well as in consolidated financial statements.

An entity's financial statements disclose related party transactions and outstanding balances with other entities in a group. **Intragroup** transactions and balances are **eliminated** in the preparation of consolidated financial statements.

1.3 Definitions

The following important definitions are given by the standard. Note that the definitions of **control** and **significant influence** are now the same as those given in IFRS 10, IAS 28 and IFRS 11.

Key terms

Related party. A related party is a person or entity that is related to the entity that is preparing its financial statements.

- (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 defined 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).
 - (viii) The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.

Related party transaction. A transfer of resources, services or obligations between related parties, regardless of whether a price is charged.

Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

Significant influence is the power to participate in the financial and operating policy decisions of an entity, but is not control over these policies. Significant ownership may be gained by share ownership, statute or agreement.

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.

Close members of the family of an individual are those family members who may be expected to influence, or be influenced by, that individual in their dealings with the entity. They may include:

- (a) The individual's domestic partner and children;
- (b) Children of the domestic partner; and
- (c) Dependants of the individual or the domestic partner.

(IAS 24: para. 9)

The most important point to remember here is that, when considering each possible related party relationship, attention must be paid to the **substance of the relationship, not merely the legal form**.

IAS 24 lists the following which are **not necessarily related parties**:

- (a) **Two entities simply because they have a director or other key management in common** (notwithstanding the definition of related party above, although it is necessary to consider how that director would affect both entities)
- (b) **Two venturers, simply because they share joint control over a joint venture.**

- (c) Certain other bodies, simply as a result of their **role in normal business dealings** with the entity
 - (i) Providers of finance
 - (ii) Trade unions
 - (iii) Public utilities
 - (iv) Government departments and agencies
- (d) **Any single customer, supplier, franchisor, distributor, or general agent** with whom the entity transacts a significant amount of business, simply by virtue of the resulting economic dependence. (IAS 24: para. 11)

1.4 Exemption for government-related entities

The disclosures listed above need not be made in respect of transactions 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.

Instead, the reporting entity should disclose:

- (a) The name of the government and the nature of its relationship with the reporting entity
- (b) Information in sufficient detail to enable users of the financial statements to understand the effect of related party transactions on those financial statements, including:
 - (i) The nature and amount of each individually significant transaction, and
 - (ii) For other transactions that are collectively significant, a qualitative or quantitative indication of their extent.

(IAS 24: paras. 24–26)

1.5 Disclosure

As noted above, IAS 24 is almost entirely concerned with disclosure and its provisions are meant to **supplement** those disclosure requirements required by national company legislation and other IFRSs (particularly IAS 1, IFRS 10, IFRS 11 and IFRS 12).

The standard lists some **examples** of transactions that are disclosed if they are with a related party:

- Purchases or sales of goods (finished or unfinished)
- Purchases or sales of property and other assets
- Rendering or receiving of services
- Leases
- Transfer of research and development
- Transfers under licence agreements
- Provision of finance (including loans and equity contributions in cash or in kind)
- Provision of guarantees and collateral security
- Settlement of liabilities on behalf of the entity or by the entity on behalf of another party.

(IAS 24: para. 21)

Relationships between **parents and subsidiaries** must be **disclosed irrespective of whether any transactions have taken place between** the related parties. An entity must disclose the **name** of its **parent** and, if different, the **ultimate controlling party**. This will enable a reader of the financial statements to be able to form a view about the effects of a related party relationship on the reporting entity.

If neither the parent nor the ultimate controlling party produces financial statements available for public use, the name of the next most senior parent that does so shall also be disclosed.

Disclosure should be made of compensation paid to key management personnel, including total amounts for short-term benefits, post-employment benefits, termination benefits and other long-term benefits, as well as for share-based payments (IAS 24: para. 17).

IAS 24 permits similar items to be aggregated and disclosed, but only if this would not affect the user's understanding of the effect of those items on the financial statements (IAS 24: para. 24).

Finally, a related party transaction should only be disclosed as being at 'arm's length' if the entity can prove that is actually the case (IAS 24: para. 23).

Exam focus point

Related parties featured in the December 2016 exam. The examiner commented that many students failed to recognise that related party transactions were material by their nature, rather than on the basis of their size.



Question

Related parties

Fancy Feet Co is a UK company which supplies handmade leather shoes to a chain of high street shoe shops. The company is also the sole importer of some famous high quality Greek stoneware which is supplied to an upmarket shop in London's West End.

Fancy Feet Co was set up 30 years ago by Georgios Kostades who left Greece when he fell out with the military government. The company is owned and run by Mr Kostades and his three children.

The shoes are purchased from a French company, the shares of which are owned by the Kostades Family Trust (Monaco).

Required

Identify the financial accounting issues arising out of the above scenario.

Answer

Issues

- (a) The basis on which Fancy Feet trades with the Greek supplier and the French company owned by the Kostades family trust.
- (b) Whether the overseas companies trade on commercial terms with the UK company or do the foreign entities control the UK company.
- (c) Who owns the Greek company: is this a related party under the provisions of IAS 24?
- (d) Should the nature of trade suggest a related party controls Fancy Feet Co? Detailed disclosures will be required in the financial statements.

Try this longer question on related parties.



Discuss whether the following events would require disclosure in the financial statements of the RP Group, a public limited company, under IAS 24 *Related Party Disclosures*.

The RP Group, investment bankers, has a number of subsidiaries, associates and joint ventures in its group structure. During the financial year to 31 October 20X9 the following events occurred.

- (a) The company agreed to finance a management buyout of a group company, AB, a limited company. In addition to providing loan finance, the company has retained a 25% equity holding in the company and has a main board director on the board of AB. RP received management fees, interest payments and dividends from AB.
- (b) On 1 July 20X9, RP sold a wholly owned subsidiary, X, a limited company, to Z, a public limited company. During the year RP supplied X with second-hand office equipment and X leased its factory from RP. The transactions were all contracted for at market rates.
- (c) The retirement benefit scheme of the group is managed by another investment bank. An investment manager of the group retirement benefit scheme is also a non-executive director of the RP Group and received an annual fee for his services of \$25,000 which is not material in the group context. The company pays \$16m per annum into the scheme and occasionally transfers assets into the scheme. In 20X9, property, plant and equipment of \$10m were transferred into the scheme and a recharge of administrative costs of \$3m was made.

Answer

- (a) IAS 24 does not require disclosure of transactions between companies and providers of finance in the ordinary course of business. As RP is a merchant bank, no disclosure is needed between RP and AB. However, RP owns 25% of the equity of AB and it would seem significant influence exists (IAS 28, **greater than 20% existing holding means significant influence is presumed**) and therefore AB could be an associate of RP. IAS 24 regards associates as related parties.

The decision as to associate status depends upon the ability of RP to exercise significant influence especially as the other 75% of votes are owned by the management of AB.

Investment banks tend to regard companies which would qualify for associate status as trade investments since the relationship is designed to provide finance.

IAS 28 presumes that a party owning or able to exercise control over 20% of voting rights is a related party. So an investor with a 25% holding and a director on the board would be expected to have significant influence over operating and financial policies in such a way as to inhibit the pursuit of separate interests. If it can be shown that this is not the case, there is no related party relationship.

If it is decided that there is a related party situation then **all material transactions** should be disclosed including **management fees, interest, dividends and the terms of the loan**.

- (b) **IAS 24 does not require intragroup transactions and balances eliminated on consolidation to be disclosed.** IAS 24 does not deal with the situation where an undertaking becomes, or ceases to be, a subsidiary during the year.

Best practice indicates that related party transactions should be disclosed for the period when X was not part of the group. Transactions between RP and X should be disclosed between 1 July 20X9 and 31 October 20X9 but transactions prior to 1 July will have been eliminated on consolidation.

There is no related party relationship between RP and Z since it is a normal business transaction unless either parties interests have been influenced or controlled in some way by the other party.

- (c) **Employee retirement benefit schemes** of the reporting entity are included in the IAS 24 definition of **related parties**.

The contributions paid, the non current asset transfer (\$10m) and the charge of administrative costs (\$3m) must be disclosed.

The **pension investment manager** would **not normally** be considered a **related party**. However, the manager is **key management personnel** by virtue of his **non-executive directorship**.

Directors are deemed to be related parties by IAS 24, and the manager receives a \$25,000 fee. IAS 24 requires the disclosure of **compensation paid to key management personnel** and the fee falls within the definition of compensation. Therefore, it must be disclosed.

2 IFRS 8 *Operating Segments*

FAST FORWARD

- An important aspect of reporting financial performance is **segment reporting**. This is covered by IFRS 8 *Operating Segments*, which is a disclosure standard.
- **Segment reporting** is necessary for a better understanding and assessment of:
 - Past performance
 - Risks and returns
 - Informed judgements
- IFRS 8 adopts a **managerial approach** to determining operating segments. Reportable segments are **operating segments** or an aggregation of operating segments that meet specified criteria.

2.1 Introduction

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. This is the reason for **segment reporting**.

- The entity's **past performance** will be better understood
- The entity's **risks and returns** may be better assessed
- More **informed judgements** may be made about the entity as a whole

Risks and returns of a **diversified, multi-national company** can only be assessed by looking at the individual risks and rewards attached to groups of products or services or in different groups of products or services or in different geographical areas. These are subject to differing rates of profitability, opportunities for growth, future prospects and risks.

Segment reporting is covered by IFRS 8 *Operating Segments*.

2.2 Objective

'An entity must 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' (IFRS 8: para. 1)

2.3 Scope

Only entities whose **equity or debt securities are publicly traded** (ie on a stock exchange) need disclose segment information. In group financial statements, only **consolidated** segmental information needs to be shown. (The statement also applies to entities filing or in the process of filing financial statements for the purpose of issuing instruments.)

2.4 Definition of operating segment

FAST FORWARD

Reportable segments are **operating segments** or aggregation of operating segments that meet specified criteria.

You need to learn this definition, as it is crucial to the standard.

Key term

Operating segment. This 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.

(IFRS 8: para. 5)

The term 'chief operating decision maker' identifies a function, not necessarily a manager with a specific title. That function is to allocate resources and to assess the performance of the entity's operating segments.

2.5 Aggregation

Two or more operating segments may be **aggregated** if the segments have **similar economic characteristics**, and the segments are similar in **each** of the following respects:

- The **nature of the products or services**
- The **nature of the production process**
- The **type or class of customer for their products or services**
- The **methods used to distribute their products or provide their services**, and
- If applicable, the **nature of the regulatory environment**

(IFRS 8: para. 12)

2.6 Determining reportable segments

FAST FORWARD

IFRS 8 adopts a **management approach** to determining operating segments.

An entity must report separate information about **each operating segment** that:

- (a) Has been identified as meeting the **definition of an operating segment**; and
- (b) It exceeds **at least one** of the following quantitative thresholds:
 - (i) Reported revenue is **10% or more of the combined revenue** of all operating segments (external and intersegment), or
 - (ii) The absolute amount of its reported profit or loss is **10% or more of the greater**, in absolute amount, of (i) the **combined reported profit** of all operating segments that did **not report a loss**, and (ii) the **combined reported loss** of all operating segments that **reported a loss**, or
 - (iii) Its assets are **10% or more of the total assets** of all operating segments.

(IFRS 8: para. 13)

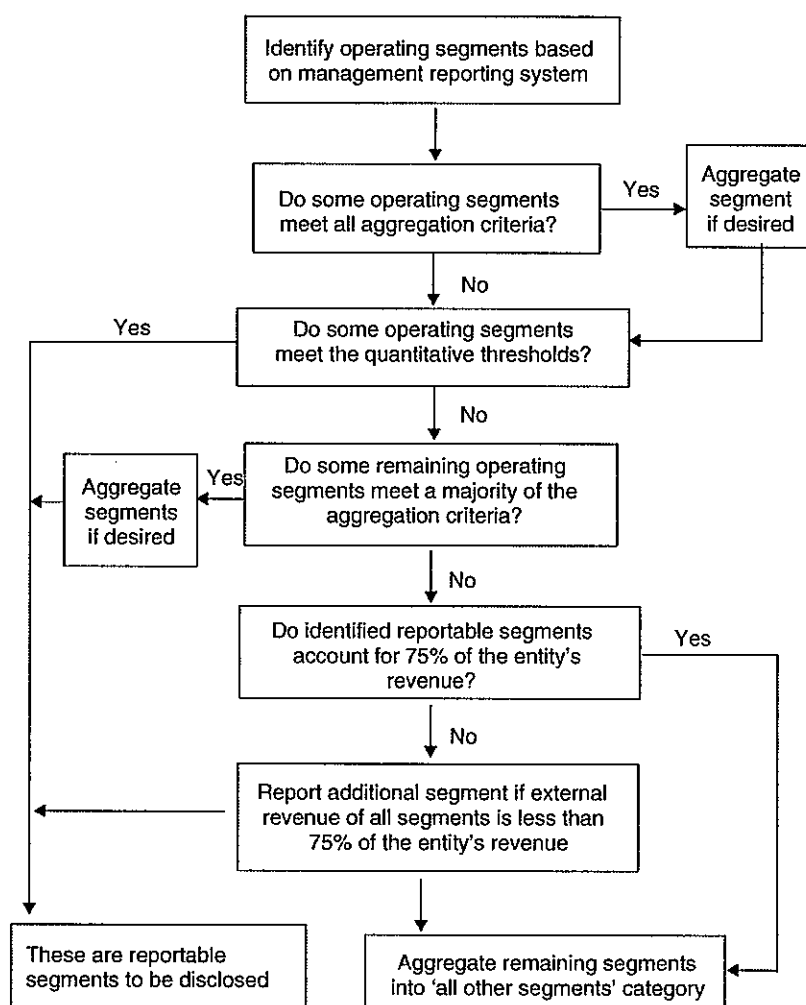
At least **75% of total external revenue** must be reported by operating segments. Where this is not the case, additional segments must be identified (even if they do not meet the 10% thresholds).

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.

Operating segments that do not meet **any of the quantitative thresholds** may be reported separately if management believes that information about the segment would be useful to users of the financial statements.

2.6.1 Decision tree to assist in identifying reportable segments

The following decision tree as shown in IFRS 8, Implementation Guidance (para.IG7) will assist in identifying reportable segments.



2.7 Disclosures

IFRS 8 disclosures are of:

- Operating segment profit or loss
- Segment assets
- Segment liabilities
- Certain income and expense items

Disclosures are also required about the revenues derived from products or services and about the countries in which revenues are earned or assets held, even if that information is not used by management in making decisions.

2.8 Example: Determining operating segments

Jesmond, a retail and leisure group, has three businesses operating in different parts of the world. Jesmond reports to management on the basis of region. The results of the regional segments for the year ended 31 December 20X9 are as follows.

Region	Revenue		Segment results profit/(loss)	Segment assets	Segment liabilities
	External \$m	Internal \$m			
European	200	3	(10)	300	200
North America	300	2	60	800	300
Other regions	500	5	105	2,000	1,400

There were no significant intra-group balances in the segment assets and liabilities. The retail outlets and leisure centres are located in capital cities in the various regions, and the company sets individual performance indicators for each hotel based on its city location.

Required

Discuss the principles in IFRS 8 for the determination of a company's reportable operating segments and how these principles would be applied for Jesmond using the information given above.

Solution

IFRS 8 states that an operating segment is a reported **separately** if:

- (i) **It meets the definition of an operating segment as defined by IFRS 8, para. 5, ie:**
 - (1) It engages in business activities from which it may **earn revenues** and **incur expenses**,
 - (2) Its 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
 - (3) **Discrete financial information** is available for the segment,
- and**
- (ii) It exceeds **at least one** of the following quantitative thresholds as stated in IFRS 8, para. 13:
 - (1) Reported revenue is **10% or more the combined revenue** of all operating segments (external and intersegment), or
 - (2) The absolute amount of its reported profit or loss is **10% or more of the greater**, in absolute amount, of (i) the **combined reported profit** of all operating segments that did **not report a loss**, and (ii) the **combined reported loss** of all operating segments that **reported a loss**, or
 - (3) Its assets are **10% or more of the total assets** of all operating segments.

At least **75% of total external revenue** must be reported by operating segments. Where this is not the case, additional segments must be identified (even if they do not meet the 10% thresholds).

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 following aggregation criteria, as stated by IFRS 8, para. 12:

- (1) The nature of the products and services
- (2) The nature of the production process
- (3) The type or class of customer for their products or services
- (4) The methods used to distribute their products or provide their services
- (5) If applicable, the nature of the regulatory environment

Operating segments that do not meet **any of the quantitative thresholds** may be reported separately if management believes that information about the segment would be useful to users of the financial statements.

For Jesmond, the thresholds are as follows.

- (i) Combined revenue is \$1,010m, so 10% is \$101m.
- (ii) Combined reported profit is \$165m, so 10% is \$16.5m.
- (iii) Combined reported loss is \$10m, so 10% is \$1m.
- (iv) Total assets are \$3,100m, so 10% is \$310m.

The **North America segment** meets the criteria. Its combined revenue is \$302m, its reported profit is \$60m and its assets are \$800m, all of which are greater than the 10% thresholds for each category.

The **European segment** also meets the criteria. Its reported revenue, at \$203m, is greater than 10% of combined revenue. Remember that **only one of the quantitative tests must be satisfied** in order for a segment to be reportable.

IFRS 8 requires further that at least 75% of total external revenue must be reported by operating segments. Currently, only 50% is so reported. Additional operating segments (the 'other regions') must be identified until this 75% threshold is reached.

IFRS 8 may result in a **change** to the way Jesmond's operating segments are reported, depending on how segments were previously identified.

Chapter Roundup

- **IAS 24** is primarily a disclosure standard. It is concerned to improve the quality of information provided by published accounts and also to strengthen their stewardship roles.
- An important aspect of reporting financial performance is **segment reporting**. This is covered by IFRS 8 *Operating Segments*, which is a disclosure standard.
- **Segment reporting** is necessary for a better understanding and assessment of:
 - Past performance
 - Risks and returns
 - Informed judgements
- IFRS 8 adopts a **managerial approach** to determining operating segments. Reportable segments are **operating segments** or an aggregation of operating segments that meet specified criteria.

Quick Quiz

- 1 What is a related party transaction?
- 2 A managing director of a company is a related party. True or False?
- 3 Give two examples of situations in which a related party relationship does not necessarily exist.
- 4 What are the criteria to determine if an operating segment is reportable?
- 5 How much of an entity's revenue must be allocated to segments?

Answers to Quick Quiz

- 1 A transfer of resources, services or obligations between related parties, regardless of whether a price is charged.
- 2 True. A member of the key management personnel of an entity is a related party of that entity.
- 3 See Paragraph 1.3
- 4 See Paragraph 2.6
- 5 At least 75% of total external revenue

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q21	Introductory	n/a	n/a

19

Reporting for small and medium-sized entities

Topic list	Syllabus reference
1 Background	C7
2 Application of IFRS to smaller entities	C7
3 <i>IFRS for Small and Medium-Sized Entities</i>	C7
4 Consequences, good and bad	C7

Introduction

Concentrate on Section 1 – this is the most important for your exam.

You should be aware that smaller entities may have different accounting needs from the larger entities, but IFRS are generally designed for larger ones. This chapter gives you the background you need to set you thinking about whether a one-size-fits-all set of standards is adequate.

Study guide

C7	Reporting requirements of small and medium-sized entities (SMEs)
(a)	Outline the principal considerations in developing a set of accounting standards for SMEs
(b)	Discuss solutions to the problem of differential financial reporting
(c)	Discuss the reasons why the IFRS for SMEs does not address certain topics

1 Background

FAST FORWARD

IFRSs are designed for entities quoted on the world's capital markets. However, **most entities are small or medium sized**.

Exam focus point

ACCA's website contains many useful articles, including the following relating to topics covered in this chapter:

- *IFRS for SMEs*

Available at www.accaglobal.com/gb/en/student/exam-support-resources/dipifr-study-resources/technical-articles.html

1.1 Scope of IFRS

Any limitation of the applicability of a specific IFRS is made clear within that standard. IFRSs are **not intended to be applied to immaterial items, nor are they retrospective**. Each individual IFRS lays out its scope at the beginning of the standard.

1.2 Application

Within each individual country **local regulations** govern, to a greater or lesser degree, the issue of financial statements. These local regulations include accounting standards issued by the national regulatory bodies and/or professional accountancy bodies in the country concerned.

The IFRSs **concentrate on essentials** and are designed not to be too complex, otherwise they would be impossible to apply on a worldwide basis.

IFRSs do not override local regulations on financial statements. Accounting bodies that are members of the IASB should simply disclose the fact where IFRSs are complied with in all material respects. Members of the IASB in individual countries will attempt to persuade local authorities, where current regulations deviate from IFRSs, that the benefits of harmonisation make local change worthwhile.

2 Application of IFRS to smaller entities

FAST FORWARD

Various approaches were proposed to deal with the so-called **Big GAAP/Little GAAP divide**.

2.1 Big GAAP/little GAAP divide

In most countries the majority of companies or other types of entity are **very small**. They are generally owned and managed by one person or a family. The owners have invested their own money in the business and there are no outside shareholders to protect.

Large entities, by contrast, particularly companies listed on a stock exchange, may have shareholders who have invested their money, possibly through a pension fund, with no knowledge whatever of the company. These shareholders need protection and the regulations for such companies need to be more stringent.

It could therefore be argued that company accounts should be of two types.

- (a) 'Simple' ones for small companies with fewer regulations and disclosure requirements
- (b) 'Complicated' ones for larger companies with extensive and detailed requirements

This is sometimes called the **big GAAP/little GAAP divide**.

2.2 Possible solutions

There are two approaches to overcoming the big GAAP/little GAAP divide:

- 1 Differential reporting, ie producing new reduced standards specifically for smaller companies, such as the IFRS for SMEs.
- 2 Providing exemptions for smaller companies from some of the requirements of existing standards.

2.3 Differential reporting

A one-size-fits-all framework does not generate relevant, and useful information, even if this information is reliable:

- (a) The costs may not be justified for the more limited needs of users of SME accounts.
- (b) The purpose of the financial statements and the use to which they are put will not be the same as for listed companies.

Differential reporting overcomes this by tailoring the reporting requirements to the entity. The main characteristic that distinguishes SMEs from other entities is the degree of public accountability. For example, a listed company or a public utility, or a company such as a bank, which holds assets in a fiduciary capacity might be regarded as publicly accountable. Despite the name SME, size is not the only or even the main criterion. (This was the position the IASB adopted – see below.)

Differential reporting may have drawbacks in terms of reducing comparability between small and larger company accounts.

Furthermore, problems may arise where entities no longer meet the criteria to be classified as small.

2.4 Exemptions from IFRS

Some IFRSs do not have any bearing on small company accounts, for example, a company with equity not quoted on a stock exchange has no need to comply with IAS 33 *Earnings per Share*, IFRS 8 *Operating Segments* or IAS 34 *Interim Financial Reporting*.

Other standards always have an impact. In particular, almost all small companies will be affected by the IFRSs on:

- Property, plant and equipment
- Inventories
- Presentation of financial statements
- Events occurring after the reporting period
- Taxes on income
- Revenue
- Provisions and contingencies

Does this mean that companies below a certain size should be exempt from other IFRSs? An alternative approach would be to reduce the exposure of small companies to IFRSs on a **standard by standard basis**. For those 'core' standards listed above, small companies would be required to follow all or most of their provisions. For more complicated standards, small companies would face nothing but very brief general obligations.

It is difficult to see how the IASB could impose any kind of specific size limits to define small companies if such an approach were adopted. Instead, it might specify that size limits which are already given in national legislation or standards could be adopted for the purpose.

To a certain extent (see IAS 33 and IFRS 8 above) partial exemption already applies. Indeed, an IFRS for Small and Medium-sized Entities that applies some but not all of the requirements of existing IFRS achieves this aim.

2.4.1 Cost of compliance

If the cost of compliance exceeds the benefits to users, an entity may decide not to follow an IFRS. This applies to all reporting entities, not just smaller ones. However, smaller entities are more likely to make use of this exception.

For example, impairment reviews can be time-consuming and a smaller entity may not have sufficient staff to spare to carry out these reviews.

2.4.2 Materiality

Another point to note is that IFRSs apply to **material** items. In the case of smaller entities, the amount that is material may be very small in monetary terms. However, the effect of not reporting that item may be material in that it would mislead users of the financial statements. A case in point is IAS 24 *Related Party Disclosures*. Smaller entities may well rely on trade with relatives of the directors/shareholders and this needs to be disclosed.

3 IFRS for Small and Medium-sized Entities

FAST FORWARD

The *IFRS for Small and Medium-sized Entities* aims to simplify financial reporting for SMEs by omitting irrelevant topics, reducing guidance and disclosure and eliminating choice. It also simplifies some of the recognition and measurement principles.

The *IFRS for Small and Medium-Sized Entities* (IFRS for SMEs) was published in 2009 and revised in 2015. It is only 230 pages, and has simplifications that reflect the needs of users of SMEs' financial statements and cost-benefit considerations. It 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.

3.1 Scope

The IFRS is suitable for all entities except those whose securities are publicly traded and financial institutions such as banks and insurance companies. It is the first set of international accounting requirements developed specifically for small and medium-sized entities (SMEs). 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.

The IFRS will be revised only once every three years. It is hoped that this will further reduce the reporting burden for SMEs.

There are no quantitative thresholds for qualification as a SME; instead, the scope of the IFRS is determined by a test of public accountability. As with full IFRS, it is up to legislative and regulatory authorities and standard setters in individual jurisdictions to decide who is permitted or required to use the IFRS for SMEs.

(IFRS for SMEs: paras. 1–3)

3.2 Effective date

The IFRS for SMEs does not contain an effective date; this is determined in each jurisdiction. The IFRS will be revised only once every three years. It is hoped that this will further reduce the reporting burden for SMEs.

(IFRS for SMEs: paras. P16, P17)

3.3 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.

The entity also has the option of considering the requirements and guidance in full IFRS dealing with similar topics. However, it is under no obligation to do this, or to consider the pronouncements of other standard setters.

(IFRS for SMEs: paras. P16, P17)

3.4 Overlap with full IFRS

In the following areas, the recognition and measurement guidance in the *IFRS for SMEs* is like that in the full IFRS.

- Provisions and contingencies
- Hyperinflation accounting
- Events after the end of the reporting period
- Taxation (since the 2015 revisions)
- Property, plant and equipment (since the 2015 revisions)

3.5 Omitted topics

The *IFRS for SMEs* does not address the following topics that are covered in full IFRS.

- Earnings per share
- Interim financial reporting
- Segment reporting
- Classification for non-current assets (or disposal groups) as held for sale

These topics were omitted because they were not expected to be relevant to the majority of SMEs. This seems logical when you consider that IAS 33 *Earnings per Share*, IAS 34 *Interim Financial Reporting* and IFRS 8 *Operating Segments* are only required to be applied by listed entities.

An entity must either apply the *IFRS for SMEs* or full IFRS, it cannot pick and choose from both. So for example, if an entity determined that it wished to provide segment reporting information because its shareholders wanted it, then the entity would have to elect to report under full IFRS and not under the *IFRS for SMEs*, so that it could apply IFRS 8 *Operating Segments*.

3.6 Examples of options in full IFRS not included in the *IFRS for SMEs*

- Choice between cost and fair value models for investment property (measurement depends on the circumstances)
- Options for government grants

3.7 Initial comprehensive review of the *IFRS for SMEs*

In May 2015, the IASB completed its comprehensive review of the *IFRS for SMEs*. The most significant amendments are as follows:

- (a) SMEs are now permitted to use a revaluation model for property, plant and equipment.

Area	IFRS for SMEs	Full IFRSs
<i>Impairment of assets</i>	<p>Impairment test (carrying amount vs recoverable amount) only required where there are indicators of impairment (except for inventories which are tested annually).</p> <p>Impairment losses are charged to profit or loss.</p> <p>Non-current assets held for sale tested for impairment in the same way as other assets</p>	<p>Annual tests for:</p> <ul style="list-style-type: none"> • Indefinite life intangibles • Intangibles not yet available for use • Goodwill <p>Impairment losses charged first to OCI re any rev'n surplus on revalued assets</p> <p>Non-current assets held for sale held under IFRS 5 rules</p>
<i>Employee benefits</i>	<p>Actuarial gains and losses can be recognised immediately in profit or loss or other comprehensive income. Actual return on plan assets recognised in profit or loss</p> <p>Simplified calculation of defined benefit obligations permitted</p>	<p>Remeasurements in other comprehensive income only</p> <p>Projected unit credit method must be used</p>

(Adapted and updated from PriceWaterhouseCoopers, 2009)

4 Consequences, good and bad

FAST FORWARD

There is **no perfect solution** to the Big GAAP/Little GAAP divide. It remains to be seen how well *the IFRS for SMEs* will work in practice.

4.1 Likely effect

Because there is no supporting guidance in the IFRS for SMEs, it is likely that differences will arise from full IFRS, even where the principles are the same. Most of the exemptions in the IFRS for SMEs are on grounds of cost or undue effort. However, despite the practical advantages of a simpler reporting framework, there will be costs involved for those moving to IFRS – even a simplified IFRS – for the first time.

4.2 Advantages and disadvantages of the IFRS for SMEs

4.2.1 Advantages

- It is virtually a '**one stop shop**'.
- It is **structured according to topics**, which should make it practical to use.
- It is written in an **accessible style**.
- There is **considerable reduction in disclosure requirements**.
- Guidance **not relevant** to private entities is **excluded**.

4.2.2 Disadvantages

- It does **not** focus on the **smallest companies**.
- The scope extends to 'non-publicly accountable' entities. Potentially, the **scope is too wide**.
- The standard will be **onerous** for **small companies**.

- (d) **Further simplifications** could be made. These might include:
- (i) Amortisation for goodwill and intangibles
 - (ii) No requirement to value intangibles separately from goodwill on a business combination
 - (iii) No recognition of deferred tax
 - (iv) No measurement rules for equity-settled share-based payment
 - (v) No requirement for consolidated accounts (as for EU small and medium-sized entities currently)
 - (vi) Fair value measurement when readily determinable without undue cost or effort.

Chapter Roundup

- IFRSs are designed for entities quoted on the world's capital markets. However, **most entities are small or medium sized**.
- Various approaches were proposed to deal with the so-called **Big GAAP/Little GAAP divide**.
- The *IFRS for Small and Medium-sized Entities* aims to simplify financial reporting for SMEs by omitting irrelevant topics, reducing guidance and disclosure and eliminating choice. It also simplifies some of the recognition and measurement principles.
- There is **no perfect solution** to the Big GAAP/Little GAAP divide. It remains to be seen how well the *IFRS for SMEs* will work in practice.

Quick Quiz

- 1 What is differential financial reporting?
- 2 The treatment of provisions is simpler in the *IFRS for SMEs* than in IAS 37. True or false?
- 3 Give examples of two accounting treatments that are covered in the full IFRSs but not in the IFRS for SMEs.
- 4 For which two accounting areas was the treatment in the IFRS for SMEs amended in 2015 so that the treatments are now aligned with the full IFRSs?

Answers to Quick Quiz

- 1 Producing new reduced standards specifically for smaller companies
- 2 False. Provisions are one area in which the recognition and measurement guidance in the *IFRS for SMEs* is like that in the full IFRS.
- 3 Any two from: earnings per share, interim financial reporting, segment reporting, classification for non-current assets (or disposal groups) as held for sale
- 4 Taxation, and property, plant and equipment

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q22	Examination	25	49 mins

Preparation of external financial reports for combined entities and joint arrangements

20

Constitution of a group

Topic list	Syllabus reference
1 Group accounts	D1
2 IFRS 10 <i>Consolidated Financial Statements</i>	D1
3 Content of group accounts and group structure	D1
4 Group accounts: The related parties issue	C5

Introduction

Consolidation is an extremely important area of your syllabus as it is examined in every exam sitting.

The key to consolidation questions in the examination is to adopt a logical approach and to practise as many questions as possible.

In this chapter we will look at the major definitions in consolidation. These matters are fundamental to your comprehension of group accounts, so make sure you can understand them and then **learn them**.

Study guide

D1	Preparation of group consolidated external reports
(a)	Explain the concept of a group and the purpose of preparing consolidated financial statements
(b)	Explain and apply the definition of subsidiary companies
(d)	Explain the need for using coterminous year-ends and uniform accounting policies when preparing consolidated financial statements and describe how it is achieved in practice
C5	Related party disclosures
(b)	Describe the potential to mislead users when related party transactions are accounted for

1 Group accounts

FAST FORWARD

Many large businesses consist of several companies controlled by one central or administrative company. Together these companies are called a **group**. The controlling company, called the **parent** or **holding company**, will own some or all of the shares in the other companies, called **subsidiaries**.

1.1 Introduction

There are many reasons for businesses to operate as groups; for the goodwill associated with the names of the subsidiaries, for tax or legal purposes and so forth. In many countries, company law requires that the results of a group should be presented as a whole. Unfortunately, it is not possible simply to add all the results together and this chapter and those following will teach you how to **consolidate** all the results of companies within a group.

In traditional accounting terminology, a **group of companies** consists of a **parent company** and one or more **subsidiary companies** which are controlled by the parent company.

1.2 Accounting standards

We will be looking at these accounting standards in this and the next four chapters:

- IFRS 3 *Business Combinations*
- IFRS 10 *Consolidated Financial Statements*
- IFRS 11 *Joint Arrangements*
- IFRS 13 *Fair Value Measurement*
- IAS 27 *Separate Financial Statements*
- IAS 28 *Investments in Associates and Joint Ventures*

These standards are all concerned with different aspects of group accounts, but there is some overlap between them, particularly between IFRS 3 and IFRS 10.

In this and the next chapter we will concentrate on IAS 27 and IFRS 10, which cover the basic group definitions and consolidation procedures of a parent-subsidiary relationship. First of all, however, we will look at all the important definitions involved in group accounts, which **determine how to treat each particular type of investment** in group accounts.

1.3 Definitions

We will look at some of these definitions in more detail later, but they are useful here in that they give you an overview of all aspects of group accounts.

Exam focus point

All the definitions relating to group accounts are extremely important. You must **learn them** and **understand** their meaning and application.

Key terms

Control. An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through power over the investee.

Power. Existing rights that give the current ability to direct the relevant activities of the investee.

Subsidiary. An entity that is controlled by another entity.

Parent. An entity that controls one or more subsidiaries.

Group. A parent and all its subsidiaries.

(IFRS 10: Appendix A)

Associate. An entity over which an investor has significant influence (IAS 28: para. 3).

We can summarise the different types of investment and the required accounting for them as follows.

Investment	Criteria	Required treatment in group accounts
Subsidiary	Control	Full consolidation
Associate	Significant influence	Equity accounting (see Chapter 23)
Investment which is none of the above	Asset held for accretion of wealth	As for single company accounts per IFRS 9

1.4 Investments in subsidiaries

'A subsidiary is an entity that is controlled by another entity' (IFRS 10: Appendix A). The important point here is **control**. In most cases, this will involve the holding company or parent owning a majority of the ordinary shares in the subsidiary (to which normal voting rights are attached). There are circumstances, however, when the parent may own only a minority of the voting power in the subsidiary, **but** the parent still has control.

1.4.1 Accounting treatment in group accounts

IFRS 10 requires a parent to present consolidated financial statements, in which the financial statements of the parent and subsidiary (or subsidiaries) are combined and presented **as a single entity** (IFRS 10: Appendix A).

1.5 Investments in associates

This type of investment is something less than a subsidiary, but more than a simple investment. The key criterion here is **significant influence**.

Key term

Significant influence. The power to participate in the financial and operating policy decisions of an investee but it is not control or joint control over those policies. (IAS 28: para. 3)

Significant influence can be determined by the holding of voting rights (usually attached to shares) in the entity. IAS 28 states that 'if an entity holds, directly or indirectly (eg through subsidiaries) **20% or more** of the voting power of the investee, it is presumed that the entity has significant influence, unless it can be clearly demonstrated that this is not the case' (IAS 28: para. 5, emphasis BPP's).

Significant influence can be presumed **not** to exist if the investor holds **less than 20%** of the voting power of the investee, unless it can be demonstrated otherwise (IAS 28: para. 5).

IAS 28 (para. 6) states that:

'[t]he existence of significant influence by an entity 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) Participation in **policy-making processes** [...];
- (c) **Material transactions** between the entity and its investee;
- (d) Interchange of managerial personnel; or
- (e) Provision of essential technical information.'

IAS 28 requires the use of the **equity method** of accounting for investments in associates. This method will be explained in detail in Chapter 23.

2 IFRS 10 *Consolidated Financial Statements*

FAST FORWARD

IFRS 10 requires a parent to present **consolidated** financial statements.

2.1 Consolidated financial statements

Key term

Consolidated financial statements. The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity. (IFRS 10: Appendix A)

When a parent issues consolidated financial statements, it should consolidate **all subsidiaries**, both foreign and domestic.

As we saw in Section 1.4, a subsidiary is 'an entity that is controlled by another entity' (IFRS 10: Appendix A).

IFRS 10 provides a definition of control (see Key Terms above) and identifies three separate elements of control:

' [A]n investor controls an investee if and only if the investor has all of the following:

- (a) **Power** over the investee
 - (b) Exposure to, or rights to, **variable returns** from its involvement with the investee; and
 - (c) **The ability to use its power** over the investee to affect the amount of the investor's returns'
- (IFRS 10: para. 7, emphasis BPP's)

2.2 Power

Power is defined as '[e]xisting rights that give the current ability to direct the relevant activities [of the investee]' (IFRS 10: para. 10). There is no requirement for that power to have been exercised (IFRS 10: para. 12).

Relevant activities 'include, but are not limited to:

- (a) Selling and purchasing of goods or services;
- (b) Managing financial assets during their life (including upon default);
- (c) Selecting, acquiring or disposing of assets;
- (d) Researching and developing new products or processes; and
- (e) Determining a funding structure or obtaining funding' (IFRS 10: para. B11).

In some cases assessing power is straightforward, for example, where power is obtained directly and solely from having the majority of voting rights or potential voting rights, and as a result the ability to direct relevant activities.

In other cases, assessment is more complex and more than one factor must be considered. IFRS 10 gives the following examples of '**rights**', that, either individually or in combination, [...] give an investor power [...]:

- (a) rights in the form of voting rights (or potential voting rights) of an investee;
- (b) rights to appoint, reassign or remove members of an investee's key management personnel who have the ability to direct the relevant activities;
- (c) rights to appoint or remove another entity that directs the relevant activities;
- (d) rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor; and
- (e) other rights (such as decision-making rights specified in a management contract) that give the holder the ability to direct the relevant activities' (IFRS 10: para. B15).

IFRS 10 suggests that the **ability** rather than contractual right to achieve the above may also indicate that an investor has power over an investee (IFRS 10: para. B18).

An investor can have power over an investee even where other entities have significant influence or other ability to participate in the direction of relevant activities.

2.2.1 Potential voting rights

An entity may own share warrants, share call options, or other similar instruments that are **convertible into ordinary shares** in another entity. If these are exercised or converted they may give the entity voting power or reduce another party's voting power over the financial and operating policies of the other entity (potential voting rights). The **existence and effect** of potential voting rights, including potential voting rights held by another entity, should be considered when assessing whether an entity has control over another entity (and therefore has a subsidiary). Potential voting rights are considered only if the rights are **substantive** (meaning that the holder must have the practical ability to exercise the right).

(IFRS 10: para. B47)

The **purpose and design of the instrument**, including its terms and conditions and the motivation of the investor in agreeing to those terms, should be considered when assessing potential voting rights (IFRS 10: para. B47).

2.3 Returns

An investor must have exposure, or rights, to **variable returns** from its involvement with the investee in order to establish control.

This is the case where the investor's returns from its involvement have the potential to vary as a result of the investee's performance.

Returns may include:

- Dividends
- Remuneration for servicing an investee's assets or liabilities
- Fees and exposure to loss from providing credit support
- Returns as a result of achieving synergies or economies of scale through an investor combining use of their assets with use of the investee's assets

(IFRS 10: para. B55–56)

2.4 Link between power and returns

In order to establish control, an investor **must be able to use** its power to affect its returns from its involvement with the investee. This is the case even where the investor delegates its decision-making powers to an agent.

2.5 Exemption from preparing group accounts

A parent **need not present** consolidated financial statements if and only if all of the following hold (IFRS 10: para. 4):

- (a) The parent is itself a **wholly-owned subsidiary** or it is a **partially owned subsidiary** of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;
- (b) Its securities are **not publicly traded**;
- (c) It is **not in the process of issuing securities** in public securities markets; and
- (d) The **ultimate or intermediate parent** publishes consolidated financial statements that comply with International Financial Reporting Standards.

A parent that does not present consolidated financial statements must comply with the IAS 27 rules on separate financial statements (discussed later in this section).

2.6 Different reporting dates

In most cases, all group companies will prepare accounts to the same reporting date. One or more subsidiaries may, however, prepare accounts to a different reporting date from the parent and the bulk of other subsidiaries in the group.

In such cases the subsidiary may prepare additional statements to the reporting date of the rest of the group, for consolidation purposes. If this is not possible, the subsidiary's accounts may still be used for the consolidation, **provided that** the gap between the reporting dates is **three months or less**.

Where a subsidiary's accounts are drawn up to a different accounting date, **adjustments should be made** for the effects of significant transactions or other events that occur between that date and the parent's reporting date.

(IFRS 10: para. B92–93)

2.7 Uniform accounting policies

Consolidated financial statements should be prepared using **uniform accounting policies** for like transactions and other events in similar circumstances.

Adjustments must be made where members of a group use different accounting policies, so that their financial statements are suitable for consolidation.

(IFRS 10: para. B87)

2.8 Date of inclusion/exclusion

IFRS 10 requires the results of subsidiaries to be included in the consolidated financial statements from:

- (a) The date of 'acquisition', ie the **date on which the investor obtains control of the investee**, to
- (b) The date of 'disposal', ie the **date the investor loses control of the investee**.

Once an investment is no longer a subsidiary, it should be treated as an associate under IAS 28 (if applicable) or as an investment under IFRS 9.

(IFRS 10: para. 20, B88)

2.9 Accounting for subsidiaries, associates and joint ventures in the parent's separate financial statements

A parent company will usually produce its own separate (single company) financial statements and these should be prepared in accordance with IAS 27. In the parent's separate financial statements, 'investments in subsidiaries, associates and joint ventures should be [accounted for] **either**:

- (a) **At cost**;
- (b) In accordance with **IFRS 9**; or
- (c) Using the **equity method** as described in **IAS 28**' (IAS 27: para. 10).

Where subsidiaries are **classified as held for sale** in accordance with IFRS 5 they should be accounted for in accordance with IFRS 5 in the parent's separate financial statements.

3 Content of group accounts and group structure

FAST FORWARD

It is important to distinguish between the parent company **individual accounts** and the **group accounts**.

3.1 Introduction

The information contained in the individual financial statements of a parent company and each of its subsidiaries does not give a picture of the group's total activities. A **separate set of group statements** can be prepared from the individual ones. Remember that a group has no separate (legal) existence, except for accounting purposes.

Consolidated accounts are one form of group accounts which combines the information contained in the separate accounts of a parent company and its subsidiaries as if they were the financial statements of a single entity. 'Group accounts' and 'consolidated accounts' are terms often used synonymously.

In simple terms a set of consolidated accounts is prepared by **adding together** the assets and liabilities of the parent company and each subsidiary. The **whole** of the assets and liabilities of each company are included, even though some subsidiaries may be only partly-owned. The 'equity and liabilities' section of the statement of financial position will indicate how much of the net assets are attributable to the group and how much to outside investors. These **outside investors** are known as the **non-controlling interest**.

Key term

Non-controlling interest. The equity in a subsidiary not attributable, directly or indirectly, to a parent.
(IFRS 10: Appendix A)

Non-controlling interest should be presented 'in the consolidated statement of financial position **within equity**, separately from the equity of the owners of the parent' (IFRS 10: para. 22).

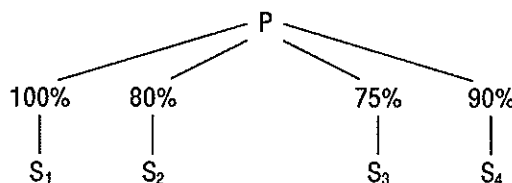
Most parent companies present their own individual accounts and their group accounts in a single **package**. The package typically comprises the following.

