CA PAKISTAN

The Institute of Chartered Accountants of Pakistan

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ADVANCED ACCOUNTING AND FINANCIAL REPORTING

STUDY SUPPORT MATERIAL

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ICAP

Advanced accounting and financial reporting

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Emile Woolf International
Bracknell Enterprise & Innovation Hub
Ocean House, 12th Floor, The Ring
Bracknell, Berkshire, RG12 1AX United Kingdom
Email: info@ewiglobal.com
www.emilewoolf.com

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Certified Finance and Accounting Professional
Advanced accounting and financial reporting

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Contents

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Syllabus objective and learning outcomes

CERTIFIED FINANCE AND ACCOUNTING PROFESSIONAL

ADVANCED ACCOUNTING AND FINANCIAL REPORTING

Objective
To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning Outcome	
On the successful completion of this paper candidates will be able to:	
1	prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.
2	evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.
3	exercise professional judgment and act in an ethical manner (that is in the best interest of society and the profession).
4	prepare financial statements of specialized entities (including small and medium sized entities in accordance with the Companies Ordinance, 1984 and the applicable reporting framework, retirement benefit funds in accordance with international pronouncements) and be able to demonstrate an understanding of reporting requirements under the laws specific to insurance, banking companies and mutual funds.

Grid		Weighting
A	Presentation of financial statements including public sector accounting	30-35
B	Financial reporting (including ethics)	50- 60
C	Specialized financial statements	10-15
	Total	**100**

Contents			Chapter
A	**Presentation of financial statements including public sector accounting**		
	1	Presentation of financial statements (IAS 1, IAS 7 and Companies Ordinance 1984)	2, 3, 25
	2	IAS 27: Separate financial statements	23
	3	IFRS 10: Consolidated financial statements	18, 19, 22
	4	IAS 28: Accounting for associates and joint ventures	20
	5	IFRS 11: Joint arrangements	20
	6	IFRS 12: Disclosure of interests in other entities	22
	7	IAS 34: Interim financial reporting	3
	8	IAS 29: Financial Reporting in Hyperinflationary Economies	33
	9	IFRS 5: Non-current assets held for sale and discontinued operations	10, 22
	10	IFRS 8: Operating segments	3
	11	Overview of IPSASs and the conceptual framework for general purpose financial reporting by public sector entities	32
	12	IPSAS 1 Presentation of financial statements	32
	13	IPSAS Financial reporting under the cash basis of accounting (this IPSAS has not been given any number).	32
B	**Financial reporting and ethics**		
	a	**Financial reporting**	
	1	The Conceptual Framework for the preparation and presentation of financial statements	2
	2	IFRS 1: First-time adoption of international financial reporting standards	30
	3	IFRS 2: Share-based payment	15
	4	IFRS 3: Business combinations	18, 19, 21
	5	IFRS 4: Insurance contracts	31
	6	IFRS 6: Exploration for and evaluation of mineral resources	29

CHAPTER 1

Regulatory framework

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with international pronouncements and under the Companies Ordinance, 1984.**

PRESENTATION OF FINANCIAL STATEMENTS INCLUDING PUBLIC SECTOR ACCOUNTING

A 1 Presentation of financial statements (Companies Ordinance 1984)

1 REGULATORY FRAMEWORK FOR ACCOUNTING IN PAKISTAN

Section overview

- Accounting regulation in Pakistan
- Companies' Ordinance 1984: Introduction to accounting requirements
- Companies' Ordinance 1984: Introduction to the fourth and fifth schedules
- Applicability of accounting standards in Pakistan
- Accounting standards: Three tier approach
- International Financial Reporting Standards

1.1 Accounting regulation in Pakistan

The objective of financial statements is to provide information about the financial position (balance sheet), financial performance (profit and loss) and cash flows of an entity that is useful to a wide range of users in making economic decisions.

The Securities and Exchange Commission of Pakistan

The Securities and Exchange Commission of Pakistan (SECP) was established by the Securities and Exchange Commission of Pakistan Act, 1997 and became operational in 1999.

It is the corporate and capital market regulatory authority in Pakistan. Its stated mission is "To develop a fair, efficient and transparent regulatory framework, based on international legal standards and best practices, for the protection of investors and mitigation of systemic risk aimed at fostering growth of a robust corporate sector and broad based capital market in Pakistan" (*SECP website*).

One of the roles of the SECP is to decide on accounting rules that must be applied by companies in Pakistan.

Companies must prepare financial statements in accordance with accounting standards approved as applicable and notified in the official gazette by the Securities and Exchange Commission of Pakistan (SECP) and in accordance with rules in the Companies' Ordinance 1984.

The Institute of Chartered Accountants in Pakistan (ICAP)

ICAP regulates the Chartered Accountancy profession. It is the body responsible for recommending accounting standards for notification by the Securities and Exchange Commission of Pakistan. The process is explained later.

1.2 Companies' Ordinance 1984: Introduction to accounting requirements

The Companies Ordinance 1984 is the primary source of company law in Pakistan. Amongst other things it establishes the requirements for financial reporting by all companies in Pakistan.

General requirements

Every company must prepare annual accounts (financial statements) that provide a true and fair view on the performance and activities of the company during the year.

The financial statements comprise:

- a balance sheet (statement of financial position): a structured representation of the financial position of an entity;

- an income statement (statement of comprehensive income): a structured representation of the financial performance of an entity.
- a statement of changes in equity;
- a cash flow statement;
- notes to the accounts which contain a summary of significant accounting policies and other information that sets out explanations of figures in the main statements and provides supplementary information.

Section 234

Section 234 requires that every balance sheet (statement of financial position) must give a true and fair view of the state of affairs of the company as at the end of its financial year, and every profit and loss account or income and expenditure account of a company must give a true and fair view of the profit and loss of the company for the financial year.

All items of expenditure must be recognised in the profit or loss account unless it may be fairly charged over several years. In such cases the whole amount must be stated with the reasons why only part is charged against the income of the financial year.

Other requirements

Assets and liabilities must be classified under headings appropriate to the company's business.

The period reported on in the accounts is called the financial year.

1.3 Companies' Ordinance 1984: Introduction to the fourth and fifth schedules

The Companies Ordinance 1984 contains a series of appendices called ***schedules*** which set out detailed requirements in certain areas.

The fourth schedule to the Companies Ordinance 1984

This schedule sets out the detailed requirements that must be complied with in respect of the balance sheet and profit and loss account of a listed company. It also applies to private and non-listed public companies that are a subsidiary of a listed company.

The schedule specifies that listed companies must follow International Financial Reporting Standards as notified for this purpose in the Official Gazette.

The fifth schedule to the Companies Ordinance 1984

This schedule applies to the balance sheets and profit and loss accounts of all other companies.

This schedule defines and applies to public interest companies, medium sized companies and small sized companies. These categories determine which accounting standards are followed. The three categories are defined in the next section.

1.4 Applicability of accounting standards in Pakistan

Listed companies are subject to the requirements of the fourth schedule which specifies the use of International Financial Reporting Standards as notified for this purpose in the Official Gazette.

The requirements of the fifth schedule that apply to other companies are more complicated. The fifth schedule identifies different classes of companies and then specifies the standards which must be applied by each class. The classes are as follows:

- Public interest companies which are non-listed companies which are either
  - A public sector company as defined in the Public Sector Companies (Corporate Governance) Rules 2013; or
  - A public utility or similar company carrying on the business of essential public service; or
  - A company that holds assets in a fiduciary capacity for a broad group of outsiders (this class includes banks, insurance companies, pension funds and mutual funds). (Note that accounting rules in addition to those set out in the fourth and fifth schedules might apply to such companies. This is covered in a later chapter).
- Large sized companies which are non-listed companies which have:
  - paid-up capital of Rs. 200 million or more: or
  - turnover of Rs. 1 billion or more.
- Medium sized companies which are non-listed companies which are not:
  - a public interest company; or
  - a large sized company; or
  - small sized company (other than a non-listed public company).
- Small sized companies which are non-listed companies (other than a non-listed public company) which have:
  - paid-up capital not exceeding Rs. 25 million: or
  - turnover not exceeding Rs. 100 million.

Accounting standards apply to these classes as follows.

Class	Criteria
Public interest companies	IFRS as approved and notified by SECP
Large sized companies	IFRS as approved and notified by SECP
Medium sized companies	IFRS for Small and Medium Entities as adopted in Pakistan by council of ICAP (or IFRS as approved and notified by SECP if they elect to do so).
Small sized companies	Revised Accounting and Financial Reporting Standards for Small-Sized Entities (AFRS for SSEs) as approved by the council of ICAP (or IFRS as approved and notified by SECP if they elect to do so).

All other companies including foreign companies which do not fall into any of the above categories must follow Full ***IFRS as approved and notified by SECP***.

The SECP may upon application made to it, grant an exemption to any company or class of company from compliance with all or any of the requirements of the standards.

The SECP encourages medium sized companies and small sized companies to follow ***IFRS as approved and notified by SECP***.

Specific rules apply to companies formed under section 42 of the Companies' Ordinance (associations not for profit) and section 43 of the Companies' Ordinance (companies limited by guarantee). This guidance is not in the syllabus but ***IFRS as approved and notified by SECP*** would apply to many of these companies.

1.5 Accounting standards: Three tier approach

As can be seen from the above, the regulatory framework in Pakistan uses a three tier approach to specify which accounting standards must be followed by an organisation.

Tier 1: Publically accountable entities

This includes:

- Any entity that has filed, or is in the process of filing, its financial statements with the Securities and Exchange Commission of Pakistan.
- Public interest companies;
- Large sized companies.

Any entity in this category must apply ***IFRS*** as approved as applicable and notified in the official gazette by the ***Securities and Exchange Commission of Pakistan***.