- **Parent company financial statements**, which will include 'investments in subsidiaries' as an asset in the statement of financial position, and income from subsidiaries (dividends) in the statement of profit or loss
- **Consolidated statement of financial position**
- **Consolidated statement of profit or loss and other comprehensive income**
- **Consolidated statement of cash flows**

It may not be necessary to publish all of the parent company's financial statements, depending on local or national regulations.

3.2 Group structure

With the difficulties of definition and disclosure dealt with, let us now look at group structures. The simplest are those in which a parent company has only a **direct interest** in the shares of its subsidiary companies. For example:



S₁ Co is a wholly owned subsidiary of P Co. S₂ Co, S₃ Co and S₄ Co are partly owned subsidiaries; a proportion of the shares in these companies is held by outside investors.

4 Group accounts: The related parties issue

FAST FORWARD

Parent companies and subsidiaries are **related parties** as per IAS 24. Bear in mind that this relationship can be exploited.

IAS 24 draws attention to the significance of related party relationships and transactions – that transactions between the parties may not be 'at arm's length' and that users of the financial statements must be made aware of this, as it may affect their view of the financial statements.

4.1 Individual company accounts

The relationship between a parent and a subsidiary is the most obvious example of a related party relationship and it offers a number of opportunities for manipulating results. Some of these may be aimed at improving the parent's individual financial statements.

Any of the following could take place:

- The subsidiary sells goods to the parent company at an artificially low price. This increases parent company profit while reducing profit in the subsidiary, thus increasing profit available for distribution to parent company shareholders at the expense of the non-controlling interest.
- The parent sells goods to the subsidiary at an artificially high price. This has the same result as above.
- The subsidiary makes a loan to the parent at an artificially low rate of interest or the parent makes a loan to the subsidiary at an artificially high rate of interest. The loans will be cancelled on consolidation but the interest payments will transfer profits from the subsidiary to the parent.
- The parent can sell an asset to the subsidiary at an amount in excess of its carrying amount. This again serves to transfer profit (and cash) to the parent.

4.2 Consolidated financial statements

The transactions above seek to improve the **individual** parent company accounts at the expense of the individual subsidiary accounts. Dividends are paid to shareholders on the basis of these individual company financial statements, not the consolidated financial statements.

The tightening up of the opportunities for excluding a subsidiary from consolidation under IFRS 10 has reduced the opportunities for improving the appearance of the **consolidated** financial statements. In the past, a number of possibilities could be exploited:

- A group could obtain loans via a subsidiary, which was not then consolidated. The loan would not appear in the consolidated statement of financial position and group gearing (% of capital provided by loans) would appear lower than it actually was.
- Sale and leaseback transactions could be carried out in which assets were sold to a non-consolidated subsidiary and leased back under an operating lease. This enabled the asset and its associated borrowings to be removed from the statement of financial position.

4.3 Disposal of subsidiaries

While the situations above are all concerned with improving the appearance of the parent company or group financial statements at the expense of those of the subsidiary, there may be occasions where the **opposite** is the intention.

For instance, when a parent company has decided to dispose of its shares in a poorly-performing subsidiary, it may seek to enhance the results of that subsidiary for the purpose of selling at a profit. In this case, transactions such as those at 4.1 above may be undertaken in the other direction – to transfer profit from the **parent** to the **subsidiary**.

4.4 Effect on trading

Even where no related party transactions have taken place, the parent/subsidiary relationship can still affect how the parties do business. For instance if, prior to acquisition by the parent, the subsidiary had a major customer or supplier who was a competitor of the parent, that trading arrangement can be expected to cease. The subsidiary may itself have been a competitor of the parent, in which case it may now have had to withdraw from certain markets in favour of the parent.

Look out for any of these issues in a consolidated accounts question.

Chapter Roundup

- Many large businesses consist of several companies controlled by one central or administrative company. Together these companies are called a **group**. The controlling company, called the **parent** or **holding company**, will own some or all of the shares in the other companies, called **subsidiaries**.
- IFRS 10 requires a parent to present **consolidated** financial statements.
- It is important to distinguish between the parent company **individual accounts** and the **group accounts**.
- Parent companies and subsidiaries are **related parties** as per IAS 24. Bear in mind that this relationship can be exploited.

Quick Quiz

- 1 Define a 'subsidiary'.
- 2 When can control be assumed?
- 3 What accounting treatment does IFRS 10 require of a parent company?
- 4 When is a parent exempted from preparing consolidated financial statements?
- 5 How should an investment in a subsidiary be accounted for in the separate financial statements of the parent?
- 6 What is a non-controlling interest?

Answers to Quick Quiz

- 1 An entity that is controlled by another entity
- 2 When the investor has rights to variable returns from the investee and is able to affect those returns by its power over the investee.
- 3 The financial statements of parent and subsidiary are combined and presented as a single entity.
- 4 When the parent is itself a wholly owned subsidiary, or a partially owned subsidiary and the non-controlling interests do not object, when its securities are not publicly traded and when its ultimate or intermediate parent publishes IFRS-compliant financial statements
- 5 (a) At cost; or
(b) In accordance with IFRS 9; or
(c) Using the equity method as described in IAS 28.
- 6 The equity in a subsidiary not attributable, directly or indirectly, to a parent

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The consolidated statement of financial position

Topic list	Syllabus reference
1 IFRS 10: Summary of consolidation procedures	D1
2 Non-controlling interests	D1
3 Dividends paid by a subsidiary	D2
4 Goodwill arising on consolidation	B5, D1, D3
5 Intra-group trading	D2
6 Intra-group sales of non-current assets	D2
7 Summary: consolidated statement of financial position	D1–2
8 Acquisition of a subsidiary during its accounting period	D1–3
9 Disposal of subsidiaries	D5
10 Fair values in acquisition accounting	D1–3/B15

Introduction

This chapter introduces the **basic procedures** required in consolidation and gives a formal step plan for carrying out a statement of financial position consolidation. This step procedure should be useful to you as a starting guide for answering any question, but remember that you cannot rely on it to answer the question for you.

Each question must be approached and **answered on its own merits**. The examination team often put small extra or different problems in because, as they are always reminding students, it is not possible to 'rote-learn' consolidation.

The **method of consolidation** shown here uses schedules for workings (retained earnings, non-controlling interest etc) rather than the ledger accounts used in some other texts. This is because we believe that ledger accounts lead students to 'learn' the consolidation journals without thinking about what they are doing – always a dangerous practice in consolidation questions.

There are plenty of questions in this chapter – work through **all** of them carefully.

Study guide

D1	Preparation of group consolidated external reports
(c)	Prepare a consolidated statement of financial position for a simple group (one or more subsidiaries) dealing with pre and post-acquisition profits, non-controlling interests and goodwill
D2	Business combinations – intra-group adjustments
(a)	Explain why intra-group transactions should be eliminated on consolidation
(b)	Report the effects of intra-group trading and other transactions including: <ul style="list-style-type: none"> – Unrealised profits in inventory and non-current assets – Intra-group loans and interest and other intra-group charges – Intra-group dividends
D3	Business combinations – fair value adjustments
(a)	Explain why it is necessary for both the consideration paid for a subsidiary and the subsidiary's identifiable assets and liabilities to be accounted for at their fair values when preparing consolidated financial statements
(b)	Compute the fair value of the consideration given including the following elements: <ul style="list-style-type: none"> – Cash – Share exchanges – Deferred consideration – Contingent consideration
(c)	Prepare consolidated financial statements dealing with fair value adjustments (including their effect on consolidated goodwill) in respect of: <ul style="list-style-type: none"> – Depreciating and non-depreciating non-current assets – Inventory – Deferred tax – Monetary liabilities – Assets and liabilities (including contingencies) not included in the subsidiary's own statement of financial position
D5	Complete disposal of shares in subsidiaries
(a)	Calculate the gain or loss on the complete disposal of shares in a subsidiary in the financial statements of the parent and the subsidiary
(b)	Explain and illustrate the effect of the complete disposal of a parent's investment in a subsidiary in the parent's individual financial statements and/or those of the group
B5	Intangible assets and goodwill
(d)	Explain the subsequent accounting treatment, including the principle of impairment tests in relation to purchased goodwill
B15	Fair value
(a)	Explain the principle under which fair value is measured according to IFRSs
(b)	Identify an appropriate fair value measurement for an asset or liability in a given set of circumstances

1 IFRS 10: Summary of consolidation procedures

FAST FORWARD

IFRS 10 lays out the basic procedures for preparing consolidated financial statements.

1.1 Basic procedure

The financial statements of a parent and its subsidiaries are **combined on a line-by-line basis** by adding together like items of assets, liabilities, equity, income and expenses. The following steps are then taken, in order that the consolidated financial statements should **show financial information about the group as if it was a single entity** (IFRS 10: Appendix A).

- (a) The carrying amount of the parent's **investment in each subsidiary** and the parent's **portion of equity** of each subsidiary are **eliminated or cancelled**
- (b) **Non-controlling interests in the net income of consolidated subsidiaries** are adjusted against group income, to arrive at the net income attributable to the owners of the parent
- (c) **Non-controlling interests** in the net assets of consolidated subsidiaries should be presented separately in the consolidated statement of financial position

Other matters to be dealt with include:

- (a) **Goodwill on consolidation** should be dealt with according to IFRS 3
- (b) **Dividends paid** by a subsidiary must be accounted for

IFRS 10 states that all intragroup balances and transactions, and the resulting **unrealised profits**, should be **eliminated in full**. **Unrealised losses** resulting from intragroup transactions should also be eliminated *unless* cost can be recovered. This will be explained later in this chapter.

(IFRS 10: Application Guidance para. B86)

1.2 Cancellation and part cancellation

The preparation of a consolidated statement of financial position, in a very simple form, consists of two procedures:

- (a) Take the individual accounts of the parent company and each subsidiary and **cancel out items** which appear as an asset in one company and a liability in another.
- (b) Add together all the uncanceled assets and liabilities throughout the group.

Items requiring cancellation include:

- (a) The asset '**investments in subsidiary companies**' which appears in the parent company's accounts will be matched with the 'share capital' in the subsidiaries' accounts.
- (b) There may be **intra-group trading** within the group. For example, S Co may sell goods on credit to P Co. P Co would then be a receivable in the financial statements of S Co, while S Co would be a payable in the financial statements of P Co.

1.3 Example: Cancellation

P Co regularly sells goods to its one subsidiary company, S Co, which it has owned since S Co's incorporation. The statement of financial position of the two companies on 31 December 20X6 are given below.

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X6

	<i>P Co</i> \$	<i>S Co</i> \$
Assets		
<i>Non-current assets</i>		
Property, plant and equipment	35,000	45,000
Investment in 40,000 \$1 shares in S Co at cost	40,000	
	<u>75,000</u>	
<i>Current assets</i>		
Inventories	16,000	12,000
Receivables: S Co	2,000	—
Other	6,000	9,000
Cash at bank	1,000	
Total assets	<u>100,000</u>	<u>66,000</u>
Equity and liabilities		
<i>Equity</i>		
40,000 \$1 ordinary shares	—	40,000
70,000 \$1 ordinary shares	70,000	—
Retained earnings	16,000	19,000
	<u>86,000</u>	<u>59,000</u>
<i>Current liabilities</i>		
Bank overdraft		3,000
Payables: P Co		2,000
Payables: Other	14,000	2,000
		<u>7,000</u>
Total equity and liabilities	<u>100,000</u>	<u>66,000</u>

Required

Prepare the consolidated statement of financial position of P Co at 31 December 20X6.

Solution

The cancelling items are:

- (a) P Co's asset 'investment in shares of S Co' (\$40,000) cancels with S Co's liability 'share capital' (\$40,000)
- (b) P Co's asset 'receivables: S Co' (\$2,000) cancels with S Co's liability 'payables: P Co' (\$2,000)

The remaining assets and liabilities are added together to produce the following consolidated statement of financial position.

P CO

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X6

	\$	\$
Assets		
<i>Non-current assets</i>		
Property, plant and equipment		80,000
<i>Current assets</i>		
Inventories	28,000	
Receivables	15,000	
Cash at bank	<u>1,000</u>	
		<u>44,000</u>
Total assets		<u>124,000</u>
Equity and liabilities		

<i>Equity</i>		
70,000 \$1 ordinary shares	70,000	
Retained earnings	<u>35,000</u>	
	105,000	
<i>Current liabilities</i>		
Bank overdraft	3,000	
Payables	<u>16,000</u>	
		19,000
Total equity and liabilities		<u>124,000</u>

Notes

- 1 P Co's bank balance is **not netted off** with S Co's bank overdraft. To offset one against the other would be less informative and would conflict with the principle that assets and liabilities should not be netted off.
- 2 The share capital in the consolidated statement of financial position is the **share capital of the parent company alone**. This must **always** be the case, no matter how complex the consolidation, because the share capital of subsidiary companies must **always** be a wholly cancelling item.

1.4 Part cancellation

An item may appear in the statements of financial position of a parent company and its subsidiary, but not at the same amounts.

- (a) The parent company may have acquired **shares in the subsidiary** at a price **greater or less than their par value**. The asset will appear in the parent company's accounts at cost, while the liability will appear in the subsidiary's accounts at par value. This raises the issue of **goodwill**, which is dealt with later in this chapter.
- (b) Even if the parent company acquired shares at par value, it **may not** have **acquired all the shares of the subsidiary** (so the subsidiary may be only partly owned). This raises the issue of **non-controlling interests**, which are also dealt with later in this chapter.
- (c) The intra-group trading balances may be out of step because of **goods or cash in transit**.
- (d) One company may have **issued loan stock** of which a **proportion only** is taken up by the other company.

The following question illustrates the techniques needed to deal with items (c) and (d) above. The procedure is to **cancel as far as possible**. The remaining uncanceled amounts will appear in the consolidated statement of financial position.

- (a) **Uncanceled loan stock** will appear as a **liability of the group**.
- (b) **Uncanceled balances on intra-group accounts** represent **goods or cash in transit**, which will appear in the consolidated statement of financial position.



Question

Consolidation

The statements of financial position of P Co and of its subsidiary S Co have been made up to 30 June. P Co has owned all the ordinary shares and 40% of the loan stock of S Co since its incorporation.

STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE

	<i>P Co</i> \$	<i>S Co</i> \$
Assets		
<i>Non-current assets</i>		
Property, plant and equipment	120,000	100,000
Investment in S Co, at cost		
80,000 ordinary shares of \$1 each	80,000	
\$20,000 of 12% loan stock in S Co	<u>20,000</u>	
	220,000	
<i>Current assets</i>		
Inventories	50,000	60,000
Receivables	40,000	30,000
Current account with S Co	18,000	
Cash	<u>4,000</u>	<u>6,000</u>
	112,000	96,000
Total assets	<u>332,000</u>	<u>196,000</u>
Equity and liabilities		
<i>Equity</i>		
Ordinary shares of \$1 each, fully paid	100,000	80,000
Retained earnings	<u>95,000</u>	<u>28,000</u>
	195,000	108,000
<i>Non-current liabilities</i>		
10% loan stock	75,000	
12% loan stock		50,000
<i>Current liabilities</i>		
Payables	47,000	16,000
Taxation	15,000	10,000
Current account with P Co	<u></u>	<u>12,000</u>
	62,000	38,000
Total equity and liabilities	<u>332,000</u>	<u>196,000</u>

The difference on current account arises because of goods in transit.

Required

Prepare the consolidated statement of financial position of P Co.

Answer

P CO

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE

	\$	\$
Assets		
<i>Non-current assets</i>		
Property, plant and equipment (120,000 + 100,000)		220,000
<i>Current assets</i>		
Inventories (50,000 + 60,000)	110,000	
Goods in transit (18,000 – 12,000)	6,000	
Receivables (40,000 + 30,000)	70,000	
Cash (4,000 + 6,000)	<u>10,000</u>	
		196,000
Total assets		<u>416,000</u>
Equity and liabilities		
<i>Equity</i>		
Ordinary shares of \$1 each, fully paid (parent)	100,000	
Retained earnings (95,000 + 28,000)	<u>123,000</u>	
		223,000

	\$	\$
<i>Non-current liabilities</i>		
10% loan stock	75,000	
12% loan stock (50,000 × 60%)	<u>30,000</u>	
		105,000
<i>Current liabilities</i>		
Payables (47,000 + 16,000)	63,000	
Taxation (15,000 + 10,000)	<u>25,000</u>	
		88,000
<i>Total equity and liabilities</i>		<u>416,000</u>

Note especially how:

- The uncanceled loan stock in S Co becomes a liability of the group.
- The goods in transit is the difference between the current accounts (\$18,000 – \$12,000).
- The investment in S Co's shares is cancelled against S Co's share capital.

1.5 A parent company which has several subsidiaries

Where a company P has several subsidiaries S_1 , S_2 , S_3 and so on, the technique for consolidation is exactly as described in this chapter. **Cancellation** is from the holding company, which has assets of investments in subsidiaries S_1 , S_2 , S_3 , to each of the several subsidiaries.

The consolidated statement of financial position will show:

- A single figure for **non-controlling interest**; and
- A single figure for **goodwill** arising.

A single working should be used for each of the constituents of the consolidated statement of financial position: one working for goodwill, one for non-controlling interest, one for retained earnings (reserves), and so on. The individual assets and liabilities of each of the companies is then combined in order to produce the consolidated figures.

2 Non-controlling interests

FAST FORWARD

In the consolidated statement of financial position it is necessary to distinguish **non-controlling interests** from those net assets attributable to the group and financed by shareholders' equity.

2.1 Introduction

It was mentioned earlier that the total assets and liabilities of subsidiary companies are included in the consolidated statement of financial position, even in the case of subsidiaries which are only partly owned. A proportion of the net assets of such subsidiaries in fact belongs to investors from outside the group (**non-controlling interests**).

IFRS 3 allows two alternative ways of calculating non-controlling interest in the group statement of financial position. Non-controlling interest can be valued at (IFRS 3: para. 19):

- Its proportionate share of the fair value of the subsidiary's net assets; or
- Full (or fair) value (usually based on the market value of the shares held by the non-controlling interest).

Note that the use of fair values at the acquisition date is not connected to the regular revaluations that will be performed by companies who adopt the revaluation model for non-current assets.

The following example shows non-controlling interest calculated at its proportionate share of the subsidiary's net assets.

2.2 Example: Non-controlling interest

P Co has owned 75% of the share capital of S Co since the date of S Co's incorporation. Their latest statements of financial position are given below. The non-controlling interest is valued at its proportional share of the fair value of the subsidiary's net assets.

STATEMENT OF FINANCIAL POSITION

	<i>P Co</i> \$	<i>S Co</i> \$
<i>Assets</i>		
<i>Non-current assets</i>		
Property, plant and equipment	50,000	35,000
30,000 \$1 ordinary shares in S Co at cost	30,000	
	<u>80,000</u>	
<i>Current assets</i>	45,000	35,000
<i>Total assets</i>	<u>125,000</u>	<u>70,000</u>
<i>Equity and liabilities</i>		
<i>Equity</i>		
\$1 ordinary shares	80,000	40,000
Retained earnings	25,000	10,000
	<u>105,000</u>	<u>50,000</u>
<i>Current liabilities</i>	20,000	20,000
<i>Total equity and liabilities</i>	<u>125,000</u>	<u>70,000</u>

Required

Prepare the consolidated statement of financial position.

Solution

All of S Co's net assets are consolidated despite the fact that the company is only 75% owned. The amount of net assets attributable to non-controlling interests is calculated as follows.

	\$
Non-controlling share of share capital ($25\% \times \$40,000$)	10,000
Non-controlling share of retained earnings ($25\% \times \$10,000$)	2,500
	<u>12,500</u>

Of S Co's share capital of \$40,000, \$10,000 is included in the figure for non-controlling interest, while \$30,000 is cancelled with P Co's asset 'investment in S Co'.

The consolidated statement of financial position can now be prepared.

P GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	\$	\$
<i>Assets</i>		
Property, plant and equipment		85,000
Current assets		80,000
<i>Total assets</i>		<u>165,000</u>
<i>Equity and liabilities</i>		
Equity attributable to owners of the parent		
Share capital	80,000	
Retained earnings $\$(25,000 + (75\% \times \$10,000))$	<u>32,500</u>	
		112,500
Non-controlling interest		12,500
		<u>125,000</u>
Current liabilities		40,000
<i>Total equity and liabilities</i>		<u>165,000</u>



2.3 Procedure

- (a) Aggregate the assets and liabilities in the statement of financial position ie 100% P + 100% S irrespective of how much P actually owns.

This shows the amount of net assets **controlled** by the group.

- (b) Share capital is that of the parent only.
 (c) Balance of subsidiary's reserves are consolidated (after cancelling any intra-group items).
 (d) Calculate the non-controlling interest share of the subsidiary's net assets.



Question

Part cancellation

Set out below are the draft statement of financial position of P Co and its subsidiary S Co. You are required to prepare the consolidated statement of financial position. The non-controlling interest is valued at its proportional share of the fair value of the subsidiary's net assets.

P Co

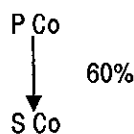
	\$	\$
Assets		
<i>Non-current assets</i>		
Property, plant and equipment		31,000
Investment in S Co		
12,000 \$1 ordinary shares at cost	12,000	
\$8,000 10% loan stock at cost	<u>8,000</u>	
		20,000
		<u>51,000</u>
Current assets		<u>21,000</u>
Total assets		<u><u>72,000</u></u>
Equity and liabilities		
<i>Equity</i>		
Ordinary shares of \$1 each	40,000	
Retained earnings	<u>22,000</u>	
		62,000
Current liabilities		<u>10,000</u>
Total equity and liabilities		<u><u>72,000</u></u>

S Co

	\$	\$
Assets		
Property, plant and equipment		34,000
Current assets		<u>32,000</u>
Total assets		<u><u>66,000</u></u>
Equity and liabilities		
<i>Equity</i>		
Ordinary shares of \$1 each	20,000	
Revaluation surplus	6,000	
Retained earnings	<u>4,000</u>	
		30,000
<i>Non-current liabilities</i>		
10% loan stock		26,000
Current liabilities		<u>10,000</u>
Total equity and liabilities		<u><u>66,000</u></u>

Answer

The group structure is:



Partly cancelling items are the components of P Co's investment in S Co, ie ordinary shares, loan stock. Non-controlling shareholders have an interest in 40% (8,000/20,000) of S Co's ordinary shares, including reserves.

You should now aggregate the assets and liabilities and produce workings for non-controlling interest, revaluation surplus and retained earnings as follows.

Workings

(1) Non-controlling interest

	\$
S Co's net assets (66,000 – 36,000)	30,000
× 40%	<u>12,000</u>

(2) Revaluation surplus

	\$
P Co	–
Share of S Co's revaluation surplus (60% × 6,000)	<u>3,600</u>
	<u>3,600</u>

(3) Retained earnings

	\$
P Co	22,000
Share of S Co's retained earnings (60% × 4,000)	<u>2,400</u>
	<u>24,400</u>

The results of the workings are now used to construct the consolidated statement of financial position.

P GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	\$	\$
Assets		
Property, plant and equipment		65,000
Current assets		<u>53,000</u>
Total assets		<u>118,000</u>
Equity and liabilities		
Equity attributable to owners of the parent		
Ordinary shares of \$1 each	40,000	
Revaluation surplus (W2)	3,600	
Retained earnings (W3)	<u>24,400</u>	
		68,000
Non-controlling interest (W1)		12,000
		<u>80,000</u>
Non-current liabilities		
10% loan stock (26,000 – 8,000)		18,000
Current liabilities		<u>20,000</u>
Total equity and liabilities		<u>118,000</u>

Notes.

- (a) S Co is a subsidiary of P Co because P Co owns 60% of its ordinary capital.
- (b) As always, the share capital in the consolidated statement of financial position is that of the parent company alone. The share capital in S Co's statement of financial position was partly cancelled against the investment shown in P Co's statement of financial position, while the uncanceled portion was credited to non-controlling interest.
- (c) The figure for non-controlling interest comprises the interest of outside investors in the share capital and reserves of the subsidiary. The uncanceled portion of S Co's loan stock is not shown as part of non-controlling interest but is disclosed separately as a liability of the group.

3 Dividends paid by a subsidiary

When a subsidiary company pays a **dividend** during the year the accounting treatment is not difficult. Suppose S Co, a 60% subsidiary of P Co, pays a dividend of \$1,000 on the last day of its accounting period. Its total reserves before paying the dividend stood at \$5,000.

- (a) \$400 of the dividend is paid to non-controlling shareholders. The cash leaves the group and will not appear anywhere in the consolidated statement of financial position.
- (b) The parent company receives \$600 of the dividend, debiting cash and crediting profit or loss. This will be cancelled on consolidation.
- (c) The remaining balance of retained earnings in S Co's statement of financial position (\$4,000) will be consolidated in the normal way. The group's share ($60\% \times \$4,000 = \$2,400$) will be included in group retained earnings in the statement of financial position; the non-controlling interest share ($40\% \times \$4,000 = \$1,600$) is credited to the non-controlling interest account in the statement of financial position.

4 Goodwill arising on consolidation

FAST FORWARD

Goodwill is the excess of the amount transferred plus the amount of non-controlling interests over the fair value of the net assets of the subsidiary.

4.1 Accounting

To begin with, we will examine the entries made by the parent company in its own statement of financial position when it acquires shares.

When a company P Co wishes to **purchase shares** in a company S Co it must pay the previous owners of those shares. The most obvious form of payment would be in **cash**. Suppose P Co purchases all 40,000 \$1 shares in S Co and pays \$60,000 cash to the previous shareholders in consideration. The entries in P Co's books would be:

DEBIT	Investment in S Co at cost	\$60,000	
CREDIT	Bank		\$60,000

However, the previous shareholders might be prepared to accept some other form of consideration. For example, they might accept an agreed number of **shares** in P Co. P Co would then issue new shares in the agreed number and allot them to the former shareholders of S Co. This kind of deal might be attractive to P Co since it avoids the need for a heavy cash outlay. The former shareholders of S Co would retain an indirect interest in that company's profitability via their new holding in its parent company.

Continuing the example, suppose that instead of \$60,000 cash the shareholders of S Co agreed to accept one \$1 ordinary share in P Co for every two \$1 ordinary shares in S Co. P Co would then need to issue and allot 20,000 new \$1 shares. How would this transaction be recorded in the books of P Co?

The former shareholders of S Co have presumably agreed to accept 20,000 shares in P Co because they consider each of those shares to have a value of \$3. This gives us the following method of recording the transaction in P Co's books.

DEBIT	Investment in S Co	\$60,000	
CREDIT	Share capital		\$20,000
	Share premium account		\$40,000

The amount which P Co records in its books as the cost of its investment in S Co may be more or less than the carrying amount of the assets it acquires. Suppose that S Co in the previous example has nil reserves and nil liabilities, so that its share capital of \$40,000 is balanced by tangible assets with a carrying amount of \$40,000. For simplicity, assume that the carrying amount of S Co's assets is the same as their market or fair value.

Now when the directors of P Co agree to pay \$60,000 for a 100% investment in S Co they must believe that, in addition to its tangible assets of \$40,000, S Co must also have intangible assets worth \$20,000. This amount of \$20,000 paid over and above the value of the tangible assets acquired is called **goodwill arising on consolidation** (sometimes **premium on acquisition**).

Following the normal cancellation procedure the \$40,000 share capital in S Co's statement of financial position could be cancelled against \$40,000 of the 'investment in S Co' in the statement of financial position of P Co. This would leave a \$20,000 debit uncanceled in the parent company's accounts and this \$20,000 would appear in the consolidated statement of financial position under the caption 'Intangible non-current assets: goodwill arising on consolidation'.

4.2 Goodwill and pre-acquisition profits

Up to now we have assumed that S Co had nil retained earnings when its shares were purchased by P Co. Assuming instead that S Co had earned profits of \$8,000 in the period before acquisition, its statement of financial position just before the purchase would look as follows.

	\$
Total assets	<u>48,000</u>
Share capital	40,000
Retained earnings	<u>8,000</u>
	<u>48,000</u>

If P Co now purchases all the shares in S Co it will acquire total assets worth \$48,000 at a cost of \$60,000. Clearly in this case S Co's intangible assets (goodwill) are being valued at \$12,000. It should be apparent that any earnings retained by the subsidiary **prior to its acquisition** by the parent company must be **incorporated in the cancellation** process so as to arrive at a figure for goodwill arising on consolidation. In other words, not only S Co's share capital, but also its **pre-acquisition** retained earnings, must be cancelled against the asset 'investment in S Co' in the financial statements of the parent company. The uncanceled balance of \$12,000 appears in the consolidated statement of financial position.

The consequence of this is that **any pre-acquisition retained earnings of a subsidiary company are not aggregated with the parent company's retained earnings** in the consolidated statement of financial position. The figure of consolidated retained earnings comprises the retained earnings of the parent company plus the **post-acquisition retained earnings only of subsidiary companies**. The post-acquisition retained earnings are simply retained earnings now *less* retained earnings at acquisition.

The subsidiary may also have share premium or revaluation surplus balances at the acquisition date. These will be brought into the goodwill calculation along with other pre-acquisition reserves. Any post-acquisition movement on these balances will be split between group and NCI.

4.3 Example: Goodwill and pre-acquisition profits

Sing Co acquired the ordinary shares of Wing Co on 31 March when the draft statements of financial position of each company were as follows.

SING CO

STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH

	\$
<i>Assets</i>	
Non-current assets	
Investment in 50,000 shares of Wing Co at cost	80,000
Current assets	40,000
<i>Total assets</i>	<u>120,000</u>
<i>Equity and liabilities</i>	
Equity	
Ordinary shares	75,000
Retained earnings	45,000
<i>Total equity and liabilities</i>	<u>120,000</u>

WING CO

STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH

	\$
Current assets	<u>60,000</u>
Equity	
50,000 ordinary shares of \$1 each	50,000
Retained earnings	10,000
	<u>60,000</u>

Required

Prepare the consolidated statement of financial position as at 31 March.

Solution

The technique to adopt here is to produce a new working: 'Goodwill'. A proforma working is set out below.

Goodwill

	\$	\$
Consideration transferred		X
Net assets acquired as represented by:		
Ordinary share capital	X	
Share premium	X	
Retained earnings on acquisition	<u>X</u>	
Goodwill		<u>(X)</u>

Applying this to our example the working will look like this.

	\$	\$
Consideration transferred		80,000
Net assets acquired as represented by:		
Ordinary share capital	50,000	
Retained earnings on acquisition	<u>10,000</u>	
Goodwill		<u>(60,000)</u>
		<u>20,000</u>

SING CO
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH

	\$
<i>Assets</i>	
Non-current assets	
Goodwill arising on consolidation (W)	20,000
Current assets (40,000 + 60,000)	100,000
Total assets	<u>120,000</u>
<i>Equity and liabilities</i>	
Ordinary shares	75,000
Retained earnings	45,000
Total equity and liabilities	<u>120,000</u>

4.4 Goodwill and non-controlling interest

Now let us look at what would happen if Sing Co had obtained less than 100% of the shares of Wing Co.

If Sing Co had paid \$70,000 for 40,000 shares in Wing Co, the goodwill working would be as follows:

	\$
Consideration transferred	70,000
Non-controlling interest (60,000 × 20%)	12,000
Net assets acquired	<u>(60,000)</u>
Goodwill	<u>22,000</u>

The above example assumes that Sing Co values the non-controlling interest at its proportionate share of net assets.

4.5 Non-controlling interest at fair value

IFRS 3 gives entities the option of valuing non-controlling interest (NCI) at fair value. The thinking behind this is that the non-controlling interest also owns some of the goodwill in the subsidiary, and that the traditional method of consolidation does not show this goodwill.

The closest approximation to fair value will be the market price of the shares held by non-controlling shareholders just before acquisition by the parent, if available (IFRS 3: para. B44).

Continuing our example above, we will assume that the market price of the shares was \$1.25. The goodwill calculation will then be as follows:

	\$
Consideration transferred	70,000
Fair value of NCI (10,000 × \$1.25)	12,500
Net assets at acquisition	<u>(60,000)</u>
Goodwill	<u>22,500</u>

Goodwill (total \$22,500) is \$500 higher than goodwill calculated measuring NCI at its share of the net assets of the subsidiary. This \$500 represents the **goodwill attributable to the NCI**.

4.6 NCI at year end

Where the option is used to value NCI at fair value, the goodwill attributable to the NCI will also be added to the NCI at the year end. The most straightforward way to calculate this is to start with the fair value of the NCI at acquisition and add the NCI share of post-acquisition retained earnings.

This is illustrated in the following worked example.

4.7 Example: NCI at year end

P acquired 75% of the shares in S on 1 January 2007 when S had retained earnings of \$15,000. The market price of S's shares just before the date of acquisition was \$1.60. P values non-controlling interest at fair value. Goodwill is not impaired.

The statements of financial position of P and S at 31 December 20X7 were as follows:

	P	S
	\$	\$
Property, plant and equipment	60,000	50,000
Shares in S	68,000	—
	<u>128,000</u>	<u>50,000</u>
Current assets	52,000	35,000
	<u>180,000</u>	<u>85,000</u>
Share capital – \$1 shares	100,000	50,000
Retained earnings	70,000	25,000
	<u>170,000</u>	<u>75,000</u>
Current liabilities	10,000	10,000
	<u>180,000</u>	<u>85,000</u>

Required

Prepare the consolidated statement of financial position of the P Group.

Solution

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	\$
<i>Assets</i>	
Property plant and equipment (60,000 + 50,000)	110,000
Goodwill (W1)	23,000
Current assets (52,000 + 35,000)	87,000
Total assets	<u>220,000</u>
<i>Equity and liabilities</i>	
Equity attributable to the owners of P	
Share capital	100,000
Retained earnings (W2)	77,500
	<u>177,500</u>
Non-controlling interest (W3)	22,500
Total equity	<u>200,000</u>
Current liabilities (10,000 + 10,000)	20,000
	<u>220,000</u>

Workings

1 Goodwill

	Group
	\$
Consideration transferred	68,000
Fair value of NCI (12,500 × \$1.60)	20,000
Net assets of S at acquisition (50,000 + 15,000)	<u>(65,000)</u>
Goodwill	<u>23,000</u>

2 Retained earnings

	P	S
	\$	\$
Per statement of financial position	70,000	25,000
Less pre- acquisition		<u>(15,000)</u>
		<u>10,000</u>
Group share of S (10,000 × 75%)	7,500	
Group retained earnings	<u>77,500</u>	

3 Non-controlling interest at year end

	\$
NCI at acquisition	20,000
Share of post-acquisition retained earnings (10,000 × 25%)	2,500
	<u>22,500</u>

4.8 Effect of NCI at fair value

You can see from the above example that the use of the fair value option increases goodwill and NCI by the same amount. That amount represents goodwill attributable to the shares held by non-controlling shareholders. It is not necessarily proportionate to the goodwill attributed to the parent. The parent may have paid proportionately more to acquire a controlling interest. If NCI was valued at share of net assets, goodwill and NCI in the example above would be as follows:

Workings

1 Goodwill

	\$
Considered transferred	68,000
NCI ((50,000 + 15,000) × 25%)	16,250
Net assets of S at acquisition (50,000 + 15,000)	(65,000)
	<u>19,250</u>

3 NCI at year end

	\$
NCI at acquisition	16,250
Share of post-acquisition retained earnings	2,500
	<u>18,750</u>

Compare these with goodwill and non-controlling interest in the solution above and you will see that both have been reduced by \$3,750 – the goodwill attributable to the NCI. So whether NCI is valued at share of net assets or at fair value, the statement of financial position will still balance.

(Again, a reminder that the use of fair values at the acquisition date is not connected to the regular revaluations that will be performed by companies who adopt the revaluation model for non-current assets.)

Exam focus point

In the exam, the consolidation question will tell you which method to use. It will state either:

'It is the group policy to value the non-controlling interest at full (or fair) value'; or

'It is the group policy to value the non-controlling interest at its proportionate share of the (fair value of the) subsidiary's identifiable net assets'.

If you are required to measure NCI at fair value, the ACCA examining team has stated that you will either be:

- (1) Given the share price of the subsidiary just before acquisition; or
- (2) Told that the NCI is valued at a certain amount.

4.9 Impairment loss and goodwill

As we have seen, IFRS 3 allows two methods of initially valuing the non-controlling interest in an entity (para.19):

- As a share of the net assets of the entity at the acquisition date, or
- At fair value

The non-controlling interest is then taken into account in the goodwill calculation:

Purchase consideration	\$
Non-controlling interest	X
	<u>X</u>
Total fair value of net assets of acquiree	X
Goodwill	(X)
	<u>X</u>

This means that the resulting goodwill will represent:

- Only the parent's share of total goodwill when valuing the non-controlling interest using the proportion of net assets method (**partial goodwill**).
- Full goodwill** (ie the parent's share plus the non-controlling interest share) when using the fair value method.

Where the proportionate share of net assets method is used to value the NCI, the carrying amount of a **cash generating unit** (see Chapter 5) therefore comprises:

- The parent and NCI share of the identifiable net assets of the unit
- Only the parent's share of the goodwill

Part of the calculation of the **recoverable amount** of the cash generating unit relates to the **unrecognised share** in the goodwill.

For the purpose of calculating the impairment loss, the carrying amount of the cash generating unit is therefore **notionally adjusted** to include the NCI share in the goodwill by grossing it up.

The consequent impairment loss calculated is only recognised to the **extent of the parent's share**.

Where the fair value method is used to value the NCI, no adjustment is required.

**Exam focus
point**

Impairment loss when NCI was measured using the proportion of net assets method was tested in both the December 2016 and June 2016 exam papers. The examiner's report stated that this topic was likely to feature regularly on exams, so it is important to make sure you understand and can apply this method.

4.10 Example: Impairment loss and goodwill: partial goodwill

The Acetone Company is testing for impairment two subsidiaries which have been identified as separate cash-generating units.

Some years ago Acetone acquired 80% of The Dushanbe Company for \$600,000 when the fair value of Dushanbe's identifiable assets was \$400,000. As Dushanbe's policy is to distribute all profits by way of dividend, the fair value of its identifiable net assets remained at \$400,000 on 31 December 20X7. The impairment review indicated Dushanbe's recoverable amount at 31 December 20X7 to be \$520,000.

Some years ago Acetone acquired 85% of The Maclulich Company for \$800,000 when the fair value of Maclulich's identifiable net assets was \$700,000. Goodwill of \$205,000 ($\$800,000 - (\$700,000 \times 85\%)$) was recognised. As Maclulich's policy is to distribute all profits by way of dividend, the fair value of its identifiable net assets remained at \$700,000 on 31 December 20X7. The impairment review indicated Maclulich's recoverable amount at 31 December 20X7 to be \$660,000.

It is Acetone group policy to value the NCI using the proportion of net assets method.

Required

Determine the following amounts in respect of Acetone's consolidated financial statements at 31 December 20X7 according to IAS 36 *Impairment of Assets*.

- The carrying amount of Dushanbe's assets to be compared with its recoverable amount for impairment testing purposes

- (b) The carrying amount of goodwill in respect of Dushanbe after the recognition of any impairment loss
- (c) The carrying amount of the NCI in Maclulich after recognition of any impairment loss

Solution

- (a) \$750,000
(b) \$96,000
(c) \$99,000

Workings

(a)		\$
	Carrying amount of Dushanbe's net assets	400,000
	Goodwill recognised on acquisition	
	\$600,000 – (80% × \$400,000)	280,000
	Notional goodwill (\$280,000 × 20/80)	70,000
		<u>750,000</u>

- (b) The impairment loss is the total \$750,000 less the recoverable amount of \$520,000 = \$230,000. Under IAS 36 this is firstly allocated against the \$350,000 goodwill. (As the impairment loss is less than the goodwill, none is allocated against identifiable net assets.) As only the goodwill relating to Acetone is recognised, only its 80% share of the impairment loss is recognised:

	\$
Carrying value of goodwill	280,000
Impairment (80% × 230,000)	(184,000)
Revised carrying amount of goodwill	<u>96,000</u>

(c)		\$
	Carrying amount of Maclulich's net assets	700,000
	Recognised goodwill	205,000
	Notional goodwill (15/85 × \$205,000)	36,176
		<u>941,176</u>
	Recoverable amount	(660,000)
	Impairment loss	<u>281,176</u>
	Allocated to:	
	Recognised and notional goodwill	241,176
	Other net assets	40,000

Therefore the NCI is (\$700,000 – \$40,000) × 15% = \$99,000.

As the NCI does not include goodwill, only the impairment allocated to other net assets is included here.

4.11 Example: Impairment loss and goodwill: full goodwill

Assume that the facts relating to the acquisition of Dushanbe are the same as above, except that it is Acetone group's policy to value the NCI on the acquisition of Dushanbe at fair value. The fair value of the NCI in Dushanbe at acquisition was \$100,000.

Required

Determine the following amounts in respect of Acetone's consolidated financial statements at 31 December 20X7 according to IAS 36 *Impairment of Assets*.

- (a) The carrying amount of Dushanbe's assets to be compared with its recoverable amount for impairment testing purposes
- (b) The carrying amount of goodwill in respect of Dushanbe after the recognition of any impairment loss



Solution

- (a) \$700,000
- (b) \$120,000

Workings

(a)		\$
	Consideration transferred	600,000
	Fair value of NCI	100,000
		<u>700,000</u>
	Fair value of net assets acquired	400,000
	Goodwill	<u>300,000</u>
		\$
	Carrying amount of Dushanbe's net assets	400,000
	Goodwill recognised on acquisition	<u>300,000</u>
		<u>700,000</u>

- (b) The impairment loss is the total \$700,000 less the recoverable amount of \$520,000 = \$180,000. Under IAS 36 this is first allocated against the \$300,000 goodwill. (As the impairment loss is less than the goodwill, none is allocated against identifiable net assets.)

	\$
Carrying value of goodwill	300,000
Impairment	<u>(180,000)</u>
Revised carrying amount of goodwill	<u>120,000</u>

In the equity of the group statement of financial position, the retained earnings will be reduced by the parent's share of the impairment loss on the full goodwill, ie \$144,000 ($80\% \times \$180,000$) and the NCI reduced by the NCI's share, ie \$36,000 ($20\% \times \$180,000$).

In the statement of profit or loss and other comprehensive income, the impairment loss of \$180,000 will be charged as an extra operating expense. As the impairment loss relates to the full goodwill of the subsidiary, so it will reduce the NCI in the subsidiary's profit for the year by \$36,000 ($20\% \times \$180,000$).

4.12 Gain on a bargain purchase

Goodwill arising on consolidation is one form of **purchased goodwill**, and is governed by IFRS 3. As explained in an earlier chapter IFRS 3 requires that goodwill arising on consolidation should be **capitalised in the consolidated statement of financial position and reviewed for impairment every year**.

Goodwill arising on consolidation is the difference between the cost of an acquisition and the value of the subsidiary's net assets acquired. This difference can be **negative**: the aggregate of the fair values of the separable net assets acquired may **exceed** what the parent company paid for them. This is often referred to as **negative goodwill**. IFRS 3 refers to it as a '**gain on a bargain purchase**' (para. 34). In this situation:

- (a) An entity should first **re-assess** the amounts at which it has measured both the cost of the combination and the acquiree's identifiable net assets (IFRS 3: para. 36). This exercise should **identify any errors**.
- (b) Any **excess remaining** should be **recognised immediately in profit or loss**.

4.13 Types of consideration

The consideration paid by the parent for the shares in the subsidiary can take different forms and this will affect the calculation of goodwill. Here are some examples:

4.13.1 Contingent consideration

IFRS 3 requires recognition of contingent consideration, measured at fair value, at the acquisition date.

IFRS 3 defines contingent consideration as:

Usually, an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met. (IFRS 3: Appendix A)

IFRS 3 recognises that, by entering into an acquisition, the acquirer becomes obliged to make additional payments. Not recognising that obligation means that the consideration recognised at the acquisition date is not fairly stated.

IFRS 3 requires recognition of contingent consideration, measured at fair value, at the acquisition date (para. 39). This is, arguably, consistent with how other forms of consideration are fair valued.

The acquirer may be required to pay contingent consideration in the form of equity or of a debt instrument or cash. Debt instruments are presented in accordance with IAS 32. Contingent consideration may occasionally be an asset, for example if the consideration has already been transferred and the acquirer has the right to the return of part of it, an asset may occasionally be recognised in respect of that right.