For clarity:

- A listed company must follow the fourth schedule and apply ***IFRS (as specified and notified by the SECP)***.
- Unlisted public interest companies and large sized companies must follow the fifth schedule and apply ***IFRS (as specified and notified by the SECP).***

If there is a conflict between ***IFRS*** and any SECP guidance or decision the SECP view must be applied.

Tier 2: Medium Sized Companies

Any company in this category must apply the ***IFRS for SMEs*** as adopted in Pakistan by council of ICAP and follow the requirements of the fifth schedule.

Tier 3: Small Sized Companies

Any company in this category must apply the ***Revised Accounting and Financial Reporting Standards for Small-Sized Entities*** (a single document drafted and issued by ICAP) and follow the requirements of the fifth schedule.

The ***AFRS*** is not examinable.

1.6 International Financial Reporting Standards

The ***International Accounting Standards Committee (IASC)*** was established in 1973 to develop international accounting standards with the aim of harmonising accounting procedures throughout the world.

The first ***International Accounting Standards*** **(IASs)** were issued in 1975. The work of the ***IASC*** was supported by another body called the ***Standing Interpretation Committee***. This body issued interpretations of rules in standards

when there was divergence in practice. These interpretations were called ***Standing Interpretation Committee Pronouncements*** or ***SICs***.

In 2001 the constitution of the ***IASC*** was changed leading to the replacement of the ***IASC*** and the ***SIC*** by new bodies called the ***International Accounting Standards Board (IASB)*** and the ***International Financial Reporting Interpretations Committee (IFRIC)***.

The ***IASB*** adopted all ***IASs*** and ***SICs*** that were extant at the time but said that standards written from that time were to be called ***International Financial Reporting Standards (IFRS)***. Interpretations are known as ***IFRIC***s.

The term ***IFRS*** is also used to refer to the whole body of rules (i.e., ***IAS*** and ***IFRS*** in total).

Thus ***IFRS*** is made up as follows:

	Published by the IASC (up to 2001)	Published by the IASB (from 2001)
Accounting standards	IASs	IFRSs
Interpretations	SICs	IFRICs

Note that many I***ASs*** and ***SICs*** have been replaced or amended by the I***ASB*** since 2001.

International accounting standards cannot be applied in any country without the approval of the national regulators in that country. All jurisdictions have some kind of formal approval process which is followed before ***IFRS*** can be applied in that jurisdiction.

Adoption process for IFRS in Pakistan

The previous sections refer to the approval of ***IFRS*** by the ***SECP*** and notification of that approval in the ***Official Gazette***

Adoption of an ***IFRS*** involves the following steps:

- As a first step the ***IFRS/IAS*** is considered by ***ICAP's Accounting Standards Committee (ASC)***, which identifies any issues that may arise on adoption.
- The ***ASC*** refers the matter to the ***Professional Standards and Technical Advisory Committee (PSTAC)*** of ***ICAP***. This committee determines how the adoption and implementation of the standard can be facilitated. It considers issues like how long any transition period should be and whether adoption of the standard would requires changes in regulations.
- If the ***PSTAC*** identifies the need for changes to regulations it refers the matter to the ***Securities and Exchange Commission of Pakistan (SECP)*** (and/or the ***State Bank of Pakistan (SBP)*** for matters affecting banks and other financial institutions). This process is managed by the ***Coordination Committees of ICAP*** and ***SECP (SBP)***.
- After the satisfactory resolution of issues the ***PSTAC*** and the ***Council*** reconsider the matter of adoption.
- ***ICAP*** recommends the adoption to the ***SECP (SBP)*** by decision of the Council. The decision to adopt the standard rests with the ***SECP*** and ***SBP***.
- ***IFRSs*** are adopted by the ***Securities and Exchange Commission of Pakistan*** by notification in the ***Official Gazette***. When notified, the standards have the authority of the law.

A full list of all ***IFRSs*** is given in the preliminaries section of this text.

2 COMPANIES' ORDINANCE 1984: FOURTH SCHEDULE

Section overview

- Fixed assets (non-current assets)
- Long term investments
- Long term loans and advances
- Long term deposits and prepayments
- Current assets
- Share capital and reserves
- Non-current liabilities
- Current liabilities
- Contingencies and commitments
- Profit and loss account
- Other disclosures

These requirements must be followed in addition to those in IFRS.

2.1 Fixed assets (non-current assets)

Fixed assets (other than investments) must be classified as follows:

- property, plant and equipment:
  - land (distinguishing between freehold and leasehold);
  - buildings (distinguishing between building on freehold land and those on leasehold land);
  - plant and machinery;
  - furniture and fittings;
  - vehicles;
  - office equipment;
  - capital work in progress;
  - development property; and
  - others (to be specified)
- intangible:
  - goodwill;
  - brand names;
  - computer software;
  - licences and franchises;
  - patents, copyright, trademarks and designs;
  - intangible assets under development; and
  - others (to be specified).

2.2 Long term investments

The aggregate amount (under separate sub-headings) in respect of the following:

- investments in related parties; and
- other investments.

The investments must be shown under the heading ***long term investments***, indicating separately:

- at cost;
- using the equity method;
- held to maturity investments, which are not due to mature within next twelve months; and
- available for sale investments which are not intended to be sold within the next 12 months.

This section introduces several terms which require further explanation. They are covered in more detail in certain international accounting standards. However, the Companies' Ordinance 1984 is in your syllabus and refers to these. Therefore, they will be explained briefly.

Related parties

A related party is an entity or person with the ability to control the company or exercise significant influence over the company in making financial and operating decisions or an entity over which the company has ability to control or exercise significant influence.

IAS 24 *Related Party Disclosures* includes a list of related parties and specifies disclosures.

The equity method

The equity method is a method of accounting where an investment is initially recognised at cost and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition.

IAS 28: *Investments in Associates and Joint Ventures* specifies the use of the equity method in accounting for associates and joint ventures.

Held to maturity investments

This is a type of asset defined in IAS 39: *Financial Instruments: Recognition and Measurement.*

Held to maturity investments are financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity.

They are measured at amortised cost. The amortised cost of a financial asset is the amount invested initially plus interest recognised at the effective rate less any cash received in respect of the asset.

Available for sale investment

This is also a type of asset defined in IAS 39: *Financial Instruments: Recognition and Measurement.*

An available for sale investment is one that is not a loan or receivable, nor held to maturity nor held for trading purposes.

IAS 39 requires that available for sale investments are remeasured to fair value at each reporting date. Any difference is recognised as other comprehensive income (see chapter 2) and accumulated as a separate reserve in equity.

2.3 Long term loans and advances

The following must be shown (under separate sub-headings) distinguishing between considered good and considered bad or doubtful.

- Loans and advances to related parties and disclosing:
  - Details of each borrower (name, amount, terms and details of security held if any);
  - Maximum amount outstanding since the later of the date of incorporation or the date of the previous balance sheet.
- Other loans and advances disclosing in respect of amounts to those other than suppliers the name of the borrower and the terms of repayment if the amount is material with particulars of security.

Illustration: Long term loans and advances

A disclosure note might look like this.

Statement of financial position (extract)	**2013**	**2012**
Non-current assets	**Rs.**	**Rs.**
Loans and advances	237,900	158,750

Note to the accounts:	**2013**	**2012**
	Rs.	**Rs.**
To employees – secured, considered good	197,026	167,952
To supplier – unsecured, considered good	98,736	28,734
	295,762	196,686
Less current portion shown under current assets	(57,862)	(37,936)
	237,900	158,750

Loans to employees are interest free loans for the purpose of cars. They are repayable within 3 years and are secured on the vehicles. The maximum amount of the loans during the year was Rs. 201,345 (2012: 174,321).

The loan to supplier is an unsecured loan given to the TZ Electric Company to fund the development of electrical supply infrastructure at our Lahore depot. The loan is repayable in equal instalments over. Mark-up is charged at 2% per annum.

2.4 Long term deposits and prepayments

Long-term deposits and long-term prepayments must be stated separately.

Any material item must be disclosed separately.

2.5 Current assets

Current assets must be classified in a way appropriate to the company's affairs, including the following:

- ❑ stores, spare parts and loose tools distinguishing each from the other where practicable;
- ❑ stock-in-trade, distinguishing between appropriate classifications (for example, raw materials and components, work in progress, finished products etc.).
- ❑ trade debts (other than loans and advances) showing separately:
  - debts considered good and debts considered doubtful or bad must be separately stated;
  - debts considered good must be distinguished between secured and unsecured;
  - the aggregate amount due from directors, chief executive and executives; and
  - the aggregate amount due from related parties with the names of those related parties.
- ❑ loans and advances due for repayment within a period of twelve months from the reporting date showing separately:
  - loans and advances considered good and those considered doubtful or bad;
  - the aggregate amount due from directors, chief executive and executives;
  - the aggregate amount due from related parties with the names of those related parties;
- ❑ trade deposits and short term prepayments and current account balances with statutory authorities;
- ❑ interest accrued;
- ❑ other receivables specifying separately the materials items;
- ❑ financial assets other than any included above showing separately:
  - the aggregate amount due from directors, chief executive and executives;
  - the aggregate amount due from related parties with the names of those related parties;
- ❑ tax refunds due from the Government, showing separately different types of tax;
- ❑ cash and bank balances, distinguishing between current and deposit accounts.

Any provision made for a fall in value of any current asset is shown as a deduction from the gross amount of that asset.

Definition

Executive: An employee, other than the chief executive and directors, whose basic salary exceeds five hundred thousand rupees in a financial year.

Illustration: Stock in trade

A disclosure note might look like this.

Statement of financial position (extract)	**2013**	**2012**
Current assets	**Rs.**	**Rs.**
Stock in trade	547,132	523,890

Note to the accounts:	**2013**	**2012**
	Rs.	**Rs.**
Raw materials	139,950	153,856
Work in progress	178,434	163,433
Finished goods	179,100	162,121
Goods purchased for sale	51,962	48,261
	549,446	527,671
Less: Provision for slow moving items	(2,314)	(3,781)
	547,132	523,890

Illustration: Trade debts

A disclosure note might look like this.