Post-acquisition changes in the fair value of the contingent consideration

The treatment depends on the circumstances (IFRS 3: para. 58):

- (a) If the change in fair value is due to additional information obtained that affects the position at the acquisition date, goodwill should be re-measured.
- (b) If the change is due to events which took place after the acquisition date, for example, meeting earnings targets:
 - (i) Account for under IFRS 9 if the consideration is in the form of a financial instrument, for example loan notes.
 - (ii) Account for under IAS 37 if the consideration is in the form of cash.
 - (iii) An equity instrument is not re-measured.

Exam focus point

The December 2016 exam paper consolidation question featured contingent consideration. The fair value of the contingent consideration changed due to events which took place after the acquisition date, and so the change was accounted for in accordance with IAS 37. The examination team commented that the majority of candidates did not realise that the change in the fair value of contingent consideration since the date of acquisition should lead to an adjustment to consolidated retained earnings.

4.13.2 Deferred consideration

An agreement may be made that part of the consideration for the combination will be paid at a future date. This consideration will therefore be discounted to its present value using the acquiring entity's cost of capital.

Example

The parent acquired 75% of the subsidiary's 80m \$1 shares on 1 January 20X6. It paid \$3.50 per share and agreed to pay a further \$108m on 1 January 20X7.

The parent company's cost of capital is 8%.



In the financial statements for the year to 31 December 20X6 the cost of the combination will be as follows:

	\$m
80m shares \times 75% \times \$3.50	210
Deferred consideration:	
\$108m \times 1/1.08	100
Total consideration	<u>310</u>

At 31 December 20X6 \$8m will be charged to finance costs, being the **unwinding of the discount** on the deferred consideration. The deferred consideration was discounted by \$8m to allow for the time value of money. At 1 January 20X7 the full amount becomes payable.

4.13.3 Share exchange

The parent has acquired 12,000 \$1 shares in the subsidiary by issuing 5 of its own \$1 shares for every 4 shares in the subsidiary. The market value of the parent company's shares is \$6.

Cost of the combination:

	\$
12,000 \times 5/4 \times \$6	90,000

Note that this is credited to the share capital and share premium of the parent company as follows:

	DR	CR
Investment in subsidiary	90,000	
Share capital (\$12,000 \times 5/4)		15,000
Share premium (\$12,000 \times 5/4 \times 5)		75,000

4.13.4 Expenses and issue costs

Expenses of the combination, such as lawyers and accountants fees are written off as incurred. However, IFRS 3 requires that the costs of issuing equity are treated as a deduction from the proceeds of the equity issue. Share issue costs will therefore be debited to the share premium account. Issue costs of financial instruments are deducted from the proceeds of the financial instrument.

(IFRS 3: para. 53)

Now we will look at a full consolidation question including non-controlling interest at fair value.



Question

Consolidated statement of financial position

The draft statements of financial position of Ping Co and Pong Co on 30 June 20X8 were as follows.

STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20X8

	Ping Co \$	Pong Co \$
Assets		
Non-current assets		
Property, plant and equipment	50,000	40,000
20,000 ordinary shares in Pong Co at cost	<u>30,000</u>	
	80,000	
Current assets		
Inventory	3,000	8,000
Owed by Ping Co		10,000
Receivables	16,000	7,000
Cash	<u>2,000</u>	<u>—</u>
	21,000	25,000
Total assets	<u>101,000</u>	<u>65,000</u>

	Ping Co \$	Pong Co \$
<i>Equity and liabilities</i>		
<i>Equity</i>		
Ordinary shares of \$1 each	45,000	25,000
Revaluation surplus	12,000	5,000
Retained earnings	<u>26,000</u>	<u>28,000</u>
	83,000	58,000
<i>Current liabilities</i>		
Owed to Pong Co	8,000	–
Trade payables	<u>10,000</u>	<u>7,000</u>
	18,000	7,000
<i>Total equity and liabilities</i>	<u>101,000</u>	<u>65,000</u>

Ping Co acquired its investment in Pong Co on 1 July 20X7 when the retained earnings of Pong Co stood at \$6,000. The agreed consideration was \$30,000 cash and a further \$10,000 on 1 July 20X9. Ping Co's cost of capital is 7%. Pong Co has an internally-developed brand name – 'Pongo' – which was valued at \$5,000 at the date of acquisition. There have been no changes in the share capital or revaluation surplus of Pong Co since that date. At 30 June 20X8 Pong Co had invoiced Ping Co for goods to the value of \$2,000 and Ping Co had sent payment in full but this had not been received by Pong Co.

There is no impairment of goodwill. It is group policy to value non-controlling interest at full fair value. At the acquisition date the non-controlling interest was valued at \$9,000.

Required

Prepare the consolidated statement of financial position of Ping Co as at 30 June 20X8.

Answer

1 Calculate goodwill

Goodwill

	Group \$
Consideration transferred (W2)	38,734
Fair value of NCI	9,000
Net assets acquired as represented by:	
Ordinary share capital	25,000
Revaluation surplus on acquisition	5,000
Retained earnings on acquisition	6,000
Intangible asset – brand name	<u>5,000</u>
	(41,000)
Goodwill	<u>6,734</u>

This goodwill must be capitalised in the consolidated statement of financial position.

2 Consideration transferred

	\$
Cash paid	30,000
Fair value of deferred consideration ($10,000 \times 1/(1.07^{2*})$)	<u>8,734</u>
	38,734

* **Note.** The deferred consideration has been discounted at 7% for two years (1 July 20X7 to 1 July 20X9).

However, at the date of the current financial statements, 30 June 20X8, the discount for one year has unwound. The amount of the discount unwound is

	\$
$(10,000 \times 1/1.07) - 8,734$	612

So this amount will be charged to finance costs in the consolidated financial statements and the deferred consideration under liabilities will be shown as \$9,346 (8,734 + 612).

3 Calculate consolidated reserves

Consolidated revaluation surplus

	\$
Ping Co	12,000
Share of Pong Co's post acquisition revaluation surplus	<u>—</u>
	<u>12,000</u>

Consolidated retained earnings

	Ping	Pong
	\$	\$
Retained earnings per question	26,000	28,000
Less pre-acquisition		<u>(6,000)</u>
Discount unwound – finance costs	(612)	<u>22,000</u>
Share of Pong: 80% × \$22,000	<u>17,600</u>	
	<u>42,988</u>	

4 Calculate non-controlling interest at year end

	\$
Fair value of non-controlling interest	9,000
Share of post-acquisition retained earnings (22,000 × 20%)	<u>4,400</u>
	<u>13,400</u>

5 Agree current accounts

Pong Co has cash in transit of \$2,000 which should be added to cash and deducted from the amount owed by Ping Co.

Cancel common items: these are the current accounts between the two companies of \$8,000 each.

6 Prepare the consolidated statement of financial position

PING CO

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20X8

	\$	\$
Assets		
<i>Non-current assets</i>		
Property, plant and equipment (50,000 + 40,000)		90,000
Intangible assets: Goodwill (W1)		6,734
Brand name (W1)		5,000
<i>Current assets</i>		
Inventories (3,000 + 8,000)	11,000	
Receivables (16,000 + 7,000)	23,000	
Cash (2,000 + 2,000)	<u>4,000</u>	
		38,000
Total assets		<u>139,734</u>
Equity and liabilities		
<i>Equity</i>		
Ordinary shares of \$1 each	45,000	
Revaluation surplus (W3)	12,000	
Retained earnings (W3)	<u>42,988</u>	
		99,988
Non-controlling interest (W4)		<u>13,400</u>
		113,388
<i>Current liabilities</i>		
Trade payables (10,000 + 7,000)		17,000
Deferred consideration (W2)		<u>9,346</u>
Total equity and liabilities		<u>139,734</u>

A question requiring a consolidated statement of financial position is highly likely to come up in the exam. There is also nearly always an adjustment for intra-group trading, which we look at next.

5 Intra-group trading

FAST FORWARD

Intra-group trading can give rise to **unrealised profit** which is eliminated on consolidation.

5.1 Unrealised profit

Any receivable/payable balances outstanding between group companies are cancelled on consolidation. No further problem arises if all such intra-group transactions are **undertaken at cost**, without any mark-up for profit.

However, each company in a group is a separate trading entity and may wish to treat other group companies in the same way as any other customer. In this case, a company (say A Co) may buy goods at one price and sell them at a higher price to another group company (B Co). The financial statements of A Co will quite properly include the profit earned on sales to B Co; and similarly B Co's statement of financial position will include inventories at their cost to B Co, ie at the amount at which they were purchased from A Co.

This gives rise to two problems.

- (a) Although A Co makes a profit as soon as it sells goods to B Co, the group does not make a sale or achieve a profit until an outside customer buys the goods from B Co.
- (b) Any purchases from A Co which remain unsold by B Co at the year end will be included in B Co's inventory. Their value in the statement of financial position will be their cost to B Co, which is not the same as their cost to the group.

The objective of consolidated accounts is to present the financial position of several connected companies as that of a single entity, the group (IFRS 10: Appendix A). This means that **in a consolidated statement of financial position the only profits recognised should be those earned by the group** in providing goods or services to outsiders; and similarly, inventory in the consolidated statement of financial position should be valued at cost to the group.

Suppose that a parent company P Co buys goods for \$1,600 and sells them to a wholly owned subsidiary S Co for \$2,000. The goods are in S Co's inventory at the year end and appear in S Co's statement of financial position at \$2,000. In this case, P Co will record a profit of \$400 in its individual accounts, but from the group's point of view the figures are:

Cost	\$1,600
External sales	nil
Closing inventory at cost	\$1,600
Profit/loss	nil

If we add together the figures for retained earnings and inventory in the individual statements of financial position of P Co and S Co the resulting figures for consolidated retained earnings and consolidated inventory will each be overstated by \$400. A **consolidation adjustment** is therefore necessary as follows.

DEBIT	Group retained earnings
CREDIT	Group inventory (statement of financial position)

with the amount of **profit unrealised** by the group.

5.2 Non-controlling interests in unrealised intra-group profits

A further problem occurs where a subsidiary company which is **not wholly owned** is involved in **intra-group trading** within the group. If a subsidiary S Co is 75% owned and sells goods to the parent company for \$16,000 cost plus \$4,000 profit, ie for \$20,000 and if these items are unsold by P Co at the end of the reporting period, the 'unrealised' profit of \$4,000 earned by S Co and charged to P Co will be partly owned by the non-controlling interest of S Co.

The correct treatment of these intragroup profits is to remove the whole profit, charging the non-controlling interest with their proportion.

Note that where the sale has been made by the parent none of the unrealised profit will be charged to the non-controlling interest.

Entries to learn

DEBIT	Group retained earnings
DEBIT	Non-controlling interest
CREDIT	Group inventory (statement of financial position)

5.3 Example: Non-controlling interests and intra-group profits

P Co has owned 75% of the shares of S Co since the incorporation of that company. During the year to 31 December 20X2, S Co sold goods costing \$16,000 to P Co at a price of \$20,000 and these goods were still unsold by P Co at the end of the year.

Draft statements of financial position of each company at 31 December 20X2 were as follows.

	<i>P Co</i>		<i>S Co</i>	
	\$	\$	\$	\$
<i>Assets</i>				
<i>Non-current assets</i>				
Property, plant and equipment	125,000		120,000	
Investment: 75,000 shares in S Co at cost	<u>75,000</u>		<u>—</u>	
		200,000		120,000
<i>Current assets</i>				
Inventories	50,000		48,000	
Trade receivables	<u>20,000</u>		<u>16,000</u>	
		<u>70,000</u>		<u>64,000</u>
<i>Total assets</i>		<u>270,000</u>		<u>184,000</u>
<i>Equity and liabilities</i>				
<i>Equity</i>				
Ordinary shares of \$1 each fully paid	80,000		100,000	
Retained earnings	<u>150,000</u>		<u>60,000</u>	
		230,000		160,000
<i>Current liabilities</i>		<u>40,000</u>		<u>24,000</u>
<i>Total equity and liabilities</i>		<u>270,000</u>		<u>184,000</u>

Required

Prepare the consolidated statement of financial position of P Co at 31 December 20X2. The fair value of the non-controlling interest at acquisition was \$25,000.

Solution

The profit earned by S Co but unrealised by the group is \$4,000 of which \$3,000 (75%) is attributable to the group and \$1,000 (25%) to the non-controlling interest.

	<i>P Co</i>	<i>S Co</i>
	\$	\$
<i>Retained earnings</i>		
Per question	150,000	60,000
Less unrealised profit		<u>(4,000)</u>
		<u>56,000</u>
Share of S Co: \$56,000 × 75%	<u>42,000</u>	
	<u>192,000</u>	
<i>Non-controlling interest</i>		
Fair value at acquisition		25,000
Share of post-acquisition retained earnings (56,000 × 25%)		<u>14,000</u>
		<u>39,000</u>

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X2

	\$	\$
Assets		
Property, plant and equipment		245,000
Current assets		
Inventories \$(50,000 + 48,000 - 4,000)	94,000	
Trade receivables	<u>36,000</u>	
		<u>130,000</u>
Total assets		<u>375,000</u>
Equity and liabilities		
Ordinary shares of \$1 each	80,000	
Retained earnings	<u>192,000</u>	
		<u>272,000</u>
Non-controlling interest		<u>39,000</u>
		<u>311,000</u>
Current liabilities		<u>64,000</u>
Total equity and liabilities		<u>375,000</u>



Question

Unrealised profit

P Co acquired 80% of the shares in S Co one year ago when the reserves of S Co stood at \$10,000. Draft statements of financial position for each company are as follows.

	\$	P Co	\$	S Co	\$
Assets					
Non-current assets					
Property, plant and equipment	80,000				40,000
Investment in S Co at cost	<u>46,000</u>				
		126,000			
Current assets		<u>40,000</u>			<u>30,000</u>
Total assets		<u>166,000</u>			<u>70,000</u>
Equity and liabilities					
Equity					
Ordinary shares of \$1 each	100,000			30,000	
Retained earnings	<u>45,000</u>			<u>22,000</u>	
		145,000			52,000
Current liabilities		<u>21,000</u>			<u>18,000</u>
Total equity and liabilities		<u>166,000</u>			<u>70,000</u>

During the year S Co sold goods to P Co for \$50,000, the profit to S Co being 20% of selling price. At the end of the reporting period, \$15,000 of these goods remained unsold in the inventories of P Co. At the same date, P Co owed S Co \$12,000 for goods bought and this debt is included in the trade payables of P Co and the receivables of S Co. Non-controlling interest is valued at full fair value. It was valued at \$9,000 at the date of acquisition.

Required

Prepare a draft consolidated statement of financial position for P Co.

P CO
CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	\$	\$
Assets		
Non-current assets		
Property, plant and equipment (80,000 + 40,000)	120,000	
Goodwill (W1)	<u>15,000</u>	
		135,000
Current assets (W3)		<u>55,000</u>
Total assets		<u>190,000</u>
Equity and liabilities		
Equity		
Ordinary shares of \$1 each	100,000	
Retained earnings (W2)	<u>52,200</u>	
		152,200
Non-controlling interest (W5)		10,800
Current liabilities (W4)		<u>27,000</u>
Total equity and liabilities		<u>190,000</u>
Workings		
1 Goodwill		
	\$	\$
Consideration transferred		46,000
Fair value of non-controlling interest		9,000
Net assets acquired as represented by		
Share capital	30,000	
Retained earnings	<u>10,000</u>	
		(40,000)
Goodwill		<u>15,000</u>
2 Retained earnings		
	P Co	S Co
	\$	\$
Retained earnings per question	45,000	22,000
Unrealised profit: 20% × \$15,000		(3,000)
Pre-acquisition		<u>(10,000)</u>
		9,000
Share of S Co 80%	<u>7,200</u>	
	<u>52,200</u>	
3 Current assets		
	\$	\$
In P Co's statement of financial position		40,000
In S Co's statement of financial position	30,000	
Less S Co's current account with P Co cancelled	<u>(12,000)</u>	
		18,000
		58,000
Less unrealised profit excluded from inventory valuation		<u>(3,000)</u>
		<u>55,000</u>

4 *Current liabilities*

	\$
In P Co's statement of financial position	21,000
Less P Co's current account with S Co cancelled	<u>(12,000)</u>
	9,000
In S Co's statement of financial position	18,000
	<u>27,000</u>

5 *Non-controlling interest*

	\$
Fair value at date of acquisition	9,000
Share of post-acquisition retained earnings (9,000 × 20%)	<u>1,800</u>
	<u>10,800</u>

6 Intra-group sales of non-current assets

FAST FORWARD

As well as engaging in trading activities with each other, group companies may on occasion wish to transfer non-current assets.

6.1 Accounting treatment

In their individual accounts the companies concerned will treat the transfer just like a sale between unconnected parties: the selling company will record a profit or loss on sale, while the purchasing company will record the asset at the amount paid to acquire it, and will use that amount as the basis for calculating depreciation.

On consolidation, the usual '**group entity**' principle applies. The consolidated statement of financial position must show assets at their cost to the group, and any depreciation charged must be based on that cost. Two consolidation adjustments will usually be needed to achieve this.

- An adjustment to alter retained earnings and non-current assets cost so as to remove any element of unrealised profit or loss. This is similar to the adjustment required in respect of unrealised profit in inventory.
- An adjustment to alter retained earnings and accumulated depreciation is made so that consolidated depreciation is based on the asset's cost to the group.

The retained earnings of the entity making the sale are debited with the unrealised profit and the additional depreciation is credited back to the entity holding the asset.

The double entry is as follows.

- Sale by parent

DEBIT	Group retained earnings
CREDIT	Non-current assets

with the profit on disposal

DEBIT	Non-current assets
CREDIT	Subsidiary's retained earnings

with the excess depreciation.
- Sale by subsidiary

DEBIT	Subsidiary's retained earnings
CREDIT	Non-current assets



with the profit on disposal

DEBIT Non-current assets
CREDIT Group retained earnings

with the additional depreciation.

In both cases, the subsidiary's retained earnings are affected. As such, the non-controlling interest will also be affected (remember that the non-controlling interest owns part of the subsidiary). This effect on the non-controlling interest is taken care of in the retained earnings working, as shown in the following example.

6.2 Example: Intra-group sale of non-current assets

P Co owns 60% of S Co and on 1 January 20X1 S Co sells plant costing \$10,000 to P Co for \$12,500. The companies make up accounts to 31 December 20X1 and the balances on their retained earnings at that date are:

P Co	after charging depreciation of 10% on plant	\$27,000
S Co	including profit on sale of plant	\$18,000

Required

Show the working for consolidated retained earnings.

Solution

Retained earnings

	P Co	S Co
	\$	\$
Per question	27,000	18,000
Disposal of plant		
Profit		(2,500)
Depreciation: $10\% \times \$2,500$	250	
		<u>15,500</u>
Share of S Co: $\$15,500 \times 60\%$	9,300	
	<u>36,550</u>	

Notes

- 1 The non-controlling interest in the retained earnings of S Co is $40\% \times \$15,500 = \$6,200$.
- 2 The profit on the transfer less related depreciation of \$2,250 ($2,500 - 250$) will be deducted from the carrying amount of the plant to write it down to cost to the group.

7 Summary: Consolidated statement of financial position

Purpose	To show the net assets which P controls and the ownership of those assets.
Net assets	Always 100% P plus 100% S providing P holds a majority of voting rights
Share capital	P only
Reason	Simply reporting to the parent company's shareholders in another form
Retained earnings	100% P plus group share of post-acquisition retained earnings of S less consolidation adjustments
Reason	To show the extent to which the group actually owns total assets less liabilities
Non-controlling interest	Fair value at acquisition plus share of post-acquisition retained profit (loss)
Reason	To show the equity in a subsidiary not attributable to the parent

8 Acquisition of a subsidiary during its accounting period

FAST FORWARD

When a parent company acquires a subsidiary during its accounting period the only accounting entries made at the time will be those recording the **cost of acquisition in the parent company's books**. At the end of the accounting period the consolidation adjustments will be made.

8.1 Pre-acquisition profits

As we have already seen, at the end of the accounting year it will be necessary to prepare consolidated accounts.

The subsidiary company's accounts to be consolidated will show the subsidiary's profit or loss for the whole year. For consolidation purposes, however, it will be necessary to distinguish between:

- (a) Profits earned before acquisition
- (b) Profits earned after acquisition

In practice, a subsidiary company's profit may not accrue evenly over the year; for example, the subsidiary might be engaged in a trade, such as toy sales, with marked seasonal fluctuations. Nevertheless, the assumption can be made that **profits accrue evenly** whenever it is impracticable to arrive at an accurate split of pre- and post-acquisition profits.

Once the amount of pre-acquisition profit has been established the appropriate consolidation workings (goodwill, retained earnings) can be produced.

It is worthwhile to summarise what happens on consolidation to the retained earnings figures extracted from a subsidiary's statement of financial position. Suppose the financial statements of S Co, a 60% subsidiary of P Co, show retained earnings of \$20,000 at the end of the reporting period, of which \$14,000 were earned prior to acquisition. The figure of \$20,000 will appear in the consolidated statement of financial position as follows.

	\$
Non-controlling interests working: their share of post-acquisition retained earnings (40% × 6,000)	2,400
Goodwill working: pre-acquisition retained earnings	14,000
Consolidated retained earnings working: group share of post-acquisition retained earnings (60% × \$6,000)	3,600
	<u>20,000</u>

Exam focus point

The DiplFR examining team has reported that many candidates fail to apportion the results of the subsidiary to include only its post-acquisition results.



Question

Acquisition

Hinge Co acquired 80% of the ordinary shares of Singe Co on 1 April 20X5. On 31 December 20X4 Singe Co's accounts showed a share premium account of \$4,000 and retained earnings of \$15,000. The statements of financial position of the two companies at 31 December 20X5 are set out below. Neither company has paid any dividends during the year. Non-controlling interest should be valued at full fair value. The market price of the subsidiary's shares was \$2.50 prior to acquisition by the parent.

Required

Prepare the consolidated statement of financial position of Hinge Co at 31 December 20X5. There has been no impairment of goodwill.



STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5

	<i>Hinge Co</i> \$	<i>Singe Co</i> \$
Assets		
Non-current assets		
Property, plant and equipment	32,000	30,000
16,000 ordinary shares of 50c each in Singe Co	50,000	
	<u>82,000</u>	
Current assets	85,000	43,000
Total assets	<u>167,000</u>	<u>73,000</u>
Equity and liabilities		
Equity		
Ordinary shares of \$1 each	100,000	
Ordinary shares of 50c each		10,000
Share premium account	7,000	4,000
Retained earnings	40,000	39,000
	<u>147,000</u>	<u>53,000</u>
Current liabilities	20,000	20,000
Total equity and liabilities	<u>167,000</u>	<u>73,000</u>

Answer

Singe Co has made a profit of \$24,000 (\$39,000 – \$15,000) for the year. In the absence of any direction to the contrary, this should be assumed to have arisen evenly over the year; \$6,000 in the three months to 31 March and \$18,000 in the nine months after acquisition. The company's pre-acquisition retained earnings are therefore as follows.

	\$
Balance at 31 December 20X4	15,000
Profit for three months to 31 March 20X5	6,000
Pre-acquisition retained earnings	<u>21,000</u>

The balance of \$4,000 on share premium account is all pre-acquisition.

The consolidation workings can now be drawn up.

1 Goodwill

	\$	\$
Consideration transferred		50,000
Non-controlling interest ($\$2.50 \times 4,000$)		10,000
Net assets acquired represented by		
Ordinary share capital	10,000	
Retained earnings (pre-acquisition)	21,000	
Share premium	4,000	
		<u>(35,000)</u>
Goodwill at acquisition		<u>25,000</u>

2 Retained earnings

	<i>Hinge Co</i> \$	<i>Singe Co</i> \$
Per question	40,000	39,000
Pre-acquisition (see above)		<u>(21,000)</u>
		<u>18,000</u>
Share of Singe: $\$18,000 \times 80\%$	14,400	
	<u>54,400</u>	

3 *Non-controlling interest at reporting date*

	\$
NCI at acquisition	10,000
Share of post-acquisition retained earnings (18,000 × 20%)	3,600
	<u>13,600</u>

HINGE CO CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5

	\$	\$
<i>Assets</i>		
Property, plant and equipment		62,000
Goodwill (W1)		25,000
Current assets		<u>128,000</u>
<i>Total assets</i>		<u>215,000</u>
<i>Equity and liabilities</i>		
<i>Equity</i>		
Ordinary shares of \$1 each	100,000	
Share premium account	7,000	
Retained earnings (W2)	<u>54,400</u>	
		161,400
Non-controlling interest (W3)		<u>13,600</u>
		175,000
Current liabilities		<u>40,000</u>
<i>Total equity and liabilities</i>		<u>215,000</u>

8.2 Example: Pre-acquisition losses of a subsidiary

As an illustration of the entries arising when a subsidiary has pre-acquisition *losses*, suppose P Co acquired all 50,000 \$1 ordinary shares in S Co for \$20,000 on 1 January 20X1 when there was a debit balance of \$35,000 on S Co's retained earnings. In the years 20X1 to 20X4 S Co makes profits of \$40,000 in total, leaving a credit balance of \$5,000 on retained earnings at 31 December 20X4. P Co's retained earnings at the same date are \$70,000.

Solution

The consolidation workings would appear as follows.

1	<i>Goodwill</i>	\$	\$
	Consideration transferred		20,000
	Net assets acquired as represented by		
	Ordinary share capital	50,000	
	Retained earnings	<u>(35,000)</u>	
	Goodwill		<u>5,000</u>
2	<i>Retained earnings</i>		
		<i>P Co</i>	<i>S Co</i>
		\$	\$
	At the end of the reporting period	70,000	5,000
	Pre-acquisition loss	—	<u>35,000</u>
			<u>40,000</u>
	S Co — share of post-acquisition retained earnings (40,000 × 100%)	<u>40,000</u>	
		<u>110,000</u>	

9 Disposals of subsidiaries

FAST FORWARD

Only 'full disposals' where the entire shareholding is sold are examinable. The subsidiary will be removed from the consolidated statement of financial position and a profit or loss on disposal will need to be calculated and accounted for.

Since we have not yet considered the preparation of the consolidated statement of profit or loss, we will consider disposals in Chapter 22 and consider the effect on both the statement of financial position and statement of profit or loss.

10 Fair values in acquisition accounting

FAST FORWARD

A subsidiary's identifiable assets and liabilities should be recognised at fair value at the acquisition date.

10.1 Fair value adjustment calculations

Until now we have calculated goodwill as the difference between the consideration transferred and the **carrying amount** of net assets acquired by the group. However, under IFRS 3 the subsidiary's identifiable assets and liabilities should be recognised at **fair value** at the date of acquisition and these fair values should be taken into account when calculating goodwill (IFRS 3: para. 32).

There are two possible ways of achieving this.

- (a) The **subsidiary company** might **incorporate any necessary fair value adjustments** in its own books of account. In this case, we can proceed directly to the consolidation, taking asset values and reserves figures straight from the subsidiary company's statement of financial position.
- (b) The **fair value adjustments** may be made as a **consolidation adjustment without being incorporated** in the subsidiary company's books. In this case, we must make the necessary adjustments to the subsidiary's statement of financial position as a working. Only then can we proceed to the consolidation.

Note. Remember that when depreciating assets are revalued there may be a corresponding alteration in the amount of depreciation charged and accumulated. There may also be consequences for **deferred tax**, which were discussed in Chapter 11 (Section 7) of this Study Text.

10.2 Example: Fair value adjustments

P Co acquired 75% of the ordinary shares of S Co on 1 September 20X5. At that date the fair value of S Co's non-current assets was \$23,000 greater than their carrying amount, and the balance of retained earnings was \$21,000. The statements of financial position of both companies at 31 August 20X6 are given below. S Co has not incorporated any revaluation in its books of account. Non-controlling interest is valued at full fair value which was deemed to be \$18,000 at the acquisition date.

P Co

STATEMENT OF FINANCIAL POSITION AS AT 31 AUGUST 20X6

	\$	\$
Assets		
Non-current assets		
Property, plant and equipment	63,000	
Investment in S Co at cost	<u>51,000</u>	
		114,000
Current assets		<u>82,000</u>
Total assets		<u>196,000</u>

	\$	\$
<i>Equity and liabilities</i>		
Equity		
Ordinary shares of \$1 each	80,000	
Retained earnings	<u>96,000</u>	176,000
Current liabilities		<u>20,000</u>
<i>Total equity and liabilities</i>		<u>196,000</u>

S CO

STATEMENT OF FINANCIAL POSITION AS AT 31 AUGUST 20X6

	\$	\$
<i>Assets</i>		
Property, plant and equipment		28,000
Current assets		<u>43,000</u>
<i>Total assets</i>		<u>71,000</u>
<i>Equity and liabilities</i>		
Equity		
Ordinary shares of \$1 each	20,000	
Retained earnings	<u>41,000</u>	61,000
Current liabilities		<u>10,000</u>
<i>Total equity and liabilities</i>		<u>71,000</u>

If S Co had revalued its non-current assets at 1 September 20X5, an addition of \$3,000 would have been made to the depreciation charged for 20X5/X6.

Required

Prepare P Co's consolidated statement of financial position as at 31 August 20X6.

Solution

P CO CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 AUGUST 20X6

	\$	\$
<i>Non-current assets</i>		
Property, plant and equipment (63,000 + 28,000 + 23,000 – 3,000)	111,000	
Goodwill (W1)	<u>5,000</u>	116,000
Current assets		<u>125,000</u>
		<u>241,000</u>
<i>Equity and liabilities</i>		
Equity		
Ordinary shares of \$1 each	80,000	
Retained earnings (W2)	<u>108,750</u>	188,750
Non-controlling interest (W3)		<u>22,250</u>
		211,000
Current liabilities		<u>30,000</u>
		<u>241,000</u>

Workings

1 Goodwill

		Group
		\$
Consideration transferred		51,000
Fair value of NCI		18,000
Net assets acquired as represented by		
Ordinary share capital	20,000	
Retained earnings	21,000	
Fair value adjustment	<u>23,000</u>	
		(64,000)
Goodwill		<u>5,000</u>

2 Retained earnings

	P Co	S Co
	\$	\$
Per question	96,000	41,000
Pre acquisition profits		(21,000)
Depreciation adjustment		<u>(3,000)</u>
Post acquisition S Co		<u>17,000</u>
Group share in S Co		
(\$17,000 × 75%)	<u>12,750</u>	
Group retained earnings	<u>108,750</u>	

3 Non-controlling interest at reporting date

	\$
Fair value at acquisition	18,000
Share of post-acquisition retained earnings (17,000 × 25%)	<u>4,250</u>
	<u>22,250</u>



Question

Fair value I

An asset is recorded in S Co's books at its historical cost of \$4,000. On 1 January 20X5 P Co bought 80% of S Co's equity. Its directors attributed a fair value of \$3,000 to the asset as at that date. It had been depreciated for two years out of an expected life of four years on the straight line basis. There was no expected residual value. On 30 June 20X5 the asset was sold for \$2,600. What is the profit or loss on disposal of this asset to be recorded in S Co's accounts and in P Co's consolidated accounts for the year ended 31 December 20X5?

Answer

S Co: Carrying amount at disposal (at historical cost) = $\$4,000 \times 1\frac{1}{2}/4 = \$1,500$
 \therefore Profit on disposal = \$1,100 (depreciation charge for the year = \$500)

P Co: Carrying amount at disposal (at fair value) = $\$3,000 \times 1\frac{1}{2}/2 = \$2,250$
 \therefore Profit on disposal for consolidation = \$350 (depreciation for the year = \$750).

The non-controlling interest would be credited with 20% of both the profit on disposal and the depreciation charge as part of the one line entry in the consolidated statement of profit or loss.

10.3 IFRS 3 recognition and measurement principles

FAST FORWARD

A subsidiary's assets and liabilities must satisfy the criteria in IFRS 3 to be recognised as part of an acquisition.

10.3.1 Recognition

To be recognised as part of the acquisition, the acquiree's assets and liabilities must:

- (a) 'Meet the definitions of assets and liabilities in the *[Conceptual] Framework*' (IFRS 3: para. 11).
- (b) 'Be part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination transaction rather than the result of separate transactions' (IFRS 3: para. 12).

Applying this criteria may result in the recognition of assets and liabilities **not previously recognised** in the acquiree's financial statements (IFRS 3: para. 13). For example, a tax benefit arising from the acquiree's tax losses that was not recognised by the acquiree may be recognised by the group if the acquirer has future taxable profits against which the unrecognised tax benefit can be applied.

Furthermore, **future losses** or other costs expected to be incurred **as a result of the business combination** should not be recognised as liabilities on acquisition.

IFRS 3 explains that a plan to restructure a subsidiary following an acquisition is not a present obligation of the acquiree at the acquisition date. Neither does it meet the definition of a contingent liability. Therefore, an acquirer **should not recognise a liability** for such a **restructuring plan** as part of allocating the cost of the combination unless the subsidiary was already committed to the plan before the acquisition. (IFRS 3: para. 11)

This **prevents creative accounting**. An acquirer cannot set up a provision for restructuring or future losses of a subsidiary and then release this to profit or loss in subsequent periods in order to reduce losses or smooth profits.

10.3.2 Measurement

The general rule under IFRS 3 is that, on acquisition, the subsidiary's assets and liabilities **must be measured at fair value** at the acquisition date, except in **limited, stated cases** (IFRS 3: para. 18).

10.3.3 Intangible assets – specific guidance

The acquiree may have **intangible assets**, such as development expenditure. These can be recognised separately from goodwill only if they are **identifiable**. An intangible asset is identifiable only if it:

- (a) Is **separable**, ie 'capable of being separated or divided from the entity and sold, transferred, or exchanged, either individually or together with a related contract, identifiable asset or liability' (IFRS 3: para. B33); or
- (b) Arises from **contractual or other legal rights** (IFRS 3: para. B34).

The acquiree may also have internally-generated assets such as brand names which have not been recognised as intangible assets. As the acquiring company is giving valuable consideration for these assets, they are now recognised as assets in the consolidated financial statements.

10.3.4 Exceptions to the recognition and measurement principles

FAST FORWARD

There are certain exceptions to the IFRS 3 recognition and measurement criteria, such as contingent liabilities.

Contingent liabilities

Contingent liabilities of the acquirer are **recognised** provided there is a **present obligation** and their **fair value can be measured reliably** (IFRS 3: para. 23).

This is a departure from the normal rules in IAS 37; contingent liabilities are not normally recognised, but only disclosed.

After their initial recognition, contingent liabilities should be measured 'at the higher of:

- (a) The amount that would be recognised in accordance with IAS 37
- (b) The amount initially recognised' (IFRS 3: para. 56).

Other exceptions to the recognition or measurement principles

- (a) **Deferred tax:** use IAS 12 values (IFRS 3: para. 24).
- (b) **Employee benefits:** use IAS 19 values (IFRS 3: para. 26).
- (c) **Indemnification assets:** measurement should be consistent with the measurement of the indemnified item, for example an employee benefit or a contingent liability (IFRS 3: para. 27).
- (d) **Reacquired rights:** value 'on the basis of the remaining contractual term of the related contract regardless of whether market participants would consider potential contractual renewals when measuring its fair value' (IFRS 3: para. 29).
- (e) **Share-based payment:** use IFRS 2 values (IFRS 3: para. 30).
- (f) **Assets held for sale:** use IFRS 5 values (IFRS 3: para. 31).

10.4 What is fair value?

FAST FORWARD

IFRS 13 gives extensive guidance on how the fair value of assets and liabilities should be established.

Fair value is defined as follows by IFRS 13 *Fair Value Measurement*.

Key term

Fair value. 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. (IFRS 13: para. 9)

IFRS 13 (see Chapter 10) provides extensive guidance on how the fair value of assets and liabilities should be established.

The following are considered in determining fair value:

- (a) The asset or liability being measured
- (b) The principal market (ie that where the most activity takes place) or where there is no principal market, the most advantageous market (ie that in which the best price could be achieved) in which an orderly transaction would take place for the asset or liability
- (c) The highest and best use of the asset or liability and whether it is used on a standalone basis or in conjunction with other assets or liabilities
- (d) Assumptions that market participants would use when pricing the asset or liability. (IFRS 13: paras. 11–16, 27)

Having considered these factors, IFRS 13 provides a hierarchy of inputs for arriving at fair value.

It requires that Level 1 inputs are used where possible:

- Level 1** 'Quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date' (IFRS 13: para. 76)
- Level 2** 'Inputs other than quoted prices included in Level 1 that are observable for the asset, either directly or indirectly' (IFRS 13: para. 81)
- Level 3** 'Unobservable inputs for the asset or liability' (IFRS 13: para. 86)

10.4.1 Examples of fair value and business combinations

For non-financial assets, fair value is decided based on the highest and best use of the asset as determined by a market participant. The following examples, adapted from the illustrative examples to IFRS 13, demonstrate what is meant by this.

Example: Land

Anscome Co has acquired land in a business combination. The land is currently developed for industrial use as a site for a factory. The current use of land is presumed to be its highest and best use unless market or other factors suggest a different use. Nearby sites have recently been developed for residential use as sites for high-rise apartment buildings. On the basis of that development and recent zoning and other changes to facilitate that development, Anscome determines that the land currently used as a site for a factory could be developed as a site for residential use (ie for high-rise apartment buildings) because market participants would take into account the potential to develop the site for residential use when pricing the land.

How would the highest and best use of the land be determined?

Solution

The highest and best use of the land would be determined by comparing both of the following:

- (a) The value of the land as currently developed for industrial use (ie the land would be used in combination with other assets, such as the factory, or with other assets and liabilities).
- (b) The value of the land as a vacant site for residential use, taking into account the costs of demolishing the factory and other costs (including the uncertainty about whether the entity would be able to convert the asset to the alternative use) necessary to convert the land to a vacant site (ie the land is to be used by market participants on a stand-alone basis).

The highest and best use of the land would be determined on the basis of the higher of those values.

(IFRS 3: Illustrative Examples para. IE7–8, adapted)

Example: Research and development project

Searcher has a research and development (R & D) project in a business combination. Searcher does not intend to complete the project. If completed, the project would compete with one of its own projects (to provide the next generation of the entity's commercialised technology). Instead, the entity intends to hold (ie lock up) the project to prevent its competitors from obtaining access to the technology. In doing this the project is expected to provide defensive value, principally by improving the prospects for the entity's own competing technology.

If it could purchase the R & D project, Developer Co would continue to develop the project and that use would maximise the value of the group of assets or of assets and liabilities in which the project would be used (ie the asset would be used in combination with other assets or with other assets and liabilities). Developer Co does not have similar technology.

How would the fair value of the project be measured?

Solution

The fair value of the project would be measured on the basis of the price that would be received in a current transaction to sell the project, assuming that the R & D would be used with its complementary assets and the associated liabilities and that those assets and liabilities would be available to Developer Co.

(IFRS 3: Illustrative Examples para. IE9, adapted)



Question

Fair value II

Tyzo Co prepares accounts to 31 December. On 1 September 20X7 Tyzo Co acquired six million \$1 shares in Kono Co at \$2.00 per share. At that date Kono Co produced the following interim financial statements.

<i>Non-current assets</i>	\$'000
Property, plant and equipment (Note 1)	16.0
<i>Current assets</i>	
Inventories (Note 2)	4.0
Receivables	2.9
Cash and cash equivalents	1.2
	<u>8.1</u>
<i>Total assets</i>	<u>24.1</u>
<i>Equity and liabilities</i>	
<i>Equity</i>	
Share capital (\$1 shares)	8.0
Reserves	4.4
	<u>12.4</u>
<i>Non-current liabilities</i>	
Long-term loans	4.0
	<u>4.0</u>
<i>Current liabilities</i>	
Trade payables	3.2
Provision for taxation	0.6
Bank overdraft	3.9
	<u>(7.7)</u>
<i>Total equity and liabilities</i>	<u>24.1</u>

Notes

- 1 The following information relates to the property, plant and equipment of Kono Co at 1 September 20X7.

	\$m
Gross replacement cost	28.4
Net replacement cost	16.6
Economic value	18.0
Net realisable value	8.0

The property, plant and equipment of Kono Co at 1 September 20X7 had a total purchase cost to Kono Co of \$27.0m. They were all being depreciated at 25% per annum pro rata on that cost. This policy is also appropriate for the consolidated financial statements of Tyzo Co. No non-current assets of Kono Co which were included in the interim financial statements drawn up as at 1 September 20X7 were disposed of by Kono Co prior to 31 December 20X7. No non-current asset was fully depreciated by 31 December 20X7.

- 2 The inventories of Kono Co which were shown in the interim financial statements are raw materials at cost to Kono Co of \$4m. They would have cost \$4.2m to replace at 1 September 20X7. Of the inventory of Kono Co in hand at 1 September 20X7, goods costing Kono Co \$3.0m were sold for \$3.6m between 1 September 20X7 and 31 December 20X7.
- 3 On 1 September 20X7 Tyzo Co took a decision to rationalise the group so as to integrate Kono Co. The costs of the rationalisation were estimated to total \$3.0m and the process was due to start on 1 March 20X8. No provision for these costs has been made in any of the financial statements given above.
- 4 It is the group's policy to value the non-controlling interests at its proportionate share of the fair value of the subsidiary's net assets.

Required

Compute the goodwill on consolidation of Kono Co that will be included in the consolidated financial statements of the Tyzo Co group for the year ended 31 December 20X7, explaining your treatment of the items mentioned above. You should refer to the provisions of relevant accounting standards.

Answer

Goodwill on consolidation of Kono Co

	\$m	\$m
Consideration ($\$2.00 \times 6m$)		12.0
Non-controlling interest ($13.2m \times 25\%$)		<u>3.3</u>
		15.3
Group share of fair value of net assets acquired		
Share capital	8.0	
Pre-acquisition reserves	4.4	
Fair value adjustments		
Property, plant and equipment ($16.6 - 16.0$)	0.6	
Inventories ($4.2 - 4.0$)	<u>0.2</u>	
		(13.2)
Goodwill		<u>2.1</u>

Notes on treatment

- (a) Share capital and pre-acquisition profits represent the carrying amount of the net assets of Kono Co at the date of acquisition. Adjustments are then required to this carrying amount in order to give the fair value of the net assets at the date of acquisition. For short-term monetary items, fair value is their carrying value on acquisition.
- (b) IFRS 3 states that the fair value of property, plant and equipment should be determined by market value or, if information on a market price is not available (as is the case here), then by reference to depreciated replacement cost, reflecting normal business practice. The net replacement cost (ie \$16.6m) represents the gross replacement cost less depreciation based on that amount, and so further adjustment for extra depreciation is unnecessary.
- (c) IFRS 3 also states that raw materials should be valued at replacement cost. In this case that amount is \$4.2m.
- (d) The rationalisation costs cannot be reported in pre-acquisition results under IFRS 3 as they are not a liability of Kono Co at the acquisition date.

Chapter Roundup

- IFRS 10 lays out the basic procedures for preparing consolidated financial statements.
- In the consolidated statement of financial position it is necessary to distinguish **non-controlling interests** from those net assets attributable to the group and financed by shareholders' equity.
- **Goodwill** is the excess of the amount transferred plus the amount of non-controlling interests over the fair value of the net assets of the subsidiary.
- IFRS 3 **requires recognition of contingent consideration, measured at fair value, at the acquisition date.**
- Intra-group trading can give rise to **unrealised profit** which is eliminated on consolidation.
- As well as engaging in trading activities with each other, group companies may on occasion wish to **transfer non-current assets.**
- When a parent company acquires a subsidiary during its accounting period the only accounting entries made at the time will be those recording the **cost of the acquisition in the parent company's books.** At the end of the accounting period the consolidation adjustments will be made.
- Only 'full disposals' where the entire shareholding is sold are examinable. The subsidiary will be removed from the consolidated statement of financial position and a profit or loss on disposal will need to be calculated and accounted for.
Since we have not yet considered the preparation of the consolidated statement of profit or loss, we will consider disposals in Chapter 22 and consider the effect on both the statement of financial position and statement of profit or loss.
- A subsidiary's identifiable assets and liabilities should be recognised at fair value at the acquisition date.
- A subsidiary's assets and liabilities must satisfy the criteria in IFRS 3 to be recognised as part of an acquisition.
- There are certain exceptions to the IFRS 3 recognition and measurement criteria, such as contingent liabilities.
- **IFRS 13 Fair Value Measurement** gives extensive guidance on how the fair value of assets and liabilities should be established.

Quick Quiz

- 1 Chicken Co owns 80% of Egg Co. Egg Co sells goods to Chicken Co at cost plus 50%. The total invoiced sales to Chicken Co by Egg Co in the year ended 31 December 20X9 were \$900,000 and, of these sales, goods which had been invoiced at \$60,000 were held in inventory by Chicken Co at 31 December 20X9. What is the reduction in aggregate group gross profit?
- 2 Major Co, which makes up its accounts to 31 December, has an 80% owned subsidiary Minor Co. Minor Co sells goods to Major Co at a mark-up on cost of 33.33%. At 31 December 20X8, Major had \$12,000 of such goods in its inventory and at 31 December 20X9 had \$15,000 of such goods in its inventory.
What is the amount by which the consolidated profit attributable to Major Co's shareholders should be adjusted in respect of the above?
Ignore taxation
 - A \$1,000 Debit
 - B \$800 Credit
 - C \$750 Credit
 - D \$600 Debit
- 3 Goodwill is always a positive figure. True or false?
- 4 A parent company can assume that, for a subsidiary acquired during its accounting period, profits accrue evenly during the year. True or false?

- 5 What entries are made in the workings to record the pre-acquisition profits of a subsidiary?
- 6 Under IFRS 13 *Fair Value Measurement*, what is meant by Level 1 inputs?
- 7 Where does unrealised profit on intra-group trading appear in the statement of profit or loss?

Answers to Quick Quiz

- 1 $\$60,000 \times \frac{50}{150} = \$20,000$
- 2 D $(15,000 - 12,000) \times \frac{33.3}{133.3} \times 80\%$
- 3 False. Goodwill can be a negative figure if the purchaser has 'got a bargain'.
- 4 Not necessarily – the examiner will advise you on this
- 5 See Section 4.2
- 6 Quoted prices in active markets for identical assets that the entity can access at the measurement date
- 7 As an addition to cost of sales

Now try the questions below from the Practice Question Bank

Number	Level	Marks	Time
Q23	Introductory	12	23 mins
Q24	Introductory	20	39 mins

22

The consolidated statement of profit or loss and other comprehensive income

Topic list	Syllabus reference
1 The consolidated statement of profit or loss	D1
2 The consolidated statement of profit or loss and other comprehensive income	D1
3 Disposal of a subsidiary	D5
4 The consolidated statement of changes in equity	D1

Introduction

This chapter deals with the consolidated statement of profit or loss and the consolidated statement of profit or loss and other comprehensive income.

Most of the consolidation adjustments will involve the **statement of profit or loss**, so that is the focus of this chapter.

A subsidiary that has been disposed of will no longer be included in the consolidated statement of financial position, but its results up to the date of disposal will form part of consolidated profit or loss.

Study guide

D1	Preparation of group consolidated external reports
(e)	Prepare a consolidated statement of profit or loss, statement of profit or loss and other comprehensive income and statement of changes in equity for a simple group (one or more subsidiaries), including an example where an acquisition occurs during the year where there is a non-controlling interest
D5	Complete disposal of shares in subsidiaries
(a)	Calculate the gain or loss on the complete disposal of shares in a subsidiary in the financial statements of the parent and the subsidiary
(b)	Explain and illustrate the effect of the complete disposal of a parent's investment in a subsidiary in the parent's individual financial statements and/or those of the group

1 The consolidated statement of profit or loss

FAST FORWARD

The source of the consolidated statement of profit or loss is the individual statements of profit or loss of the separate companies in the group.

The consolidated statement of profit or loss combines the financial statements of parent and subsidiary (subsidiaries) to present the results for the accounting period as the results of a **single economic unit**.

1.1 Consolidation procedure

It is customary in practice to prepare a working paper (known as a **consolidation schedule**) on which the individual statements of profit or loss are set out side by side and totalled to form the basis of the consolidated statement of profit or loss.

Exam focus point

In an examination it is very much quicker not to do this. Use workings to show the calculation of complex figures such as the non-controlling interest and show the derivation of others on the face of the statement of profit or loss, as shown in our examples.

FAST FORWARD

In the consolidated statement of profit or loss, non-controlling interest is brought in as a one-line adjustment at the end of the statement.

1.2 Simple example: Consolidated statement of profit or loss

P Co acquired 75% of the ordinary shares of S Co on that company's incorporation in 20X3. The summarised statements of profit or loss and movement on retained earnings of the two companies for the year ending 31 December 20X6 are set out below.

	P Co	S Co
	\$	\$
Sales revenue	75,000	38,000
Cost of sales	(30,000)	(20,000)
Gross profit	45,000	18,000
Administrative expenses	(14,000)	(8,000)
Profit before tax	31,000	10,000
Income tax expense	(10,000)	(2,000)
Profit for the year	<u>21,000</u>	<u>8,000</u>

Note. Movement on retained earnings

Retained earnings brought forward	<u>87,000</u>	<u>17,000</u>
Profit for the year	<u>21,000</u>	<u>8,000</u>
Retained earnings carried forward	<u>108,000</u>	<u>25,000</u>

Required

Prepare the consolidated statement of profit or loss and extract from the statement of changes in equity showing retained earnings and non-controlling interest.

Solution

P Co

CONSOLIDATED STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X6

	\$
Sales revenue (75 + 38)	113,000
Cost of sales (30 + 20)	<u>(50,000)</u>
Gross profit	63,000
Administrative expenses (14 + 8)	<u>(22,000)</u>
Profit before tax	41,000
Income tax expense	<u>(12,000)</u>
Profit for the year	<u>29,000</u>
Profit attributable to:	
Owners of the parent	27,000
Non-controlling interest (\$8,000 × 25%)	<u>2,000</u>
	<u>29,000</u>

STATEMENT OF CHANGES IN EQUITY (EXTRACT)

	Retained Earnings	Non-controlling Interest	Total Equity
	\$	\$	\$
Balance at 1 January 20X6	99,750	4,250	104,000
Total comprehensive income for the year	<u>27,000</u>	<u>2,000</u>	<u>29,000</u>
Balance at 31 December 20X6	<u>126,750</u>	<u>6,250</u>	<u>133,000</u>

Notice how the non-controlling interest is dealt with.

- Down to the line '**profit for the year**' the **whole** of S Co's results is included without reference to group share or non-controlling share. A **one-line adjustment** is then inserted to deduct the non-controlling share of S Co's profit.
- The non-controlling share (\$4,250) of S Co's retained earnings brought forward ($17,000 \times 25\%$) is **excluded** from group retained earnings. This means that the carried forward figure of \$126,750 is the figure which would appear in the statement of financial position for group retained earnings.

This last point may be clearer if we construct the working for group retained earnings.

Group retained earnings

	P Co	S Co
	\$	\$
At year end	108,000	25,000
Less pre-acquisition retained earnings		<u>—</u>
		<u>25,000</u>
S Co – share of post-acquisition retained earnings ($25,000 \times 75\%$)	<u>18,750</u>	
	<u>126,750</u>	

The non-controlling share of S Co's retained earnings comprises the non-controlling interest in the \$17,000 profits brought forward plus the non-controlling interest (\$2,000) in \$8,000 retained profits for the year.

We will now look at the complications introduced by **intra-group trading**, **intra-group dividends** and **pre-acquisition profits** in the subsidiary.

1.3 Intra-group trading

FAST FORWARD

Intra-group sales and purchases are eliminated from the consolidated statement of profit or loss.

Like the consolidated statement of financial position, the consolidated statement of profit or loss should deal with the results of the group as those of a single entity. When one company in a group sells goods to another the relevant amount is added to the sales revenue of the first company and to the cost of sales of the second. Yet as far as the entity's dealings with outsiders are concerned no sale has taken place.

The consolidated figures for sales revenue and cost of sales should represent **sales to and purchases from outsiders**. An adjustment is therefore necessary to reduce the sales revenue and cost of sales figures by the value of intra-group sales during the year.

We have also seen in an earlier chapter that any unrealised profits on intra-group trading should be excluded from the figure for group profits. This will occur whenever goods sold at a profit within the group remain in the inventory of the purchasing company at the year end. The best way to deal with this is to **calculate the unrealised profit on unsold inventories at the year end and reduce consolidated gross profit by this amount**. Cost of sales will be the balancing figure.

1.4 Example: Intra-group trading

Suppose in our earlier example that S Co had recorded sales of \$5,000 to P Co during 20X6. S Co had purchased these goods from outside suppliers at a cost of \$3,000. One half of the goods remained in P Co's inventory at 31 December 20X6.

Prepare the revised consolidated statement of profit or loss.

Solution

The consolidated statement of profit or loss for the year ended 31 December 20X6 would now be as follows.

	\$
Sales revenue (75 + 38 – 5)	108,000
Cost of sales (30 + 20 – 5 + 1*)	<u>(46,000)</u>
Gross profit (45 + 18 – 1*)	62,000
Administrative expenses	<u>(22,000)</u>
Profit before taxation	40,000
Income tax expense	<u>(12,000)</u>
Profit for the year	<u>28,000</u>
Profit attributable to :	
Owners of the parent	26,250
Non-controlling interest (8,000 – 1,000) × 25%	<u>1,750</u>
	<u>28,000</u>

Note.

Retained earnings brought forward	99,750
Profit for the year	<u>26,250</u>
Retained earnings carried forward	<u>126,000</u>

*Unrealised profit: $\frac{1}{2} \times (\$5,000 - \$3,000)$

An adjustment will be made for the unrealised profit against the inventory figure in the consolidated statement of financial position.

1.5 Intra-group dividends

In our example so far we have assumed that S Co retains all of its after-tax profit. It may be, however, that S Co distributes some of its profits as dividends. As before, the **non-controlling interest** in the subsidiary's profit should be calculated immediately after the figure of after-tax profit. For this purpose, no

account need be taken of how much of the non-controlling interest is to be distributed by S Co as dividend.

Note that group retained earnings are only adjusted for dividends paid to the parent company shareholders. Dividends paid by the subsidiary to the parent are cancelled on consolidation and dividends paid to the non-controlling interest are replaced by the allocation to the non-controlling interest of their share of the profit for the year of the subsidiary.

1.6 Pre-acquisition profits

FAST FORWARD

Only the **post-acquisition** profits of the subsidiary are brought into the consolidated profit or loss.

As explained above, the figure for retained earnings carried forward must be the same as the figure for retained earnings in the consolidated statement of financial position. We have seen in previous chapters that retained earnings in the consolidated statement of financial position comprise:

- The **whole of the parent company's** retained earnings
- A **proportion of the subsidiary company's** retained earnings. The proportion is the **group's share of post-acquisition retained earnings** in the subsidiary. From the total retained earnings of the subsidiary we must therefore **exclude** both the **non-controlling share** of total retained earnings and the **group's share of pre-acquisition** retained earnings.

A similar procedure is necessary in the consolidated statement of profit or loss if it is to link up with the consolidated statement of financial position. Previous examples have shown how the non-controlling share of profits is treated in the statement of profit or loss. Their share of profits for the year is deducted from profit after tax, while the figure for profits brought forward in the consolidation schedule includes only the group share of the subsidiary's profits.

In the same way, when considering examples which include pre-acquisition profits in a subsidiary, the figure for profits brought forward should include only the group share of the post-acquisition retained profits. If the subsidiary is **acquired during the accounting year**, it is therefore necessary to apportion its profit for the year between pre-acquisition and post-acquisition elements. This can be done by simple time apportionment (ie assuming that profits arose evenly throughout the year) but there may be seasonal trading or other effects which imply a different split than by time apportionment.

With a mid-year acquisition, the entire statement of profit or loss of the subsidiary is split between pre-acquisition and post-acquisition amounts. Only the post-acquisition figures are included in the consolidated statement of profit or loss.



Question

Acquisition

P Co acquired 60% of the \$100,000 equity of S Co on 1 April 20X5. The statements of profit or loss of the two companies for the year ended 31 December 20X5 are set out below.

	P Co	S Co	S Co (⁹ / ₁₂)
	\$	\$	\$
Sales revenue	170,000	80,000	60,000
Cost of sales	(65,000)	(36,000)	(27,000)
Gross profit	105,000	44,000	33,000
Other income – dividend received S Co	3,600		
Administrative expenses	(43,000)	(12,000)	(9,000)
Profit before tax	65,600	32,000	24,000
Income tax expense	(23,000)	(8,000)	(6,000)
Profit for the year	<u>42,600</u>	<u>24,000</u>	<u>18,000</u>
<i>Note</i>			
Dividends (paid 31 December)	12,000	6,000	
Profit retained	<u>30,600</u>	<u>18,000</u>	
Retained earnings brought forward	81,000	40,000	
Retained earnings carried forward	<u>111,600</u>	<u>58,000</u>	

Required

Prepare the consolidated statement of profit or loss and the retained earnings and non-controlling interest extracts from the statement of changes in equity.

Answer

The shares in S Co were acquired three months into the year. Only the post-acquisition proportion (9/12ths) of S Co's statement of profit or loss is included in the consolidated statement of profit or loss. This is shown above for convenience.

P CO CONSOLIDATED STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X5

	\$
Sales revenue (170 + 60)	230,000
Cost of sales (65 + 27)	(92,000)
Gross profit	138,000
Administrative expenses (43 + 9)	(52,000)
Profit before tax	86,000
Income tax expense (23 + 6)	(29,000)
Profit for the year	<u>57,000</u>
Profit attributable to:	
Owners of the parent	49,800
Non-controlling interest (18 × 40%)	<u>7,200</u>
	<u>57,000</u>

STATEMENT OF CHANGES IN EQUITY (Extracts)

	Retained earnings \$	Non- controlling interest \$
Balance at 1 January 20X5	81,000	–
Dividends paid (6,000 – 3,600)	(12,000)	(2,400)
Total comprehensive income for the year	49,800	7,200
Added on acquisition of subsidiary (W)	–	58,400
Balance at 31 December 20X5	<u>118,800</u>	<u>63,200</u>

Note. All of S Co's profits brought forward are pre-acquisition.

Working

	\$
Added on acquisition of subsidiary:	
Share capital	100,000
Retained earnings brought forward	40,000
Profits Jan-March 20X5 (24,000 – 18,000)	6,000
	<u>146,000</u>
Non-controlling share 40%	<u>58,400</u>



Question

Non-controlling interest

The following information relates to Brodick Co and its subsidiary Lamlash Co for the year to 30 April 20X7.

	<i>Brodick Co</i>	<i>Lamlash Co</i>
	\$'000	\$'000
Sales revenue	1,100	500
Cost of sales	(630)	(300)
Gross profit	470	200
Administrative expenses	(105)	(150)
Dividend from Lamlash Co	24	—
Profit before tax	389	50
Income tax expense	(65)	(10)
Profit for the year	<u>324</u>	<u>40</u>

Note

Dividends paid	200	30
Profit retained	124	10
Retained earnings brought forward	460	48
Retained earnings carried forward	<u>584</u>	<u>58</u>

Additional information

- (a) The issued share capital of the group was as follows.

Brodick Co: 5,000,000 ordinary shares of \$1 each

Lamlash Co: 1,000,000 ordinary shares of \$1 each

- (b) Brodick Co purchased 80% of the issued share capital of Lamlash Co on 1 November 20X6. At that time, the retained earnings of Lamlash stood at \$52,000.

Required

Insofar as the information permits, prepare the Brodick group consolidated statement of profit or loss for the year to 30 April 20X7, and extracts from the statement of changes in equity showing group retained earnings and the non-controlling interest.

Answer

BRODICK GROUP CONSOLIDATED STATEMENT OF PROFIT OR LOSS FOR THE YEAR TO 30 APRIL 20X7

	\$'000
Sales revenue $(1,100 + (500 \times 6/12))$	1,350
Cost of sales $(630 + (300 \times 6/12))$	(780)
Gross profit	570
Administrative expenses $(105 + (150 \times 6/12))$	(180)
Profit before tax	390
Income tax expense $(65 + (10 \times 6/12))$	(70)
Profit for the year	<u>320</u>
Profit attributable to:	
Owners of the parent	316
Non-controlling interest (W1)	4
	<u>320</u>

STATEMENT OF CHANGES IN EQUITY

	Retained earnings	Non-controlling interest
	\$'000	\$'000
Balance brought forward 1 May 20X6	460	—
Added on acquisition of subsidiary (W2)	—	210
Dividends paid – per Qn/(30,000 – 24,000)	(200)	(6)
Total comprehensive income for the year (W1)	316	4
Balance carried forward 30 April 20X7	<u>576</u>	<u>208</u>

Workings

1	Non-controlling interests	\$'000
	In Lamlash (20% × 40) × 6/12	4
2	Added on acquisition of subsidiary	\$'000
	Share capital	1,000
	Retained earnings	52
		<u>1,052</u>
	Non-controlling interest share 20%	210

1.7 Summary

The table below summarises the main points about the consolidated statement of profit or loss.

Purpose	To show the results of the group for an accounting period as if it were a single entity
Sales revenue to profit for year	100% P + 100% S (excluding intra-group transactions)
Reason	To show the results of the group which were controlled by the parent company
Intra-group sales	Strip out intra-group activity from both sales revenue and cost of sales.
Unrealised profit on intra-group sales	(a) Goods sold by P. Increase cost of sales by unrealised profit (b) Goods sold by S. Increase cost of sales by full amount of unrealised profit and decrease non-controlling interest by their share of unrealised profit
Depreciation	If the value of S's non-current assets have been subjected to a fair value uplift then any additional depreciation must be charged to profit or loss. The non-controlling interest will need to be adjusted for their share.
Transfer of non-current assets	Expenses must be increased by any profit on the transfer and reduced by any additional depreciation arising from the increased carrying value of the asset
Non-controlling interests	<p>S's profit after tax (PAT) X</p> <p>Less: * unrealised profit (X)</p> <p>* profit on disposal of non-current assets (X)</p> <p>additional depreciation following FV uplift (X)</p> <p>Add: ** additional depreciation following disposal of non-current assets X</p> <p>X</p> <p>NCI% X</p> <p>* Only applicable if sales of goods and non-current assets made by subsidiary</p> <p>** Only applicable if sale of non-current assets made by subsidiary</p>
Reason	To show the extent to which profits generated through P's control are in fact owned by other parties

2 The consolidated statement of profit or loss and other comprehensive income

FAST FORWARD

The consolidated statement of profit or loss and other comprehensive income is produced using the consolidated statement of profit or loss as a basis.

The most commonly examined items of other comprehensive income are revaluation gains and losses, although you may also encounter items such as actuarial surpluses/deficits and gains/losses on effective cash flow hedges. A consolidated statement of profit or loss and other comprehensive income should be fairly easy to produce once you have done the consolidated statement of profit or loss.

We will take the last question and add an item of comprehensive income to illustrate this.

2.1 Example: Comprehensive income

The consolidated statement of profit or loss of the Brodick Group is as in the answer to the last question. In addition, Lamlash made a \$200,000 revaluation gain on one of its properties during the year following acquisition.

2.2 Solution

BRODICK GROUP
CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR TO 30 APRIL 20X7

	\$'000
Sales revenue	1,350
Cost of sales	(780)
Gross profit	570
Administrative expenses	(180)
Profit before tax	390
Income tax expense	(70)
Profit for the year	320
Other comprehensive income	
Gain on property revaluation	200
Total comprehensive income for the year	<u>520</u>
Profit attributable to:	
Owners of the parent	316
Non-controlling interest	4
	<u>320</u>
Total comprehensive income attributable to:	
Owners of the parent (316 + (200 × 80%))	476
Non-controlling interest (4 + (200 × 20%))	44
	<u>520</u>

2.3 Consolidated statement of profit or loss and other comprehensive income (separate statement)

If we were using the two-statement format we would produce a separate statement of profit or loss and statement of other comprehensive income.

2.4 Example: Other comprehensive income

BRODICK GROUP

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

Profit for the year	320
Other comprehensive income:	
Gain on property revaluation	<u>200</u>
Total comprehensive income for the year	<u>520</u>
Total comprehensive income attributable to:	
Owners of the parent (316 + (200 × 80%))	476
Non-controlling interest (4 + (200 × 20%))	<u>44</u>
	<u>520</u>

2.5 Full worked example

On 1 July 20X8 Crystal acquired 60,000 of the 100,000 shares in Pebble, its only subsidiary. The draft statements of profit or loss and other comprehensive income of both companies at 31 December 20X8 are shown below:

	<i>Crystal</i>	<i>Pebble</i>
	\$'000	\$'000
Revenue	43,000	26,000
Cost of sales	<u>(28,000)</u>	<u>(18,000)</u>
Gross profit	15,000	8,000
Other income – dividend received from Pebble	2,000	–
Distribution costs	<u>(2,000)</u>	<u>(800)</u>
Administrative expenses	<u>(4,000)</u>	<u>(2,200)</u>
Finance costs	<u>(500)</u>	<u>(300)</u>
Profit before tax	10,500	4,700
Income tax expense	<u>(1,400)</u>	<u>(900)</u>
Profit for the year	9,100	3,800
Other comprehensive income:		
Gain on property revaluation (Note (i))	–	2,000
Investment in equity instrument	<u>200</u>	<u>–</u>
Total comprehensive income for the year	<u>9,300</u>	<u>5,800</u>

Additional information:

- At the date of acquisition the fair values of Pebble's assets were equal to their carrying amounts with the exception of a building which had a fair value \$1m in excess of its carrying amount. At the date of acquisition the building had a remaining useful life of 20 years. Building depreciation is charged to administrative expenses. The building was revalued again at 31 December 20X8 and its fair value had increased by an additional \$1m.
- Sales from Crystal to Pebble were \$6m during the post-acquisition period. All of these goods are still held in inventory by Pebble. Crystal marks up all sales by 20%.
- Despite the property revaluation, Crystal has concluded that goodwill in Pebble has been impaired by \$500,000.
- It is Crystal's policy to value the non-controlling interest at full (fair) value.
- Income and expenses can be assumed to have arisen evenly throughout the year.

Prepare the consolidated statement of profit or loss and other comprehensive income for the year ended 31 December 20X8.

Solution

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

	\$'000
Revenue $(43,000 + (26,000 \times 6/12) - 6,000 \text{ (W1)})$	50,000
Cost of sales $(28,000 + (18,000 \times 6/12) - 6,000 + 1,000 \text{ (W1)})$	(32,000)
Gross profit	18,000
Distribution costs $(2,000 + (800 \times 6/12))$	(2,400)
Administrative expenses $(4,000 + (2,200 \times 6/12) + 25 \text{ (W2)} + 500 \text{ impairment})$	(5,625)
Finance costs $(500 + (300 \times 6/12))$	(650)
Profit before tax	9,325
Income tax expense $(1,400 + (900 \times 6/12))$	(1,850)
Profit for the year	7,475
Other comprehensive income	
Gain on property revaluation (post-acquisition)	1,000
Investment in equity instrument	200
Total comprehensive income for the year	8,675
Profit attributable to:	
Owners of the parent	6,925
Non-controlling interest (W3)	550
	7,475
Total comprehensive income attributable to:	
Owners of the parent	7,725
Non-controlling interest $(550 + (1,000 \times 40\%))$	950
	8,675

Workings

- Unrealised profit
Remove intra-group trading:
DR Revenue \$6m/CR Cost of sales \$6m
Unrealised profit = $6,000 \times 20/120 = 1,000$ – add to cost of sales
- Movement on fair value adjustment
The fair value adjustment of \$1m will be depreciated over the remaining life of the building. The amount to be charged at 31 December is:
 $1,000,000/20 \times 6/12 = 25,000$
40% of this (10,000) will be charged to the NCI.
- Non-controlling interest – share of profit for the year

	\$'000
Share of post-acquisition profit $(3,800 \times 6/12 \times 40\%)$	760
Movement on fair value adjustment $(25 \times 40\%)$	(10)
Share of goodwill impairment $(500 \times 40\%)$	(200)
	<u>550</u>

3 Disposal of a subsidiary

FAST FORWARD

Only 'full disposals' where the entire shareholding is sold are examinable. The subsidiary will be removed from the consolidated statement of financial position and a profit or loss on disposal will need to be calculated and accounted for.

After a subsidiary is sold, it is no longer included in the consolidated statement of financial position. A profit or loss on disposal is calculated and included in the consolidated statement of profit or loss. If the disposal is part-way through the year, the subsidiary is consolidated only for the part of the year prior to disposal.

When a subsidiary is disposed of, this must be accounted for in both the parent's separate financial statements and the consolidated financial statements.

3.1 Parent's separate financial statements

This calculation is straightforward: the proceeds are compared with the carrying amount of the investment sold. The investment will be held at cost or at fair value if held as an investment in equity instruments:

	\$
Fair value of consideration received	X
Less carrying amount of investment disposed of	(X)
Profit/(loss) on disposal	<u>X/(X)</u>

3.2 Group financial statements

(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

The subsidiary which has been disposed of will no longer be included within the consolidated statement of financial position as it is no longer a subsidiary at the date the statement of financial position is being prepared.

(IFRS 10: para. B98)

3.3 Group profit/loss on disposal

The group profit or loss on disposal is the difference between the sales proceeds and the group's investment in the subsidiary. This investment consists of the group's share of the subsidiary's net assets up to the date of disposal, plus any remaining goodwill in the subsidiary, minus the non-controlling interests in the subsidiary.

The basic proforma is as follows:

	\$	\$
Fair value of consideration received		X
Less: share of consolidated carrying amount at date of disposal		
net assets	X	
goodwill	X	
less non-controlling interests	<u>(X)</u>	
Profit/(loss) on disposal		<u>(X)</u> <u>X/(X)</u>

(IFRS 10: para. B98)



Question

Disposal

Horse Co bought 80% of the share capital of Hoof Co for \$648,000 on 1 October 20X5. At that date Hoof Co's retained earnings balance stood at \$360,000. The statements of financial position at 30 September 20X8 and the summarised statements of profit or loss to that date are given below, prior to any entries being made to reflect the disposal below. (There is no other comprehensive income.)

	Horse Co \$'000	Hoof Co \$'000
Non-current assets	720	540
Investment in Hoof Co	648	—
Current assets	740	740
	<u>2,108</u>	<u>1,280</u>
Equity		
\$1 ordinary shares	1,080	360
Retained earnings	828	720
Current liabilities	200	200
	<u>2,108</u>	<u>1,280</u>
Profit before tax	306	252
Tax	(90)	(72)
Profit for the year	<u>216</u>	<u>180</u>

Assume that profits accrue evenly throughout the year and no dividends have been paid.

It is the group's policy to value the non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Ignore taxation.

Required

Prepare the consolidated statement of financial position and consolidated statement of profit or loss at 30 September 20X8 assuming that Horse Co sells its entire holding in Hoof Co for \$1,300,000 on 30 September 20X8. (Assume no impairment of goodwill.)

Answer

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 20X8

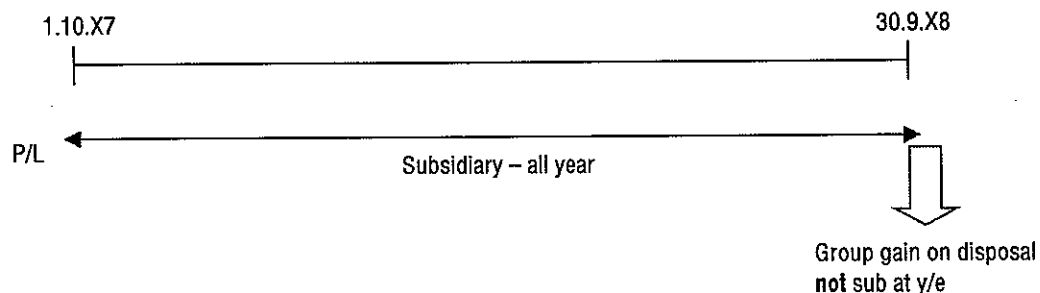
	\$'000
Non-current assets	720
Current assets (740 + 1,300)	<u>2,040</u>
	<u>2,760</u>
Equity	
\$1 ordinary shares	1,080
Retained earnings (W4)	1,480
Current liabilities	200
	<u>2,760</u>

CONSOLIDATED STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 30 SEPTEMBER 20X8

	\$'000
Profit before tax (306 + 252)	558
Profit on disposal (W2)	364
Tax (90 + 72)	(162)
	<u>760</u>
Profit attributable to:	
Owners of the parent	724
Non-controlling interest (20% × 180)	36
	<u>760</u>

Workings

1 Timeline



2 Profit on disposal of Hoof Co

	\$'000	\$'000
Fair value of consideration received		1,300
Less: consolidated carrying amount at date of disposal:		
Net assets (360 + 720)	1,080	
Goodwill (W3)	72	
Less: non-controlling interests (1,080 × 20%)	(216)	
		(936)
		<u>364</u>

3 Goodwill

	\$'000
Consideration transferred	648
NCI at acquisition (720 × 20%)	144
Less: net assets at acquisition (360 + 360)	(720)
	<u>72</u>

4 Retained earnings carried forward

	Horse	Hoof
	\$'000	\$'000
Per question/date of disposal	828	720
Add group gain on disposal (W2)	364	–
Reserves at acquisition	–	(360)
		<u>360</u>
Share of post-acq'n reserves up to the disposal (80% × 360)	288	
	<u>1,480</u>	

3.4 Mid-year disposal

If the disposal of the subsidiary is mid-year, then net assets and the non-controlling interest at the disposal date will need to be calculated. Additionally, if the subsidiary has declared or paid any **dividends** during the year of disposal (prior to the disposal date) and has not yet accounted for them, then these dividends must be deducted from the net assets of the subsidiary.

3.4.1 Example

Returning to Horse and Hoof above, let's say that Horse disposed of its holding in Hoof on 31 March 20X8 for \$1,200,000, at a point when Hoof's post-tax profits were \$90,000 ($180,000 \times 6/12$), the results would be as follows:

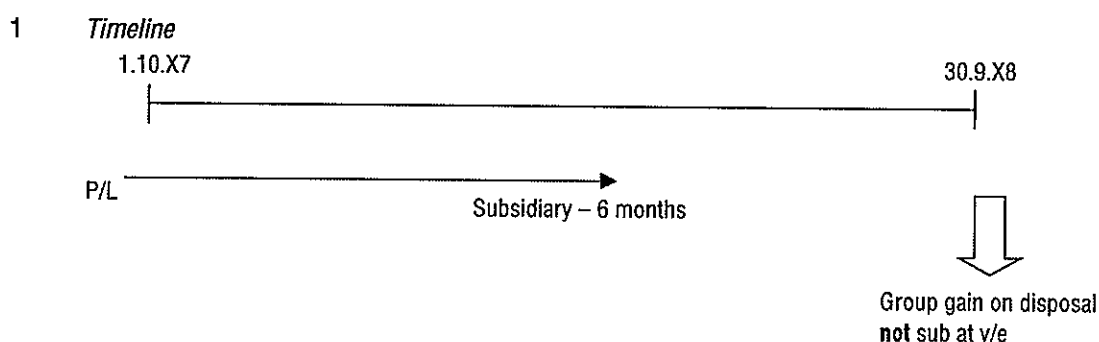
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 20X8

	\$'000
Non-current assets	720
Current assets (740 + 1,200)	1,940
	<u>2,660</u>
<i>Equity</i>	
\$1 ordinary shares	1,080
Retained earnings (W4)	1,380
Current liabilities	200
	<u>2,660</u>

CONSOLIDATED STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 30 SEPTEMBER 20X8

	\$'000
Profit before tax (306 + (252 × 6/12))	432
Profit on disposal (W2)	336
Tax (90 + (72 × 6/12))	(126)
	<u>642</u>
Profit attributable to:	
Owners of the parent	624
Non-controlling interest (20% × 90)	18
	<u>642</u>

Workings



2 <i>Profit on disposal of Hoof Co</i>		
	\$'000	\$'000
Fair value of consideration received		1,200
Less: consolidated carrying amount at date of disposal:		
Net assets (360 + 720 – 90)	990	
Goodwill (W3)	72	
Less non-controlling interests (990 × 20%)	(198)	
		<u>(864)</u>
		<u>336</u>

3 <i>Goodwill</i>		\$'000
Consideration transferred		648
NCI at acquisition (720 × 20%)		144
Less: net assets at acquisition (360 + 360)		(720)
		<u>72</u>

4 *Retained earnings carried forward*

	<i>Horse</i>	<i>Hoof</i>
	\$'000	\$'000
Per question/date of disposal (Hoof 720 – 90)	828	630
Add group gain on disposal (W2)	336	–
Reserves at acquisition	–	(360)
		<u>270</u>
Share of post-acq'n reserves up to the disposal (80% × 270)	<u>216</u>	
	<u>1,380</u>	

3.4.2 Example: Mid-year disposal and dividends

Quadra acquired 80% of Saturn on 1 January 20X6 for \$560,000 when Saturn had share capital of \$200,000 and retained earnings of \$376,000. At the acquisition date the fair value of the non-controlling interest was \$134,000. Quadra's policy is to value the non-controlling interest at fair value. There has been no impairment of goodwill since acquisition.

On 30 June 20X9, Quadra disposed of its investment in Saturn, raising proceeds of \$700,000.

The following are extracts from the accounts of Saturn for the year ended 31 December 20X9:

	\$'000
Retained earnings b/f	430
Profit for the year	48

A final dividend for 20X8 of \$20,000 was paid on 14 March 20X9. This has not yet been accounted for.

Required

What profit or loss on disposal of Saturn is reported in the Quadra group accounts for the year ended 31 December 20X9?

Solution

	\$'000	\$'000
Fair value of consideration received		700.0
Less: share of consolidated carrying amount at date of disposal		
net assets (W1)	634.0	
Goodwill (W2)	118.0	
less non-controlling interests (W3)	<u>(145.6)</u>	
		<u>(606.4)</u>
Group profit on disposal of Saturn		<u>93.6</u>

1 *Net assets of Saturn at date of disposal*

	\$'000
Share capital	200
Retained earnings	430
Profit up to date of disposal (1/2 × 48)	24
Dividend	<u>(20)</u>
	<u>634</u>

2 *Goodwill on acquisition of Saturn*

	\$'000
Consideration transferred	560
Fair value of NCI	134
Net assets of Saturn at acquisition (200 + 376)	<u>(576)</u>
Goodwill	<u>118</u>

3 Non-controlling interests in Saturn at date of disposal

	\$'000
At acquisition	134.0
NCI share of retained earnings up to disposal date $20\% \times (430 - 376 + 24 - 20)$	11.6
	<u>145.6</u>

4 Consolidated statement of changes in equity

FAST FORWARD

The consolidated statement of changes in equity reconciles the movement in equity in the consolidated statement of financial position at the beginning and end of the period.

Exam focus point

You will need to be able to produce a consolidated statement of changes in equity reconciling equity attributable to the owners of the parent and also NCI. The preparation of a consolidated statement of changes in equity featured in the June 2016 exam for 7 marks.

A consolidated statement of changes in equity in the Dip IFR exam is likely to look like this:

	Equity attributable to owners of the parent \$'000	Non-controlling interest \$'000	Total \$'000
Balance at 1 Jan 20X9	X	X	X
Total comprehensive income for the year	X	X	X
Dividends	(X)	(X)	(X)
Balance at 31 Dec 20X9	<u>X</u>	<u>X</u>	<u>X</u>

The figures in the statement involve no new calculations. They are worked out as follows:

- The opening and closing balances of equity attributable to owners of the parent are calculated by adding together the parent share capital and the group reserves balance calculated using the workings you have prepared for consolidated statement of position examples.
- The opening and closing non-controlling interest balances are also calculated using the workings you have seen in the context of the consolidated statement of financial position.
- The figures for total comprehensive income are taken from the reconciliation at the end of the statement of profit or loss and other comprehensive income.
- The dividend shown in equity attributable to owners of the parent is the dividend paid by the parent.
- The dividend shown in the non-controlling interest column is the non-controlling interest share of the dividend paid by the subsidiary.



Question

Consolidated statement of changes in equity I

Delta Group is preparing its financial statements for the year ended 31 March 20X1. Using the following information, prepare the consolidated statement of changes in equity along with relevant extracts from the statement of financial position.

DELTA GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION
AS AT 31 MARCH 20X0 (EXTRACT)

<i>Equity and liabilities</i>	\$'000
Equity	
Share capital	90,000
Retained earnings	40,000
Total equity	<u>130,000</u>
Non-controlling interest	<u>25,000</u>
	<u>155,000</u>

- (a) On 1 April 20X0 a bond was issued carrying a zero interest rate but redeemable at an amount of \$16,105,100 on 31 March 20X5. The total proceeds for the issue were \$12m. As an alternative to redemption, the bond-holders have the option to convert the bond into equity shares. Had the option not been available, the bond-holders would have only been prepared to invest \$10m given their requirement for a 10% return on their investment.
- (b) The total dividend paid in the year to ordinary shareholders was \$20m.
- (c) The group's total comprehensive income for the year was \$10m, of which \$0.5m is attributable to the non-controlling interest.

Answer

DELTA GROUP
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY OF
FOR THE YEAR ENDED 31 MARCH 20X1

	<i>Share capital</i>	<i>Other reserves</i>	<i>Retained earnings</i>	<i>Total</i>	<i>Non-controlling interest</i>	<i>Total equity</i>
	<i>\$'000</i>	<i>\$'000</i>	<i>\$'000</i>	<i>\$'000</i>	<i>\$'000</i>	<i>\$'000</i>
Balance at 31 March 20X0	90,000	—	40,000	130,000	25,000	155,000
Total comprehensive income for the year			9,500	9,500	500	10,000
Dividend paid			(20,000)	(20,000)	—	(20,000)
Equity element of convertible bond (<i>Working</i>)		2,000		2,000		2,000
Balance at 31 March 20X1	<u>90,000</u>	<u>2,000</u>	<u>29,500</u>	<u>121,500</u>	<u>25,500</u>	<u>147,000</u>

DELTA GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION
FOR THE YEAR ENDED 31 MARCH 20X1 (EXTRACT)

<i>Equity and liabilities</i>	
Equity	
Share capital	90,000
Retained earnings	29,500
Other reserves	2,000
Total equity	<u>121,500</u>
Non-controlling interest	<u>25,500</u>
	<u>147,000</u>

Working: Equity and debt elements of convertible bond

	\$'000
Total proceeds from redeemable debt	12,000
Less: loan element of convertible	10,000
Equity element	<u>2,000</u>



Question

Consolidated statement of changes in equity II

The following information relates to the Bull Group for the year ended 30 April 20X7.

BULL GROUP

**CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME
FOR THE YEAR TO 30 APRIL 20X7**

	\$'000
Sales revenue	1,600
Cost of sales	(930)
Gross profit	670
Administrative expenses	(255)
Profit before tax	415
Income tax expense	(75)
Profit for the year	340
Other comprehensive income (not re-classified to P/L)	
Gain on property revaluation	300
Total comprehensive income for the year	<u>640</u>

Profit attributable to:

	\$'000
Owners of the parent	332
Non-controlling interest	8
	<u>340</u>

Total comprehensive income attributable to:

	\$'000
Owners of the parent	592
Non-controlling interest	48
	<u>640</u>

Further information relating to Bull Co and its subsidiary Lamb Co for the year to 30 April 20X7:

	<i>Bull</i> \$'000	<i>Lamb</i> \$'000
Dividends paid	200	30
Reserves brought forward	360	105
Reserves carried forward	<u>584</u>	<u>315</u>

- The issued share capital of the group was as follows:
Bull Co: 5,000,000 ordinary shares of \$1 each
Lamb Co: 1,000,000 ordinary shares of \$1 each
- Bull Co purchased 80% of the issued share capital of Lamb Co in 20X0. At that time, the revenue reserves of Lamb amounted to \$50,000. Neither company had any balance on the revaluation surplus until the current year.
- It is the group's policy to value NCI on acquisition at its proportionate share of the subsidiary's net assets.

Required

Prepare the Bull group consolidated statement of changes in equity for the year to 30 April 20X7.

BULL GROUP
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR TO 30 APRIL 20X7

	<i>Equity attributable to owners of the parent</i>	<i>Non- controlling interest</i>	<i>Total</i>
	<i>\$'000</i>	<i>\$'000</i>	<i>\$'000</i>
Balance at 1 Jan 20X6 (W1)/(W2)	5,404	221	5,625
Total comprehensive income for the year (W5)	592	48	640
Dividends (W6)	(200)	(6)	(206)
Balance at 31 Dec 20X7 (W3)/(W4)	<u>5,796</u>	<u>263</u>	<u>6,059</u>

Workings

1 *Equity attributable to owners of the parent b/fwd*

	<i>Bull \$'000</i>	<i>Lamb \$'000</i>
Reserves per question	360	105
Less pre-acquisition		<u>(50)</u>
		55
Group share of S ($55 \times 80\%$)	44	
Group reserves b/fwd	<u>404</u>	
Add share capital (Bull only)	<u>5,000</u>	
Equity attributable to owners of the parent b/fwd	<u>5,404</u>	

Note. This working is exactly the same as that used to calculate retained earnings for the consolidated statement of financial position, but with an extra stage at the end to add on the parent's share capital which also forms part of **equity**.

2 *Non-controlling interest b/fwd*

	<i>\$</i>
NCI at acquisition ($20\% \times (1,000 + 50)$)	210
NCI share of L's post acquisition reserves ($20\% \times 55$ (W1))	<u>11</u>
NCI b/fwd	<u>221</u>

Note. This working is exactly the same as that used in connection with the consolidated statement of financial position. The non-controlling interest at acquisition would normally be part of the goodwill working. Here, it has been calculated by applying the NCI % to the total of share capital and pre-acquisition reserves of Lamb.

3 *Equity attributable to owners of the parent c/fwd*

	<i>Bull \$'000</i>	<i>Lamb \$'000</i>
Retained earnings c/fwd per question	584	315
Less pre-acquisition		<u>(50)</u>
		265
Group share of S ($265 \times 80\%$)	212	
Group reserves c/fwd	<u>796</u>	
Add share capital (Bull only)	<u>5,000</u>	
Equity attributable to owners of the parent c/fwd	<u>5,796</u>	

Note. This working operates in exactly the same way as Working 1, but using the closing reserves balances of the two companies. Notice also that there is no need to separate out the revaluation surpluses that exist in both companies, as the statement of changes in equity layout that you need to use in the exam combines all of the reserves and share capital into one figure.



4 *Non-controlling interest c/fwd*

NCI at acquisition (W2)	\$
NCI share of L's post-acquisition reserves (20% × 265 (W3))	210
NCI c/fwd	53
	<u>263</u>

This working operates in exactly the same way as working (2), but using the non-controlling interests' share of the subsidiary's post acquisition reserves up to the end of the year.

- 5 The figures for total comprehensive income are taken from the reconciliation at the end of the statement of total comprehensive income.
- 6 The dividend deducted from equity attributable to owners of the parent is the dividend paid by Bull. The dividend in the non-controlling interest column is the non-controlling interest share of the dividend paid by Lamb (30 × 20%).

4.1 Mid-year disposal example

Returning to the example of Horse and Hoof in Section 3.4, the consolidated statement of changes in equity following the mid-year disposal of Hoof would look as follows.

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 30 SEPTEMBER 20X8

	<i>Equity shares</i>	<i>Retained profits</i>	<i>Non-controlling interest</i>	<i>Total</i>
	\$'000	\$'000	\$'000	\$'000
At 1.10.X7 (W1/W2)	1,080	756	180	2,016
Profit for the year		624	18	642
Eliminated on disposal			(198)	(198)
At 30.9.X8	<u>1,080</u>	<u>1,380</u>	<u>0</u>	<u>2,460</u>

Workings

1	Retained earnings brought forward	\$'000
	Horse (828 – 216)	612
	Hoof (720 – 180 – 360) × 80%	144
		<u>756</u>
2	NCI brought forward	\$'000
	Acquisition date	144
	Post-acq reserves (720 – 180 – 360) × 20%	36
		<u>180</u>

Chapter Roundup

- The source of the consolidated statement of profit or loss is the individual statements of profit or loss of the separate companies in the group.
- In the consolidated statement of profit or loss, non-controlling interest is brought in as a one-line adjustment at the end of the statement.
- Intra-group sales and purchases are eliminated from the consolidated statement of profit or loss.
- Only the post-acquisition profits of the subsidiary are brought into the consolidated profit or loss.
- The consolidated statement of profit or loss and other comprehensive income is produced using the consolidated statement of profit or loss as a basis.
- Only 'full disposals' where the entire shareholding is sold are examinable. The subsidiary will be removed from the consolidated statement of financial position and a profit or loss on disposal will need to be calculated and accounted for.
- After a subsidiary is sold, it is no longer included in the consolidated statement of financial position. A profit or loss on disposal is calculated and included in the consolidated statement of profit or loss. If the disposal is part-way through the year, the subsidiary is consolidated only for the part of the year prior to disposal.
- The consolidated statement of changes in equity reconciles the movement in equity in the consolidated statement of financial position at the beginning and end of the period.