Statement of financial position (extract)	**2013**	**2012**
Current assets	**Rs.**	**Rs.**
Trade debts	493,657	472,010

Note to the accounts:	**2013**	**2012**
	Rs.	**Rs.**
Considered good – secured	19,247	15,652
Considered good – unsecured	474,410	456,358
Considered doubtful – unsecured	10,192	8,763
	503,849	480,773
Less: Provision for doubtful debts	(10,192)	(8,763)
	493,657	472,010

The considered good – unsecured trade debts include Rs. 47, 438 (2012 Rs. 26,342) from X Limited, a related party.

2.6 Share capital and reserves

Share capital and reserves must be classified under the following sub-heads:

- issued, subscribed and paid up capital, distinguishing in respect of each class between:
  - shares allotted for consideration paid in cash;
  - shares allotted for consideration other than cash; and
  - shares allotted as bonus shares; and
- reserves (distinguishing between capital reserves and revenue reserves).

Definition

Capital reserve: A reserve not regarded free for distribution by way of dividend. (Includes capital redemption reserve, capital repurchase reserve account, share premium account, profit prior to incorporation).

Revenue reserve: A reserve that is normally regarded as available for distribution.

Illustration: Share capital

A disclosure note might look like this.

Statement of financial position (extract)	**2013**	**2012**
	Rs. 000	**Rs. 000**
Issued subscribed and paid-up capital (Ordinary shares of Rs. 10 each)	41,800	38,000

Note to the accounts:	**2013**	**2012**	**2013**	**2012**
	Rs. 000	**Rs. 000**	**Number of shares**	**Number of shares**
Authorised share capital (Ordinary shares of Rs. 10 each)	50,000	50,000	5,000,000	5,000,000
Issued subscribed and paid-up capital (Ordinary shares of Rs. 10 each)				
Fully paid in cash	35,000	35,000	3,500,000	3,500,000
Fully paid for consideration other than cash	3,000	3,000	300,000	300,000
Bonus issue	3,800	nil	380,000	nil
	41,800	38,000	4,180,000	3,800,000

2.7 Non-current liabilities

Non-current liabilities must be classified under the following sub-headings:

- long term financing;
- debentures;
- liabilities against assets subject to finance lease;
- long term murabaha;
- long term deposits; and
- deferred liabilities.

Long term loans must be classified as secured and unsecured, and the following must be shown separately under each class:

- loans from banking companies and other financial institutions, other than those as specified below;
- loans from related parties; and
- other loans.

Long-term deposits must be classified according to their nature.

2.8 Current liabilities

Current liabilities and provisions must be classified under the following sub-headings:

- trade and other payables, which shall be classified as:
  - creditors;
  - murabaha;
  - accrued liabilities;
  - advance payments;
  - payable to employee retirement benefit funds;
  - unpaid and unclaimed dividend; and
  - others (to be specified, if material);
- interest, profit, return or mark-up accrued on loans and other payables;
- short term borrowings which shall be classified as:
  - short-term borrowings, distinguishing between secured and unsecured and between loans taken from:
    - banking companies and other financial institutions other than related parties;
    - related parties; and
    - others;
  - short-term running finance, distinguishing between secured and unsecured;
- current portion of long term borrowings;
- current portion of long term murabaha; and
- provision for taxation, showing separately income tax and other taxes.

Illustration: Trade and other payables

A disclosure note might look like this.

Statement of financial position (extract)	2013	2012
Current liabilities	Rs.	Rs.
Trade and other payables	316,715	268,803

Note to the accounts:	2013	2012
	Rs.	Rs.
Trade creditors	275,102	228,869
Accrued liabilities	13,610	14,599
Advance payments	23,457	22,222
Others	4,546	3,113
	316,715	268,803

2.9 Contingencies and commitments

The following must be shown separately as a footnote to the balance-sheet:

- the aggregate amount of any guarantees given by the company on behalf of any related party and where practicable, the general nature of the guarantee;
- where practicable the aggregate amount or estimated amount, if it is material, of contracts for capital expenditure, so far as not provided for or a statement that such an estimate cannot be made; and
- any other commitment, if the amount is material, indicating the general nature of the commitment.

2.10 Profit and loss account

The profit and loss account must disclose separately the manufacturing, trading and operating results.

A manufacturing concern must show the cost of goods manufactured.

The profit and loss account must disclose all material items of income and expenses including the following:

- The turnover (sales) showing the gross sales figure with trade discount and sales tax as a deduction.
- Expenses, classified according to their function under the following sub-heads (along with additional information on their nature):
  - cost of sales;
  - distribution cost;
  - administrative expenses;
  - other operating expenses; and
  - finance cost.

- Other operating income:
  - income from financial assets;
  - income from investments in and debts, loans, advances and receivables to each related party; and
  - income from assets other than financial assets.
- Finance cost must show separately the amount of interest on borrowings from related parties (if any).
- Other information:
  - debts written off as irrecoverable distinguishing between trade debts, loans, advances and other receivables; and
  - provisions for doubtful or bad debts distinguishing between trade debts, loans, advances and other receivables.
  - In each case the company must disclose:
    - debts due by directors, chief executive, and executives of the company and any of them severally or jointly with any other person; and
    - debts due by other related parties.
- The aggregate amount of auditors' remuneration, showing separately fees, expenses and other remuneration for services rendered as auditors and for services rendered in any other capacity and stating the nature of such other services. (Amounts must be shown separately for joint auditors).
- If a donation is made and any director or his spouse has interest in the donee, the company must disclose the names of such directors, their interest in the donee and the names and address of all donees.

Illustration: Turnover

A disclosure note might look like this.

Profit and loss account (extract)	**2013**	**2012**
	Rs.	**Rs.**
Turnover	578,554	533,991

Note to the accounts:	**2013**	**2012**
	Rs.	**Rs.**
Gross sales	673,669	611,670
Less:		
Sales tax	(83,839)	(74,566)
Trade discounts	(11,276)	(3,113)
	578,554	533,991

Payments to senior management

A company must disclose the aggregate amount charged in the financial statements in respect of the directors, chief executive and executives by the company as fees, remuneration, allowances, commission, perquisites or benefits or in any other form or manner and for any services rendered.

The company must give full particulars of the aggregate amounts separately for the directors, chief executive and executives together with the number of such directors and executives, under appropriate headings such as:

- fees;
- managerial remuneration;
- commission or bonus, indicating their nature;
- reimbursable expenses which are in the nature of a perquisite or benefit;
- pension, gratuities, company's contribution to provident, superannuation and other staff funds, compensation for loss of office and in connection with retirement from office;
- other perquisites and benefits in cash or in kind stating their nature and, where practicable, their approximate money values; and
- the amounts, if material, by which any items shown above are affected by any change in an accounting policy.

Illustration: Remuneration of chief executive, directors and executives

Note to the accounts	Chief executive	Executive directors	Executives
	Rs.000	Rs.000	Rs.000
Fees	1,650	5,478	–
Managerial remuneration	11,225	33,675	323,280
Bonus	2,000	6,000	12,000
Retirement benefits	2,000	4,800	37,900
Housing	8,666	–	–
Transport	2,345	6,734	26,778
	27,886	56,687	399,958
Number of persons	1	4	48

Sale of fixed assets

For sale of fixed assets where the book value of the asset or assets exceeds in aggregate fifty thousand rupees, a company must disclose particulars of the assets and in aggregate:

- cost or valuation, as the case may be;
- the book value;
- the sale price and the mode of disposal (e.g. by tender or negotiation); and
- particulars of the purchaser.

2.11 Other disclosures

A company must disclose the following:

- The general nature of any credit facilities available to the company under any contract (other than trade credit) and not used as at the date of the balance sheet.
- Any penalty imposed under any law by any authority.
- The fact of any reduction, enhancement or waiver of a penalty.

Where any property or asset, acquired with the funds of the company, is not held in the name of the company, or is not in the possession and control of the company, this fact must be disclosed together with a description and value of the property or asset and the person in whose name and possession or control it is.

Note: In the exam, you may be required to make any or all of these disclosures therefore their knowledge and presentation is expected at this level.

3 COMPANIES' ORDINANCE 1984: FIFTH SCHEDULE

Section overview

- Sundry requirements
- Fixed assets (non-current assets)
- Long term investments
- Long term loans and advances
- Long term deposits and prepayments
- Current assets
- Share capital and reserves
- Non-current liabilities
- Current liabilities
- Contingencies and commitments
- Profit and loss account
- Other disclosures

3.1 Sundry requirements

The figures in the financial statements may be rounded to the thousands of rupees.

Financial statements must disclose:

- ❑ all material information necessary to make the financial years statements clear and understandable;
- ❑ any change in an accounting policy that has a material effect in the current year or may have a material effect in the subsequent year together with reasons for the change and the financial effect of the change, if material.

3.2 Fixed assets (non-current assets)

Fixed assets (other than investments) must be classified as follows:

- ❑ property, plant and equipment:
  - land (distinguishing between free-hold and leasehold);
  - buildings (distinguishing between building on free-hold land and those on leasehold land);
  - plant and machinery;
  - furniture and fittings;
  - vehicles;
  - office equipment
  - capital work in progress:
  - development property; and
  - others (to be specified)

- ❑ intangible:
  - goodwill;
  - brand names;
  - computer software;
  - licences and franchises;
  - patents, copyright, trademarks and designs; and
  - others (to be specified).

3.3 Long term investments

The aggregate amount (under separate sub-headings) in respect of the following:

- ❑ investments in related parties; and
- ❑ other investments.

A company that is not a small sized company must also disclose investments under the heading ***long term investments***, indicating separately:

- ❑ held to maturity investments, which are not due to mature within next twelve months; and
- ❑ available for sale investments which are not intended to be sold within the next 12 months.
- ❑ market value of listed securities and book value of unlisted securities as per their latest available financial statements.