Quick Quiz

- 1 Where does unrealised profit on intra-group trading appear in the statement of profit or loss?
- 2 At the beginning of the year a 75% subsidiary transfers a non-current asset to the parent for \$500,000. Its carrying value was \$400,000 and it has four years of useful life left. How is this accounted for at the end of the year in the consolidated statement of profit or loss?
- 3 A subsidiary sells goods which cost \$100,000 to its parent with a mark-up of 25%. At the year-end, 30% of these goods remain in the parent's inventory. What adjustment is required to revenue in the consolidated statement of profit or loss?
- 4 A parent sells goods to a 70% subsidiary, generating a profit of \$14,000. One quarter of this profit is unrealised at the year-end. What adjustment should be made to the non-controlling interest to reflect this?
- 5 Alpha Co owns a 75% stake in Beta Co. On 1 September 20X5 Alpha sold its entire stake in Beta. Alpha's revenue for the year ended 31 December 20X5 was \$1.5m and Beta's revenue for the same period was \$360,000. What amount should appear as revenue in the consolidated statement of profit or loss for the year ended 31 December 20X5?

Answers to Quick Quiz

- 1 As a deduction from consolidated gross profit.
- 2

	\$
Unrealised profit	100,000
Additional depreciation (100 ÷ 4)	(25,000)
Net charge to profit or loss	<u>75,000</u>

	DR	CR
	\$	\$
Non-current asset		100,000
Additional depreciation	25,000	
Group profit (75%)	56,250	
Non-controlling interest (25%)	<u>18,750</u>	
	<u>100,000</u>	<u>100,000</u>

- 3 \$125,000 (the transfer price of the goods sold) must be deducted. The fact that 30% of the profit is unrealised does not affect revenue.
- 4 No adjustment is necessary, as the sale is from the parent to the subsidiary. (If the sale was from subsidiary to parent then the profits attributable to non-controlling interest would be reduced by \$1,050 (\$14,000 × 25% × 30%).)
- 5 \$1,740,000. This is Alpha's revenue of \$1.5m plus 8/12 of Beta's revenue for the year. Note that 100% of Beta's revenue is consolidated for the pre-disposal period, not just 75%.

Now try the questions below from the Practice Question Bank

Number	Level	Marks	Time
Q26	Introductory	15	29 mins
Q27	Introductory	15	29 mins
Q29	Introductory	10	19 mins

Accounting for associates

23

Topic list	Syllabus reference
1 Accounting for associates	D4
2 The equity method	D4
3 Statement of profit or loss and statement of financial position	D4

Introduction

In this chapter we deal with the treatment of associates in the consolidated financial statements. As the group's share of profit in the associate appears under profit or loss rather than other comprehensive income, we have concentrated on the separate statement of profit or loss.

Study guide

D4	Business combinations – associates and joint arrangements
(a)	Define associates and joint arrangements
(c)	Prepare consolidated financial statements to include a single subsidiary and an associated company or a joint arrangement

1 Accounting for associates

FAST FORWARD

A company investing in an associate does not have control but it does have significant influence. IAS 28 *Investments in Associates and Joint Ventures* requires that, in consolidated financial statements, **associates** should be accounted for using **equity accounting principles**.

1.1 Definitions

We looked at some of the important definitions in Chapter 20; these are repeated here with some additional important terms.

Key terms

Associate. An entity over which the investor has significant influence.

Significant influence. The power to participate in the financial and operating policy decisions of the investee but it is not control or joint control over those policies.

Equity method. A method of accounting whereby the investment is initially recorded at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss.

(IAS 28: para. 3)

We have already looked at how the **status** of an investment in an associate should be determined. Go back to Section 1 of Chapter 20 to revise it. (**Note.** As for an investment in a subsidiary, any **potential voting rights** should be taken into account in assessing whether the investor has **significant influence** over the investee.)

IAS 28 requires all investments in associates to be accounted for in the consolidated accounts using the equity method, **unless** the investment is classified as 'held for sale' in accordance with IFRS 5 in which case it should be accounted for under IFRS 5 (see Chapter 16), or the exemption in the paragraph below applies.

An investor is exempt from applying the equity method if:

- (a) It is a parent exempt from preparing consolidated financial statements under IFRS 10, or
- (b) All of the following apply:
 - (i) The investor is a **wholly-owned subsidiary** or it is a **partially owned subsidiary** of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the investor not applying the equity method;
 - (ii) The investor's securities are **not publicly traded**.
 - (iii) It is **not in the process of issuing securities** in public securities markets; and
 - (iv) The **ultimate or intermediate parent** publishes consolidated financial statements that comply with International Financial Reporting Standards in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with IFRS 10.

(IAS 28: para. 17)

IAS 28 **does not allow** an investment in an associate to be excluded from equity accounting when an investee operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor. Significant influence must be lost before the equity method ceases to be applicable.

The use of the equity method should be **discontinued** from the date that the investor **ceases to have significant influence** (IAS 28: para. 22).

From that date, the investor shall account for the investment in accordance with IFRS 9 *Financial Instruments*. The carrying amount of the investment at the date that it ceases to be an associate shall be regarded as its cost on initial measurement as a financial asset under IFRS 9.

1.2 Separate financial statements of the investor

If an investor **issues consolidated financial statements** (because it has subsidiaries), an investment in an associate should be accounted for in its **separate financial statements** either:

- (a) at **cost**; or
- (b) in accordance with **IFRS 9** [(at fair value)]; or
- (c) using the **equity method** as described in **IAS 28** (IAS 27: para. 10, emphasis BPP's).

If an investor that does **not issue consolidated financial statements** (ie it has no subsidiaries) but has an investment in an associate this should similarly be included in the financial statements of the investor either at cost, or in accordance with IFRS 9 or using the equity method as described in IAS 28 (see Chapter 10).

2 The equity method

2.1 Application of the equity method: consolidated accounts

Many of the procedures required to apply the equity method are the same as are required for full consolidation. In particular, **intra-group unrealised profits** must be excluded.

2.1.1 Consolidated statement of profit or loss

The basic principle is that the investing company (X Co) should take account of its **share of the earnings** of the associate, Y Co, whether or not Y Co distributes the earnings as dividends. X Co achieves this by adding to consolidated profit the group's share of Y Co's profit after tax.

Notice the difference between this treatment and the **consolidation** of a subsidiary company's results. If Y Co were a subsidiary X Co would take credit for the whole of its sales revenue, cost of sales etc and would then make a one-line adjustment to remove any non-controlling share.

Under equity accounting, the associate's sales revenue, cost of sales and so on are **not amalgamated** with those of the group. Instead the group share only of the associate's profit after tax for the year is added to the group profit.

2.1.2 Consolidated statement of financial position

A figure for **investment in associates** is shown which at the time of the acquisition must be stated at cost. At the end of each accounting period the group share of the retained reserves of the associate is added to the original cost to get the total investment to be shown in the consolidated statement of financial position.

2.2 Example: associate

P Co, a company with subsidiaries, acquires 25,000 of the 100,000 \$1 ordinary shares in A Co for \$60,000 on 1 January 20X8. In the year to 31 December 20X8, A Co earns profits after tax of \$24,000, from which it pays a dividend of \$6,000.

How will A Co's results be accounted for in the individual and consolidated accounts of P Co for the year ended 31 December 20X8?

Solution

In the **individual accounts** of P Co, the investment will be recorded on 1 January 20X8 at cost. Unless there is an impairment in the value of the investment (see below), this amount will remain in the individual statement of financial position of P Co permanently. The only entry in P Co's individual statement of profit or loss will be to record dividends received. For the year ended 31 December 20X8, P Co will:

DEBIT	Cash	\$1,500	
CREDIT	Income from shares in associates		\$1,500

In the **consolidated financial statements** of P Co equity accounting principles will be used to account for the investment in A Co. Consolidated profit after tax will include the group's share of A Co's profit after tax ($25\% \times \$24,000 = \$6,000$). To the extent that this has been distributed as dividend, it is already included in P Co's individual accounts and will automatically be brought into the consolidated results. That part of the group's share of profit in the associate which has not been distributed as dividend (\$4,500) will be brought into consolidation by the following adjustment.

DEBIT	Investment in associates	\$4,500	
CREDIT	Share of profit of associates		\$4,500

The asset 'Investment in associates' is then stated at \$64,500, being cost plus the group share of post-acquisition retained profits.

Exam focus point

A common mistake made by struggling students is to add the associate's accounts line-by-line into the rest of the group's, as though it were a subsidiary. You need to make sure you apply the equity accounting rules to associates.

3 Statement of profit or loss and statement of financial position

3.1 Consolidated statement of profit or loss

FAST FORWARD

In the **consolidated statement of profit or loss** the investing group takes credit for its **share of the after-tax profits** of associates whether or not they are distributed as dividends.

A **consolidation schedule** may be used to prepare the consolidated statement of profit or loss of a group with associates. Note the treatment of the associate's profits in the following example.

3.2 Illustration

The following **consolidation schedule** relates to the P Co group, consisting of the parent company, an 80% owned subsidiary (S Co) and an associate (A Co) in which the group has a 30% interest.

CONSOLIDATION SCHEDULE

	Group \$'000	P Co \$'000	S Co \$'000	A Co \$'000
Sales revenue	1,400	600	800	300
Cost of sales	(770)	(370)	(400)	(120)
Gross profit	630	230	400	180
Administrative expenses	(290)	(110)	(180)	(80)
	340	120	220	100
Interest receivable	30	30	—	—
	370	150	220	100
Interest payable	(20)	—	(20)	—
Share of profit of associate (57 × 30%)	17	—	—	—
	367	150	200	100

	Group	P Co	S Co	A Co
Income tax expense				
Group	(145)	(55)	(90)	
Associate		—	—	(43)
Profit for the year	<u>222</u>	<u>95</u>	<u>110</u>	<u>57</u>
Non-controlling interest (110 × 20%)	<u>(22)</u>			
	<u>200</u>			

Notes:

- Group sales revenue, group gross profit and costs such as depreciation etc exclude the sales revenue, gross profit and costs etc of associated companies.
- The group share of the associated company profits is credited to group profit or loss. If the associated company has been acquired during the year, it would be necessary to deduct the pre-acquisition profits (remembering to allow for tax on current year profits).
- The non-controlling interest will only ever apply to subsidiary companies.

3.3 Pro-forma consolidated statement of profit or loss

The following is a **suggested layout** (using the figures given in the illustration above) for the consolidated statement of profit or loss of a company having subsidiaries as well as associated companies.

	\$'000
Sales revenue	1,400
Cost of sales	<u>(770)</u>
Gross profit	630
Other income: interest receivable	30
Administrative expenses	<u>(290)</u>
Finance costs	<u>(20)</u>
Share of profit of associate	17
Profit before tax	<u>367</u>
Income tax expense	<u>(145)</u>
Profit for the year	<u>222</u>
Profit attributable to:	
Owners of the parent	200
Non-controlling interest	<u>22</u>
	<u>222</u>

3.4 Consolidated statement of financial position

FAST FORWARD

In the **consolidated statement of financial position**, the investment in associates should be shown as:

- Cost of the investment in the associate; plus
- Group share of post-acquisition profits; less
- Any amounts paid out as dividends; less
- Any amount written off the investment

As explained earlier, the consolidated statement of financial position will contain an **asset 'Investment in associates'**. The amount at which this asset is stated will be its original cost plus the group's share of any **post-acquisition profits** which have not been distributed as dividends.

3.5 Example: Consolidated statement of financial position

On 1 January 20X6 the net tangible assets of A Co amount to \$220,000, financed by 100,000 \$1 ordinary shares and revenue reserves of \$120,000. P Co, a company with subsidiaries, acquires 30,000 of the shares in A Co for \$75,000. During the year ended 31 December 20X6 A Co's profit after tax is \$30,000, from which dividends of \$12,000 are paid.

Show how P Co's investment in A Co would appear in the consolidated statement of financial position at 31 December 20X6.

Solution

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X6 (extract)

	\$
Non-current assets	
Investment in associated company	
Cost	75,000
Group share of post-acquisition retained profits (30% × \$18,000)	<u>5,400</u>
	<u>80,400</u>



Question

Associate I

Set out below are the draft accounts of Parent Co and its subsidiaries and of Associate Co. Parent Co acquired 40% of the equity capital of Associate Co three years ago when the latter's reserves stood at \$40,000.

SUMMARISED STATEMENTS OF FINANCIAL POSITION

	<i>Parent Co & subsidiaries</i> \$'000	<i>Associate Co</i> \$'000
Tangible non-current assets	220	170
Investment in Associate at cost	60	—
Loan to Associate Co	20	—
Current assets	100	50
Loan from Parent Co	<u>—</u>	<u>(20)</u>
	<u>400</u>	<u>200</u>
Share capital (\$1 shares)	250	100
Retained earnings	<u>150</u>	<u>100</u>
	<u>400</u>	<u>200</u>

SUMMARISED STATEMENTS OF PROFIT OR LOSS

	<i>Parent Co & subsidiaries</i> \$'000	<i>Associate Co</i> \$'000
Profit before tax	95	80
Income tax expense	<u>35</u>	<u>30</u>
Net profit for the year	<u>60</u>	<u>50</u>

Required

Prepare the summarised consolidated accounts of Parent Co.

Notes:

- (1) Assume that the associate's assets/liabilities are stated at fair value.
- (2) Assume that there are no non-controlling interests in the subsidiary companies.



PARENT CO
CONSOLIDATED STATEMENT OF PROFIT OR LOSS

	\$'000
Net profit	95
Share of profits of associated company (50 × 40%)	20
Profit before tax	<u>115</u>
Income tax expense	(35)
Profit attributable to the members of Parent Co	<u>80</u>

PARENT CO
CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	\$'000
<i>Assets</i>	
Tangible non-current assets	220
Investment in associate (see Note)	84
Loan to associate	20
Current assets	<u>100</u>
<i>Total assets</i>	<u>424</u>
<i>Equity and liabilities</i>	
Share capital	250
Retained earnings (W)	<u>174</u>
<i>Total equity and liabilities</i>	<u>424</u>

Note

	\$'000
<i>Investment in associate</i>	
Cost of investment	60
Share of post-acquisition retained earnings (W)	<u>24</u>
	<u>84</u>

Working

<i>Retained earnings</i>	<i>Parent & Subsidiaries</i>	<i>Associate</i>
	\$'000	\$'000
Per question	150	100
Pre-acquisition		<u>40</u>
Post-acquisition		<u>60</u>
Group share in associate (\$60 × 40%)	<u>24</u>	
Group retained earnings	<u>174</u>	



Question

Associate II

Alfred Co bought a 25% shareholding on 31 December 20X8 in Grimbald Co at a cost of \$38,000.

During the year to 31 December 20X9 Grimbald Co made a profit before tax of \$82,000 and the taxation charge on the year's profits was \$32,000. A dividend of \$20,000 was paid on 31 December out of these profits.

Required

Calculate the entries for the associate which would appear in the consolidated accounts of the Alfred group, in accordance with the requirements of IAS 28.

Answer

CONSOLIDATED STATEMENT OF PROFIT OR LOSS

	\$
Group share of profit of associate ($82,000 \times 25\%$)	20,500
Less taxation ($32,000 \times 25\%$)	<u>(8,000)</u>
Share of profit of associate	<u>12,500</u>

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	\$
Investment in associate (W)	<u>45,500</u>

Working

	\$
Cost of investment	38,000
Share of post-acquisition retained earnings ($(82,000 - 32,000 - 20,000) \times 25\%$)	<u>7,500</u>
	<u>45,500</u>

The following points are also relevant and are similar to a parent-subsidiary consolidation situation.

- Use financial statements drawn up to the **same reporting date** (IAS 28: para. 33).
- If this is impracticable, adjust the financial statements for **significant transactions/events** in the intervening period. The difference between the reporting date of the associate and that of the investor must be no more than three months (IAS 28: para. 34).
- Use **uniform accounting policies** (IAS 28: para. 35). The associate's financial statements should be adjusted to reflect group policies if necessary.

3.6 Transactions between investor and associate

Unrealised profits and losses resulting from transfers of assets between an investor (including its consolidated subsidiaries) and an associate are eliminated to the extent of the investor's interest in the associate. This is very similar to the procedure for eliminating intra-group transactions between a parent and a subsidiary. The important thing to remember is that **only the group's share is eliminated**.

3.7 Example: Parent sells to associate

Parent Co, a parent with subsidiaries, holds 25% of the equity shares in Associate Co. During the year, Parent Co makes sales of \$1,000,000 to Associate Co at cost plus a 25% mark-up. At the year-end, Associate Co has all these goods still in inventories.

Solution

Parent Co has made an unrealised profit of \$200,000 ($1,000,000 \times 25/125$) on its sales to the associate. The group's share (25%) of this must be eliminated:

DEBIT	Share of profit of associate (consolidated profit or loss)	\$50,000
CREDIT	Investment in associate (consolidated statement of financial position)	\$50,000

Note that if the sale had been made by the associate to the group the double entry required to eliminate the unrealised profit would be **exactly the same**.

3.8 Associate's losses

When the equity method is being used and the investor's share of losses of the associate equals or exceeds its interest in the associate, the investor should **discontinue** including its share of further losses. The investment is reported at nil value. After the investor's interest is reduced to nil, **additional losses** should only be recognised where the investor has incurred obligations or made payments on behalf of the associate (for example, if it has guaranteed amounts owed to third parties by the associate).

(IAS 28: para. 39)

3.9 Impairment losses

Any impairment loss is recognised in accordance with IAS 36 *Impairment of Assets* for each associate individually.

In the case of an associate, any impairment loss will be deducted from the carrying value in the statement of financial position.

The working would be as follows.

	\$
Cost of investment	X
Share of post-acquisition retained earnings	X
	<u>X</u>
Impairment loss	(X)
Investment in associate	<u>X</u>

Exam focus point

It is not unusual in the exam to have both an associate and a subsidiary to account for in a consolidation.



Question

Consolidated statement of financial position

The statements of financial position of J Co and its investee companies, P Co and S Co, at 31 December 20X5 are shown below.

STATEMENTS OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5

	<i>J Co</i> \$'000	<i>P Co</i> \$'000	<i>S Co</i> \$'000
<i>Non-current assets</i>			
Freehold property	1,950	1,250	500
Plant and machinery	795	375	285
Investments	1,500	—	—
	<u>4,245</u>	<u>1,625</u>	<u>785</u>
<i>Current assets</i>			
Inventory	575	300	265
Trade receivables	330	290	370
Cash	50	120	20
	<u>955</u>	<u>710</u>	<u>655</u>
Total assets	<u>5,200</u>	<u>2,335</u>	<u>1,440</u>
<i>Equity and liabilities</i>			
<i>Equity</i>			
Share capital – \$1 shares	2,000	1,000	750
Retained earnings	1,460	885	390
	<u>3,460</u>	<u>1,885</u>	<u>1,140</u>
<i>Non-current liabilities</i>			
12% loan stock	500	100	—
<i>Current liabilities</i>			
Trade payables	680	350	300
Bank overdraft	560	—	—
	<u>1,240</u>	<u>350</u>	<u>300</u>
Total equity and liabilities	<u>5,200</u>	<u>2,335</u>	<u>1,440</u>

Additional information

- J Co acquired 600,000 ordinary shares in P Co on 1 January 20X0 for \$1,000,000 when the retained earnings of P Co were \$200,000.
- At the date of acquisition of P Co, the fair value of its freehold property was considered to be \$400,000 greater than its value in P Co's statement of financial position. P Co had acquired the property in January 20W0 and the buildings element (comprising 50% of the total value) is depreciated on cost over 50 years.
- J Co acquired 225,000 ordinary shares in S Co on 1 January 20X4 for \$500,000 when the retained earnings of S Co were \$150,000.
- P Co manufactures a component used by both J Co and S Co. Transfers are made by P Co at cost plus 25%. J Co held \$100,000 inventory of these components at 31 December 20X5. In the same period J Co sold goods to S Co of which S Co had \$80,000 in inventory at 31 December 20X5. J Co had marked these goods up by 25%.
- The goodwill in P Co is impaired and should be fully written off. An impairment loss of \$92,000 is to be recognised on the investment in S Co.
- Non-controlling interest is valued at full fair value. P Co shares were trading at \$1.60 just prior to the acquisition by J Co.

Required

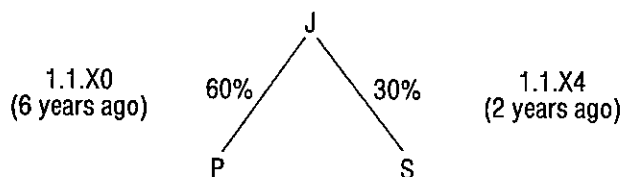
Prepare, in a format suitable for inclusion in the annual report of the J Group, the consolidated statement of financial position at 31 December 20X5.

J GROUP CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5

	\$'000
<i>Non-current assets</i>	
Freehold property (W2)	3,570.00
Plant and machinery (795 + 375)	1,170.00
Investment in associate (W7)	475.20
	<u>5,215.20</u>
<i>Current assets</i>	
Inventory (W3)	855.00
Receivables (330 + 290)	620.00
Cash (50 + 120)	170.00
	<u>1,645.00</u>
Total assets	<u>6,860.20</u>
<i>Equity and liabilities</i>	
<i>Equity</i>	
Share capital	2,000.00
Retained earnings (W8)	1,792.20
	<u>3,792.20</u>
Non-controlling interest (W9)	878.00
	<u>4,670.20</u>
<i>Non-current liabilities</i>	
12% loan stock (500 + 100)	600.00
<i>Current liabilities</i> (680 + 560 + 350)	1,590.00
Total equity and liabilities	<u>6,860.20</u>

Workings

1 *Group structure*



2 *Freehold property*

	\$'000
J Co	1,950
P Co	1,250
Fair value adjustment	400
Additional depreciation $(400 \times 50\% \div 40) \times 6 \text{ years } (20X0-20X5)$	(30)
	<u>3,570</u>

3 *Inventory*

	\$'000
J Co	575
P Co	300
PUP $(100 \times \frac{25}{125})$ (W4)	(20)
	<u>855</u>

4 *Unrealised profit (PUP)*

	\$'000
On sales by P to J (parent co) $100 \times \frac{25}{125}$	20.0
On sales by J to S (associate) $80 \times \frac{25}{125} \times 30\%$	4.8

5	<i>Fair value adjustments</i>	<i>Difference at acquisition</i>	<i>Difference now</i>
		\$'000	\$'000
	Property	400	400
	Additional depreciation: $200 \times 6/40$	<u>—</u>	<u>(30)</u>
		<u>400</u>	<u>370</u>
	\therefore Charge \$30,000 to retained earnings		
6	<i>Goodwill</i>	\$'000	\$'000
	<i>P Co</i>		
	Consideration transferred		1,000
	Non-controlling interest ($400 \times \$1.60$)		640
	Net assets acquired		
	Share capital	1,000	
	Retained earnings	200	
	Fair value adjustment	<u>400</u>	
			<u>(1,600)</u>
	Goodwill at acquisition		40
	Impairment loss		<u>(40)</u>
			<u>0</u>
7	<i>Investment in associate</i>		\$'000
	Cost of investment		500.00
	Share of post-acquisition profit ($390 - 150$) $\times 30\%$		72.00
	Less PUP		(4.80)
	Less impairment loss		<u>(92.00)</u>
			<u>475.20</u>
8	<i>Retained earnings</i>	<i>J</i>	<i>P</i>
		\$'000	\$'000
	Retained earnings per question	1,460.0	885.0
	Adjustments		
	Unrealised profit (W4)	(4.8)	(20.0)
	Fair value adjustments (W5)		(30.0)
	Impairment loss (P)		<u>(40.0)</u>
			795.0
	Less pre-acquisition reserves		<u>(200.0)</u>
		<u>1,455.20</u>	<u>595.0</u>
	P: $60\% \times 595$	357.00	
	S: $30\% \times 240$	72.00	
	Impairment loss S	<u>(92.00)</u>	
		<u>1,792.20</u>	
9	<i>Non-controlling interest at reporting date</i>		\$'000
	NCI at acquisition (W6)		640.00
	Share of post-acquisition retained earnings ($595 \times 40\%$)		<u>238.00</u>
			<u>878.00</u>

Chapter Roundup

- A company investing in an associate does not have control but it does have **significant influence**. IAS 28 requires that, in consolidated financial statements, **associates** should be accounted for using **equity accounting principles**.
- In the **consolidated statement of profit or loss** the investing group takes credit for its **share of the after-tax profits** of associates, whether or not they are distributed as dividends.
- In the **consolidated statement of financial position**, the investment in associates should be shown as:
 - Cost of the investment in the associate; plus
 - Group share of post-acquisition profits; less
 - Any amounts paid out as dividends; less
 - Any amount written off the investment.

Quick Quiz

- 1 Define an associate.
- 2 How should associates be accounted for in the separate financial statements of the investor?
- 3 What is the effect of the equity method on the consolidated statement of profit or loss and statement of financial position?
- 4 Alpha Co purchased 80% of the equity shares of Bravo Co and 30% of the equity shares of Gamma Co on 1 September 20X5. The revenue figures for the companies for the year ended 31 December 20X5 were \$2.1m, \$1.5m and \$0.9m respectively. What amount should be shown as revenue in the consolidated statement of profit or loss for the year ended 31 December 20X5?
- 5 A parent sells goods to its 30% associate, generating a profit of \$100,000. All these goods are included within the associate's inventory at the year end. What adjustment should be made to the inventories figure on the consolidated statement of financial position as a result of this unrealised profit?

Answers to Quick Quiz

- 1 An entity in which an investor has a significant influence, but which is not a subsidiary or a joint venture of the investor.
- 2 Either at cost or in accordance with IFRS 9 or using the equity method as described in IAS 28.
- 3 (a) *Consolidated statement of profit or loss.* Investing company includes its share of the earnings of the associate, by adding its share of profit after tax.
(b) *Consolidated statement of financial position.* Investment in associates is initially included in assets at cost. This will increase or decrease each year according to whether the associated company makes a profit or loss.
- 4 \$2.6m. This is 100% of Alpha's revenue plus 4/12 of 100% of Bravo's revenue. None of the revenue of the associate is included, as equity accounting only includes a share of profit after tax.
- 5 Zero. As the goods are included within the associate's inventories and the individual assets and liabilities of the associate are not consolidated, consolidated inventories should not be adjusted. Instead the entry (\$30,000, being group's share) will be adjusted against the value of the investment in associate (which is the group's share of the net assets of the associate).

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q25	Examination	20	39 mins
Q28	Introductory	25	49 mins

24

Accounting for joint arrangements

Topic list	Syllabus reference
1 IFRS 11 <i>Joint Arrangements</i>	D4
2 Accounting treatment of joint arrangements	D4

Introduction

IFRS 11 covers all types of **joint arrangements**. It establishes principles for how joint operations should be distinguished from joint ventures and how to account for each type of joint arrangement in individual financial statements and in consolidated financial statements.

Study guide

D4	Business combinations – associates and joint arrangements
(a)	Define associates and joint arrangements
(b)	Distinguish between joint operations and joint arrangements
(c)	Prepare consolidated financial statements to include a single subsidiary and an associated company or a joint arrangement

1 IFRS 11 *Joint Arrangements*

FAST FORWARD

- IFRS 11 classes joint arrangements as either **joint operations** or **joint ventures**.
- A **contractual arrangement** must exist which establishes joint control.
- **Joint control** is important: one **operator** must not be able to govern the financial and operating policies of the joint venture.

The classification of a joint arrangement as a joint operation or a joint venture depends upon the **rights and obligations** of the parties to the arrangement.

Joint arrangements are often found when each party can **contribute in different ways** to the activity. For example, one party may provide finance, another purchases or manufactures goods, while a third offers its marketing skills.

IFRS 11 *Joint Arrangements* covers all types of joint arrangements. It is not concerned with the financial statements of the joint arrangement itself (if separate accounts are maintained), but rather **how the interest in a joint arrangement is accounted for by each party**.

1.1 Definitions

Key terms

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.
(IFRS 11: Appendix A)

In a joint arrangement, the parties involved are subject to a **contractual arrangement**. That contractual arrangement gives two or more of the parties **joint control** of the arrangement (IFRS 11: para. 5).

There are two types of joint arrangement: **joint operations** and **joint ventures**.

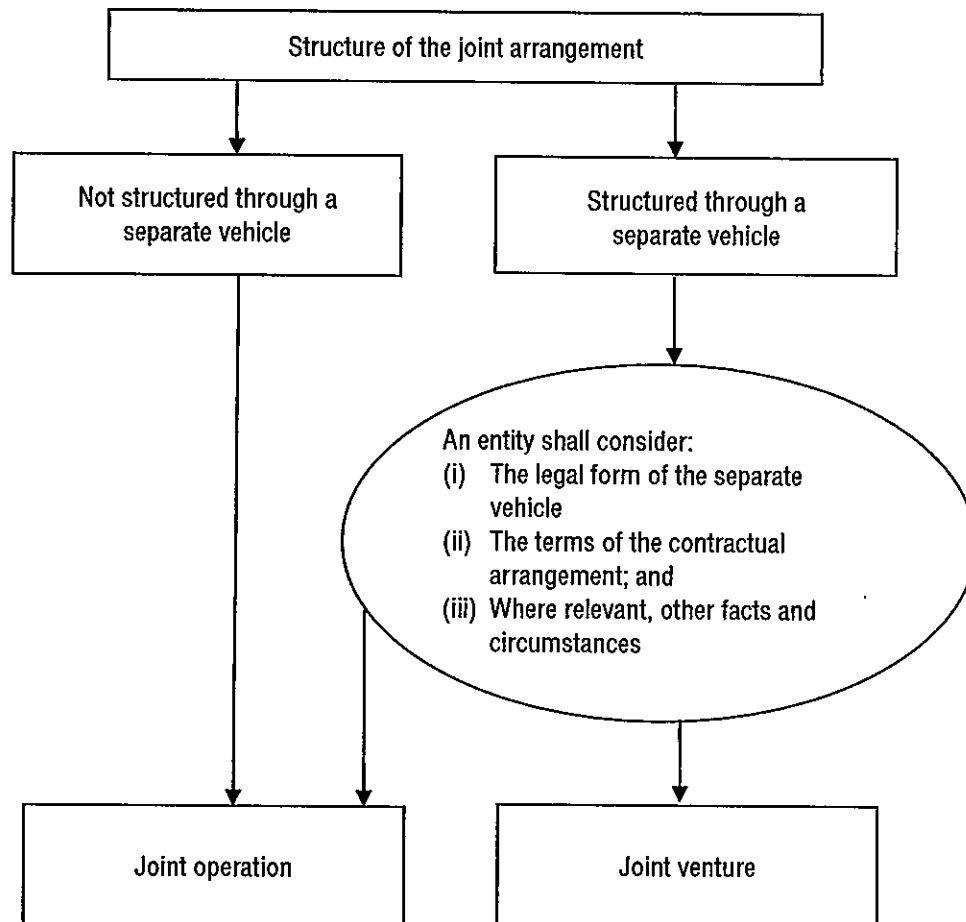
Key terms

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.

Joint venture. A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.
(IFRS 11: Appendix A)

Under these definitions, accounting treatment is determined based on whether or not the investor has **direct rights** to assets and obligations for liabilities that should be recognised separately in its financial statements, rather than merely following the legal form of the joint arrangement.

The basic issues that underlie the classifications are summarised in the following diagram.



(IFRS 11: Application Guidance, para. B21)

1.1.1 Contractual arrangement

The existence of a contractual agreement distinguishes a joint arrangement from an investment in an associate. **If there is no contractual arrangement, then a joint arrangement does not exist.**

Evidence of a contractual arrangement could be in one of several forms.

- **Contract** between the parties
- **Minutes** of discussion between the parties
- Incorporation in the **articles or by-laws** of the joint venture

The contractual arrangement is usually **in writing**, whatever its form, and it will deal with the following issues surrounding the joint venture (IFRS 11: Application Guidance, para. B4):

- **Its activity, duration and reporting obligations**
- The appointment of its **board of directors** (or equivalent) and the **voting rights** of the parties
- **Capital contributions** to it by the parties
- How its output, income, expenses or results are **shared** between the parties

It is the contractual arrangement which establishes **joint control** over the joint venture, so that no single party can control the activity of the joint venture on its own.

The terms of the contractual arrangement are key to deciding whether the arrangement is a joint venture or joint operation. IFRS 11 presents the following table which compares examples of contractual terms that are common to joint operations and contractual terms that are common to joint ventures.

Assessing the terms of the contractual arrangement		
	Joint operation	Joint venture
The terms of the contractual arrangement	The contractual arrangement provides the parties to the joint arrangement with rights to the assets, and obligations for the liabilities, relating to the arrangement.	The contractual arrangement provides the parties to the joint arrangement with rights to the net assets of the arrangement (ie it is the separate vehicle , not the parties, that has rights to the assets, and obligations for the liabilities, relating to the arrangement).
Rights to assets	The contractual arrangement establishes that 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 contractual arrangement establishes that 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 contractual arrangement establishes that the parties to the joint arrangement share all liabilities, obligations, costs and expenses 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).	<p>The contractual arrangement establishes that the joint arrangement is liable for the debts and obligations of the arrangement.</p> <p>The contractual arrangement establishes that the parties to the joint arrangement are liable to the arrangement only to the extent of their respective investments in the arrangement or to their respective obligations to contribute any unpaid or additional capital to the arrangement, or both.</p>
	The contractual arrangement establishes that the parties to the joint arrangement are liable for claims raised by third parties.	The contractual arrangement states that creditors of the joint arrangement do not have rights of recourse against any party with respect to debts or obligations of the arrangement.

Revenues, expenses, profit or loss	The contractual arrangement establishes the allocation of revenues and expenses on the basis 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, which could differ from their ownership interest in the joint arrangement. In other instances, the parties might have agreed to share the profit or loss relating to the arrangement on the basis of a specified proportion such as the parties' ownership interest in the arrangement. This would not prevent the arrangement from being a joint operation if the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement.	The contractual arrangement establishes each party's share in the profit or loss relating to the activities of the arrangement.
Guarantees	The parties to joint arrangements are often required to provide guarantees to third parties that, for example, receive a service from, or provide financing to, the joint arrangement. The provision of such guarantees, or the commitment by the parties to provide them, does not, by itself, determine that the joint arrangement is a joint operation. The feature that determines whether the joint arrangement is a joint operation or a joint venture is whether the parties have obligations for the liabilities relating to the arrangement (for some of which the parties might or might not have provided a guarantee).	

(IFRS 11: Application Guidance, para. BC27)

The following question is based on the Illustrative Examples in IFRS 11, and gives an example of how a joint arrangement may work in practice.



Question

Joint arrangement

Two real estate companies (the parties) set up a separate vehicle (entity X) for the purpose of acquiring and operating a shopping centre. The contractual arrangement between the parties establishes joint control of the activities that are conducted in entity X. The main feature of entity X's legal form is that the entity, not the parties, has rights to the assets, and obligations for the liabilities, relating to the arrangement. These activities include the rental of the retail units, managing the car park, maintaining the centre and its equipment, such as lifts, and building the reputation and customer base for the centre as a whole.

The terms of the contractual arrangement are such that:

- Entity X owns the shopping centre. The contractual arrangement does not specify that the parties have rights to the shopping centre.
- The parties are not liable in respect of the debts, liabilities or obligations of entity X. If entity X is unable to pay any of its debts or other liabilities or to discharge its obligations to third parties, the

liability of each party to any third party will be limited to the unpaid amount of that party's capital contribution.

- (c) The parties have the right to sell or pledge their interests in entity X.
- (d) Each party receives a share of the income from operating the shopping centre (which is the rental income net of the operating costs) in accordance with its interest in entity X.'

(IFRS 11: Illustrative Examples, paras. IE9–IE10)

Required

Explain how entity X should be classified in accordance with IFRS 11 *Joint Arrangements*.

Answer

Entity X has been set up as a **separate vehicle**. As such, it could be either a joint operation or joint venture, so other facts must be considered.

There are no facts that suggest that the two real estate companies have rights to substantially all the benefits of the assets of entity X nor an obligation for its liabilities (IFRS 11: Illustrative Examples, para. IE12).

Each party's liability is limited to any unpaid capital contribution.

As a result, each party has an interest in the **net assets** of entity X and should account for it as a **joint venture** using the **equity method** (IFRS 11: Illustrative Examples, para. IE13).

2 Accounting treatment of joint arrangements

FAST FORWARD

- The accounting treatment of joint arrangements depends on whether the arrangement is a joint venture or joint operation.
- **Joint operations** are accounted for by including the investor's share of assets, liabilities, income and expenses as per the contractual arrangement.
- **Joint ventures** are accounted for using the **equity method** as under IAS 28.

2.1 Accounting for joint operations

In its separate financial statements a joint operator recognises (IFRS 11: para. 20):

- (a) Its own assets, liabilities and expenses
- (b) Its share of assets held and expenses and liabilities incurred jointly
- (c) Its revenue from the sale of its share of the output arising from the joint operation
- (d) Its share of revenue from the sale of output by the joint operation itself.

No adjustments are necessary on consolidation as the figures are already incorporated correctly into the separate financial statements of the joint operator.



Question

Joint operations

Can you think of examples of situations where this type of arrangement might take place?

IFRS 11 gives examples in the oil, gas and mineral extraction industries. In such industries companies may, say, jointly control and operate an oil or gas pipeline. Each company transports its own products down the pipeline and pays an agreed proportion of the expenses of operating the pipeline (perhaps based on volume). In this case the parties have rights to assets (such as exploration permits and the oil or gas produced by the activities).

A further example is a property which is jointly controlled, with each operator taking a share of the rental income and bearing a portion of the expense.

2.2 Joint ventures

Joint ventures are accounted for using the **equity method** given in IAS 28 *Associates and Joint Ventures* (IFRS 11: para. 24). The equity method is covered in detail in Chapter 23.

2.2.1 Application of the equity method to joint ventures

The consolidated statement of financial position is prepared by (IAS 28: para. 27):

- 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 venturer ceases to have joint control over, or have significant influence on, a joint venture.

2.2.2 Joint venturer sells to joint venture

A joint venturer 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 venturers 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.

2.2.3 Joint venturer purchases from joint venture

When a joint venturer purchases assets from a joint venture, the joint venturer 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, ie until the profit is realised.

Losses should be treated in the same way, **except** losses should be recognised 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.

(IAS 28: paras. 28, 29)

2.3 Accounting for acquisition of an interest in a joint operation

The principles of IFRS 3 must be applied on the acquisition of an interest in a joint operation where that joint operation constitutes a business as defined by IFRS 3. Therefore on the acquisition of a joint operation meeting the definition of a business, the joint operator must:

- (a) Measure the identifiable assets and liabilities at fair value (or in accordance with IFRS 3)
- (b) Recognise acquisition costs in accordance with IFRS 3
- (c) Recognise goodwill for the excess consideration given
- (d) Perform an impairment test for the cash-generating unit to which goodwill is allocated annually

(IFRS 11: paras. 21A, B33A–D)

Chapter Roundup

- IFRS 11 classes joint arrangements as either **joint operations** or **joint ventures**.
- A **contractual arrangement** must exist which establishes joint control.
- **Joint control** is important: one **operator** must not be able to govern the financial and operating policies of the joint venture.
- The accounting treatment of joint arrangements depends on whether the arrangement is a joint venture or joint operation.
- **Joint operations** are accounted for by including the investor's share of assets, liabilities, income and expenses as per the contractual arrangement.
- **Joint ventures** are accounted for using the **equity method** as under IAS 28.

Quick Quiz

- 1 A joint venture is a joint arrangement whereby the parties that have _____ of the arrangement have rights to the _____ of the arrangement.
Complete the blanks.
- 2 How should a venturer account for its share of a joint operation?
- 3 How should a venturer account for its share of a joint venture?
- 4 A joint arrangement that is structured through a separate vehicle will always be a joint venture. True or false?
- 5 How should a joint venture deal with gains on downstream transactions?

Answers to Quick Quiz

- 1 A joint venture is a joint arrangement whereby the parties that have **joint control** of the arrangement have rights to the **net assets** of the arrangement.
- 2 (a) The assets it controls and the liabilities it incurs
(b) The expenses it incurs and the income it earns
- 3 A joint venture is accounted for using the equity method as required by IAS 28 *Associates and Joint Ventures*.
- 4 False. Joint arrangements that are structured through a separate vehicle may be either joint ventures or joint arrangements. The classification will depend on whether the venturer has rights to the **net assets** of the arrangement. This will depend on the terms of the contractual arrangements.
- 5 When a joint venturer purchases assets from a joint venture, the joint venturer 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, ie until the profit is realised.



Practice question bank

Note. The questions included within this Practice Question Bank are for practice only, and are not necessarily in the same format or at the same level of difficulty as real exam questions.

1 Setting and regulating standards

- (a) Explain the objectives of the IFRS Foundation.
- (b) Describe how the IASB goes about developing and issuing new international financial reporting standards.
- (c) Briefly describe the potential barriers to harmonisation of financial reporting standards across the globe.
- (d) Briefly outline the role of IFRS Interpretations Committee.

2 Hardwood

Hardwood currently reports under local GAAP. It will adopt International Financial Reporting Standards (IFRSs) for the first time in its financial statements for the year ended 31 December 20X5.

The directors of Hardwood are unclear as to the impact of IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

Required

Advise the directors of Hardwood on the following in this question.

- (a) The procedure for preparing IFRS financial statements for the first time (as required by IFRS 1)
- (b) The practical steps that the company should take in order to ensure an efficient transfer to accounting under IFRS
- (c) In its previous financial statements for 31 December 20X3 and 20X4, which were prepared under local GAAP, the company:
 - (i) Made a number of routine accounting estimates, including accrued expenses and provisions, and;
 - (ii) Did not recognise a provision for a court case arising from events that occurred in September 20X4. When the court case was concluded on 30 June 20X5, Hardwood was required to pay \$10m and paid this on 10 July 20X5.

In the opinion of the directors, the company's estimates of accrued expenses and provisions under local GAAP were made on a basis consistent with IFRSs.

Required

Discuss how the matters above should be dealt with in the financial statements of Hardwood for the year ended 31 December 20X5.

3 Conceptual framework I

- (a) Explain the main purposes of the International Accounting Standards Board's *Conceptual Framework for Financial Reporting*.
- (b) Identify any four user groups of financial statements and explain what information they are likely to want from them.

4 Conceptual framework II

- (a) State the objectives of financial statements.
- (b) State the definition of assets, liabilities and equity.
- (c) Explain the IASB approach to the application of relevance, faithful representation, comparability and verifiability in the preparation of financial statements.

5 Jenson

25 mins

The timing of revenue (income) recognition has long been an area of debate and inconsistency in accounting. It has now become the subject of a new standard, IFRS 15 *Revenue from Contracts with Customers*.

The IASB in the *Conceptual Framework* has defined the 'elements' of financial statements, and it uses these to determine when a gain or loss occurs.

Required

- (a) Explain what is meant by a performance obligation in relation to revenue recognition and discuss the criteria used in the *Conceptual Framework* for determining when a gain or loss arises.
(5 marks)

- (b) Jenson has entered into the following transactions/agreements in the year to 31 March 20X5.
 - (i) Goods, which had a cost of \$20,000, were sold to Wholesaler for \$35,000 on 1 July 20X4. Jenson has an option to repurchase the goods from Wholesaler at any time within the next two years. The repurchase price will be \$35,000 plus interest charged at 12% per annum from the date of sale to the date of repurchase. It is expected that Jenson will repurchase the goods.
 - (ii) Jenson owns the rights to a fast food franchise. On 1 April 20X4 it sold the right to open a new outlet to Mr Cody. The franchise is for five years. Jenson received an initial fee of \$50,000 for the first year and will receive \$5,000 per annum thereafter. Jenson has continuing service obligations on its franchise for advertising and product development that amount to approximately \$8,000 per annum for each franchised outlet. A reasonable profit margin on the provision of the continuing services is deemed to be 20% of revenues received.
 - (iii) On 1 September 20X4 Jenson received subscriptions in advance of \$240,000. The subscriptions are for 24 monthly publications of a magazine produced by Jenson. At the year end Jenson had produced and despatched six of the 24 publications.