3.4 Long term loans and advances

The following must be shown (under separate sub-headings) distinguishing between considered good and considered bad or doubtful.

- ❑ Loans and advances to related parties and disclosing:
- ❑ Other loans and advances.

Any provision made for bad or doubtful loans and advances is shown as a deduction under each sub-heading above.

Information on terms and conditions, securities obtained and any other material information must be disclosed.

3.5 Long term deposits and prepayments

Long-term deposits and long-term prepayments must be stated separately.

3.6 Current assets

Current assets must be classified in a way appropriate to the company's affairs, including the following:

- ❑ stores, spare parts and loose tools distinguishing each from the other where practicable;
- ❑ stock-in-trade, distinguishing between appropriate classifications (for example, raw materials and components, work in progress, finished products etc.).

- ❑ trade debts (other than loans and advances) showing separately:
  - debts considered good and debts considered doubtful or bad must be separately stated;
  - debts considered good must be distinguished between secured and unsecured;
  - the aggregate amount due from directors, chief executive and executives (does not apply to small sized companies); and
  - the aggregate amount due from related parties with the names of those related parties (does not apply to small sized companies).
- ❑ loans and advances due for repayment within a period of twelve months from the reporting date showing separately:
  - loans and advances considered good and those considered doubtful or bad;
  - the aggregate amount due from directors, chief executive and executives (does not apply to small sized companies);
  - the aggregate amount due from related parties with the names of those related parties (does not apply to small sized companies);
- ❑ trade deposits and short term prepayments and current account balances with statutory authorities;
- ❑ interest accrued;
- ❑ other receivables specifying separately the materials items;
- ❑ financial assets other than any included above showing separately:
  - the aggregate amount due from directors, chief executive and executives (does not apply to small sized companies);
  - the aggregate amount due from related parties with the names of those related parties (does not apply to small sized companies);
- ❑ tax refunds due from the Government, showing separately different types of tax;
- ❑ cash and bank balances, distinguishing between current and deposit accounts.

Any provision made for a fall in value of any current asset is shown as a deduction from the gross amount of that asset.

3.7 Share capital and reserves

Share capital and reserve must be classified under the following sub-heads:

- ❑ issued, subscribed and paid up capital, distinguishing in respect of each class between:
  - shares allotted for consideration paid in cash;
  - shares allotted for consideration other than cash; and
  - shares allotted as bonus shares; and
- ❑ reserves by distinguishing between capital reserves and revenue reserves.

3.8 Non-current liabilities

A company which is not a small company must classify non-current liabilities under the following sub-headings:

- long term financing;
- debentures;
- liabilities against assets subject to finance lease;
- long term murabaha;
- long term deposits; and
- deferred liabilities.

Long term loans must be classified as secured and unsecured, and the following must be shown separately under each class:

- loans from banking companies and other financial institutions, other than those as specified below;
- loans from related parties; and
- other loans.

Long-term deposits must be classified according to their nature.

3.9 Current liabilities

Current liabilities and provisions must be classified under the following sub-headings:

- trade and other payables, which shall be classified as:
  - creditors;
  - murabaha;
  - accrued liabilities;
  - advance payments;
  - payable to employee retirement benefit funds;
  - unpaid and unclaimed dividend; and
  - others (to be specified, if material);
- interest, profit, return or mark-up accrued on loans and other payables;
- short term borrowings which shall be classified as:
  - short-term borrowings, distinguishing between secured and unsecured and between loans taken from:
    - banking companies and other financial institutions other than related parties;
    - related parties; and
    - others;
  - short-term running finance, distinguishing between secured and unsecured;
- current portion of long term borrowings;
- current portion of long term murabaha; and
- provision for taxation, showing separately income tax and other taxes.

3.10 Contingencies and commitments

The following must be shown separately as a footnote to the balance-sheet:

- the aggregate amount of any guarantees given by the company on behalf of any related party and where practicable, the general nature of the guarantee;
- where practicable the aggregate amount or estimated amount, if it is material, of contracts for capital expenditure, so far as not provided for or a statement that such an estimate cannot be made; and
- any other commitment, if the amount is material, indicating the general nature of the commitment.

3.11 Profit and loss account

The profit and loss account must disclose separately the manufacturing, trading and operating results.

A manufacturing concern must show the cost of goods manufactured.

The profit and loss account must disclose all material items of income and expenses including the following:

- The turnover (sales) showing the gross sales figure with trade discount and sales tax as a deduction.
- Expenses, classified according to their function under the following sub-heads (along with additional information on their nature):
  - cost of sales;
  - distribution cost;
  - administrative expenses;
  - other operating expenses; and
  - finance cost.
- Other operating income:
  - income from financial assets;
  - income from investments in and debts, loans, advances and receivables to each related party; and
  - income from assets other than financial assets.
- Finance cost must show separately the amount of interest on borrowings from related parties (if any). This does not apply to a small sized company.
- Other information:
  - debts written off as irrecoverable distinguishing between trade debts, loans, advances and other receivables; and
  - provisions for doubtful or bad debts distinguishing between trade debts, loans, advances and other receivables.
  - In each case the company must disclose:
    - debts due by directors, chief executive, and executives of the company and any of them severally or jointly with any other person; and
    - debts due by other related parties.

- Number of employees at the year-end and the average number of employees during the year.

Payments to senior management

This does not apply to a small sized company.

A company must disclose the aggregate amount charged in the financial statements in respect of the directors, chief executive and executives by the company as fees, remuneration, allowances, commission, perquisites or benefits or in any other form or manner and for any services rendered.

The company must give full particulars of the aggregate amounts separately for the directors, chief executive and executives together with the number of such directors and executives, under appropriate headings such as:

- ❑ fees;
- ❑ managerial remuneration;
- ❑ commission or bonus, indicating their nature;
- ❑ reimbursable expenses which are in the nature of a perquisite or benefit;
- ❑ pension, gratuities, company's contribution to provident, superannuation and other staff funds, compensation for loss of office and in connection with retirement from office;
- ❑ other perquisites and benefits in cash or in kind stating their nature and, where practicable, their approximate money values; and
- ❑ the amounts, if material, by which any items shown above are affected by any change in an accounting policy.

3.12 Other disclosures

A company must disclose the following:

- ❑ The general nature of any credit facilities available to the company under any contract (other than trade credit) and not used as at the date of the balance sheet.
- ❑ Any penalty imposed under any law by any authority.
- ❑ The fact of any reduction, enhancement or waiver of a penalty.

Where any property or asset, acquired with the funds of the company, is not held in the name of the company, or is not in the possession and control of the company, this fact must be disclosed together with a description and value of the property or asset and the person in whose name and possession or control it is.

If any loan or advance has been granted on terms softer than those generally prevalent in trade or any relief allowed in matters of interest, repayment, security or documentation, details with reasons for this must be disclosed along with the nature of interest of the company or its directors or other officers.

Note: In the exam, you may be required to make any or all of these disclosures therefore their knowledge and presentation is expected at this level.

CHAPTER 2

Accounting and reporting concepts

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 1 The Conceptual Framework for the preparation and presentation of financial statements

B (a) 9 IFRS 13: Fair value measurement

1 A CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

Section overview

- The meaning of GAAP
- The meaning of a conceptual framework
- The purpose of a conceptual framework
- The alternative to a conceptual framework

1.1 The meaning of GAAP

The preparation and presentation of financial statements is based on a large number of concepts, principles and detailed rules. Some of these are contained in law, and others are in financial reporting standards. Many of the most fundamental concepts are not contained in any law or regulation or standard, but are simply accepted accounting principles and conventions.

All the concepts, principles, conventions, laws, rules and regulations that are used to prepare and present financial statements are known as Generally Accepted Accounting Principles or GAAP.

'Generally accepted accounting principles' vary from country to country, because each country has its own legal and regulatory system. The way in which businesses operate also differs from country to country. (For example, there is US GAAP, UK GAAP and Pakistan GAAP).

Many countries have now adopted International Financial Reporting Standards or IFRSs, sometimes called international accounting standards. It is now fairly common to refer to the totality of the rules as IFRS or IAS.

1.2 The meaning of a conceptual framework

A conceptual framework is a system of concepts and principles that underpin the preparation of financial statements. These concepts and principles should be consistent with one another.

The International Accounting Standards Committee (the predecessor of the IASB) issued a conceptual framework document in 1989. This was called the *Framework for the Preparation and Presentation of Financial Statements* and was adopted by the IASB. It is comprised of the following sections:

- The objective of financial statements (now replaced – see below)
- Underlying assumptions of financial statements
- Qualitative characteristics of financial statements (now replaced – see below)
- 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.

The IASB has been working closely with FASB (the US standard setter) on a wide range of projects with the aim of converging IFRS and US GAAP. One of the projects has had the aim of producing a conceptual framework common to each GAAP.

The new conceptual framework is being developed on a chapter by chapter basis. Each chapter is being released as an exposure draft and then, subject to comments received, released as the final version. To date, two chapters have been finalised and these replace the sections on "*The objective of financial statements"* and "*Qualitative characteristics of financial statements"* from the original document.

To avoid confusion the IASB has published a new document called *"The conceptual framework for financial reporting"* which includes the new chapters and those retained from the original framework.

The new document is made up of the following sections:

- **Chapter 1** – The objective of general purpose financial statements.
- **Chapter 2** – The reporting entity (to be added – currently in release as an exposure draft).
- **Chapter 3** – Qualitative characteristics of financial information.
- **Chapter 4** – The Framework (1989): The remaining text (These sections are unchanged as of yet).
    - Underlying assumptions of financial statements.
    - 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.

The original document was known as ***The Framework***. This text will describe the new document as ***The Conceptual Framework***. Note that the changes are not fundamental in terms of their impact on IFRS.

1.3 The purpose of a conceptual framework

Most preparers and users of financial statements recognise that there is a need for a formal conceptual framework and that this can be useful in a number of ways.

Where there is a formal conceptual framework for accounting, accounting practice and accounting standards are based on this framework.