Required

Describe how Jenson should treat each of the above examples in its financial statements in the year to 31 March 20X5.
(13 marks)

(Total = 18 marks)

6 Gains

20 mins

Required

Using the information below prepare the Statement of changes in equity for Gains for the year ended 31 December 20X9. (10 marks)

(a) *Gains*

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME (EXTRACT)

	\$'000
Profit before interest and tax	792
Finance income	24
Finance cost	(10)
Profit before tax	806
Income tax expense	(240)
PROFIT FOR THE YEAR	566
Other comprehensive income:	
Gain on property revaluation	120
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	686

(b) *Non-current assets*

- (i) Assets held at cost were impaired by \$25,000.
- (ii) Freehold land and buildings were revalued to \$500,000 (Book value \$380,000).
- (iii) A previously revalued asset was sold for \$60,000.

Details of the revaluation are:

	\$
Book value at revaluation	30,000
Revaluation	50,000
	80,000
Depreciation $(80,000 / 10) \times 3$	24,000
	56,000

Gains has been following paragraph 41 of IAS 16 which allows a reserve transfer of the realised revaluation surplus (the difference between depreciation based on revalued amount and depreciation based on cost) as the asset is used to retained earnings.

Revaluations during the year related to land.

- (iv) Details of investment properties are as follows:

	\$
Original cost	120,000
Revaluation surplus	40,000
Value at 1.1.20X9	160,000

The properties had a valuation on 31 December 20X9 of \$110,000. Gains previously accounted for its investment properties by crediting gains to a revaluation surplus as allowed by local GAAP. Gains now wishes to apply the fair value model of IAS 40 which states that gains and losses should be accounted for in profit or loss. The elimination of the previous revaluation surplus is to be treated as a change in accounting policy in accordance with IAS 8. No adjustment has yet been made for the change in accounting policy or subsequent fall in value.

(c) *Share capital*

During the year the company had the following changes to its capital structure:

- (i) An issue of 200,000 \$1 ordinary bonus shares capitalising its share premium reserve
- (ii) An issue of 400,000 \$1 ordinary shares (issue price \$1.40 per share).

(d) *Equity*

The book value of equity at the start of the year was as follows:

	\$
Share capital	2,800,000
Share premium	1,150,000
Retained earnings	2,120,000
Revaluation surplus	750,000
	<u>6,820,000</u>

(e) *Dividends*

Dividends paid during the year amounted to \$200,000.

7 Lis

20 mins

On 1 January 20X3 Lis entered into a lease agreement to rent an asset for a six-year period, at which point it will be returned to the lessor and scrapped, with annual payments of \$18,420 made in advance. The initial measurement of the lease liability amounts to \$65,586, discounted at the implicit interest rate shown in the lease agreement of 12.5%.

Lis expects to sell goods produced by the asset during the first five years of the lease term, but has leased the asset for six years as this is the requirement of the lessor, and in case this expectation changes. Lis has the right to determine the use of the asset during the lease term and will obtain substantially all the economic benefit from its use.

Required

Explain how the above lease would be accounted for the year ending 31 December 20X3 including producing relevant extracts from the statement of profit or loss and statement of financial position.

You are not required to prepare the notes to the financial statements.

(10 marks)

8 Eastway

29 mins

- (a) A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration (IFRS 16: para.9).

Explain what is meant by 'control' in this context.

(5 marks)

- (b) Propfield Co, a property company, owns Eastway, a large shopping centre with a 30 units which it rents out to retailers.

Sellerwell Co enters into a contract with Propfield Co giving Sellerwell the right to use Unit 21 of Eastway for a four-year period.

The contract gives Propfield the right to require Sellerwell to move to another retail unit. However, if it does so, Propfield must pay for Sellerwell's relocation costs and provide Sellerwell with a retail unit of similar quality and specifications to Unit 21. The only reason Propfield would benefit economically from relocating Sellerwell is if a major new tenant were to decide to occupy a large amount of retail space at a rate high enough to cover the costs of relocating Sellerwell and other tenants in the retail space. While this scenario is possible, at inception of the contract, it is thought to be unlikely to occur.

Sellerwell must, under the contract, use Unit 21 to operate its well-known retail brand to sell its goods during the hours that the shopping centre is open. Sellerwell makes all of the decisions about how the retail unit is used. For example, Sellerwell decides on the mix of goods sold from the unit, the pricing of the goods sold and the quantities of inventory held. Sellerwell also controls physical access to the unit throughout the four-year period of use.

The contract requires Sellerwell to make fixed payments to Propfield, as well as variable payments that are a percentage of sales from Unit 21.

As part of the contract, Propfield provides marketing, cleaning and security services.

Required

Determine whether the contract between Propfield and Sellerwell contains a lease. (10 marks)

(Total = 15 marks)

9 Biogenics

20 mins

- (a) Over the last 20 years many companies have spent a great deal of money internally developing new intangible assets such as software. The treatment for these assets is prescribed by IAS 38 *Intangible Assets*.

Required

In accordance with IAS 38, discuss whether internally-developed intangible assets should be recognised, and if so how they should be initially recorded and subsequently accounted for.

(3 marks)

- (b) Biogenics is a publicly listed pharmaceutical company. During the year to 31 December 20X9 the following transactions took place:
- (i) \$6m was spent on developing a new obesity drug which received clinical approval on 1 July 20X9 and is proving commercially successful. The directors expect the project to be in profit within 12 months of the approval date. The patent was registered on 1 July 20X9. It cost \$1.5m and remains in force for three years.
 - (ii) A research project was set up on 1 October 20X9 which is expected to result in a new cancer drug. \$200,000 was spent on computer equipment and \$400,000 on staff salaries. The equipment has an expected life of four years.
 - (iii) On 1 September 20X9 Biogenics acquired an up-to-date list of GPs at a cost of \$500,000 and has been visiting them to explain the new obesity drug. The list is expected to generate sales throughout the life-cycle of the drug.

Required

Prepare extracts from the statement of financial position of Biogenics at 31 December 20X9 relating to the above items and summarise the costs to be included in the statement of profit or loss for that year.

(7 marks)

(Total = 10 marks)

10 Extract

49 mins

Extract prepares its financial statements to 31 December each year. During the years ended 31 December 20X0 and 31 December 20X1, the following event occurred.

Extract is involved in extracting minerals in a number of different countries. The process typically involves some contamination of the site from which the minerals are extracted. Extract makes good this contamination only where legally required to do so by legislation passed in the relevant country.

The company has been extracting minerals in Copperland since January 20W8 and expects its site to produce output until 31 December 20X5. On 23 December 20X0, it came to the attention of the directors of Extract that the government of Copperland was virtually certain to pass legislation requiring the making good of mineral extraction sites. The legislation was duly passed on 15 March 20X1. The directors of Extract estimate that the cost of making good the site in Copperland will be \$2m. This estimate is of the actual cash expenditure that will be incurred on 31 December 20X5.

Required

- (a) Explain why there was a need for an accounting standard dealing with provisions, and summarise the criteria that need to be satisfied before a provision is recognised. (12 marks)

- (b) Compute the effect of the estimated cost of making good the site on the financial statements of Extract for both of the years ended 31 December 20X0 and 20X1. Give full explanations of the figures you compute.

The annual discount rate to be used in any relevant calculations is 10%.

The relevant discount factors at 10% are:

Year 4 at 10%	0.683
Year 5 at 10%	0.621

(13 marks)

(Total = 25 marks)

11 Jerzy

During the year ended 30 November 20X3, the directors of Jerzy decided to form a defined benefit pension scheme for the employees of the company and contributed cash of \$160m to it on the final day of the reporting period. The following details relate to the scheme at 30 November 20X3:

	\$m
Present value of obligation	208
Fair value of plan assets	200
Current service cost	176
Interest cost – scheme liabilities	32
Expected return on pension scheme assets	16

The only entry in the financial statements made to date is in respect of the cash contribution which has been included in trade receivables. The directors have been uncertain as to how to deal with the above pension scheme in the consolidated financial statements.

Required

Show how the defined benefit pension scheme should be dealt with in the financial statements for the year ended 30 November 20X3.

12 PQR

39 mins

- (a) PQR has the following financial instruments in its financial statements for the year ended 31 December 20X5:
- An investment in the debentures of STU, nominal value \$40,000, purchased on their issue on 1 January 20X5 at a discount of \$6,000 and carrying a 4% coupon. PQR plans to hold these until their redemption on 31 December 20X8. The internal rate of return of the debentures is 8.6%.
 - A foreign currency forward contract purchased to hedge the commitment to purchase a machine in foreign currency six months after the year end.
 - 100,000 redeemable preference shares issued in 20X0 at \$1 per share with an annual dividend payment of 6 cents per share, redeemable in 20X8 at their nominal value.

Required

Advise the directors (insofar as the information permits) about the accounting for the financial instruments stating the effect of each on the gearing of the company. Your answer should be accompanied by calculations where appropriate. (10 marks)

- (b) PQR owns 100,000 barrels of crude oil which were purchased on 1 July 20X5 at a cost of \$26.00 per barrel.

In order to hedge the fluctuation in the market value of the oil, PQR signs a futures contract on the same date to deliver 100,000 barrels of oil on 31 March 20X6 at a futures price of \$27.50 per barrel.

Due to unexpected increased production by OPEC, the market price of oil on 31 December 20X5 slumped to \$22.50 per barrel and the futures price for delivery on 31 March 20X6 was \$23.25 per barrel at that date.

Required

Explain the impact of the transactions on the financial statements of the company for the year ended 31 December 20X5. (10 marks)

(Total = 20 marks)

13 Sirius

39 mins

Sirius is a large national public limited company (plc). The directors' service agreements require each director to purchase 'B' ordinary shares on becoming a director and this capital is returned to the director on leaving the company. Any decision to pay a dividend on the 'B' shares must be approved in a general meeting by a majority of all of the shareholders in the company. Directors are the only holders of 'B' shares.

Sirius would like advice on how to account under International Financial Reporting Standards (IFRSs) for the following events in its financial statements for the year ended 30 April 20X8.

- (a) The capital subscribed to Sirius by the directors and shareholders is shown as follows in the statement of financial position as at 30 April 20X8:

Equity

	\$m
Ordinary 'A' shares	100
Ordinary 'B' shares	20
Retained earnings	30
Total equity	150

On 30 April 20X8 the directors had recommended that \$3m of the profits should be paid to the holders of the ordinary 'B' shares, in addition to the \$10m paid to directors under their employment contracts. The payment of \$3m had not been approved in a general meeting. The directors would like advice as to whether the capital subscribed by the directors (the ordinary 'B' shares) is equity or a liability and how to treat the payments out of profits to them. (5 marks)

- (b) When a director retires, amounts become payable to the director as a form of retirement benefit as an annuity. These amounts are not based on salaries paid to the director under an employment contract. Sirius has contractual or constructive obligations to make payments to former directors as at 30 April 20X8 as follows.

- (i) Certain former directors are paid a fixed annual amount for a fixed term beginning on the first anniversary of the director's retirement. If the director dies, an amount representing the present value of the future payment is paid to the director's estate.
- (ii) In the case of other former directors, they are paid a fixed annual amount which ceases on death.

The rights to the annuities are determined by the length of service of the former directors and are set out in the former directors' service contracts. (5 marks)

- (c) On 1 May 20X7 Sirius acquired another company, Marne plc. The directors of Marne, who were the only shareholders, were offered an increased profit share in the enlarged business for a period of two years after the date of acquisition as an incentive to accept the purchase offer. After this period, normal remuneration levels will be resumed. Sirius estimated that this would cost them \$5m at 30 April 20X8, and a further \$6m at 30 April 20X9. These amounts will be paid in cash shortly after the respective year ends. (5 marks)

- (d) Sirius raised a loan with a bank of \$2m on 1 May 20X7. The market interest rate of 8% per annum is to be paid annually in arrears and the principal is to be repaid in ten years' time. The terms of the loan allow Sirius to redeem the loan after seven years by paying the interest to be charged over the seven year period, plus a penalty of \$200,000 and the principal of \$2m. The effective interest rate of the repayment option is 9.1%. The directors of Sirius are currently restructuring the funding of the company and are in initial discussions with the bank about the possibility of repaying the loan within the next financial year. Sirius is uncertain about the accounting treatment for the current loan agreement and whether the loan can be shown as a current liability because of the discussions with the bank. (5 marks)

Required

Discuss the principles and nature of the accounting treatment of the above elements under International Financial Reporting Standards in the financial statements for the year ended 30 April 20X8. (Total = 20 marks)

14 DT Group

39 mins

DT, a public limited company, has decided to adopt the provisions of IFRSs for the first time in its financial statements for the year ending 30 November 20X1. The amounts of deferred tax provided as set out in the notes of the group financial statements for the year ending 30 November 20X0 were as follows:

	\$m
Tax depreciation in excess of accounting depreciation	38
Other temporary differences	11
Liabilities for health care benefits	(12)
Losses available for offset against future taxable profits	(34)
	<u>3</u>

The following notes are relevant to the calculation of the deferred tax liability as at 30 November 20X1:

- (a) DT acquired a 100% holding in a foreign company on 30 November 20X1. The subsidiary does not plan to pay any dividends for the financial year to 30 November 20X1 or in the foreseeable future. The carrying amount in DT's consolidated financial statements of its investment in the subsidiary at 30 November 20X1 is made up as follows:

	\$m
Carrying value of net assets acquired excluding deferred tax	76
Goodwill (before deferred tax and impairment losses)	14
Carrying amount/cost of investment	<u>90</u>

The tax base of the net assets of the subsidiary at acquisition was \$60m. No deduction is available in the subsidiary's tax jurisdiction for the cost of the goodwill.

Immediately after acquisition on 30 November 20X1, DT had supplied the subsidiary with inventories amounting to \$30m at a profit of 20% on selling price. The inventories had not been sold by the year end and the tax rate applied to the subsidiary's profit is 25%. There was no significant difference between the fair values and carrying values on the acquisition of the subsidiary.

- (b) The carrying amount of the property, plant and equipment (excluding that of the subsidiary) is \$2,600m and their tax base is \$1,920m. Tax arising on the revaluation of properties of \$140m, if disposed of at their revalued amounts, is the same at 30 November 20X1 as at the beginning of the year. The revaluation of the properties is included in the carrying amount above.

Other taxable temporary differences (excluding the subsidiary) amount to \$90m as at 30 November 20X1.

- (c) The liability for health care benefits in the statement of financial position had risen to \$100m as at 30 November 20X1 and the tax base is zero. Health care benefits are deductible for tax purposes when payments are made to retirees. No payments were made during the year to 30 November 20X1.

- (d) DT Group incurred \$300m of tax losses in 20X0. Under the tax law of the country, tax losses can be carried forward for three years only. The taxable profits for the years ending 30 November were anticipated to be as follows:

20X1	20X2	20X3
\$m	\$m	\$m
110	100	130

The auditors are unsure about the availability of taxable profits in 20X3 as the amount is based upon the projected acquisition of a profitable company. It is anticipated that there will be no future reversals of existing taxable temporary differences until after 30 November 20X3.

- (e) Income tax of \$165m on a property disposed of in 20X0 becomes payable on 30 November 20X4 under the deferral relief provisions of the tax laws of the country. There had been no sales or revaluations of property during the year to 30 November 20X1.
- (f) Income tax is assumed to be 30% for the foreseeable future in DT's jurisdiction and the company wishes to discount any deferred tax liabilities at a rate of 4% if allowed by IAS 12.
- (g) There are no other temporary differences other than those set out above. The directors of DT have calculated the opening balance of deferred tax using IAS 12 to be \$280m.

Required

- (a) Calculate the liability for deferred tax required by the DT Group at 30 November 20X1 and the deferred tax expense in profit or loss for the year ending 30 November 20X1 using IAS 12. (15 marks)
- (b) Prepare a brief report for the directors commenting on the effect that the application of IAS 12 will have on the financial statements of the DT Group. (5 marks)

(Total = 20 marks)

15 Courtney

20 mins

The following transactions relate to Courtney for the year ended 31 December 20X7.

- (a) Courtney purchased 6,000 kg of materials on December 20X7 to use in their production process. The supplier is located in Erehwon where the currency is the Won.

The goods cost 300,000 Wons and have not been paid for at the year end.

The relevant exchange rates are:

1 December	US\$1 = 20 Wons
31 December	US\$1 = 16 Wons

Required

Show how this transaction will be included in the financial statements at 31 December 20X7.

- (b) Courtney's finance manager does not understand the difference between functional and presentation currencies. Courtney's local currency is the US\$. They are a wholly owned autonomous subsidiary of a large corporation based in Europe who reports group results in Euros.

Required

Define functional and presentation currencies in relation to Courtney and in its parent.

(10 marks)

16 Biological assets

20 mins

IAS 41 *Agriculture* prescribes the accounting treatment and disclosures related to agricultural activities. An entity is encouraged, but not required, to provide a quantified description of each group of biological assets, distinguishing between consumables and bearer biological assets, or between mature and immature biological assets, as appropriate.

Required

- (a) Distinguish between a biological asset and agricultural produce.
- (b) Explain how agricultural produce is measured in the financial statements of an entity.
- (c) Give five examples of biological assets and their relative agricultural produce.
- (d) Explain what is meant by consumable and bearer biological assets, giving one example for each.

(10 marks)

17 Vident

39 mins

The directors of Vident will adopt IFRS for the current year ended 31 May 20X5. The directors are reviewing the impact of IFRS 2 *Share-based Payment* on the financial statements for the year ended 31 May 20X5. However, the directors of Vident are unhappy about having to apply the standard and have put forward the following arguments as to why they should not recognise an expense for share-based payments.

- (i) They feel that share options have no cost to their company and, therefore, there should be no expense charged in profit and loss.
- (ii) They do not feel that the expense arising from share options under IFRS 2 actually meets the definition of an expense under the *Conceptual Framework* document.
- (iii) The directors are worried about the dual impact of the IFRS on earnings per share, as an expense is shown in the statement of profit or loss and the impact of share options is recognised in the diluted earnings per share calculation.
- (iv) They feel that accounting for share-based payment may have an adverse effect on their company and may discourage it from introducing new share option plans.

The following share option schemes were in existence at 31 May 20X5:

Director's name	Grant date	Options granted	Fair value of options		Performance conditions	Vesting date	Exercise date
			at grant date	Exercise price			
			\$	\$			
J. Van Heflin	1 June 20X3	20,000	5	4.50	A	6/20X5	6/20X6
R. Ashworth	1 June 20X4	50,000	6	6	B	6/20X7	6/20X8

The price of the company's shares at 31 May 20X5 is \$12 per share and at 31 May 20X4 was \$12.50 per share.

The performance conditions which apply to the exercise of executive share options are as follows:

Performance Condition A

The share options do not vest if the growth in the company's earnings per share (EPS) for the year is less than 4%.

The rate of growth of EPS was 4.5% (20X3), 4.1% (20X4), 4.2% (20X5). The directors must still work for the company on the vesting date.



Performance Condition B

The share options do not vest until the share price has increased from its value of \$12.50 at the grant date (1 June 20X4) to above \$13.50. The director must still work for the company on the vesting date.

No directors have left the company since the issue of the share options and none are expected to leave before June 20X7. The shares vest and can be exercised on the first day of the due month.

The directors are uncertain about the deferred tax implications of IFRS 2. Vident operates in a country where a tax allowance will not arise until the options are exercised and the tax allowance will be based on the option's intrinsic value at the exercise date.

Assume a tax rate of 30%.

Required

- (a) Explain reasons why share-based payments should be recognised in financial statements and why the directors' arguments are unacceptable. (7 marks)
- (b) Discuss (with suitable calculations) how the directors' share options would be accounted for in the financial statements for the year ended 31 May 20X5 including the adjustment to opening balances. (7 marks)
- (c) Explain the deferred tax implications (with suitable calculations) for the company which arise from the recognition of a remuneration expense for the directors' share options. (6 marks)

(Total = 20 marks)

18 Polymer

78 mins

Note. This question requires the preparation of financial statements for an individual entity. Such a question is unlikely to be asked in an exam setting, however, extracts may be required in the scenario questions.

The following list of account balances has been prepared by Polymer, plastics manufacturers, on 31 May 20X8, which is the end of the company's accounting period:

	\$	\$
300,000 ordinary shares of \$1 each, fully paid		300,000
100,000 8.4% cumulative redeemable preference shares of \$1 each, fully paid		100,000
Revaluation surplus		50,000
Share premium reserve		100,000
General reserve		50,000
Retained earnings – 31 May 20X7		283,500
Patents and trademarks	215,500	
Freehold land at cost	250,000	
Leasehold property at cost	75,000	
Amortisation of leasehold property – 31 May 20X7		15,000
Factory plant and equipment at cost	150,000	
Accumulated depreciation – plant and equipment – 31 May 20X7		68,500
Furniture and fixtures at cost	50,000	
Accumulated depreciation – furniture and fixtures – 31 May 20X7		15,750
Motor vehicles at cost	75,000	
Accumulated depreciation – motor vehicles – 31 May 20X7		25,000
10% loan notes (20Y0 – 20Y5)		100,000
Trade receivables/ trade payables	177,630	97,500
Bank overdraft		51,250

	\$	\$
Inventories – raw materials at cost – 31 May 20X7	108,400	
Purchases – raw materials	750,600	
Carriage inwards – raw materials	10,500	
Manufacturing wages	250,000	
Manufacturing overheads	125,000	
Cash	5,120	
Work in progress – 31 May 20X7	32,750	
Sales		1,526,750
Administrative expenses	158,100	
Selling and distribution expenses	116,800	
Legal and professional expenses	54,100	
Allowance for receivables – 31 May 20X8		5,750
Inventories – finished goods – 31 May 20X7	184,500	
	<u>2,789,000</u>	<u>2,789,000</u>

Additional information:

- (1) Inventories at 31 May 20X8 were:

	\$
Raw materials	112,600
Finished goods	275,350
Work in progress	37,800

- (2) Depreciation for the year is to be charged as follows:

Plant and equipment	8% on cost – charged to production
Furniture and fixtures	10% on cost – charged to admin
Motor vehicles	20% on reducing value – 25% admin – 75% selling and distribution

- (3) Financial, legal and professional expenses include:

	\$
Solicitors' fees for purchase of freehold land during year	5,000

- (4) Provision is to be made for a full year's interest on the loan notes.
- (5) Income tax on the profits for the year is estimated at \$40,000 and is due for payment on 28 February 20X9.
- (6) The directors recommended on 30 June that a dividend of 3.5c per share be paid on the ordinary share capital. No ordinary dividend was paid during the year ended 31 May 20X7.
- (7) The leasehold land and buildings are held on a 50 year lease, acquired ten years ago.

Required

- (a) From the information given above, prepare the statement of profit or loss and other comprehensive income of Polymer for the year to 31 May 20X8 and a statement of financial position at that date for publication in accordance with International Financial Reporting Standards.

Notes to the financial statements are not required. (25 marks)

- (b) Explain what the IASB *Conceptual Framework* is trying to achieve. (10 marks)

- (c) Explain and give an example of the effect on the published financial statements if the going concern convention is held not to apply. (5 marks)

(Total = 40 marks)

19 Hewlett

12 mins

Hewlett granted 200 options on its \$1 ordinary shares to 800 qualifying employees on 1 January 20X3. Each grant is conditional upon the employee being employed by Hewlett until 31 December 20X5.

Hewlett estimated at 1 January 20X3 that:

- (i) The fair value of each option was \$7.50 (before adjustment for the possibility of forfeiture).
- (ii) Approximately 50 employees would leave during 20X3, 40 during 20X4 and 30 during 20X5 thereby forfeiting their rights to receive the options. The departures were expected to be evenly spread within each year.

The exercise price of the options was \$1.50 and the market value of a Hewlett share on 1 January 20X3 was \$7.

In the event, only 40 employees left during 20X3 (and the estimate of total departures was revised down to 95 at 31 December 20X3), 20 during 20X4 (and the estimate of total departures was revised to 70 at 31 December 20X4) and none during 20X5, spread evenly during each year.

The directors of Hewlett have asked you to illustrate how the scheme is accounted for under IFRS 2 *Share-based Payment*.

Required

Show the double entries for the charge to profit or loss for employee services over the three years and for the share issue, assuming all employees entitled to benefit from the scheme exercised their rights and the shares were issued on 31 December 20X5. (6 marks)

20 Pilum

20 mins

A statement showing the retained profit of Pilum for the year ended 31 December 20X4 is set out below.

	\$	\$
Profit before tax		2,530,000
Less income tax expense		<u>(1,127,000)</u>
		1,403,000
Transfer to reserves		<u>(230,000)</u>
Dividends:		
Paid preference interim dividend	138,000	
Paid ordinary interim dividend	414,000	
Declared preference final dividend	<u>138,000</u>	
		<u>(690,000)</u>
Retained		<u>483,000</u>

On 1 January 20X4 the issued share capital of Pilum was 4,600,000 6% preference shares of \$1 each and 4,120,000 ordinary shares of \$1 each.

Required

Calculate the earnings per share (on basic and diluted basis) in respect of the year ended 31 December 20X4 for each of the following circumstances. (Each of the three circumstances (a) to (c) is to be dealt with separately.)

- (a) On the basis that there was no change in the issued share capital of the company during the year ended 31 December 20X4.
- (b) On the basis that the company made a rights issue of \$1 ordinary shares on 1 October 20X4 in the proportion of 1 for every 5 shares held, at a price of \$1.20. The market price for the shares at close of trade on the last day of quotation cum rights was \$1.78 per share.

- (c) On the basis that the company made no new issue of shares during the year ended 31 December 20X4 but on that date it had in issue \$1,500,000 10% convertible loan stock 20X8 – 20Y1. This loan stock will be convertible into ordinary \$1 shares as follows.

20X8	90 \$1 shares for \$100 nominal value loan stock
20X9	85 \$1 shares for \$100 nominal value loan stock
20Y0	80 \$1 shares for \$100 nominal value loan stock
20Y1	75 \$1 shares for \$100 nominal value loan stock

Assume where appropriate that the income tax rate is 30%.

(10 marks)

21 Ace

On 1 April 20X1, Ace Co owned 75% of the equity share capital of Deuce Co and 80% of the equity share capital of Trey Co. On 1 April 20X2, Ace Co purchased the remaining 25% of the equity shares of Deuce Co. In the two years ended 31 March 20X3, the following transactions occurred between the three companies:

- On 30 June 20X1 Ace Co manufactured a machine for use by Deuce Co. The cost of manufacture was \$20,000. The machine was delivered to Deuce Co for an invoiced price of \$25,000. Deuce Co paid the invoice on 31 August 20X1. Deuce Co depreciated the machine over its anticipated useful life of five years, charging a full year's depreciation in the year of purchase.
- On 30 September 20X2, Deuce Co sold some goods to Trey Co at an invoiced price of \$15,000. Trey Co paid the invoice on 30 November 20X2. The goods had cost Deuce Co \$12,000 to manufacture. By 31 March 20X3, Trey Co had sold all the goods outside the group.
- For each of the two years ended 31 March 20X3, Ace Co provided management services to Deuce Co and Trey Co. Ace Co did not charge for these services in the year ended 31 March 20X2 but in the year ended 31 March 20X3 decided to impose a charge of \$10,000 per annum to Trey Co. The amount of \$10,000 is due to be paid by Trey Co on 31 May 20X3.

Required

Summarise the related party disclosures which will be required in respect of transactions (a) to (c) above for both of the years ended 31 March 20X2 and 31 March 20X3 in the financial statements of Ace Co, Deuce Co and Trey Co.

Note. You may assume that Ace Co presents consolidated financial statements for both of the years dealt with in the question.

22 Small and medium-sized entities

49 mins

In July 2009, the IASB issued its *IFRS for SMEs*, and it was updated in 2015. The aim of the standard is to provide a simplified, self-contained set of accounting principles for companies which are not publicly accountable. The IFRS reduces the volume of accounting guidance applicable to SMEs by more than 90% when compared to a full set of IFRSs.

Required

- Discuss the advantages and disadvantages of SMEs following a separate *IFRS for SMEs* as opposed to full IFRSs. (10 marks)

The *IFRS for SMEs* removes choices of accounting treatment, eliminates topics that are not generally relevant to SMEs, simplifies methods for recognition and measurement and reduces the disclosure requirements of full IFRSs.

Required

- Give some examples from full IFRSs with choice or complex recognition and measurement requirements. Explain how the *IFRS for SMEs* removes this choice or simplifies the recognition and measurement requirements. (13 marks)

Appropriateness and quality of discussion

(2 marks)

(Total = 25 marks)

23 Barcelona and Madrid

23 mins

Barcelona acquired 60% of Madrid's ordinary share capital on 1 October 20X2 at a price of \$1.06 per share. The balance on Madrid's retained earnings at that date was \$104m and the general reserve stood at \$11m.

Their respective statements of financial position as at 30 September 20X6 are as follows:

	Barcelona \$m	Madrid \$m
<i>Non-current assets</i>		
Property, plant & equipment	2,848	354
Patents	45	—
Investment in Madrid	159	—
	<u>3,052</u>	<u>354</u>
<i>Current assets</i>		
Inventories	895	225
Trade and other receivables	1,348	251
Cash and cash equivalents	212	34
	<u>2,455</u>	<u>510</u>
	<u>5,507</u>	<u>864</u>
<i>Equity</i>		
Share capital (20c ordinary shares)	920	50
Retained earnings	2,086	394
General reserve	775	46
	<u>3,781</u>	<u>490</u>
<i>Non-current liabilities</i>		
Long-term borrowings	558	168
<i>Current liabilities</i>		
Trade and other payables	1,168	183
Current portion of long-term borrowings	—	23
	<u>1,168</u>	<u>206</u>
	<u>5,507</u>	<u>864</u>

At the date of acquisition the fair values of some of Madrid's assets were greater than their carrying amounts. One line of Madrid's inventory had a fair value of \$8m above its carrying amount. This inventory had all been sold by 30 September 20X6. Madrid's land and buildings had a fair value \$26m above their carrying amount. \$20m of this is attributable to the buildings, which had a remaining useful life of ten years at the date of acquisition.

It is group policy to value non-controlling interests at full (or fair) value. The fair value of the non-controlling interests at acquisition was \$86m.

Annual impairment tests have revealed cumulative impairment losses relating to recognised goodwill of \$20m to date.

Required

Produce the consolidated statement of financial position for the Barcelona Group as at 30 September 20X6.
(12 marks)

24 Reprise

39 mins

Reprise purchased 75% of Encore for \$2,000,000 ten years ago when the balance on its retained earnings was \$1,044,000. The statements of financial position of the two companies as at 31 March 20X4 are as follows:

	<i>Reprise</i> \$'000	<i>Encore</i> \$'000
<i>Non-current assets</i>		
Investment in Encore	2,000	—
Land and buildings	3,350	—
Plant and equipment	1,010	2,210
Motor vehicles	510	345
	<u>6,870</u>	<u>2,555</u>
<i>Current assets</i>		
Inventories	890	352
Trade receivables	1,372	514
Cash and cash equivalents	89	51
	<u>2,351</u>	<u>917</u>
	<u>9,221</u>	<u>3,472</u>
<i>Equity</i>		
Share capital – \$1 ordinary shares	1,000	500
Retained earnings	4,225	2,610
Revaluation surplus	<u>2,500</u>	—
	<u>7,725</u>	<u>3,110</u>
<i>Non-current liabilities</i>		
10% debentures	500	—
<i>Current liabilities</i>		
Trade payables	<u>996</u>	<u>362</u>
	<u>9,221</u>	<u>3,472</u>

The following additional information is available:

- (1) Included in trade receivables of Reprise are amounts owed by Encore of \$75,000. The current accounts do not at present balance due to a payment for \$39,000 being in transit at the year end from Encore.
- (2) Included in the inventories of Encore are items purchased from Reprise during the year for \$31,200. Reprise marks up its goods by 30% to achieve its selling price.
- (3) \$180,000 of the recognised goodwill arising is to be written off due to impairment losses.
- (4) Encore shares were trading at \$4.40 just prior to acquisition by Reprise and this price is used to value non-controlling interests.

Required

Prepare the consolidated statement of financial position for the Reprise group of companies as at 31 March 20X4. It is the group policy to value the non-controlling interests at full (or fair) value.

(20 marks)

25 Alpha Group

39 mins

Alpha holds investments in two other entities, Beta and Gamma. All three entities prepare financial statements to 31 March and the statement of financial position of the three entities at 31 March 20X7 were as follows:

	Alpha \$'000	Beta \$'000	Gamma \$'000
Assets			
<i>Non-current assets:</i>			
Property, plant and equipment	125,000	85,000	75,000
Investments (Note 2)	32,000	—	—
	<u>157,000</u>	<u>85,000</u>	<u>75,000</u>
<i>Current assets:</i>			
Inventories (Note 3)	33,000	30,000	28,000
Trade receivables (Note 4)	43,000	30,000	31,000
Cash and cash equivalents	11,000	10,000	9,000
	<u>87,000</u>	<u>70,000</u>	<u>68,000</u>
Total assets	<u>244,000</u>	<u>155,000</u>	<u>143,000</u>
Equity and liabilities			
<i>Equity</i>			
Share capital (\$1 shares)	70,000	50,000	50,000
Retained earnings	55,000	44,000	28,000
Total equity	<u>125,000</u>	<u>94,000</u>	<u>78,000</u>
<i>Non-current liabilities:</i>			
Long-term borrowings	50,000	25,000	22,000
Deferred tax	35,000	12,000	17,000
Total non-current liabilities	<u>85,000</u>	<u>37,000</u>	<u>39,000</u>
<i>Current liabilities:</i>			
Trade and other payables (Note 4)	25,000	17,000	20,000
Current tax payable	9,000	7,000	6,000
Total current liabilities	<u>34,000</u>	<u>24,000</u>	<u>26,000</u>
Total equity and liabilities	<u>244,000</u>	<u>155,000</u>	<u>143,000</u>

Note 1 – purchase of shares in Beta

On 1 April 20X6 Alpha purchased 40 million shares in Beta by issuing one share in Alpha for every two shares purchased in Beta. This share issue has not been recorded in the books of Alpha.

The quoted price of an Alpha share at 1 April 20X6 was \$6 and the quoted price of a Beta share at the same date was \$2.40. Alpha incurred costs of \$800,000 in relation to the cost of issuing its shares. These costs have been charged as an expense in the statement of profit or loss of Alpha for the year ended 31 March 20X7. The non-controlling interest is measured at fair value using the quoted price of Beta's shares at acquisition.

The retained earnings of Beta as shown in its statement of financial position at 31 March 20X6 were \$35m. The directors of Alpha carried out a fair value exercise on the net assets of Beta at that date. The following matters arose out of the exercise:

- (i) Property, plant and equipment comprised non-depreciable land with a carrying amount of \$50m and a market value of \$60m, plus plant and equipment with a carrying amount of \$30m and a market value of \$38m. The estimated future economic life of the plant and equipment at 1 April 20X6 was four years (straight-line depreciation). None of the property, plant and equipment held by Beta at 1 April 20X6 had been disposed of by 31 March 20X7.
- (ii) At 1 April 20X6 Beta was engaged in legal action against a supplier in respect of damages caused by the supply of faulty products. Beta was claiming damages of \$5m. In the middle of March 20X6

the customer had offered an out of court settlement of \$3m and Beta's lawyers advised that this was a fair offer given the likelihood of success in court. However, Beta refused the offer, took the case to court, and subsequently won the case. The directors of Beta had not recognised any receivable in respect of the case in the statement of financial position at 31 March 20X6 because the claim was a contingent asset. The directors of Alpha considered that the fair value of the contingent asset at 1 April 20X6 was \$3m.

- (iii) At 1 April 20X6 Beta had a long standing portfolio of loyal customers that regularly ordered goods and services from Beta. In addition, the workforce of Beta was highly trained and the expertise of the workforce was seen by the directors as conferring significant competitive advantage to Beta. The customer relationships and the expertise of the workforce were not included in the statement of financial position of Beta at 31 March 20X6 because the directors did not consider that they met the recognition criteria in IAS 38 *Intangible assets* for internally developed intangible assets. The directors of Alpha considered that the customer relationships had a market value of \$20m at 1 April 20X6 and that based on the life cycle of the existing products, the existing customers would continue to order goods and services from Beta for at least five years from that date. They estimated that the fair value of the competitive advantage conferred by the workforce was \$15m at 1 April 20X6 and that the average period to retirement for a typical employee was 20 years.
- (iv) The financial director of Alpha has stated that the fair value adjustments will create temporary differences for deferred tax purposes.

Note 2 – purchase of shares in Gamma

On 1 April 20X5 Alpha purchased 20 million shares in Gamma for a cash payment of \$1.60 per share. The retained earnings of Gamma were \$15m at 1 April 20X5. This shareholding has resulted in the directors of Alpha being able to exercise a significant influence over the operating and financial policies of Gamma. The fair value of the net assets of Gamma at 1 April 20X5 was equal to their carrying amounts in Gamma's statement of financial position.

Note 3 – inventories

The inventories of Beta and Gamma at 31 March 20X7 included components purchased from Alpha during the year at a cost of \$20m to Beta and \$16m to Gamma. Alpha supplied these components at cost plus a mark up of 25%.

Note 4 – trade receivables and payables

The trade receivables of Alpha included \$5m receivable from Beta and \$4m receivable from Gamma in respect of the purchase of components (see Note 3). The trade payables of Beta and Gamma include an equivalent amount payable to Alpha.

Note 5 – other information

- (i) Neither the goodwill arising on acquisition of Beta nor the investment in Gamma has suffered any impairment since the dates of investment by Alpha in these entities.
- (ii) The rate of tax to apply to temporary differences is 25%.

Required

Prepare the consolidated statement of financial position of Alpha at 31 March 20X7.

(20 marks)

26 Fallowfield and Rusholme

29 mins

Fallowfield acquired a 60% holding in Rusholme three years ago when Rusholme's retained earnings balance stood at \$16,000. Both businesses have been very successful since the acquisition and their respective statements of profit or loss for the year ended 30 June 20X8 are as follows:

	<i>Fallowfield</i>	<i>Rusholme</i>
	\$	\$
Revenue	403,400	193,000
Cost of sales	(201,400)	(92,600)
Gross profit	202,000	100,400
Distribution costs	(16,000)	(14,600)
Administrative expenses	(24,250)	(17,800)
Dividends from Rusholme	15,000	
Profit before tax	176,750	68,000
Income tax expense	(61,750)	(22,000)
PROFIT FOR THE YEAR	<u>115,000</u>	<u>46,000</u>

STATEMENT OF CHANGES IN EQUITY (EXTRACT)

	<i>Fallowfield</i>	<i>Rusholme</i>
	<i>Retained earnings</i>	<i>Retained earnings</i>
	\$	\$
Balance at 1 July 20X7	163,000	61,000
Dividends	(40,000)	(25,000)
Profit for the year	115,000	46,000
Balance at 30 June 20X8	<u>238,000</u>	<u>82,000</u>

Additional information:

During the year Rusholme sold some goods to Fallowfield for \$40,000, including 25% mark up. Half of these items were still in inventories at the year-end.

Required

Produce the consolidated statement of profit or loss of Fallowfield and its subsidiary for the year ended 30 June 20X8, and an extract from the statement of changes in equity, showing retained earnings.

Goodwill is to be ignored.

(15 marks)

27 Panther Group

29 mins

Panther operated as a single company, but in 20X4 decided to expand its operations. Panther acquired a 60% interest in Sabre on 1 July 20X4 for \$2,000,000.

The statements of profit or loss and other comprehensive income of Panther and Sabre for the year ended 31 December 20X4 are as follows:

	<i>Panther</i>	<i>Sabre</i>
	\$'000	\$'000
Revenue	22,800	4,300
Cost of sales	(13,600)	(2,600)
Gross profit	9,200	1,700
Distribution costs	(2,900)	(500)
Administrative expenses	(1,800)	(300)
Finance costs	(200)	(70)
Finance income	50	—
Profit before tax	4,350	830
Income tax expense	(1,300)	(220)
PROFIT FOR THE YEAR	<u>3,050</u>	<u>610</u>
Other comprehensive income for the year, net of tax	1,600	180
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	<u>4,650</u>	<u>790</u>

Historically, Sabre had been a significant trading partner of Panther. During 20X4, Panther purchased \$640,000 of goods from Sabre. Of these, \$60,000 remained in inventories at the year end. Sabre makes a mark-up on cost of 20% under the transfer pricing agreement between the two companies. The fair value of the identifiable net assets of Sabre on purchase were \$200,000 greater than their book value. The difference relates to properties with a remaining useful life of 20 years.

On 1 January 20X4 (to protect its supply lines), Panther had advanced a loan to Sabre amounting to \$800,000 at a market interest rate of 5%. The loan is due for repayment in 20X9.

Statement of changes in equity (extracts) for the two companies:

	<i>Panther Reserves</i>	<i>Sabre Reserves</i>
	\$'000	\$'000
Balance at 1 January 20X4	12,750	2,480
Dividend paid	(900)	—
Total comprehensive income for the year	4,650	790
Balance at 31 December 20X4	<u>16,500</u>	<u>3,270</u>

Panther and Sabre had \$400,000 and \$150,000 of share capital in issue throughout the period respectively.

Required

Prepare the consolidated statement of profit or loss and other comprehensive income and statement of changes in equity (extract for reserves) for the Panther Group for the year ended 31 December 20X4.

No adjustments for impairment losses were necessary in the group financial statements.

Assume income and expenses (other than intragroup items) accrue evenly.

(15 marks)

28 Hever

49 mins

Hever has held shares in two companies, Spiro and Aldridge, for a number of years. As at 31 December 20X4 they have the following statements of financial position:

	<i>Hever \$'000</i>	<i>Spiro \$'000</i>	<i>Aldridge \$'000</i>
<i>Non-current assets</i>			
Property, plant & equipment	370	190	260
Investments	<u>218</u>	<u>—</u>	<u>—</u>
	<u>588</u>	<u>190</u>	<u>260</u>
<i>Current assets</i>			
Inventories	160	100	180
Trade receivables	170	90	100
Cash	<u>50</u>	<u>40</u>	<u>10</u>
	<u>380</u>	<u>230</u>	<u>290</u>
	<u>968</u>	<u>420</u>	<u>550</u>
<i>Equity</i>			
Share capital (\$1 ords)	200	80	50
Share premium	100	80	30
Retained earnings	<u>568</u>	<u>200</u>	<u>400</u>
	<u>868</u>	<u>360</u>	<u>480</u>
<i>Current liabilities</i>			
Trade payables	100	60	70
	<u>968</u>	<u>420</u>	<u>550</u>

You ascertain the following additional information:

- (1) The 'investments' in the statement of financial position comprise solely Hever's investment in Spiro (\$128,000) and in Aldridge (\$90,000).
- (2) The 48,000 shares in Spiro were acquired when Spiro's retained earnings balance stood at \$20,000.

The 15,000 shares in Aldridge were acquired when that company had a retained earnings balance of \$150,000.

- (3) When Hever acquired its shares in Spiro the fair value of Spiro's net assets equalled their book values with the following exceptions:

	\$'000
Property, plant and equipment	50 higher
Inventories	20 lower (sold during 20X4)

Depreciation arising on the fair value adjustment to non-current assets since this date is \$5,000.

- (4) During the year, Hever sold inventories to Spiro for \$16,000, which originally cost Hever \$10,000. Three-quarters of these inventories have subsequently been sold by Spiro.
- (5) No impairment losses on goodwill had been necessary by 31 December 20X4.
- (6) It is group policy to value non-controlling interests at full (or fair) value. The fair value of the non-controlling interests at acquisition was \$90,000.

Required

Produce the consolidated statement of financial position for the Hever group (incorporating the associate).
(25 marks)

29 Smith Group

Smith Co bought 80% of the share capital of Jones Co for \$324,000 on 1 October 20X5. At that date Jones Co's retained earnings balance stood at \$180,000. The statements of financial position at 30 September 20X8 and the summarised statements of profit or loss to that date are given below. (There is no other comprehensive income.)

	Smith Co \$'000	Jones Co \$'000
Non-current assets	360	270
Investment in Jones Co	324	—
Current assets	370	370
	<u>1,054</u>	<u>640</u>
Equity		
\$1 ordinary shares	540	180
Retained earnings	414	360
Current liabilities	100	100
	<u>1,054</u>	<u>640</u>
Profit before tax	153	126
Tax	(45)	(36)
Profit for the year	<u>108</u>	<u>90</u>

On 30 September 20X8, Smith Co sold its entire holding in Jones Co for \$650,000 in cash. No entries have been made in the accounting records for this transaction.

It is the group's policy to value the non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets. There has been no impairment of goodwill related to Jones Co.