Lack of a formal framework often means that standards are developed randomly or only to deal with particular problems. The result is that standards are inconsistent with each other or with legislation.

Lack of a conceptual framework may also mean that accounting standards fail to address important issues. For example, until the IASB developed its Framework, there was no proper definition of terms such as 'asset', 'liability', 'income' and 'expenses'.

The business environment is becoming increasingly complex. It is unlikely that accounting standards can cover all possible transactions. Where an entity enters into an unusual transaction and there is no relevant accounting standard, it can refer to the framework and apply the principles in it.

It can also be argued that a conceptual framework strengthens the credibility of financial reporting and the accounting profession in general.

1.4 The alternative to a conceptual framework

The alternative to a system based on a conceptual framework is a system based on detailed rules.

Accounting standards based on detailed rules are open to abuse. 'Creative accounting' is the name given to techniques which enable management to give a biased impression (usually favourable) of the company's performance while still complying with accounting standards and other regulations. During the 1980s there were a number of scandals in which investors were misled by the financial statements of apparently healthy companies which then collapsed. This was one of the original reasons why the IASB and other standard setters developed their conceptual frameworks. Principles are normally much harder to evade than rules.

Another disadvantage of a rule-based system is that standard setters are more likely to be influenced by 'vested interests' such as large companies or a particular business sector. The existence of a conceptual framework is an important safeguard against this kind of political pressure.

Despite these problems, some preparers and regulators still appear to favour rule based standards. Standards based on principles may require management to use its judgement (and to risk making a mistake), while rules simply need to be followed. This can be important where management can face legal action if an investor makes a poor decision based on the financial statements.

The use of a conceptual framework can lead to standards that are theoretical and complex. They may give the 'right answer' but be very difficult for the ordinary preparer to understand and apply. However, a system of extremely detailed rules can also be very difficult to apply.

2 THE IASB CONCEPTUAL FRAMEWORK

Section overview

- Introduction
- Underlying assumption
- Users and their information needs
- Objective of general purpose financial statements

2.1 Introduction

Financial reports are based on estimates, judgements and models rather than exact depictions. The Conceptual Framework establishes the concepts that underlie those estimates, judgements and models.

The Conceptual Framework deals with:

- the objective of financial reporting;
- the qualitative characteristics of useful financial information;
- the definition, recognition and measurement of the elements from which financial statements are constructed; and
- concepts of capital and capital maintenance.

The Conceptual Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. Its purpose is:

- to assist the IASB in the development of future IFRSs and in its review of existing IFRSs;
- to assist the IASB 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;
- to assist national standard-setting bodies in developing national standards;
- to assist preparers of financial statements in applying IFRSs and in dealing with topics that have yet to form the subject of an IFRS;
- to assist auditors in forming an opinion on whether financial statements comply with IFRSs;
- to assist users of financial statements in interpreting the information contained in financial statements prepared in compliance with IFRSs; and
- to provide those who are interested in the work of the IASB with information about its approach to the formulation of IFRSs.

This Conceptual Framework is not an IFRS and nothing in the Conceptual Framework overrides any specific IFRS.

On very rare occasions there may be a conflict between the Conceptual Framework and an IFRS. In those cases, the requirements of the IFRS prevail over those of the Conceptual Framework.

2.2 Underlying assumption

The going concern basis of accounting is the assumption in preparing the financial statements that the entity will continue to operate for the foreseeable future, and does not intend to go into liquidation and will not be forced into liquidation. The going concern assumption is particularly relevant for the valuation of assets.

This is found in chapter 4 of ***The Conceptual Framework***.

2.3 Users and their information needs

Many existing and potential investors, lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need. These are the primary users to whom general purpose financial reports are directed.

- ❑ General purpose financial reports cannot provide all the information needed and users also need to consider pertinent information from other sources.
- ❑ General purpose financial reports do not show the value of a reporting entity; but they provide information to help users estimate a value.
- ❑ Individual primary users have different information needs. The aim of IFRSs is to provide information that will meet the needs of the maximum number of primary users.

Other users

- ❑ Regulators and members of the public other than investors, lenders and other creditors may also find general purpose financial reports useful but these reports are not primarily directed to these groups.
- ❑ A company's management is interested in financial information but the management does not need to rely on general purpose financial reports.

2.4 Objective of general purpose financial statements

The objective of general purpose financial reporting forms the foundation of the Conceptual Framework. Other aspects of the Conceptual Framework flow logically from the objective.

The objective

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.

- In order to make these decisions the users need information to help them assess the prospects for future net cash inflows to an entity.
- In order to assess an entity's prospects for future net cash inflows, users need information about:
  - the resources of the entity;
  - claims against the entity; and
  - how efficiently and effectively the entity's management have discharged their responsibilities to use the entity's resources. (This information is also useful for decisions by those who have the right to vote on or otherwise influence management performance).

Information provided

General purpose financial statements provide information about:

- the financial position of the entity which is information about economic resources and the claims against them; and
- changes in its financial position which could be due to:
  - financial performance; and/or
  - other events or transactions (e.g. share issues).

Economic resources and claims

Information about the nature and amounts of economic resources and claims can help users to:

- identify the financial strengths and weaknesses of a reporting entity;
- to assess a reporting entity's liquidity and solvency and its needs for additional financing;

Information about priorities and payment requirements of existing claims helps users to predict how future cash flows will be distributed among those with a claim against the reporting entity.

Changes in economic resources and claims – Financial performance

Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period.

This is important because such information provides a better basis for assessing the entity's past and future performance than information solely about cash receipts and payments during that period.

Importance of information about a reporting entity's financial performance:

- It helps users to understand the return generated from its economic resources. This in turn provides an indication of how well management has discharged its responsibilities to make efficient and effective use of these resources.

- It shows the capacity of a reporting entity to generate net cash inflows through its operations rather than by obtaining additional resources directly from investors and creditors.
- It gives an indication of the extent to which events such as changes in market prices or interest rates affect its ability to generate net cash inflows.
- Information about the variability and components of return is also important, especially in assessing the uncertainty of future cash flows.
- Information about past financial performance is helpful in predicting the entity's future returns on its economic resources.

Another aspect of performance is management of cash flow. Information about a reporting entity's cash flows during a period helps users to assess the entity's ability to generate future net cash inflows. It indicates how the reporting entity obtains and spends cash, including information about its borrowing and repayment of debt, cash dividends or other cash distributions to investors, and other factors that may affect the entity's liquidity or solvency. Information about cash flows helps users understand a reporting entity's operations, evaluate its financing and investing activities, assess its liquidity or solvency and interpret other information about financial performance.

Changes in economic resources and claims – Other events and transactions

Information about this type of change is necessary to give users a complete understanding of why the reporting entity's economic resources and claims changed and the implications of those changes for its future financial performance.

Objectives of financial statements: summary

The objectives of financial statements are met by:

- the main financial statements (statement of financial position, statement of profit or loss and other comprehensive income (or statement of profit or loss and statement of other comprehensive income), statement of cash flows, and statement of changes in equity), and
- supporting notes to the accounts, which provide additional details.

3 QUALITATIVE CHARACTERISTICS OF USEFUL FINANCIAL INFORMATION

Section overview

- Introduction
- Relevance
- Faithful representation
- Enhancing qualitative characteristics
- Cost constraint on useful information

3.1 Introduction

This is covered by chapter 3 of ***The IASB Conceptual Framework***.

Information must have certain characteristics in order for it to be useful for decision making. The *IASB Conceptual Framework* describes:

- fundamental qualitative characteristics; and
- enhancing qualitative characteristics

Fundamental qualitative characteristics:

- relevance; and
- faithful representation

The qualitative characteristics that enhance the usefulness of information that is relevant and a faithful representation are:

- comparability;
- verifiability
- timeliness; and
- understandability

> "If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable".

Emphasis

Information must be both relevant and faithfully represented if it is to be useful.

The enhancing qualitative characteristics cannot make information useful if that information is irrelevant or not faithfully represented.

3.2 Relevance

Information must be relevant to the decision-making needs of users. Information is relevant if it can be used for predictive and/or confirmatory purposes.

- It has **predictive value** if it helps users to predict what might happen in the future.
- It has **confirmatory value** if it helps users to confirm the assessments and predictions they have made in the past.

The relevance of information is affected by its 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.

- Materiality is an entity-specific aspect of relevance based on the nature or magnitude (or both) of the items to which the information relates in the context of an individual entity's financial report.
- Therefore, it is not possible for the IASB to specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

3.3 Faithful representation

Financial reports represent economic phenomena (economic resources, claims against the reporting entity and the effects of transactions and other events and conditions that change those resources and claims) by depicting them in words and numbers.

To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the phenomena that it purports to represent.

A perfectly faithful representation would have three characteristics. It would be:

- complete – the depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.
- neutral – the depiction is without bias in the selection or presentation of financial information; and
- free from error – where there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process.

3.4 Enhancing qualitative characteristics

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 another date.

Consistency is related to comparability but is not the same. Consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities. Consistency helps to achieve the goal of comparability.

Verifiability

This quality 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 that a particular depiction is a faithful representation.
- Quantified information need not be a single point estimate to be verifiable. A range of possible amounts and the related probabilities can also be verified.

Verification can be direct or indirect.

- Direct verification means verification through direct observation, e.g. by counting cash.
- Indirect verification means checking the inputs to a model, formula or other technique and recalculating the outputs using the same methodology. For example, the carrying amount of inventory might be verified by checking the inputs (quantities and costs) and recalculating the closing inventory using the same assumption (e.g. FIFO).

Timeliness

This means having information available to decision-makers in time to be capable of influencing their decisions.

Understandability

Information is made understandable by classifying, characterising and presenting it in a clear and concise manner.

Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently.

3.5 Cost constraint on useful information

Reporting financial information that is relevant and faithfully represents what it purports to represent helps users to make decisions with more confidence. This results in more efficient functioning of capital markets and a lower cost of capital for the economy as a whole. An individual investor, lender or other creditor also receives benefits by making more informed decisions. However, it is not possible for general purpose financial reports to provide all the information that every user finds relevant.

The benefits obtained from financial information should exceed the cost of obtaining and providing it. Information should not be provided if the cost is not worth the benefit.

Since it is difficult to measure the benefits of financial information, the setters of accounting standards must use their judgement in deciding whether certain items of information should be provided in the financial statements (and if so, in how much detail).

4 THE ELEMENTS OF FINANCIAL STATEMENTS

Section overview

- Assets
- Liabilities
- Equity
- Income
- Expenses

The IASB Framework discusses the five elements of financial statements:

- ❑ for reporting financial position: assets, liabilities and equity
- ❑ for reporting financial performance: income and expenses.

4.1 Assets

An asset is defined as:

- ❑ a resource controlled by the entity;
- ❑ as a result of past events; and
- ❑ from which future economic benefits are expected to flow to the entity.

Resource controlled by the entity

Control is the ability to obtain economic benefits from the asset, and to restrict the ability of others to obtain the same benefits from the same item.

An entity usually uses assets to produce goods or services to meet the needs of its customers, and because customers are willing to pay for the goods and services, this contributes to the cash flow of the entity. Cash itself is an asset because of its command over other resources.

Many assets have a physical form, but this is not an essential requirement for the existence of an asset.

The result of past events

Assets result from past transactions or other past events. An asset is not created by any transaction that is expected to occur in the future but has not yet happened. For example, an **intention** to buy inventory does not create an asset.

Expected future economic benefits

An asset should be expected to provide future economic benefits to the entity. Providing future economic benefits can be defined as contributing, directly or indirectly, to the flow of cash (and cash equivalents) into the entity.

4.2 Liabilities

A liability is defined as:

- a present obligation of an entity
- arising from past events
- the settlement of which is expected to result in an outflow of resources that embody economic benefits.

Present obligation

A liability is an obligation that already exists. An obligation may be legally enforceable as a result of a binding contract or a statutory requirement, such as a legal obligation to pay a supplier for goods purchased.

Obligations may also arise from normal business practice, or a desire to maintain good customer relations or the desire to act in a fair way. For example, an entity might undertake to rectify faulty goods for customers, even if these are now outside their warranty period. This undertaking creates an obligation, even though it is not legally enforceable by the customers of the entity.

Past transactions or events

A liability arises out of a past transaction or event. For example, a trade payable arises out of the past purchase of goods or services, and an obligation to repay a bank loan arises out of past borrowing.

Future outflow of economic resources

The settlement of a liability should result in an outflow of resources that embody economic benefits. This usually involves the payment of cash or transfer of other assets. A liability is measured by the value of these resources that will be paid or transferred.

Some liabilities can be measured only with a substantial amount of **estimation**. These may be called **provisions**.

4.3 Equity

Equity is the residual interest in an entity after the value of all its liabilities has been deducted from the value of all its assets. It is a 'balance sheet value' of the entity's net assets. It does not represent in any way the market value of the equity.

Equity may be sub-classified in the statement of financial position, into share capital, retained profits and other reserves that represent capital maintenance adjustments.

4.4 Income

Income is defined as 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.

Financial performance is measured by profit or loss and gains or losses recognised in other comprehensive income. Profit is measured as income less expenses.

The concept of income includes both revenue and gains.

- **Revenue** is income arising in the course of the ordinary activities of the entity. It includes sales revenue, fee income, royalties' income and income from investments (interest and dividends). Revenue is recognised in the statement of profit or loss.
- **Gains** represent other items that meet the definition of income. Gains may be recognised in the statements of profit or loss or in the statement of other comprehensive income. For example:
  - Income includes gains on the disposal of non-current assets. These are recognised in the statement of profit or loss.
  - Income also includes unrealised gains which occur whenever an asset is revalued upwards, but is not disposed of. For example, an unrealised gain occurs when a property owned by the entity is revalued upwards. Unrealised gains might be recognised in the statement of profit or loss (e.g. revaluation gains on property accounted for under IAS 40) or in the statement of other comprehensive income (e.g. revaluation gains on property accounted for under the IAS 16 fair value model).

4.5 Expenses

Expenses are 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.

Expenses include:

- **Expenses** arising in the normal course of activities, such as the cost of sales and other operating costs, including depreciation of non-current assets. Expenses result in the outflow of assets (such as cash or finished goods inventory) or the depletion of assets (for example, the depreciation of non-current assets).
- **Losses** include for example, the loss on disposal of a non-current asset, and losses arising from damage due to fire or flooding. Losses are usually reported as net of related income.

5 RECOGNITION IN THE FINANCIAL STATEMENTS

Section overview

- Probability of future economic benefit flowing in or out
- Reliability of measurement
- Recognition of assets, liabilities, income and expenses
- Assessment of the Framework

The IASB Framework states that an element (asset, liability, equity, income or expense) should be recognised in the statement of financial position or in profit and loss (the statement of profit or loss) when it:

- ❑ meets the definition of an element, and also
- ❑ satisfies certain criteria for recognition.

Items that fail to meet the criteria for recognition should not be included in the financial statements. However, some if these items may have to be disclosed as additional details in a **note** to the financial statements.

The criteria for recognition are as follows:

- ❑ It must be **probable** that the future economic benefit associated with the item will flow either into or out of the entity.
- ❑ The item should have a cost or value that can be measured reliably.

5.1 Probability of future economic benefit flowing in or out

The concept of probability relates to the degree of certainty or uncertainty that the future economic benefit associated with the item will flow into or out of the entity.

The degree of certainty or uncertainty should be assessed on the basis of the evidence available at the time the financial statements are prepared.

For example, if it is considered fairly certain that a trade receivable will be paid at a future date, it is appropriate to recognise the receivable as an asset in the statement of financial position. However, there is probably a reasonable degree of certainty that some trade receivables will become 'bad debts' and the economic benefit will not flow into the entity. It would then be appropriate to recognise an 'expense' for the expected reduction in economic benefits (as an allowance for irrecoverable debts).

5.2 Reliability of measurement

An item should be recognised in the financial statements only if it has a cost or value that can be measured with reliability.

In many cases, the value of an item has to be estimated because its value is not known with certainty. Using reasonable estimates is an essential part of preparing financial statements, and provided that the estimates are reasonable, it is appropriate to recognise items in the financial statements.

However, if it is not possible to make a reasonable estimate, the item should be excluded from the statement of financial position and statement of profit or loss and other comprehensive income.

An item that cannot be estimated with reliability at one point in time might be estimated with greater certainty at a later time, when it would then be appropriate to include it in the financial statements.

5.3 Recognition of assets, liabilities, income and expenses

Recognition of assets

An asset is recognised in the statement of financial position when there is an increase in future economic benefits relating to an increase in an asset (or a reduction in a liability) which can be measured reliably.

An asset should not be recognised when expenses have been incurred but it is unlikely that any future economic benefits will flow to the entity. Instead, the item should be treated as an expense, and the cost of the asset should be 'written off'.

Recognition of liabilities

A liability is recognised when it is **probable** that an outflow of resources that embody economic benefits will result from the settlement of a present obligation, and the amount of the obligation can be measured reliably.

Recognition of income

Income is recognised in the statement of profit when an increase in future economic benefits arises from an increase in an asset (or a reduction in a liability) and this can be measured reliably.

Recognition of expenses

Expenses are recognised in the statement of profit or loss when a decrease in future economic benefits arises from a decrease in an asset or an increase in a liability, which can be measured reliably.

Note that an expense is recognised at the same time as an increase in a liability (for example, trade payables) or a reduction in an asset (for example, cash).

Expenses are recognised in the **statement of profit or loss** by means of a direct association between items of income and the expenses incurred in creating that income.

- **Matching of costs and income** involves the simultaneous recognition of revenues and related expenses.
- When economic benefits arise over several accounting periods, and the association with income can only be decided in broad terms, expenses should be recognised in profit and loss (the statement of profit or loss) of each accounting period on the basis of **'systematic and rational allocation procedures'**. For example, depreciation charges for a non-current asset are allocated between accounting periods on a systematic and rational basis, by means of an appropriate depreciation policy and depreciation method.

- When an item of expenditure is not expected to provide any future economic benefits, it should be recognised immediately as an expense in the statement of profit or loss. When the future economic benefits associated with an asset are no longer expected to arise, the value of the asset is written off, and the write-off is treated as an expense.
- An expense may also be recognised when a liability arises without the recognition of any matching asset. For example, a liability might arise when an entity recognises that it will have to make a payment to settle a legal dispute. The cost of the future liability is treated as an expense in the period when the liability is recognised.

5.4 Assessment of the Framework

In theory, IASs and IFRSs are based on the IASB Framework. In practice, the standards are a mixture of principles and rules.

Many standards (for example, the main standards dealing with non-current assets) reflect the fundamental principles in the Framework and are consistent with each other. This improves the quality of financial reporting as there are fewer options available and the standards are based on the definitions in the Framework.

However, some of the more recent standards (for example, the standards on financial instruments) have been heavily influenced by US accounting practice. These standards are complex and tend to contain many detailed rules and definitions.

It can be argued that the success of the IASB's Framework is that recent accounting standards have been successful in providing consistent accounting rules. The application of the definitions in the Framework and the recognition and measurement criteria should mean that any accounting issue not covered by a standard can be dealt with.

The development of the new Conceptual Framework with FASB should further improve reporting in the future.

6 ACCOUNTING CONCEPTS

Section overview

- Consistency of presentation
- Materiality and aggregation
- Offsetting

In addition to the accounting concepts in the IASB Framework, some other accounting concepts are used in financial reporting. These concepts, together with the underlying assumptions of going concern and accruals, are explained in IAS 1 *Presentation of financial statements*.