Assume that profits accrue evenly throughout the year. Ignore taxation.

Required

Prepare Smith Group's consolidated statement of financial position and statement of profit or loss at 30 September 20X8.

(10 marks)



Practice answer bank

1 Setting and regulating standards

- (a) The objectives of the IFRS Foundation are to:
- (i) To **develop** a single set of **high quality, understandable, enforceable and globally accepted** international financial reporting standards (IFRSs) through its standard-setting body, the IASB;
 - (ii) To **promote** the use and **rigorous application** of those standards;
 - (iii) To **take account** of the needs of a **range of sizes and types of entities in diverse economic settings** (eg entities operating in **emerging economies** and **small and medium-sized entities** (SMEs));
 - (iv) To **promote and facilitate adoption** of International Financial Reporting Standards (IFRSs) through the **convergence** of national accounting standards and IFRSs.

- (b) The overall agenda of the IASB will initially be set by discussion with the IFRS Advisory Council. The process for developing an individual standard would involve the following steps:

Step 1 During the early stages of a project, IASB may establish an **Advisory Committee** to give advice on issues arising in the project. Consultation between the Advisory Committee and the IFRS Advisory Council occurs throughout the project.

Step 2 IASB may develop and publish **Discussion Documents** for public comment.

Step 3 Following the receipt and review of comments, IASB would develop and publish an **Exposure Draft** for public comment.

Step 4 Following the receipt and review of comments, the IASB would issue a final **International Financial Reporting Standard**.

The period of exposure for public comment is normally 120 days. However, in exceptional circumstances, proposals may be issued with a comment period of 30 days.

- (c) **Barriers to harmonisation**

- (i) **Different purposes of financial reporting.** In some countries the purpose is solely for tax assessment, while in others it is for investor decision-making.
- (ii) **Different legal systems.** These prevent the development of certain accounting practices and restrict the options available.
- (iii) **Different user groups.** Countries have different ideas about who the relevant user groups are and their respective importance. In the USA investor and creditor groups are given prominence, while in Europe employees enjoy a higher profile.
- (iv) **Needs of developing countries.** Developing countries are obviously behind in the standard setting process and they need to develop the basic standards and principles already in place in most developed countries.
- (v) **Nationalism** is demonstrated in an unwillingness to accept another country's standard.
- (vi) **Cultural differences** result in objectives for accounting systems differing from country to country.
- (vii) **Unique circumstances.** Some countries may be experiencing unusual circumstances which affect all aspects of everyday life and impinge on the ability of companies to produce proper reports, for example hyperinflation, civil war, currency restriction and so on.
- (viii) **The lack of strong accountancy bodies.** Many countries do not have strong independent accountancy or business bodies which would press for better standards and greater harmonisation.

- (d) The role of the IFRS Interpretations Committee is to:
- (i) Review on a timely basis, newly identified financial **reporting issues not specifically addressed in IFRSs**.
 - (ii) **Clarify issues** where **unsatisfactory** or **conflicting** interpretations have developed, or seem likely to develop in the absence of authoritative guidance with a view to reaching a consensus on the appropriate treatment.

2 Hardwood

- (a) Hardwood's first IFRS financial statements will be for the year ended 31 December 20X5. IFRS 1 requires that at least one year's comparative figures are presented and therefore the date of transition to IFRSs is the beginning of business on 1 January 20X4 (or close of business on 31 December 20X3).

Therefore the procedure for adopting IFRSs is:

- (i) Identify accounting policies that comply with IFRSs effective at 31 December 20X5 (the reporting date for the first IFRS financial statements);
- (ii) Restate the opening statement of financial position at 1 January 20X4 (the date of transition) using these IFRSs retrospectively, by:
 - Recognising all assets and liabilities whose recognition is required by IFRSs;
 - Not recognising items as assets or liabilities if IFRSs do not permit such recognition;
 - Reclassifying items that were recognised under previous GAAP as one type of asset, liability or component of equity, but are a different type of asset liability or component of equity under IFRSs; and
 - Measuring all recognised assets and liabilities in accordance with IFRSs.

The company will almost certainly need to change some of its accounting policies and to adjust some of the amounts that it reported previously at the same dates using local GAAP. It should recognise these adjustments directly in retained earnings (ie, in equity).

- (iii) Explain the effect of the transition from local GAAP to IFRSs, by presenting:
 - A reconciliation of equity reported under local GAAP to equity under IFRSs at the date of transition and at the reporting date; and
 - A reconciliation of the profit or loss reported under local GAAP to profit or loss reported under IFRSs for the period.

If Hardwood presented a statement of cash flows under local GAAP, it should also explain any material adjustments to the statement of cash flows.

Although the general rule is that all IFRSs should be applied retrospectively, a number of exemptions are available. These are intended to cover cases in which the cost of complying fully with a particular requirement would outweigh the benefits to users of the financial statements. Hardwood may choose to take advantage of any or all of the exemptions, which relate to fair values and revaluation; business combinations; employee benefits; cumulative foreign currency translation differences; compound financial instruments; and assets and liabilities of subsidiaries, associates and joint ventures.

- (b) Changing from local GAAP to IFRSs is likely to be a complex process and should be carefully planned. Although local GAAP and IAS/IFRS may follow broadly the same principles there are still likely to be many important differences in the detailed requirements of individual standards.

If Hardwood has overseas subsidiaries outside the EU it will also need to ensure that they comply with any local reporting requirements. This may mean that subsidiaries have to prepare two sets of financial statements: one using their local GAAP; and one using IFRSs (for the consolidation).

The process will be affected by the following:

- (i) The differences between local GAAP and IFRSs as they affect the group financial statements in practice. The company will need to carry out a detailed review of current accounting policies, paying particular attention to areas where there are significant differences between local GAAP and IFRSs. These will probably include deferred tax, business combinations, employee benefits and foreign currency translation. It should be possible to estimate the effect of the change by preparing pro-forma financial statements using IFRSs.
- (ii) The level of knowledge of IFRSs of current finance staff (including internal auditors). It will probably be necessary to organise training and the company may need to recruit additional personnel.
- (iii) The group's accounting systems. Management will need to assess whether computerised accounting systems can produce the information required to report under IFRSs. They will also need to produce new consolidation packages and accounting manuals.

Lastly, the company should consider the impact of the change to IFRSs on investors and their advisers. For this reason management should try to quantify the effect of IFRSs on results and other key performance indicators as early as possible.

(c) (i) *Accounting estimates*

Estimates under IFRSs at the date of transition must be consistent with those made at the same date under previous GAAP, (after adjustments to reflect any difference in accounting policies). The only exception to this is if the company has subsequently discovered that these estimates were in error. This is not the case here and therefore the estimates are not adjusted in the first IFRS financial statements.

(ii) *Court case*

The treatment of this depends on the reason why Hardwood did not recognise a provision under local GAAP at 31 December 20X4.

If the requirements of local GAAP were consistent with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, presumably the directors concluded that an outflow of economic benefit was not probable and that the recognition criteria were not met. In this case, Hardwood's assumptions under IFRSs are consistent with its previous assumptions under local GAAP. Hardwood does not recognise a provision at 31 December 20X4 and accounts for the payment in the year ended 31 December 20X5.

If the requirements of local GAAP were not consistent with IAS 37, Hardwood must determine whether it had an obligation at 31 December 20X4. The directors should take account of all available evidence, including any additional evidence provided by events after the reporting date. Similarly, under IAS 10 *Events After the Reporting Period*, the resolution of a court case after the reporting date is an adjusting event if it confirms that the company had a present obligation at that date.

The outcome of the court case confirms that Hardwood had a liability in September 20X4 (when the events that resulted in the case occurred). Therefore the company should recognise a provision at 31 December 20X4.

3 Conceptual framework I

(a) The stated **purposes** of the *Conceptual Framework* are as follows.

- (i) To assist the Board in the development of future IFRSs and in its review of existing IFRSs.
- (ii) To assist the Board in promoting harmonisation of regulations, accounting standards and procedures by reducing the number of alternative accounting treatment permitted by IFRSs.
- (iii) To assist national standard-setting bodies in developing national standards.
- (iv) To assist preparers of financial statements in applying IFRSs and in dealing with topics that have yet to form the subject of an IFRS.

- (v) To assist auditors in forming an opinion on whether financial statements comply with IFRSs.
 - (vi) To assist users of financial statements in interpreting the information contained in financial statements prepared in compliance with IFRSs.
 - (vii) To provide those who are interested in the work of the IASB with information about its approach to the formulation of IFRSs.
- (b) The people who might be **interested** in financial information about the company may be classified as follows.
- (i) **Shareholders in the company.** They will be interested in the company's profitability and its ability to pay dividends. They will also be interested in the company's long term prospects
 - (ii) **Managers of the company.** These are people appointed by the company's owners to supervise the day-to-day activities of the company. They need information about the company's financial situation as it is currently and as it is expected to be in the future. This is to enable them to manage the business efficiently and to take effective control and planning decisions.
 - (iii) **Trade contacts,** including suppliers who provide goods to the company on credit and customers who purchase the goods or services provided by the company. Suppliers will want to know about the company's ability to pay its debts; customers need to know that the company is a secure source of supply and is in no danger of having to close down.
 - (iv) **Providers of finance to the company.** These might include a bank which permits the company to operate an overdraft, or provides longer-term finance by granting a loan. The bank will want to ensure that the company is able to keep up with interest payments, and eventually to repay the amounts advanced.
 - (v) **The taxation authorities,** who will want to know about business profits in order to assess the tax payable by the company on its profits and any sales taxes.
 - (vi) **Employees of the company.** These should have a right to information about the company's financial situation, because their future careers and the size of their wages and salaries depend on it.

4 Conceptual framework II

- (a) The *Conceptual Framework* (OB2) states that:
- 'The objective of financial statements is to provide 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.'
- Such financial statements will meet the needs of most users. The information is, however, **restricted**.
- (i) It is based on **past events** not expected future events.
 - (ii) It does not necessarily contain **non-financial information**.
- The statements also show the **results of management's stewardship**.
- (b) An asset is a **resource controlled** by an entity as a result of **past events** and from which **future economic benefits** are expected to flow to the entity.
- A liability is a **present obligation** of an entity arising from **past events**, the settlement of which is expected to result in an **outflow** from the entity of **resources embodying economic benefits**.
- Equity is the **residual interest** in the **assets** of the entity **after deducting all its liabilities**.
- (c) **Relevance**
- Relevance is the first of the *Conceptual Framework's* fundamental qualitative characteristics.
- Information must be relevant, which means that it is capable of making a difference in the decisions of users. This is irrespective of whether or not it is already available from other sources.

Relevance involves information having **predictive value**, **confirmatory value**, or both. Predictive value means that it can be used to predict future outcomes. Confirmatory value means that it can help provide feedback about previous evaluations.

Faithful representation

Faithful representation is the second fundamental qualitative characteristic.

Information that represents faithfully has three characteristics: it is **complete**, **neutral** and **free from error**.

Being complete means including all information necessary for a user to understand the phenomenon being depicted. Being neutral means being without bias in the selection or presentation of information. Being free from error does not mean perfectly accurate in all respects, but that the description of phenomena, and the process used to produce reported information, are free from error.

Comparability

Comparability is the first enhancing qualitative characteristic. It means that information is comparable with similar information about other entities, and about the same entity for another period or date.

Achieving the goal of comparability involves **consistency**, which means using the same methods for the same items.

Verifiability

Verifiability is the second enhancing qualitative characteristic. If information is verifiable this means that **different knowledgeable and independent observers** could reach **consensus** that information constitutes a **faithful representation**. If information is verifiable in this way then this helps to assure users that information does faithfully represent what it purports to represent.

Tutorial note. The other enhancing qualitative characteristics are **timeliness** and **understandability**.

5 Jenson

Tutorial note. This is an important subject and it is closely linked with the IASB's *Conceptual Framework*.

- (a) IFRS 15 *Revenue from Contracts with Customers* defines a performance obligation as a promise in a contract with a customer to transfer to the customer goods and/or services. A performance obligation is satisfied when the customer obtains control of the asset.

Each good or service that is **distinct** is treated as a separate performance obligation and revenue is recognised as performance obligations are satisfied. A contract can include a number of separate performance obligations.

A performance obligation can be satisfied at a point in time, such as a contract for the sale of goods, or satisfied over time, as in a construction contract. When a performance obligation is satisfied over time, an entity must allocate revenue according to the amount of the performance obligation that has been satisfied during a period.

The IASB's *Conceptual Framework* defines income and expenses in terms of increases in economic benefits (income) and outflow or depletion of assets (expenses), not in terms of an earnings or matching process. The statement of financial position thus assumes primary importance in the recognition of earnings and profits. Income **can only be recognised** if there is an **increase** in the equity (ie net assets) of an entity not resulting from contributions from owners. Similarly, an expense is recognised if there is a **decrease** in the ownership interest of an entity not resulting from distributions to owners. Thus income arises from recognition of assets and derecognition of liabilities, and expenses arise from derecognition of assets and recognition of liabilities. The IASB explains that it is not possible to reverse this definitional process, ie by defining assets and

liabilities in terms of income and expenses, because it has not been possible to formulate robust enough base definitions of income and expenses. (This is partly because the choice of a 'critical event' in the operating cycle of business, after which revenue can be recognised, can be subjective.)

- (b) (i) This agreement is worded as a **sale**, but it is a repurchase agreement with a call option that is likely to be exercised and a repurchase price that is above the original sale price. It is therefore accounted for as a **financing arrangement**. Jenson should continue to recognise the inventory in the statement of financial position and should treat the receipt from Wholesaler as a loan, not revenue. Finance costs will be charged to profit or loss of $\$35,000 \times 12\% \times 9/12 = \$3,150$.
- (ii) The franchise agreement represents a performance obligation satisfied over time, so the initial fee of \$50,000 should be spread evenly over the term of the franchise. This will give revenue of \$10,000 in year 1 and \$15,000 thereafter. The profit will therefore be 20% for year 1 and approximately 46% for years 2–5.
- (iii) Jenson has received payment for 24 publications but only six have been despatched. So it has satisfied six out of 24 performance obligations. It can therefore recognise revenue of \$60,000 ($240,000 \times 6/24$) and the remaining \$180,000 should be presented as a liability.

6 Gains

GAINS – STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20X9

	Share capital \$'000	Share premium \$'000	Retained earnings \$'000	Revaluation surplus \$'000	Total \$'000
Balance at 1 January 20X9	2,800	1,150	2,120	750	6,820
Change in accounting policy			40	(40)	–
Restated balance	2,800	1,150	2,160	710	6,820
<i>Changes in equity for 20X9</i>					
Issue of share capital	600	(40)	–	–	560
Dividends			(200)		(200)
Total comprehensive income for the year (566 – (W1) 50)	–	–	516	120	636
Transfer to retained earnings (W2)			35	(35)	–
Balance at 31 December 20X9	3,400	1,110	2,511	795	7,816

Workings

- 1 Loss on investment property (160 – 110) (50)
- 2 Calculation of profit realised on sale of revalued asset

	\$
Revaluation recognised in past	50,000
Less: amounts transferred to retained earnings:	
(80,000/10 – 30,000 / 10) × 3	(15,000)
	<u>35,000</u>

7 Lis

The right-of-use asset should be capitalised in the statement of financial position. The asset should be depreciated over the shorter of its useful life (five years) and the lease term (six years).

A lease liability will be shown in the statement of financial position increased by interest calculated using the interest rate implicit in the lease, 12.5%, and reduced by lease payments made in advance.

The lease liability will initially be recognised at \$65,586. The right-of-use asset will be measured at \$84,006 (the initial lease liability of \$65,586 + the first payment of \$18,420 made at commencement of the lease).

Financial statement extracts

STATEMENT OF PROFIT OR LOSS (extract)	\$
Depreciation (W1)	16,801
Finance costs (W2)	8,198
STATEMENT OF FINANCIAL POSITION (extract)	\$
<i>Non-current assets</i>	
Right-of-use asset (W1)	67,205
<i>Non-current liabilities</i>	
Lease liability (W2)	55,364
<i>Current liabilities</i>	
Lease liability (W2) (73,784 – 55,364)	18,420

Workings

1	Carrying amount of right-of-use asset	\$
	Initial measurement of right-of-use asset	
	Initial lease liability	65,586
	Rental payment at commencement of lease	<u>18,420</u>
		84,006
	Depreciation of asset: \$84,006/5 years useful life	16,801
	Carrying amount at year end (\$84,006 – \$16,801)	<u>67,205</u>

The asset is depreciated over the shorter of its useful life (five years) and lease term (six years).

2	Lease liability	\$
1.1.X3	Initial measurement of lease liability	65,586
1.1.X3 – 31.12.X3	Interest at 12.5% (\$65,586 × 12.5%)	<u>8,198</u>
31.12.X3	Lease liability c/d	<u>73,784</u>
1.1.X4	Payment in advance	<u>(18,420)</u>
1.1.X4	Lease liability c/d after next instalment	<u>55,364</u>

The interest element (\$8,198) of the current liability can also be shown separately as interest payable.

Tutorial note. If the lease payments were in arrears, instead of in advance, the calculation of the lease liability would differ to that given above. The initial lease liability would be higher at \$74,672, being six payments of \$18,420 discounted using a discount rate of 12.5%, as the first lease payment, excluded from the answer above because it is paid at commencement of the lease, would be included. The lease liability would then be calculated as follows:

Lease payments are made in arrears:

		\$
1.1.X1	Lease liability (present value of future lease payments)	74,672
1.1.X1 – 31.12.X1	Interest at 12.5%	<u>9,334</u>
31.12.X1	Instalment in arrears	<u>(18,420)</u>
31.12.X1	Liability carried down	
1.1.X2 – 31.12.X2	Interest at 12.5%	8,198
31.12.X2	Instalment in arrears	<u>(18,420)</u>
31.12.X2	Liability due in more than 1 year	<u>55,364</u>

8 Eastway

- (a) The right to control the use of an identified asset depends on the lessee having:
- (i) The right to obtain substantially all of the economic benefits from use of the identified asset; and
 - (ii) The right to direct the use of the identified asset (IFRS 16: para. B9). This arises if either:
 - (1) The customer has the right to direct how and for what purpose the asset is used during the whole of its period of use, or
 - (2) The relevant decisions about use are pre-determined and the customer can operate the asset without the supplier having the right to change those operating instructions.

A lessee does not control the use of an identified asset if the lessor can substitute the underlying asset for another asset during the lease term and would benefit economically from doing so.

(IFRS 16: para. B14)

- (b) The contract contains a lease of retail space. Sellerwell has the right to use Unit 21 for four years. Unit 21 is an identified asset. It is explicitly specified in the contract. While Propfield has the right to substitute the retail unit, Propfield could benefit economically from substituting it only in specific circumstances. Propfield's substitution right is not substantive because, at inception of the contract, those circumstances are not considered likely to occur.

Sellerwell has the right to control the use of Unit 21 throughout the four-year period of use because:

- (i) Sellerwell has the right to obtain substantially all of the economic benefits from use of Unit 21 over the four-year period of use. Sellerwell has exclusive use of Unit 21 throughout the period of use. Although a portion of the cash flows derived from sales from Unit 21 will flow from Sellerwell to Propfield, this represents consideration that Sellerwell pays Propfield for the right to use the retail unit. It does not prevent Sellerwell from having the right to obtain substantially all of the economic benefits from use of Unit 21.
- (ii) Sellerwell has the right to direct the use of Unit 21 because the conditions in paragraph IFRS 16B24(a) exist. The contractual restrictions on the goods that can be sold from Unit 21, and when Unit 21 is open, define the scope of Sellerwell's right to use Unit 21. Within the scope of its right of use defined in the contract, Sellerwell makes the relevant decisions about how and for what purpose Retail Unit A is used by being able to decide, for example, the mix of products that will be sold in the retail unit and the sale price for those products. Sellerwell has the right to change these decisions during the five-year period of use.

Although marketing, cleaning and security are essential to the efficient use of Unit 21, Propfield's decisions in this regard do not give it the right to direct how and for what purpose Unit 21 is used. Consequently, Propfield does not control the use of Unit 21 during the period of use and Propfield's decisions do not affect Sellerwell's control of the use of Unit 21.

9 Biogenics

- (a) To be recognised, an intangible asset must first of all meet the definition of an intangible asset in IAS 38. It must be controlled by the entity, it must be separately identifiable and it must be something from which the entity expects future economic benefits to flow. It must then meet the recognition criteria of having a cost that can be measured reliably.

For this reason internally-generated intangibles are not normally recognised as assets. They have not been acquired for a consideration and therefore do not have a cost or value that can be measured reliably. For this reason, a brand name that has been acquired can be capitalised, a brand name that has been internally developed can not be capitalised. The exception to this is development costs which can be capitalised if/when they meet the IAS 38 criteria. They are initially recognised at cost.

(b) STATEMENT OF FINANCIAL POSITION (extracts)

<i>Non-current assets</i>		\$		
Property, plant and equipment (W1)		187,500		
Intangible assets (W2)		6,691,000		
COSTS CHARGED TO PROFIT OR LOSS				
Depreciation (W1)		12,500		
Amortisation (W2)		1,309,000		
Staff salaries		400,000		
<i>Workings</i>		\$		
1	<i>Computer equipment</i>			
	Cost	200,000		
	Depreciation (200 × 3/48)	<u>(12,500)</u>		
	Carrying amount	<u>187,500</u>		
2	<i>Intangible assets</i>			
	<i>Patent</i>	<i>Development costs</i>	<i>Customer list</i>	<i>Total</i>
	\$'000	\$'000	\$'000	\$'000
Cost	1,500	6,000	500	8,000
Amortisation:				
(6/36)	(250)	(1,000)	—	—
(4/34)	<u>—</u>	<u>—</u>	(59)	<u>(1,309)</u>
	<u>1,250</u>	<u>5,000</u>	<u>441</u>	<u>6,691</u>

Top tip. A good knowledge of IAS 37 is needed in this question. Do not disregard the discounting aspects, these calculations are quite straightforward as you are given the formulae in the exam.

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* was issued to prevent entities from using provisions for creative accounting. It was common for entities to recognise material provisions for items such as future losses, restructuring costs or even expected future expenditure on repairs and maintenance of assets. These could be combined in one large provision (sometimes known as the 'big bath'). Although these provisions reduced profits in the period in which they were recognised (and were often separately disclosed on grounds of materiality), they were then released to enhance profits in subsequent periods. To make matters worse, provisions were often recognised where there was no firm commitment to incur expenditure. For example, an entity might set up a provision for restructuring costs and then withdraw from the plan, leaving the provision available for profit smoothing.

IAS 37 states that a provision should not be recognised unless:

- (i) An entity has a present obligation (legal or constructive) as a result of a past event; and
- (ii) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- (iii) A reliable estimate can be made of the amount of the obligation.

An obligation can be legal or constructive. An entity has a constructive obligation if:

- (i) It has indicated to other parties that it will accept certain responsibilities (by an established pattern of past practice or published policies); and
 - (ii) As a result, it has created a valid expectation on the part of those other parties that it will discharge those responsibilities.
- (b) Extract should recognise a provision for the estimated costs of making good the site because:
- (i) It has a present obligation to incur the expenditure as a result of a past event. In this case the obligating event occurred when it became virtually certain that the legislation would be passed. Therefore the obligation existed at 31 December 20X0; and
 - (ii) An outflow of resources embodying economic benefits is probable; and
 - (iii) It is possible to make a reliable estimate of the amount.

Effect on the financial statements

For the year ended 31 December 20X0:

- A provision of \$1,242,000 ($2,000,000 \times 0.621$) is reported as a liability.
- A non-current asset of \$1,242,000 is also recognised. The provision results in a corresponding asset as the expenditure gives the company access to an inflow of resources embodying future economic benefits; there is no effect on profit or loss for the year.

For the year ended 31 December 20X1:

- Depreciation of \$248,400 ($1,242,000 \times 20\%$) is charged to profit or loss. The non-current asset is depreciated over its remaining useful economic life of five years from 31 December 20X0 (the site will cease to produce output on 31 December 20X5).
- Therefore at 31 December 20X1 the carrying amount of the non-current asset will be \$993,600 ($1,242,000 - 248,400$).
- At 31 December 20X1 the provision will be \$1,366,000 ($2,000,000 \times 0.683$).
- The increase in the provision of \$124,000 ($1,366,000 - 1,242,000$) is recognised in profit or loss as a finance cost. This arises due to the unwinding of the discount.

11 Jerzy

The defined benefit pension scheme is treated in accordance with IAS 19 *Employee Benefits*.

The pension scheme has a deficit of liabilities over assets:

	\$m
Fair value of plan assets	200
Present value of obligation	<u>(208)</u>
	<u>(8)</u>

The deficit is reported as a liability in the notes to the statement of financial position.

The notes to the statement of profit or loss and other comprehensive income for the year includes:

	\$m
Current service cost	176
Net interest	<u>(16)</u>
	<u>192</u>

IAS 19 requires actuarial gains and losses at the end of the previous accounting period to be recognised within other comprehensive income.

Other comprehensive income for the year would therefore include:

	\$m
Actuarial gain on defined benefit pension scheme assets	<u>24</u>

Alternatively, they may be immediately within profit and loss. There were no actuarial gains or losses at the start of the current period. Recognising the gain in this way would provide useful information to users of the financial statements, given that the pension scheme is new and results in a significant additional charge to the statement of profit or loss.

Adjustment to the financial statements:

Dr Retained earnings	\$168m	
Cr Receivables		\$160m
Cr Defined benefit pension scheme liability		\$8m

Working

	\$m
Scheme assets:	
Contributions paid	160
Expected return on plan assets	16
Actuarial gain (balancing figure)	24
Fair value of plan assets	<u>200</u>
Scheme liabilities:	
Current service cost	176
Interest cost	<u>32</u>
Present value of obligation	<u>208</u>
Net pension liability	<u>5</u>

12 PQR

(a) Investment in debentures

Given that these debentures are planned to be held until redemption, under IFRS 9 *Financial Instruments* they would be held at amortised cost, on the assumption that:

- (i) The objective of the business model within which the asset is held is to hold assets in order to collect contractual cash flows; and
- (ii) 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 outstanding.

This means that they are initially shown at their cost (including any transaction costs) and their value increased over time to the redemption value by applying a constant effective interest rate which takes into account not only the annual income due from the coupon, but also amortisation of the redemption premium. Their value is reduced by distributions received, ie the coupon.

Consequently the amortised cost valuation of these debentures at the year end would be:

Cost (40,000 – 6,000)	34,000	
Effective interest at 8.6%	2,924	Shown as finance income
Coupon received (4% × 40,000)	<u>(1,600)</u>	Debited to cash
	<u>35,324</u>	

Note. The debentures are an asset belonging to the equity holders and so as the increase in value is recognised until redemption, the equity of the business will increase, marginally reducing gearing.

Forward contract

Providing the transaction is designated as a hedge with formal documentation, and it meets the following criteria, it qualifies for hedge accounting:

- (i) There is an economic relationship between the hedged item and the hedging instrument, ie the hedging instrument and the hedged item have values that generally move in the opposite direction because of the same risk, which is the hedged risk;

- (ii) The effect of credit risk does not dominate the value changes that result from that economic relationship, ie the gain or loss from credit risk does not frustrate the effect of changes in the underlyings on the value of the hedging instrument or the hedged item, even if those changes were significant; and
- (iii) The hedge ratio of the hedging relationship (quantity of hedging instrument vs quantity of hedged item) is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item.

A foreign currency forward contract can be argued to be either a hedge of the future cash flow or a hedge of the fair value. IFRS 9 therefore allows foreign currency hedges of firm commitments to be classed as either a cash flow hedge or a fair value hedge.

If the contract is classed as a cash flow hedge, given that the machine is not yet recognised in the books, any gain or loss on the hedging instrument is split into two components:

- The effective portion of the hedge (which matches the change in expected cash flow) is recognised initially in other comprehensive income (ie recognised in reserves). It is transferred out of reserves either when the asset is recognised (adjusting the asset base and future depreciation) or when the cash flow is recognised in profit or loss (eg by depreciation) as a reclassification adjustment. Both options therefore apply the accruals concept.
- The ineffective portion of the hedge is recognised in profit or loss immediately as it has not hedged anything.

If the contract is classed as a fair value hedge, all gains and losses on the hedging instrument must be recognised immediately in profit or loss. However, in order to match those against the asset hedged, the gain or loss on the fair value of the asset hedged is also recognised in profit or loss (and as an asset or liability in the statement of financial position). This is arguably less transparent as it results in part of the asset value (the change in fair value) being recognised in the statement of financial position until the purchase actually occurs – consequently, IFRS 9 allows the option to treat foreign currency forward contracts as a cash flow hedge.

Note. Gearing will be different depending on whether the forward contract is accounted for as a cash flow hedge or a fair value hedge (and whether a gain or loss on the hedging instrument occurs). Gearing will be less volatile if a fair value hedge is used as the change in fair value of the hedged asset is also recognised offsetting gains or losses on the hedging instrument, whereas this is not the case until the asset is purchased (and recognised) for the cash flow hedge.

Redeemable preference shares

Redeemable preference shares, although called shares, are not, in substance, equity, they are a debt instrument, ie a loan made to the company which receives interest and is paid back at a later date.

Consequently, IAS 32 requires them to be classed as such, ie as a non-current liability in the statement of financial position. The 'dividends' paid will be shown in profit or loss as finance costs and accrued at the end of the year if outstanding, whether declared or not.

The shares are consequently a financial liability held at amortised cost. In this case, given that the shares are issued and redeemed at the same value, the effective interest rate and nominal coupon rate will be the same (6%) and each year \$6,000 will be shown as a finance cost in profit or loss and the balance outstanding under non-current liabilities at each year end will be \$100,000 as follows:

	\$	
Cash received/ b/d value	100,000	
Effective interest at 6%	6,000	shown as finance cost
Coupon paid (6% × 100,000)	(6,000)	credited to cash
	<u>100,000</u>	

In the financial statements for the year ending 31 December 20X7, the shares will need to be reclassified as a current liability given that they will be repaid within one year.

Note. Given that these shares are classed as a financial liability, gearing will be higher (as they are treated as debt) than if they were ordinary shares (which would be treated as equity).

- (b) The futures contract was entered into to protect PQR from a fall in oil prices and hedge the value of the inventories. It is therefore a fair value hedge.

The inventories are recorded at their cost of \$2,600,000 (100,000 barrels at \$26.00) on 1 July 20X5.

The futures contract has a zero value at the date it is entered into and so no entry is made in the financial statements.

Tutorial note. However, the existence of the contract and associated risk would be disclosed from that date in accordance with IFRS 7 (detail outside the scope of the syllabus).

At the year end the inventories must be shown at the lower of cost and net realisable value. Hence they will be shown at \$2,250,000 (100,000 barrels at \$22.50) and a loss of \$350,000 recognised in profit or loss.

However, a gain has been made on the futures contract:

	\$
The company has a contract to sell on 31 March 20X6 at \$27.50	2,750,000
A contract entered into at the year end would sell at \$23.25 on 31 March 20X6	2,325,000
Gain (= the value the contract could be sold on for to a third party)	<u>425,000</u>

The gain on the futures contract is also recognised in profit or loss:

DEBIT	Future contract asset	\$425,000	
CREDIT	Profit or loss		\$425,000

The net effect on profit or loss is a gain of \$75,000 (\$425,000 less \$350,000) whereas without the hedging contract the whole loss of \$350,000 would have been the only impact on profit or loss.

Note. If the inventories had gained in value, this gain would also be recognised in profit or loss as hedge accounting is being applied (normally gains on inventories are not recognised until sale). A loss would have occurred on the futures contract, which would also be recognised in profit or loss.

13 Sirius

Tutor's hint. This question requires you to understand IAS 32, IAS 19, and IFRS 9, so it is a good question with which to test your understanding. Make sure you review this answer carefully against your own and identify any weak areas that you need to work on.

- (a) **Directors' ordinary 'B' shares**

The capital of Sirius must be shown **either as a liability or as equity**. The criteria for distinguishing between financial liabilities and equity are found in IAS 32 *Financial Instruments: Presentation*.

Equity and liabilities must be classified **according to their substance, not just their legal form**.

A **financial liability** is defined as any liability that is:

- (i) A contractual obligation:
 - To deliver cash or another financial asset to another entity; or
 - To exchange financial instruments with another entity under conditions that are potentially unfavourable; or
- (ii) A contract that will or may be settled in 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.

The **ordinary 'B' shares**, the capital subscribed by the directors must, according to the directors' service agreements, be returned to any director on leaving the company. There is thus a

contractual obligation to deliver cash. The redemption is **not discretionary**, and Sirius has no right to avoid it. The mandatory nature of the repayment makes this capital a **liability** (if it were discretionary, it would be equity). On initial recognition, that is when the 'B' shares are purchased, the financial liability must be stated at the **present value of the amount due on redemption**, discounted over the life of the service contract. In subsequent periods, the financial liability may be carried at fair value through profit or loss, or at amortised cost under IFRS 9.

In contrast, the **payment of \$3m** to holders of 'B' shares, is discretionary in that it must be approved in a general meeting by a majority of all shareholders. This approval may be refused, and so it would not be correct to show the \$3m as a liability in the statement of financial position at 30 April 20X8. Instead, it should be recognised when approved. The dividend when recognised will be treated as **interest expense**. This is because IAS 32 (para 35–36) requires the treatment of dividends to follow the treatment of the instrument, ie because the instrument is treated as a liability, the dividends are treated as an expense.

(b) **Directors' retirement benefits**

These are unfunded defined benefit plans, which are likely to be governed by IAS 19 *Employee Benefits*, but IAS 32 and IFRS 9 on financial instruments, and IAS 37 *Provisions, Contingent Liabilities and Contingent assets* also apply.

Sirius has contractual or constructive obligations to make payments to former directors. The treatment and applicable standard depends on the obligation.

(i) **Fixed annuity with payment to director's estate on death**

This **meets the definition of a financial liability under IAS 32**, because there is a contractual obligation to deliver cash or a financial asset. The firm does not have the option to withhold the payment. The rights to these annuities are earned over the directors' period of service, so it follows that the costs should also be recognised over this service period.

(ii) **Fixed annuity ceasing on death**

The timing of the death is clearly uncertain, which means that the annuities have a **contingent element** with a mortality risk to be calculated by an actuary. It meets the definition of an insurance contract, which is outside the scope of IFRS 9, as are employers' obligations under IAS 19. However, insofar as there is a constructive obligation, these annuities fall within the scope of IAS 37, because these are liabilities of uncertain timing or amount. The amount of the obligation should be measured in a manner similar to a warranty provision: that is the **probability of the future cash outflow** of the present obligation should be measured for the class of all such obligations. An estimate of the costs should include any liability for post retirement payments that directors have earned so far. The liability should **be built up over the service period** and will in practice be calculated on an actuarial basis as under IAS 19 *Employee Benefits*. If the effect is material, the liability will be discounted. It should be **re-calculated every year** to take account of directors joining or leaving, or any other changes.

(c) **Acquisition of Marne**

An increased profit share is payable to the directors of Marne if the purchase offer is accepted. The question arises of whether this additional payment constitutes **remuneration or consideration** for the business acquired. Because the payment is for two years only, after which time remuneration falls back to normal levels, the payment should be seen as part of the **purchase consideration**.

The second issue is the treatment of this consideration. IFRS 3 (revised January 2008) *Business Combinations* requires that an acquirer must be identified for all business combinations. In this case Sirius is the acquirer. The cost of the combination must be measured as the sum of the fair values, at the date of exchange, of assets given or liabilities assumed in exchange for control.

IFRS 3 recognises that, by entering into an acquisition, the acquirer becomes obliged to make additional payments. Not recognising that obligation means that the consideration recognised at the acquisition date is not fairly stated.

The revised IFRS 3 requires recognition of contingent consideration, measured at fair value, at the acquisition date. This is, arguably, consistent with how other forms of consideration are fair valued.

The acquirer may be required to pay contingent consideration in the form of equity or of a debt instrument or cash. In this case, it is in the form of cash, or increased remuneration.

Accordingly, the cost of the combination must include the full \$11m, measured at net present value at 1 May 20X7. The payment of \$5m would be discounted for one year and the payment of \$6m for two years.

(d) **Repayment of bank loan**

The bank loan is to be repaid in ten years' time, but the terms of the loan state that Sirius can pay it off in seven years. The issue arises as to whether the early repayment option is likely to be exercised.

If, when the loan was taken out on 1 May 20X7 the option of early repayment was not expected to be exercised, then at 30 April 20X8 the normal terms apply. The loan would be stated at \$2m in the statement of financial position, and the effective interest would be $8\% \times \$2\text{m} = \$160,000$, the interest paid.

If at 1 May 20X7 it was expected that the early repayment option would be exercised, then the effective interest rate would be 9.1%, and the effective interest $9.1\% \times \$2\text{m} = \$182,000$. The cash paid would still be \$160,000, and the difference of \$22,000 would be added to the carrying amount of the financial liability in the statement of financial position, giving \$2,022,000.

IFRS 9 *Financial Instruments* requires that the carrying amount of a financial asset or liability should be adjusted to reflect actual cash flows or revised estimates of cash flows. This means that, even if it was thought at the outset that early repayment would not take place, if expectations then change, the carrying amount must be revised to reflect future estimated cash flows using the effective interest rate.

The directors of Sirius are currently in discussion with the bank regarding repayment in the next financial year. However, these discussions do not create a legal obligation to repay the loan in 12 months, and Sirius has an unconditional right to defer settlement for longer than 12 months. Accordingly, it would not be correct to show the loan as a current liability on the basis of the discussions with the bank.

14 DT Group

(a) **Calculation of deferred tax liability**

	Carrying amount \$m	Tax base \$m	Temporary differences \$m
Goodwill (Note 1)	14	—	—
Subsidiary (Note 1)	76	60	16
Inventories (Note 2)	24	30	(6)
Property, plant and equipment (Note 3)	2,600	1,920	680
Other temporary differences			90
Liability for health care benefits	(100)	0	(100)
Unrelieved tax losses (Note 4)			(100)
Property sold – tax due 30.11.20X4 (165/30%)			550
Temporary differences			<u>1,130</u>
Deferred tax liability	1,320	at 30%	396
(680 + 90 + 550)			
Deferred tax liability	16	at 25%	4
Deferred tax asset	(200)	at 30%	(60)
Deferred tax asset	(6)	at 25%	(1.5)
	<u>1,130</u>		<u>338.5</u>

	Carrying amount \$m	Tax base \$m	Temporary differences \$m
Deferred tax liability b/d (given)			280
Deferred tax attributable to subsidiary to goodwill $(76 - 60) \times 25\%$			4
\therefore Deferred tax expense for the year charged to P/L (balance)			54.5
Deferred tax liability c/d (from above)			<u>338.5</u>

Notes:

- 1 As no deduction is available for the cost of goodwill in the subsidiary's tax jurisdiction, then the tax base of goodwill is zero. Paragraph 15(a) of IAS 12, states that DT Group should not recognise a deferred tax liability of the temporary difference associated in B's jurisdiction with the goodwill. Goodwill will be increased by the amount of the deferred tax liability of the subsidiary ie \$4m.
- 2 Unrealised group profit eliminated on consolidation are provided for at the receiving company's rate of tax (ie at 25%).
- 3 The tax that would arise if the properties were disposed of at their revalued amounts which was provided at the beginning of the year will be included in the temporary difference arising on the property, plant and equipment at 30 November 20X1.
- 4 DT Group has unrelieved tax losses of \$300m. This will be available for offset against current year's profits (\$110m) and against profits for the year ending 30 November 20X2 (\$100m). Because of the uncertainty about the availability of taxable profits in 20X3, no deferred tax asset can be recognised for any losses which may be offset against this amount. Therefore, a deferred tax asset may be recognised for the losses to be offset against taxable profits in 20X2. That is $\$100m \times 30\%$ ie \$30m.

(b)

Report

To: The Directors, DT Group
From: Accountant
Date: XX.XX.XX

Effect of application of IAS 12 on financial statements

The application of IAS 12 will have the following effect on the financial statements of the DT group: The deferred tax liability of DT Group will rise in total by \$335.5m ($\$338.5m - \$3m$), thus reducing net assets, distributable profits, and post-tax earnings.

The profit for the year will be reduced by \$54.5m which would probably be substantially more under IAS 12 than the old method of accounting for deferred tax.

A prior period adjustment will occur of $\$280m - \$3m$ as IFRS are being applied for the first time (IFRS 1) ie \$277m.

The borrowing position of the company may be affected and the directors may decide to cut dividend payments.

However, the amount of any unprovided deferred tax may have been disclosed under the previous GAAP standard used.

IAS 12 brings this liability into the statement of financial position but if the bulk of the liability had already been disclosed the impact on the share price should be minimal.

I hope that this report is helpful to you.

Signed, Accountant

15 Courtney

- (a) Courtney must recognise the purchase of goods at the exchange rate in place at the date of the transaction.

Therefore:

$$300,000 \text{ Wons}/20 = \$15,000$$

DR	Purchases	\$15,000	
	CR	Trade payables	\$15,000

At the year end, the supplier has not been paid, so the liability is still outstanding. It must be translated at the closing rate at the year end and any exchange gains or losses recognised in the statement of profit or loss.

The liability at 31 December 20X7 is:

$$3,000,000 \text{ Wons}/16 = \$18,750$$

It has increased and Courtney must recognise an exchange loss of \$3,750 ($18,750 - 15,000$).

DR	Statement of profit or loss	\$3,750	
	CR	Trade payables	\$3,750

- (b) Functional currency is the currency of the primary economic environment in which the entity operates. Determining an entity's functional currency involves looking at the currency that influences sales prices and costs. Additionally, if an entity raises finance in its home currency, that is likely to be its functional currency.

In Courtney's case, it operates in US\$, which is the functional currency.

The presentation currency is the currency in which the financial statements are presented. Courtney may well prepare financial statements in their functional currency (US\$), but the parent company reports in euros, so Courtney's results will have to be translated into euros so that they can be consolidated. The group presentation currency is the euro.

16 Biological assets

- (a) A **biological asset** is a living animal or plant whereas **agricultural produce** is the harvested produce of an entity's biological assets.
- (b) Agricultural produce is measured at its **fair value less estimated point-of-sale costs** at the point of harvest.
- (c) Examples of biological assets and agricultural produce are:

<i>Biological asset</i>	<i>Agricultural produce</i>
Sheep	Wool
Pigs	Meat
Dairy cattle	Milk
Fruit tree	Oranges etc
Plant	Cotton
Bush	Tea leaves
Vine	Grapes
Chicken	Eggs

- (d) Consumable biological assets are those that are to be harvested as agricultural produce or sold as biological assets. Examples include livestock intended for the production of meat, livestock held for sale, fish in farms, crops such as maize and wheat and trees being grown for lumber.

Bearer biological assets are those other than consumable biological assets. Examples include livestock from which milk is produced or livestock held for breeding, vines, fruit trees and trees from which firewood is harvested without felling.

Plant-based bearer biological assets are now accounted for under **IAS 16**. These are assets which are not in themselves consumed, but are used solely to grow produce over several periods. This would apply to grape vines, tea bushes and fruit trees from the list above.

17 Vident

(a) **Why share-based payments should be recognised in the financial statements**

Directors argument: Share options have no cost to the company.

When shares are **issued for cash** or in a business acquisition, **an accounting entry is needed to recognise the receipt of cash** (or other resources) as consideration for the issue. Share options (the right to receive shares in future) **are also issued in consideration for resources**: services rendered by directors or employees. These resources are **consumed by the company** and it would be **inconsistent not to recognise an expense**.

Directors argument: Share issues do not meet the definition of an expense in the IASB Conceptual Framework.

The *Conceptual Framework* defines an expense as a **decrease in economic benefits** in the form of **outflows of assets or incurrences of liabilities**. It is not immediately obvious that employee services meet the definition of an asset and therefore **it can be argued that consumption of those services does not meet the definition of an expense**. However, share options are **issued for consideration in the form of employee services** so that **arguably there is an asset**, although it is **consumed at the same time that it is received**. Therefore the recognition of an expense relating to share based payment is **consistent with the Conceptual Framework**.

Directors argument: The expense relating to share options is already recognised in the diluted earnings per share calculation.

It can be argued that to recognise an expense in profit or loss **would have the effect of distorting diluted earnings per share** as diluted earnings per share would then **take the expense into account twice**. This is not a valid argument. There are **two events** involved: **issuing the options**; and **consuming the resources** (the directors' services) received as consideration. The diluted earnings per share calculation **only reflects the issue of the options**; there is **no adjustment to basic earnings**. Recognising an expense reflects the consumption of services. There is **no 'double counting'**.