6.1 Consistency of presentation

Consistency of presentation is needed if financial information is to be comparable. IAS 1 states that there should be consistency in the presentation and classification of items in the financial statements from one year to the next. There are just two exceptions to the requirement for consistency:

- Consistency is not required when it is apparent, following a significant change in the entity's operations or a review of its financial statements, that a different presentation or classification would be more appropriate.
- Consistency is not appropriate if a new accounting standard (or the interpretation of a Standard by IFRIC) requires a change in the presentation of information.

6.2 Materiality and aggregation

IAS 1 also states that each **material** class of similar items should be presented separately in the financial statements.

In addition, items of a dissimilar nature should not be aggregated together in the financial statements (combined as a single item and in a single total), unless their value is immaterial.

6.3 Offsetting

IAS 1 states that:

- Assets and liabilities should not be offset against each other.
- Similarly incomes and expenses should not be offset against each other.

Instead they should be reported separately.

The **exceptions to this rule** are when:

- offsetting is required or permitted by an accounting standard or the Interpretation of a standard
- offsetting reflects the economic substance of a transaction. An example specified in IAS 1 is reporting of a gain or loss on disposal of a non-current asset at sale value minus the carrying value of the asset and the related selling expenses.

7 MEASUREMENT AND CAPITAL MAINTENANCE

Section overview

- Measurements of elements of financial statements
- Fair value
- Capital maintenance concepts

7.1 Measurements of elements of financial statements

The Conceptual Framework allows that several measurement bases are used for the elements in financial statements. These include:

- **Historical cost**. Assets are measured at the amount of cash paid, or at the fair value of the consideration given to acquire them. Liabilities are measured at:
  - the amount of proceeds received in exchange for the obligation (for example, bank loan or a bank overdraft), or
  - the amount of cash that will be paid to satisfy the liability.
- **Current cost or current value** is the basis used in current value accounting/current cost accounting. Assets are measured at the amount that would be paid to purchase the same or a similar asset currently. Liabilities are measured at the amount that would be required to settle the obligation currently.
- **Realisable value** (or **settlement value**). This method of measurement is relevant when an entity is not a going concern, and is faced with liquidation (and a forced sale of its assets). Assets are measured at the amount that could be obtained by selling them. Liabilities are measured at the amount that would be required to settle them currently.
- **Present value**. Assets might be measured at the value of the future net cash inflows that the item is expected to generate, discounted to a present value. Similarly, a liability might be measured at the discounted present value of the expected cash outflows that will be made to settle the liability.

Historical cost is the most commonly used measurement basis. However, the other bases of measurement are often used to modify historical cost. For example, inventories are measured at the lower of cost and net realisable value. Deferred income is measured at present value. Some non-current assets may be valued at current value.

The Framework does not favour one measurement base over the others.

7.2 Fair value

Fair value is a possible basis for the valuation of assets in the financial statements. Although it is not described in the IASB Conceptual Framework, many IASs and IFRSs require it to be used instead of historical cost or as an alternative to historical cost. For example, IAS 39 requires many types of investment to be measured at fair value.

Fair value may be used in financial statements in the following circumstances:

- After its initial recognition at acquisition, a non-current asset may be re-valued to its fair value.
- Inventory is measured in the statement of financial position at the lower of cost or net realisable value. Net realisable value (NRV) is the selling price of the inventory item in the ordinary course of business, less the estimated further costs to completion and the expected selling costs. NRV may or may not be the same as fair value.
- Revenue should be measured in the statement of profit or loss at the fair value of the consideration received or receivable (IAS 18).

Fair value is often approximately the same as current value, but sometimes fair value and current value can be very different.

Problems with the use of fair value

Fair value is easy to understand and less complicated to apply than value to the business/current value. Arguably, it is also more reliable than value to the business, because market value is more easily verified than (for example) economic value. However, it has some serious disadvantages:

- There may not be an active market for some kinds of asset. Where there is no active market, estimates have to be used and these may not be reliable.
- It anticipates sales and profits which may never happen (the entity may have no plans to sell the asset).
- Market values can move up and down quite rapidly. This may distort trends in the financial statements and make it difficult for users to assess an entity's performance over time.

A notable example of this problem occurred during 2007 and 2008 with the collapse of the market for certain types of asset-backed securities (mortgage-related securities known as CDOs). Many banks, particularly in the US and Europe, announced huge losses, largely due to the requirement to write down their investments in these financial instruments to fair value, even though fair value was difficult to assess.

Despite these problems, it looks increasingly likely that the IASB will require greater use of fair value in future.

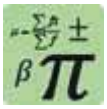
7.3 Capital maintenance concepts

The Conceptual Framework states that there are two concepts of capital:

- A financial concept of capital;
- A physical concept of capital.

Different systems of accounts used different capital maintenance concepts. The choice of capital maintenance has a profound effect on the measurement of profit.

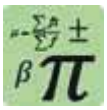
Consider the basic accounting equation.



Formula: Accounting equation

Assets	=	Liabilities	+	Equity	or	Assets	–	Liabilities	=	Equity
A	=	L	+	E		A	–	L	=	E
						Net assets				

Like any other equation, changes on one side of the accounting equation are matched by changes in the other side. Therefore, Profit or loss for a period can be calculated from the difference between the opening and closing net assets after adjusting for any distributions during the period.



Formula: Profit

Change in equity = Closing equity – Opening equity

Increase in equity = Profit + capital introduced – distributions

Profit = Increase in equity – capital introduced + distributions

This shows that the value ascribed to opening equity is crucial in the measurement of profit.

Financial capital maintenance

With the **financial concept of capital maintenance**, a profit is not earned during a period unless the financial value of equity at the end of the period exceeds the financial value of equity at the beginning of the period (after adjusting for equity capital raised or distributed).

Historical cost accounting is based on the concept of **money financial capital maintenance**. Under this concept, an entity makes a profit when its closing equity exceeds its opening equity measured as the number of units of currency at the start of the period. Note that this is a separate issue from asset valuation. Assets could be revalued during the period but this would have no effect on the opening capital position.

An alternative view of financial capital maintenance is used in constant purchasing power accounting. This system is based on the concept of **real financial capital maintenance**. Under this concept, an entity makes a profit when its closing equity exceeds opening equity remeasured to maintain its purchasing power.

This requires the opening equity to be uplifted by the general inflation rate. This is achieved by a simple double entry.

Illustration: Adjustment to maintain opening equity

	Debit	Credit
Statement of profit or loss	X	
Inflation reserve		X

Physical capital maintenance

A **physical concept of capital** is that the capital of an entity is represented by its productive capacity or operating capability. Where a physical concept of capital is used, the main concern of users of the financial statements is with the maintenance of the operating capability of the entity.

With a physical concept of capital maintenance, a profit is not earned during a period unless (excluding new equity capital raised during the period and adding back any distribution of dividends to shareholders) the operating capability of the business is greater at the end of the period than at the beginning of the period.

This requires the opening equity to be uplifted by the specific rates of inflation that apply to the individual components of the net assets of the company. Again, this is achieved by the same simple double entry.

The following example should help you to understand this.

Example: Capital maintenance concepts

X Limited commenced business on 1 January with a single item of inventory which cost Rs.10,000.

During the year it sold the item for Rs. 14,000 (cash).

During the year general inflation was 5% but the inflation specific to the item was 10%.

Profit is calculated under each concept in the following ways.

	Capital maintenance concept		
	Financial (money terms)	Financial (real terms)	Physical
Statement of profit or loss	Rs.	Rs.	Rs.
Revenue	14,000	14,000	14,000
Cost of sale	(10,000)	(10,000)	(10,000)
Inflation adjustment (inflation rate applied to opening equity):			
5% × Rs.10,000		(500)	
10% × Rs.10,000			(1,000)
	4,000	3,500	3,000
Statement of financial position	Rs.	Rs.	Rs.
Net assets	14,000	14,000	14,000
Equity:			
Opening equity			
Before adjustment	10,000	10,000	10,000
Inflation reserve (see above)		500	1,000
After adjustment	10,000	10,500	11,000
Retained profit (profit for the year)	4,000	3,500	3,000
	14,000	14,000	14,000

Commentary on the example

Under historical cost accounting, the profit is Rs. 4,000. If the business paid this out as a dividend it would have Rs. 10,000 left.

Rs. 10,000 is the opening equity expressed as a number of units of currency. This means that the company would have maintained its equity expressed as a number of units of currency. However, inflation in the period has caused the purchasing power of the currency to decline. This means that Rs. 10,000 no longer has the same purchasing power that it had a year ago. The company has not maintained its capital in real terms.

To maintain its opening equity in real terms the company would have to ensure that it had the same purchasing power at the year-end as it had at the start. Inflation was 5% so the company would need Rs. 10,500 at the year-end in order to have the same purchasing power as it had at the start of the year. The company can achieve this by transferring Rs. 500 from profit and loss into an inflation reserve. Profit would then be reported as Rs. 3,500.

If the business paid out Rs. 3,500 as a dividend it would have Rs. 10,500 left. This is not enough to buy the same asset that it had at the start of the year. The asset has been subject to specific inflation of 10% therefore the company would need Rs. 11,000 at the year-end in order to buy the same asset.

This means that the company would not have the same capacity to operate as it had a year ago.

To maintain its opening equity in physical terms the company would have to ensure that it had the same ability to operate at the year-end as it had at the start. In other words it would need to have Rs. 11,000. The company can achieve this by transferring Rs. 1,000 from profit and loss into an inflation reserve. Profit would then be reported as Rs. 3,000.

Comparing the two concepts

Neither the IASB Conceptual Framework nor accounting standards require the use of a specific capital maintenance concept. In practice, almost all entities use money financial capital maintenance, but both concepts can provide useful information.

Financial capital maintenance is likely to be the most relevant to investors as they are interested in maximising the return on their investment and therefore its purchasing power.

Physical capital maintenance is likely to be most relevant to management and employees as they are interested in assessing an entity's ability to maintain its operating capacity. This is particularly true for manufacturing businesses, where management may need information about the ability of the business to continue to produce the same or a greater volume of goods.