Directors argument: Accounting for share based payment may discourage the company from introducing new share option plans.

This is quite **possibly true**. Accounting for share based payment **reduces earnings**. However, it **improves the information provided** in the financial statements, as these now make users aware of the **true economic consequences** of issuing share options as remuneration. The economic consequences are the reason why share option schemes may be discontinued. IFRS 2 simply **enables management and shareholders to reach an informed decision** on the best method of remuneration.

(b) **Accounting for share options in the financial statements for the year ended 31 May 20X5**

The basic principle of accounting for share options is that **an expense is recognised for the services rendered** by the directors and a **corresponding amount is credited to equity**. The transaction is **measured at the fair value of the options granted at the grant date** and fair value is taken to be the **market price**. Where (as is usual) options vest only after staff have completed a specified period of service, the expense is **allocated to accounting periods over this period of service**.

Options granted to J. Van Heflin on 1 June 20X3

The **performance conditions have been met** and the director is **still working for the company** at 31 May 20X5. As the **number of shares** that will vest is **fixed**, the expense is **allocated on a straight line basis to the two years ended 31 May 20X5**.

Options granted to R. Ashworth on 1 June 20X4

The **performance conditions** (the increase in the share price to \$13.50) **have not yet been met**. However, such 'market conditions' need not be considered as they are already factored into the fair value of the share options. In terms of the period of service condition, the director is **still working for the company and must work for the company for three years** before the options vest, so the **expense is recognised**. Again, the **number of shares is fixed**, so the expense is **allocated on a straight line basis over the three years to 31 May 20X7**. The expense to be recognised is calculated as follows:

	At 1 June 20X4	Year ended 31 May 20X5
	\$	\$
J. Van Heflin ($20,000 \times \$5 \times \frac{1}{2}$)	50,000	50,000
R. Ashworth ($50,000 \times \$6 \times \frac{1}{3}$)		100,000
	<u>50,000</u>	<u>150,000</u>

At 1 June 20X4 the **opening balance of retained earnings is reduced by \$50,000** and a separate component of equity is **increased by \$50,000**.

An **expense of \$150,000 is recognised** in profit or loss for the year ended 31 May 20X5. **Equity** (the same separate component as before) is **credited with \$150,000**.

(c) **Deferred tax implications of the recognition of an expense for directors' share options**

The company will **recognise an expense** for the consumption of employee services given in consideration for share options granted, **but will not receive a tax deduction until the share options are actually exercised**. Therefore a **temporary difference arises** and IAS 12 *Income Taxes* requires the recognition of deferred tax.

A **deferred tax asset** (a deductible temporary difference) results from the **difference** between the **tax base of the services received** (a tax deduction in future periods) and the **carrying value of zero**. IAS 12 requires the **measurement** of the deductible temporary difference to be based on the **intrinsic value of the options at the year end**. This is the **difference between the fair value of the share and the exercise price of the option**.

If the amount of the **estimated future tax deduction exceeds the amount of the related cumulative remuneration expense**, the tax deduction relates not only to the remuneration expense, but to equity. If this is the case, the **excess should be recognised directly in equity**.

At 1 June 20X4

Deferred tax asset:

	\$
Fair value ($20,000 \times \$12.50 \times \frac{1}{2}$)	125,000
Exercise price of option ($20,000 \times \$4.50 \times \frac{1}{2}$)	(45,000)
Intrinsic value (estimated tax deduction)	<u>80,000</u>
Tax at 30%	<u>24,000</u>

The cumulative remuneration expense is \$50,000, which is less than the estimated tax deduction. Therefore:

- A deferred tax asset of \$24,000 is recognised in the opening statement of financial position.
- Opening retained earnings are increased by \$15,000 ($50,000 \times 30\%$).
- The excess of \$9,000 ($30,000 \times 30\%$) goes to equity.

The comparative is re-stated for the options granted on 1 June 20X3.

Year to 31 May 20X5

Deferred tax asset:

	\$
Fair value:	
(20,000 × \$12)	240,000
(50,000 × \$12 × 1/3)	200,000
	<u>440,000</u>
Exercise price of options	
(20,000 × \$4.50)	(90,000)
(50,000 × \$6 × 1/3)	(100,000)
Intrinsic value (estimated tax deduction)	<u>250,000</u>
Tax at 30%	75,000
Less previously recognised	<u>(24,000)</u>
	<u>51,000</u>

The cumulative remuneration expense is \$200,000, which is less than the estimated tax deduction. Therefore:

- A deferred tax asset of \$75,000 is recognised in the statement of financial position at 31 May 20X5.
- There is potential deferred tax income of \$51,000 for the year ended 31 May 20X5.
- Of this, \$6,000 (50,000 × 30% – 9,000) goes directly to equity.
- The remainder (\$45,000) is recognised in profit or loss for the year.

18 Polymer

Tutor's hint. Redeemable preference shares are presented under IAS 32 *Financial Instruments: Presentation* as a loan payable and dividends on them are presented as interest payable.

(a) POLYMER CO: STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 MAY 20X8

	\$
Revenue	1,526,750
Cost of sales (W3)	<u>(1,048,000)</u>
Gross profit	478,750
Distribution costs (W4)	(124,300)
Administrative expenses (W5)	(216,200)
Finance costs (W6)	<u>(18,400)</u>
Profit before tax	119,850
Income tax expense	<u>(40,000)</u>
PROFIT FOR THE YEAR	<u>79,850</u>

POLYMER CO: STATEMENT OF FINANCIAL POSITION AS AT 31 MAY 20X8

	\$
ASSETS	
Non-current assets	
Property, plant and equipment (W7)	452,250
Intangible assets	<u>215,500</u>
	<u>667,750</u>
Current assets	
Inventories (W8)	425,750
Receivables (W9)	171,880
Cash and cash equivalents	<u>5,120</u>
	<u>602,750</u>
Total assets	<u>1,270,500</u>

	\$
EQUITY AND LIABILITIES	
Equity	
Share capital	300,000
Share premium reserve	100,000
Retained earnings (283,500 + 79,850)	363,350
General reserve	50,000
Revaluation surplus	50,000
	<u>863,350</u>
Non-current liabilities	
10% loan notes	100,000
8.4% cumulative redeemable preference shares	100,000
	<u>200,000</u>
Current liabilities	
Trade and other payables (W10)	115,900
Short-term borrowings	51,250
Current tax payable	40,000
	<u>207,150</u>
Total equity and liabilities	<u>1,270,500</u>

Workings

1	Depreciation	
	Cost of sales: $8\% \times 150,000$	12,000
	Administration: $10\% \times 50,000$	5,000
	$1/4 \times 20\% \times 50,000$	<u>2,500</u>
		7,500
	Distribution: $3/4 \times 20\% \times 50,000$	7,500
2	Depreciation (amortisation) of lease	
	$\$75,000 \times 1/50$	1,500
3	Cost of sales	
		\$
	Opening inventories (108,400 + 32,750 + 184,500)	325,650
	Purchases	750,600
	Carriage inwards	10,500
	Manufacturing wages	250,000
	Manufacturing overheads	125,000
	Depreciation of plant (W1)	12,000
	Closing inventories (W9)	<u>(425,750)</u>
		1,048,000
4	Distribution costs	
		\$
	Per question	116,800
	Depreciation (W1)	<u>7,500</u>
		124,300

5	<i>Administrative expenses</i>						
	Per question						158,100
	Legal expenses			54,100			
	less: solicitors' fees capitalised			<u>(5,000)</u>			
							49,100
	Depreciation (W1)						7,500
	Amortisation of lease (W2)						<u>1,500</u>
							<u>216,200</u>
6	<i>Finance costs</i>						\$
	Interest expense on loan notes (\$100,000 × 10%)						10,000
	Dividend on redeemable preference shares (\$100,000 × 8.4%)						<u>8,400</u>
							<u>18,400</u>
7	<i>Property, plant and equipment</i>						
		<i>Freehold land</i>	<i>Leasehold property</i>	<i>Plant & equipment</i>	<i>Furniture & fixtures</i>	<i>Motor vehicles</i>	<i>Total</i>
		\$	\$	\$	\$	\$	\$
	<i>Carrying amount per TB</i>						
	Cost or valuation	250,000	75,000	150,000	50,000	75,000	
	Accumulated dep'n	<u>—</u>	<u>(15,000)</u>	<u>(68,500)</u>	<u>(15,750)</u>	<u>(25,000)</u>	
	Carrying amount	250,000	60,000	81,500	34,250	50,000	
	Solicitor's fees	5,000					
	Depreciation charge	<u>—</u>	<u>(1,500)</u>	<u>(12,000)</u>	<u>(5,000)</u>	<u>(10,000)</u>	
	Carrying amount	<u>255,000</u>	<u>58,500</u>	<u>69,500</u>	<u>29,250</u>	<u>40,000</u>	<u>452,250</u>
	31 May 20X8						
8	<i>Inventories</i>						\$
	Raw materials						112,600
	Work in progress						37,800
	Finished goods						<u>275,350</u>
							<u>425,750</u>
9	<i>Receivables</i>						\$
	Trade receivables (177,630 – 5,750 allowance for receivables)						<u>171,880</u>
10	<i>Trade and other payables</i>						\$
	Trade payables						97,500
	Loan interest payable						10,000
	Preference dividend payable						<u>8,400</u>
							<u>115,900</u>

(b) The stated **purposes** of the *Conceptual Framework* are as follows.

- (i) To assist the Board in the development of future IFRSs and in its review of existing IFRSs.
- (ii) To assist the Board in promoting harmonisation of regulations, accounting standards and procedures by reducing the number of alternative accounting treatment permitted by IFRSs.
- (iii) To assist national standard-setting bodies in developing national standards.
- (iv) To assist preparers of financial statements in applying IFRSs and in dealing with topics that have yet to form the subject of an IFRS.
- (v) To assist auditors in forming an opinion on whether financial statements comply with IFRSs.

- (vi) To assist users of financial statements in interpreting the information contained in financial statements prepared in compliance with IFRSs.
- (vii) To provide those who are interested in the work of the IASB with information about its approach to the formulation of IFRSs.

One of the ideas behind the *Conceptual Framework* is to **avoid the fire-fighting approach**, which has characterised the development of accounting standards in the past, and instead develop an underlying philosophy as a basis for consistent accounting principles so that each standard fits into the whole framework. Research began from an analysis of the fundamental objectives of accounting and their relationship to the information needs of accounts users. The *Conceptual Framework* has gone behind the requirements of existing accounting standards, which define accounting treatments for particular assets, liabilities, income and expenditure, to define the nature of assets, liabilities, income and expenditure.

- (c) The **going concern assumption** is that an entity will continue in operational existence for the foreseeable future. This means that the financial statements of an entity are prepared on the assumption that the entity will **continue** trading. If this were not the case, various adjustments would have to be made to the accounts: provisions for losses; revaluation of assets to their possible market value; all non-current assets and liabilities would be reclassified as current; and so forth.

Unless it can be assumed that the business is a going concern, other accounting assumptions cannot apply.

For example, it is meaningless to speak of consistency from one accounting period to the next when this is the final accounting period.

The **accruals basis** of accounting states that items are recognised as assets, liabilities, equity, income and expenses when they satisfy the definitions and recognition criteria in the *Conceptual Framework*. The effect of this is that revenue and expenses which are related to each other are matched, so as to be dealt with in the same accounting period, without regard to when the cash is actually paid or received. This is particularly relevant to the purchase of non-current assets. The cost of a non-current asset is spread over the accounting periods expected to benefit from it, thus matching costs and revenues. In the absence of the going concern convention, this cannot happen, as an example will illustrate.

Suppose a company has a machine which cost \$10,000 two years ago and now has a carrying amount of \$6,000. The machine can be used for another three years, but as it is highly specialised, there is no possibility of selling it, and so it has no market value.

If the going concern assumption applies, the machine will be shown at **cost less depreciation** in the accounts (ie \$6,000), as it still has a part to play in the continued life of the entity. However, if the assumption cannot be applied, the machine will be given a nil value and other assets and liabilities will be similarly revalued on the basis of winding down the company's operations.



19 Hewlett

Accounting entries

31.12.X3		\$	\$
DEBIT	Profit or loss (Staff costs)	352,500	
CREDIT	Equity reserve $((800 - 95) \times 200 \times \$7.50 \times 1/3)$		352,500
31.12.X5			
DEBIT	Profit or loss (Staff costs) (W1)	377,500	
CREDIT	Equity reserve		377,500
31.12.X3			
DEBIT	Profit or loss (Staff costs) (W2)	380,000	
CREDIT	Equity reserve		380,000
<i>Issue of shares:</i>			
DEBIT	Cash $(740 \times 200 \times \$1.50)$	222,000	
DEBIT	Equity reserve	1,110,000	
CREDIT	Share capital $(740 \times 200 \times \$1)$		148,000
CREDIT	Share premium (balancing figure)		962,000

Workings

1	Equity reserve at 31.12.X4	
		\$
	Equity b/d	352,500
	\therefore P/L charge	377,500
	Equity c/d $((800 - 70) \times 200 \times \$7.50 \times 2/3)$	<u>730,000</u>
2	Equity reserve at 31.12.X5	
		\$
	Equity b/d	730,000
	\therefore P/L charge	380,000
	Equity c/d $((800 - 40 - 20) \times 200 \times \$7.50 \times 3/3)$	<u>1,110,000</u>

20 Pilum

(a) Earnings per share

	\$
Profit before tax	2,530,000
Less income tax expense	<u>(1,127,000)</u>
Profit for the year	1,403,000
Less preference dividends	<u>(276,000)</u>
Earnings	1,127,000
Earnings per share =	<u>1,127,000</u>
	4,120,000
=	<u>27.4c</u>

(b) The first step is to calculate the theoretical ex-rights price. Consider the holder of 5 shares.

	No.	\$
Before rights issue	5	8.90
Rights issue	1	<u>1.20</u>
After rights issue	<u>6</u>	<u>10.10</u>



The theoretical ex-rights price is therefore $\$10.10/6 = \1.68 .

The number of shares in issue before the rights issue must be multiplied by the fraction:

$$\frac{\text{Fair value immediately before exercise of rights}}{\text{theoretical ex - rights price}} = \frac{\$1.78}{\$1.68}$$

Weighted average number of shares in issue during the year:

Date	Narrative	Shares	Time period	Bonus fraction	Total
1.1.X4	b/d	4,120,000	$\times 9/12$	1.78/1.68	3,273,929
1.10.X4	Rights issue	824,000			
		<u>4,944,000</u>	$\times 3/12$		<u>1,236,000</u>
					<u>4,509,929</u>

$$\begin{aligned} \text{EPS} &= \frac{\$1,127,000}{4,509,929} \\ &= 25.0\text{c} \end{aligned}$$

- (c) The maximum number of shares into which the loan stock could be converted is $90\% \times 1,500,000 = 1,350,000$. The calculation of diluted EPS should be based on the assumption that such a conversion actually took place on 1 January 20X4. Shares in issue during the year would then have numbered $(4,120,000 + 1,350,000) = 5,470,000$ and revised earnings would be:

	\$	\$
Earnings from (a) above		1,127,000
Interest saved by conversion $(1,500,000 \times 10\%)$	150,000	
Less attributable tax $(150,000 \times 30\%)$	<u>(45,000)</u>	
		105,000
		<u>1,232,000</u>
\therefore Diluted EPS =		<u>1,232,000</u>
		5,470,000
		<u>22.5c</u>

21 Ace

Year ended 31 March 20X2

Relationship

Ace Co has a 75% subsidiary (Deuce Co) and an 80% subsidiary (Trey Co).

Ace is a related party of Deuce and Trey and vice versa.

Deuce and Trey are also related parties because they are subject to 'common control'. Any transactions between Ace, Deuce and Trey need not be disclosed in Ace's **consolidated** accounts as they are eliminated.

Disclosures

Ace Co

- Intragroup sale of machine for \$25,000 at profit of \$5,000. No balances outstanding.
- Management services provided to Deuce (nil charge) and Trey (nil charge)

No disclosure is required in the group accounts of Ace of these items as they are eliminated.

Deuce

- Parent (and ultimate controlling party) is Ace Co
- Machine purchased from parent \$25,000 (original cost \$20,000) and depreciation charge \$5,000. No amounts outstanding at year end.
- Purchase of management services from Ace (nil charge)

Trey

- Parent (and ultimate controlling party) is Ace Co
- Purchase of management services from Ace (nil charge)

For all transactions the nature of the related party relationship (ie parent, subsidiary, fellow subsidiary) should be disclosed.

Year ended 31 March 20X3

Relationship

Ace Co has a 100% subsidiary (Deuce Co) and an 80% subsidiary (Trey Co).

Ace is a related party of Deuce and Trey and vice versa. Deuce and Trey are related because they remain under common control. Any transactions between Ace, Deuce and Trey need not be disclosed in Ace's **consolidated** accounts as they are eliminated.

Disclosures

Ace Co

- Management services provided to Deuce (nil charge) and Trey (\$10,000 outstanding)

No disclosure is required in the group accounts of Ace of these items as they are eliminated.

Deuce

- Parent (and ultimate controlling party) is Ace Co

Disclosure of intragroup transactions is still required even though Deuce is a wholly-owned subsidiary:

- Sale of inventories to Trey for \$15,000 (original cost \$12,000) all sold on, no amounts outstanding at year end
- Purchase of management services from Ace (nil charge)

Trey

- Parent (and ultimate controlling party) is Ace Co
- Purchase of inventories from Deuce \$15,000 (original cost \$12,000) all sold, no amounts outstanding at year end
- Purchase of management services from Ace costing \$10,000. All outstanding at year end

For all transactions the nature of the related party relationship (ie parent, subsidiary, fellow subsidiary) should be disclosed.

22 Small and medium-sized entities

(a) Advantages

Although International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB) were originally designed to be suitable for all types of entity, in recent years IFRSs have come increasingly complex. They are now designed primarily to meet the information needs of **institutional investors in large listed entities**.

Shareholders of SMEs are often also directors. Therefore, through managing the company and maintaining the financial records, they are already aware of the company's financial performance and position and so do not need the level of detail in financial statements required by external institutional investors of larger companies.

The main external users of **SMEs tend to be lenders, trade suppliers and the tax authorities**. They have **different needs** from institutional investors and are more likely to focus on shorter-term cash flows, liquidity and solvency.

Full IFRSs cover a wide range of issues, contain a sizeable amount of implementation guidance and include disclosure requirements appropriate for public companies. This can make them **too complex for users of SMEs to understand**.

Many SMEs feel that following full IFRSs places an unacceptable burden on preparers of SME accounts – a burden that has been growing as IFRSs become more detailed and more countries adopt them. The **cost of following full IFRSs often appears to outweigh the benefits**.

The **disclosure** requirements of full IFRSs are very **extensive** and as such, can result in **information overload** for the users of SME accounts, reducing the understandability of financial statements.

Some IFRSs still offer **choice of accounting treatments**, leading to **lack of comparability** between different companies adopting different accounting standards.

Disadvantages

If SMEs follow their own simplified IFRSs, their accounts are **no longer be comparable** with larger companies following full IFRSs or with SMEs choosing to follow full IFRSs. This may make it harder to attract investors.

The changeover from full IFRSs to the simplified *IFRS for SMEs*, will require training and possible changes in systems. This will place both a **time and cost** burden on the company.

Full IFRSs are now well established and respected and act as a form of **quality control** on financial statements which comply with them. It could be argued therefore that financial statements which no longer comply with full IFRSs will **lose their credibility**. This is often called the 'Big GAAP, Little GAAP divide'.

The *IFRS for SMEs* **reduce disclosures** required by full IFRSs substantially. Omission of certain key information might actually make the financial statements **harder to understand**.

Conclusion

The IASB believes that the advantages for SMEs of having a separate simplified set of IFRSs outweigh the disadvantages. They believe that both preparers and users of SME accounts will benefit.

(b) Examples of full IFRSs with choice

- (i) Under IAS 40 *Investment Property*, either the cost model or fair value model (through profit or loss) are permitted. The *IFRS for SMEs* requires the fair value model (through profit or loss) to be used as long as fair value can be measured without undue cost or effort. This promotes consistency in the treatment of investment properties between SMEs financial statements.
- (ii) IAS 38 *Intangible Assets* allows either the cost model or revaluation model (where there is an active market). The *IFRS for SMEs* does not permit the revaluation model to be used. This eliminates the use of other comprehensive income, simplifying financial reporting and the need for costly revaluations.
- (iii) IFRS 3 *Business Combinations* allows an entity to adopt the full or partial goodwill method in its consolidated financial statements. The *IFRS for SMEs* only allows the partial goodwill method, ie excluding non-controlling interests in goodwill. This avoids the need for SMEs to determine the fair value of the non-controlling interests not purchased when undertaking a business combination.

The *IFRS for SMEs* does not eliminate choice completely but disallows the third of the above options. It is one of the rare uses of other comprehensive income under the *IFRS for SMEs*.

Examples of IFRSs with complex recognition and measurement requirements

- (iv) IAS 38 *Intangible Assets* requires internally generated assets to be capitalised if certain criteria (proving future economic benefits) are met. In reality, it is an onerous exercise to test these criteria for each type of internally generated asset and leads to inconsistency with some items being expensed and some capitalised.

The *IFRS for SMEs* removes these capitalisation criteria and requires all internally generated research and development expenditure to be expensed through profit or loss.

- (v) IFRS 3 *Business Combinations* requires goodwill to be tested annually for impairment. In reality, it is very difficult to ascertain the recoverable amount for goodwill so instead the assets of the business need to be combined into cash-generating units or even a group of cash-generating units in order to determine any impairment loss. The impairment then needs to be allocated to goodwill and the other individual assets. This is a complex exercise.

The *IFRS for SMEs* requires goodwill to be amortised instead. This is a much simpler approach and the *IFRS for SMEs* specifies that if an entity is unable to make a reliable estimate of the useful life, it is presumed to be ten years, simplifying things even further.

- (vi) IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* requires grants to be recognised only when it is reasonably certain that the entity will comply with the conditions attached to the grant and the grants will be received. Grants relating to income are recognised in profit or loss over the period the related costs are recognised in profit or loss. Grants relating to assets are either netted off the cost of the asset (reducing depreciation by the amount of the grant over the asset's useful life) or presented as deferred income (and released to profit or loss as income over the useful life of the asset).

The *IFRS for SMEs* simplifies this and specifies that where there are no specified future performance conditions, the grant should be recognised as income when it is receivable. Otherwise, it should be recognised as income when the performance conditions are met. This is more consistent with the IASB *Conceptual Framework's* definition of income than the IAS 20 approach.

- (vii) IAS 23 *Borrowing Costs* requires borrowing costs to be capitalised for qualifying assets for the period of construction. This involves a complex calculation particularly where funds are borrowed generally as a weighted average rate on loans outstanding has to be calculated in order to determine the amount of interest to be capitalised.

The *IFRS for SMEs* requires borrowing costs to be expensed, removing the need for such a complex calculation.

- (viii) IAS 36 *Impairment of Assets* requires annual impairment tests for indefinite life intangibles, intangibles not yet available for use and goodwill. This is a complex, time-consuming and expensive test.

The *IFRS for SMEs* only requires impairment tests where there are indicators of impairment.

The full IFRS requires impairment losses to be charged firstly to other comprehensive income for revalued assets then to profit or loss. The *IFRS for SMEs* requires all impairment losses to be recognised in profit or loss, given that tangible and intangible assets cannot be revalued under the *IFRS for SMEs*.

23 Barcelona and Madrid

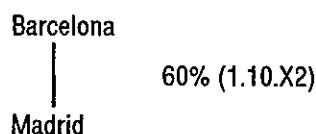
BARCELONA GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 20X6

	\$m
<i>Non-current assets</i>	
Property, plant & equipment (2,848 + 354 + (W6) 18)	3,220
Patents	45
Goodwill (W2)	26
	<u>3,291</u>
<i>Current assets</i>	
Inventories (895 + 225)	1,120
Trade and other receivables (1,348 + 251)	1,599
Cash and cash equivalents (212 + 34)	246
	<u>2,965</u>
	<u>6,256</u>
<i>Equity attributable to owners of the parent</i>	
Share capital	920
Retained earnings (W3)	2,238
General reserve (W4)	796
	<u>3,954</u>
<i>Non-controlling interests (W5)</i>	202
	<u>4,156</u>
<i>Non-current liabilities</i>	
Long-term borrowings (558 + 168)	726
<i>Current liabilities</i>	
Trade and other payables (1,168 + 183)	1,351
Current portion of long-term borrowings	23
	<u>1,374</u>
	<u>6,256</u>

Workings

1 Group structure



2 Goodwill

	\$m	\$m
Consideration transferred (250m × 60% × \$1.06)		159
Non-controlling interests at fair value		86
Net assets at acquisition as represented by:		
Share capital	50	
Retained earnings	104	
General reserve	11	
Fair value adjustments (W6)	34	
		<u>(199)</u>
Goodwill at acquisition		46
Impairment losses to date		<u>(20)</u>
Goodwill at year end		<u>26</u>

* 20/10 years \times 4

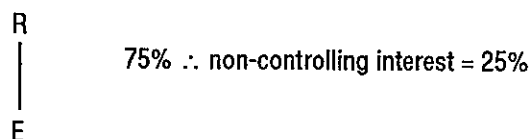
REPRISE GROUP CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20X4

\$'000

<i>Equity attributable to owners of the parent</i>	\$'000
Share capital	1,000
Revaluation surplus	2,500
Retained earnings (W3)	5,257.3
	<u>8,757.3</u>
<i>Non-controlling interest (W4)</i>	896.5
	<u>9,653.8</u>
<i>Non-current liabilities</i>	
10% debentures	500
<i>Current liabilities</i>	
Trade payables (996 + 362 – (W6) 36)	1,322
	<u>11,475.8</u>

Workings

1 Group structure



2 Goodwill

	\$'000	\$'000
Consideration transferred		2,000
Non-controlling interest (at 'full' FV) (125,000 × \$4.40)		550
		<u>2,550</u>
Net assets acquired as represented by:		
Share capital	500	
Retained earnings	<u>1,044</u>	
		<u>(1,544)</u>
Goodwill at acquisition		1,006
Impairment losses to date		<u>(180)</u>
Goodwill at end of reporting period		<u>826</u>

3 Consolidated retained earnings

	<i>Reprise</i>	<i>Encore</i>
	\$'000	\$'000
Per question	4,225	2,610
PUP (W5)	(7.2)	
Pre-acquisition retained earnings		<u>(1,044)</u>
	<u>4,217.8</u>	<u>1,566</u>
Encore – share of post acquisition retained earnings (1,566 × 75%)	1,174.5	
Less goodwill impairment losses to date (180 × 75%)	<u>(135)</u>	
	<u>5,257.3</u>	

4 Non-controlling interests

	\$'000
NCI at acquisition (W2)	550
NCI share of post acquisition retained earnings ((W3) 1,566 × 25%)	391.5
NCI share of impairment losses (180 × 25%)	<u>(45)</u>
	<u>896.5</u>

Note. Goodwill impairment charged to the NCI is in proportion to the NCI shareholding.

5 *Unrealised profit on inventories*

Unrealised profit included in inventories is:

$$\$31,200 \times \frac{30}{130} = \$7,200$$

6 *Trade receivables/trade payables*

Intragroup balance of \$75,000 is reduced to \$36,000 once cash-in-transit of \$39,000 is followed through to its ultimate destination.

25 Alpha Group

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AT 31 MARCH 20X7

\$'000

Assets

Non-current assets:

Property, plant and equipment (125,000 + 85,000 + 10,000 + 6,000) (W2)	226,000
Goodwill (W3)	28,250
Other intangible assets (W2)	16,000
Investment in associate (W4)	35,920
	<u>306,170</u>

Current assets:

Inventories (33,000 + 30,000 – 4,000) (W5)	59,000
Trade receivables (43,000 + 30,000 – 5,000)	68,000
Cash and cash equivalents	21,000
	<u>148,000</u>
	<u>454,170</u>

Total assets

Equity and liabilities

Equity attributable to owners of the parent

Share capital (70,000 + 20,000)	90,000
Share premium ((20,000 × \$5) – 800)	99,200
Retained earnings (W6)	57,540
	<u>246,740</u>
Non-controlling interest (W5)	24,450
Total equity	<u>271,190</u>

Non-current liabilities:

Long-term borrowings	75,000
Deferred tax (35,000 + 12,000 + 8,000 + 1,300 – 1,320)	54,980
	<u>129,980</u>

Current liabilities:

Trade and other payables (25,000 + 17,000 – 5,000)	37,000
Current tax payable	16,000
	<u>53,000</u>

Total liabilities

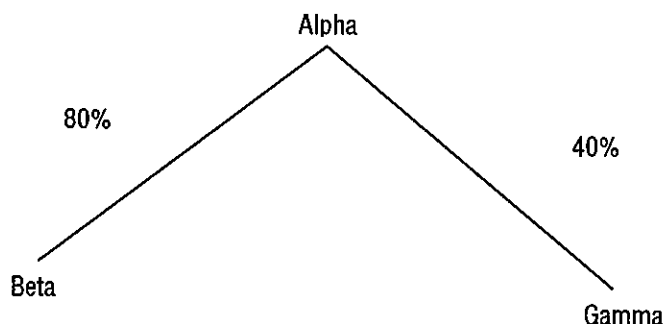
Total equity and liabilities

<u>182,980</u>
<u>454,170</u>



Workings

1 Group structure



2 Fair value adjustments: Beta

	Acquisition date	Movement	Reporting date
	\$'000	\$'000	\$'000
Land	10,000		10,000
Plant and equipment	8,000	(2,000)	6,000
Contingencies	3,000	(3,000)	—
Customer relationships	20,000	(4,000)	16,000
	<u>41,000</u>	<u>(9,000)</u>	<u>32,000</u>
Deferred tax on temporary differences (25%)	(10,250)	2,250	(8,000)
	<u>30,750</u>	<u>(6,750)</u>	<u>24,000</u>

3 Goodwill

	\$'000	\$'000
Consideration transferred		
Fair value of shares issued (20,000 × \$6)		120,000
Fair value of non-controlling interest (10,000 × \$2.40)		<u>24,000</u>
		144,000
Less net fair value of assets and liabilities acquired		
Share capital	50,000	
Retained earnings	35,000	
Fair value adjustments	<u>30,750</u>	
		<u>(115,750)</u>
		<u>28,250</u>
Non-controlling interest at fair value (above)		24,000
Non-controlling interest share of net assets at acquisition (115,750 × 20%)		<u>(23,150)</u>
Goodwill attributable to non-controlling interest		<u>850</u>

4 Investment in associate

	\$'000
Cost of associate (20,000 × \$1.60)	32,000
Share of post acquisition retained reserves ((78,000 – 65,000) × 40%)	5,200
Less provision for unrealised profit (25/125 × 16,000 × 40%)	<u>(1,280)</u>
	<u>35,920</u>

5	<i>Non-controlling interest</i>			
				\$'000
	Net assets at end of the reporting period			94,000
	Fair value adjustments			24,000
				<u>118,000</u>
	NCI % (20%)			23,600
	Add goodwill attributable to NCI			850
				<u>24,450</u>
6	<i>Retained earnings</i>			
		<i>Alpha</i>	<i>Beta</i>	<i>Gamma</i>
		\$'000	\$'000	\$'000
	Per question	55,000	44,000	28,000
	Acquisition costs	800		
	Provision for unrealised profit			
	Beta ($25/125 \times 20,000$)	(4,000)		
	Gamma ($25/125 \times 16,000 \times 40\%$)	(1,280)		
	Deferred tax ($5,280 \times 25\%$)	1,320		
	Fair value adjustments		(6,750)	
	Pre-acquisition retained earnings		(35,000)	(15,000)
		<u>51,840</u>	<u>2,250</u>	<u>13,000</u>
	Beta: share of post-acquisition retained earnings ($2,250 \times 80\%$)	1,800		
	Gamma: share of post-acquisition retained earnings ($13,000 \times 40\%$)	5,200		
	Deferred tax ($5,200 \times 25\%$)	(1,300)		
		<u>57,540</u>		

Note. Deferred tax is recognised on the group's interest in the retained earnings of Gamma because Alpha has no control over their distribution.

26 Fallowfield and Rusholme

FALLOWFIELD GROUP CONSOLIDATED STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 30 JUNE 20X8

	\$
Revenue ($403,400 + 193,000 - 40,000$)	556,400
Cost of sales ($201,400 + 92,600 - 40,000 + 4,000$)	(258,000)
Gross profit	298,400
Distribution costs ($16,000 + 14,600$)	(30,600)
Administrative expenses ($24,250 + 17,800$)	(42,050)
Profit before tax	225,750
Income tax expense ($61,750 + 22,000$)	(83,750)
PROFIT FOR THE YEAR	<u>142,000</u>
Profit attributable to:	
Owners of the parent	125,200
Non-controlling interests (W2)	16,800
	<u>142,000</u>

STATEMENT OF CHANGES IN EQUITY (EXTRACT)

	<i>Retained earnings</i>
	\$
Balance at 1 July 20X7 (W3)	190,000
Dividends	(40,000)
Profit for the year	125,200
Balance at 30 June 20X8 (W4)	<u>275,200</u>

Workings

1 Group structure

Fallowfield

60% three years ago

Pre-acquisition ret'd earnings: \$16,000

Rusholme

2 Non-controlling interests

	\$
Rusholme – profit for the year	46,000
Less: PUP ($40,000 \times \frac{1}{2} \times \frac{25}{125}$)	<u>4,000</u>
	42,000
Non-controlling interest share 40%	<u>16,800</u>

3 Retained earnings brought forward

	<i>Fallowfield</i>	<i>Rusholme</i>
	\$	\$
Per question	163,000	61,000
Pre-acquisition retained earnings		<u>(16,000)</u>
		45,000
Group share of post acquisition retained earnings:		
Rusholme ($45,000 \times 60\%$)	<u>27,000</u>	
	<u>190,000</u>	

4 Retained earnings carried forward

	<i>Fallowfield</i>	<i>Rusholme</i>
	\$	\$
Per question	238,000	82,000
PUP	–	<u>(4,000)</u>
Pre-acquisition retained earnings		<u>(16,000)</u>
		62,000
Group share of post acquisition retained earnings:		
Rusholme ($62,000 \times 60\%$)	<u>37,200</u>	
	<u>275,200</u>	

27 Panther Group

PANTHER GROUP

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X4

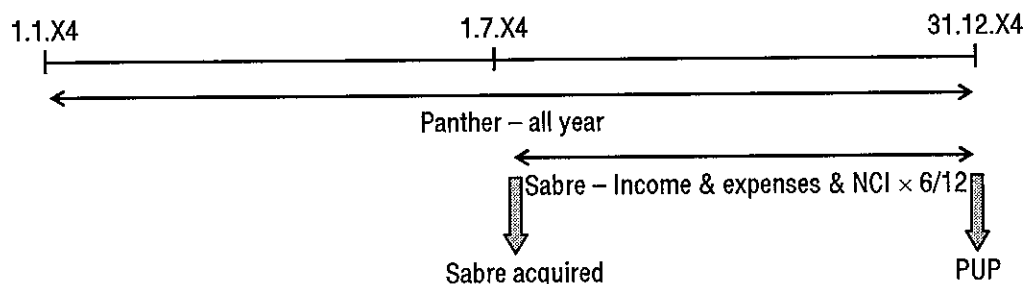
	\$'000
<i>Revenue</i> $[22,800 + (4,300 \times 6/12) - (640 \times 6/12)]$	24,630
<i>Cost of sales</i> $[13,600 + (2,600 \times 6/12) - (640 \times 6/12) + (W3) 10 + (W5) 5]$	<u>(14,595)</u>
Gross profit	10,035
<i>Distribution costs</i> $(2,900 + (500 \times 6/12))$	(3,150)
<i>Administrative expenses</i> $(1,800 + (300 \times 6/12))$	(1,950)
<i>Finance costs</i> $[200 + (70 \times 6/12) - (W4) 20 \text{ cancellation}]$	(215)
<i>Finance income</i> $(50 - (W4) 20 \text{ cancellation})$	30
<i>Profit before tax</i>	4,750
<i>Income tax expense</i> $[1,300 + (220 \times 6/12)]$	<u>(1,410)</u>
PROFIT FOR THE YEAR	3,340
<i>Other comprehensive income for the year, net of tax</i> $[1,600 + (180 \times 6/12)]$	<u>1,690</u>
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	<u>5,030</u>
Profit attributable to:	
Owners of the parent $(3,340 - 116)$	3,224
Non-controlling interests (W2)	<u>116</u>
	<u>3,340</u>
Total comprehensive income attributable to:	
Owners of the parent $(5,030 - 152)$	4,878
Non-controlling interests (W2)	<u>152</u>
	<u>5,030</u>

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20X4 (EXTRACT)

	Reserves \$'000
Balance at 1 January 20X4 (Panther only)	12,750
Dividend paid	(900)
Total comprehensive income for the year	<u>4,878</u>
Balance at 31 December 20X4 (W6)	<u>16,728</u>

Workings

1 Timeline



2 *Non-controlling interests*

	<i>PfY</i>	<i>TCI</i>
	\$'000	\$'000
Profit/TCI for the year $(610 \times 6/12)/(790 \times 6/12)$	305	395
Less: PUP (W3)	(10)	(10)
Additional depreciation on fair value adjustment (W5)	(5)	(5)
	<u>290</u>	<u>380</u>
NCI share ($\times 40\%$)	<u>116</u>	<u>152</u>

3 *Unrealised profit on intragroup trading*

$$\text{Sabre to Panther} = \$60,000 \times \frac{20\%}{120\%} = \$10,000$$

Adjust cost of sales and non-controlling interests in books of seller (Sabre).

4 *Interest on intragroup loan*

The loan is an intragroup item for the last six months of the year (ie only since Sabre's acquisition by Panther):

$$\$800,000 \times 5\% \times 6/12 = \$20,000$$

Cancel in books of Panther and Sabre.

5 *Fair value adjustments*

	<i>At acq'n</i>		<i>At year end</i>
	<i>1.7.X4</i>	<i>Movement</i>	<i>31.12.X4</i>
	\$'000	\$'000	\$'000
Property	200	$(200/20 \times 6/12)$	(5) 195

6 *Group reserves carried forward (proof)*

	<i>Panther</i>	<i>Sabre</i>
	\$'000	\$'000
Reserves per question	16,500	3,270
PUP (W3)		(10)
Fair value movement (W5)		(5)
Pre acquisition reserves $[2,480 + ((610 + 180) \times 6/12)]$		<u>(2,875)</u>
		<u>380</u>
Group share of post acquisition reserves:		
Sabre $(380 \times 60\%)$	<u>228</u>	
	<u>16,728</u>	

28 Hever

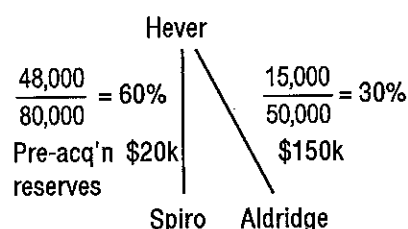
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X4

	\$'000
<i>Non-current assets</i>	
Property, plant & equipment $(370 + 190 + (W7) 45)$	605
Goodwill (W2)	8
Investment in associate (W3)	<u>165</u>
	<u>778</u>
<i>Current assets</i>	
Inventories $(160 + 100 - (W6) 1.5)$	258.5
Trade receivables $(170 + 90)$	260
Cash $(50 + 40)$	<u>90</u>
	<u>608.5</u>
	<u>1,386.5</u>

	\$'000
<i>Equity attributable to owners of the parent</i>	
Share capital	200
Share premium	100
Retained earnings (W4)	758.5
	<u>1,058.5</u>
<i>Non-controlling interests (W5)</i>	168
	<u>1,226.5</u>
<i>Current liabilities</i>	
Trade payables (100 + 60)	160
	<u>1,386.5</u>

Workings

1 Group structure



∴ In the absence of information to the contrary, Spiro is a subsidiary, and Aldridge an associate of Hever.

2 Goodwill on consolidation – Spiro

	\$'000	\$'000
Consideration transferred		128
Non-controlling interests (at 'full' fair value)		90
Net assets at acquisition:		
Share capital	80	
Retained earnings	20	
Share premium	80	
Fair value adjustments (W7)	30	
		<u>(210)</u>
Goodwill arising on consolidation		8

3 Investment in associate

	\$'000
Cost of associate	90
Share of post-acquisition retained reserves (W4)	75
	<u>165</u>

4 Retained earnings

	Hever \$'000	Spiro \$'000	Aldridge \$'000
Per question	568	200	400
PUP (W6)	(1.5)	–	–
Fair value movement (W7)		15	
Pre-acquisition retained earnings		<u>(20)</u>	<u>(150)</u>
		195	250
Group share of post-acquisition ret'd earnings:			
Spiro (195 × 60%)	117		
Aldridge (250 × 30%)	75		
Less: group share of impairment losses to date	(0)		
Less: impairment losses on associate to date	<u>(0)</u>		
	758.5		

5	<i>Non-controlling interests</i>			\$'000
	NCI at acquisition (W2)			90
	NCI share of post acquisition ret'd earnings ((W4) $195 \times 40\%$)			<u>78</u>
				168
6	<i>Unrealised profit on inventories</i>			
	Mark-up: $\$16,000 - \$10,000 = \$6,000 \therefore \frac{1}{4} \times \$6,000 = \$1,500$			
7	<i>Fair values – adjustment to net assets</i>			
		<i>At acquisition</i>	<i>Movement</i>	<i>At year end</i>
	Property, plant and equipment	50	(5)	45
	Inventories	<u>(20)</u>	<u>20</u>	<u>0</u>
		<u>30</u>	<u>15</u>	<u>45</u>

29 Smith Group

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 20X8

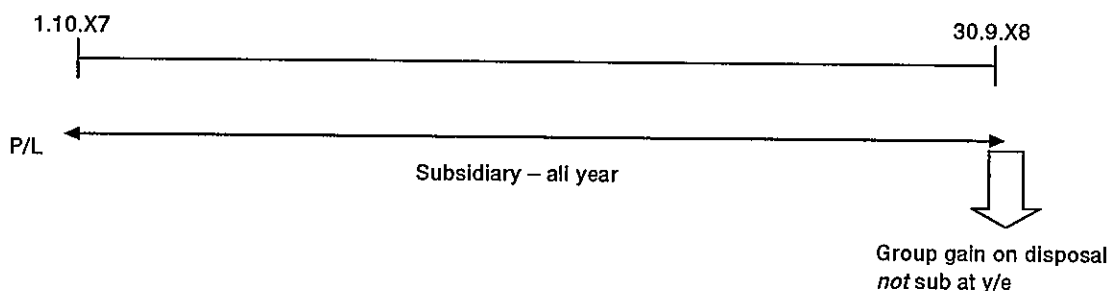
	\$'000
Non-current assets	360
Current assets (370 + 650)	<u>1,020</u>
	1,380
<i>Equity</i>	
\$1 ordinary shares	540
Retained earnings (W3)	740
Current liabilities	<u>100</u>
	1,380

CONSOLIDATED STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 30 SEPTEMBER 20X8

	\$'000
Profit before tax (153 + 126)	279
Profit on disposal (W2)	182
Tax (45 + 36)	<u>(81)</u>
	380
Profit attributable to:	
Owners of the parent	362
Non-controlling interest ($20\% \times 90$)	<u>18</u>
	380

Workings

1 Timeline



2	<i>Profit on disposal of Jones Co</i>	\$'000	\$'000
	Fair value of consideration received		650
	Less share of consolidated carrying value when control lost:		
	Net assets (640 – 100)	540	
	Goodwill (W)	36	
	Non-controlling interest: 20% × 540	<u>(108)</u>	
			<u>(468)</u>
			<u>182</u>
	<i>Working: Goodwill</i>		
			\$'000
	Consideration transferred		324
	NCI (20% × 360)		72
	Less FV of net assets acquired: (180 + 180)		<u>(360)</u>
			<u>36</u>
3	<i>Retained earnings carried forward</i>		
		<i>Smith</i>	<i>Jones</i>
		\$'000	\$'000
	Per question/date of disposal	414	360
	Add group gain on disposal (W2)	182	–
	Reserves at acquisition	–	<u>(180)</u>
			<u>180</u>
	Share of post-acq'n reserves up to the disposal (80% × 180)	<u>144</u>	
		<u>740</u>	



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