8 FAIR PRESENTATION

Section overview

- What is meant by fair presentation (or a true and fair view)?
- Fair presentation and compliance with IFRSs
- Where fair presentation conflicts with an accounting standard

8.1 What is meant by fair presentation (or a true and fair view)?

Financial statements are often described as showing a 'true and fair view' or 'presenting fairly' the financial position and performance of an entity, and changes in its financial position. In some countries (for example, the UK) this is the central requirement of financial reporting.

Under 'international GAAP' (specifically IAS 1) financial statements are required to present fairly the financial position, financial performance and cash flows of the entity.

The Framework does not deal directly with this issue. However, it does state that if an entity complies with international accounting standards, and if its financial information has the desirable qualitative characteristics of information, then its financial statements 'should convey what is generally understood as a true and fair view of such information'.

IAS 1 states that: '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 IASB Framework.

The use of the term faithful representation means more than that the amounts in the financial statements should be materially correct. It implies that information should present clearly the transactions and other events that it is intended to represent. To provide a faithful representation, financial information must account for transactions and other events in a way that reflects their substance and economic reality (in other words, their true commercial impact) rather than their legal form. If there is a difference between economic substance and legal form, the financial information should represent the economic substance.

Faithful representation also implies that the amounts in the financial statements should be classified and presented, and disclosures made in such a way that important information is not obscured and users are not misled.

8.2 Fair presentation and compliance with IFRSs

The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.' IAS 1 states that:

- When the financial statements of an entity comply fully with International Financial Reporting Standards, this fact should be disclosed.

- An entity should not claim to comply with IFRSs unless it complies with **all** the requirements of **every** applicable Standard.

IAS 1 appears to equate fair presentation with compliance with accounting standards.

In some situations fair presentation may require more than this. It is important to apply the spirit (or general intention) behind an accounting standard as well as the strict letter (what the standard actually says).

The requirement to 'present fairly' also applies to transactions which are not covered by any specific accounting standard. It is worth noting that there is no IFRS that covers complex transactions and arrangements which have been deliberately structured so that their economic substance is different from their legal form.

IAS 1 states that a fair presentation requires an entity:

- to select and apply accounting policies in accordance with IAS 8 Accounting policies, changes in accounting estimates and errors. IAS 8 explains how an entity should develop an appropriate accounting policy where there is no standard.
- to present information in a manner that provides relevant, reliable, comparable and understandable information
- to provide additional disclosures where these are necessary to enable users to understand the impact of particular transactions and other events on the entity's financial performance and financial position (even where these are not required by IFRSs).

8.3 Where fair presentation conflicts with an accounting standard

IAS 1 acknowledges that in extremely rare circumstances, compliance with a standard or an Interpretation may produce financial statements that are so misleading that they do not provide useful information and no longer give a fair presentation.

An entity can then depart from the requirements of the standard or Interpretation. It must disclose:

- that management has concluded that the financial statements present fairly the entity's financial position, financial performance and cash flows;
- that it has complied with applicable standards and Interpretations, except that it has departed from a particular requirement to achieve a fair presentation;
- the title of the standard or Interpretation from which the entity has departed, the nature of the departure, including the treatment that the standard or Interpretation would require, the reason why that treatment would be misleading, and the treatment adopted; and
- for each period presented, the financial impact of the departure on each item in the financial statements that would have been reported in complying with the requirement.

CHAPTER 3

Presentation of financial statements

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with international pronouncements and under the Companies Ordinance, 1984.**

PRESENTATION OF FINANCIAL STATEMENTS INCLUDING PUBLIC SECTOR ACCOUNTING

A 1 Presentation of financial statements (IAS 1, IAS 7 and Companies Ordinance 1984)

A 7 IAS 34: Interim financial reporting

A 10 IFRS 8: Operating segments

FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 14 IAS 10: Events after the reporting date

B (a) 24 IAS 24: Related party disclosures

1 IAS 1: PRESENTATION OF FINANCIAL STATEMENTS

Section overview

- Form and content
- Statement of financial position
- Statement of profit or loss and other comprehensive income
- Statement of changes in equity (SOCIE)
- Notes to the financial statements

1.1 Form and content

IAS 1: Presentation of Financial Statements sets out the rules on the form and content of financial statements.

A complete set of financial statements consists of:

- a statement of financial position as at the end of the period;
- a statement of comprehensive income for the period (made up of a statement of profit or loss and a statement of other comprehensive income);
- a statement of changes in equity for the period;
- a statement of cash flows (this is dealt with in a later chapter); and
- notes to these statements, consisting of a summary of significant accounting policies used by the entity and other explanatory notes;
- comparative information in respect of the previous period (as specified); and
- a statement of financial position as at the beginning of the preceding period when an entity applies an accounting policy retrospectively or retrospectively restates or reclassifies items (as specified).

1.2 Statement of financial position

Current and non-current assets and liabilities

IAS 1 requires an entity to present current and non-current assets, and current and non-current liabilities, as separate classifications on the face of its statement of financial position unless a liquidity presentation provides more relevant and reliable information. In such cases, all assets and liabilities must be presented broadly in order of liquidity.

Some items may be presented using a current/non-current distinction and others in order of liquidity if this provides information that is more relevant and reliable.

Whichever method of presentation is adopted an entity must disclose the amount expected to be recovered or settled after more than twelve months for each asset and liability line item that combines current and non-current amounts.

Information to be presented on the face of the statement of financial position

IAS 1 provides a list of items that, **as a minimum**, must be shown on the face of the statement of financial position as a 'line item' (in other words, on a separate line in the statement):

Additional line items should be included in the statement of financial position when presenting them separately and is 'relevant to an understanding of the entity's financial position.

Some of the line items in the statement of financial position should be sub-classified into different categories, giving details of how the total figure is made up. This sub-classification may be presented either:

- as additional lines on the face of the statement of financial position (adding up to the total amount for the item as a whole); or
- in notes to the financial statements.

Note: In Pakistan, the fourth/fifth schedules to the Companies Ordinance 1984 are followed.

1.3 Statement of profit or loss and other comprehensive income

A single statement or two statements

The statement provides information about the performance of an entity in a period. It consists of two parts:

- a statement of profit or loss – a list of income and expenses which result in a profit or loss for the period; and
- a statement of other comprehensive income – a list of other gains and losses that have arisen in the period.

IAS 1 allows an entity to present the two sections in a single statement or in two separate statements.

IAS 1 provides a list of items that, **as a minimum**, must be shown on the face of the statement of profit or loss and other comprehensive income.

Additional line items should be presented on the face of the statement of comprehensive income when it is relevant to an understanding of the entity's financial performance.

Information to be shown on the face of the statement of comprehensive income (or the statement of profit or loss, if separate) or in the notes

The following information may be shown either on the face of the statement of comprehensive income or in a note to the financial statements:

- **material items** of income and expense
- an **analysis of expenses**, providing either:
  - expenses analysed by their nature, or
  - expenses analysed by the function that has incurred them.

Information to be presented in the other comprehensive income section

The other comprehensive income section must present line items for amounts of other comprehensive income in the period, classified by nature (including share of the other comprehensive income of associates and joint ventures accounted for using the equity method) and grouped into those that, in accordance with other IFRSs:

- will not be reclassified subsequently to profit or loss:

- revaluation surpluses on property, plant and equipment (IAS 16) (but remember in Pakistan such changes are not recognised in OCI as per Companies Ordinance 1984);
- revaluation surpluses on intangible assets (IAS 38) (but remember in Pakistan such changes are not recognised in OCI as per Companies Ordinance 1984);
- remeasurements of defined benefit pension schemes (IAS 19); and

❑ will be reclassified subsequently to profit or loss when specific conditions are met, including:

- gains and losses on retranslation of foreign operations (IAS 21);
- gains and losses recognised on remeasurement of available for sale financial assets (IAS 39); and
- gains and losses recognised on the effective element of cash flow hedges (IAS 39)

Example: Reclassification adjustments

Year 1:

A company buys a foreign subsidiary at the start of year 1.

At the end of year 1 the financial statements of the subsidiary are retranslated resulting in an exchange loss of Rs. 100,000.

	Debit	Credit
Other comprehensive income	100,000	
Net assets of S		100,000

This debit is transferred to a separate balance in equity.

Year 2:

The company sells the subsidiary at the start of year 2.

The loss previously recognised in OCI must now be recognised in P&L. The double entry to achieve this is:

	Debit	Credit
Profit or loss	100,000	
Other comprehensive income		100,000

This credit in OCI in turn is transferred to the separate balance in equity where it nets the debit that was taken there in year 1 back to zero.

1.4 Statement of changes in equity (SOCIE)

A SOCIE shows the amount at the beginning of the period, changes during the period, and the amount at the end of the period for each component of equity.

For each component of equity, the SOCIE should show changes resulting from:

❑ profit (gain) or loss for the period;

❑ each item of other comprehensive income;

- ❑ transactions with owners in their capacity as owners.
  - new issues of shares;
  - payments of dividends;
  - repurchases and cancellation of its own shares by the company; and
  - charges in respect of equity-settled share based payment transactions.

Transactions with owners in their capacity as owners are not gains or losses so are not shown in the statement of comprehensive income but they do affect equity. The SOCIE highlights such transactions.

1.5 Notes to the financial statements

Notes contain information in addition to that presented in the statement of financial position, statement of comprehensive income, statement of changes in equity and statement of cash flows.

Notes provide narrative descriptions of items in those statements and information about items that do not qualify for recognition in those statements. They also explain how totals in those statements are formed.

Disclosure of accounting policies

An entity must disclose the following in the summary of significant accounting policies:

- ❑ the measurement basis (or bases) used in preparing the financial statements; and
- ❑ the other accounting policies used that are relevant to an understanding of the financial statements.
- ❑ the judgements (apart from those involving estimations) made by management in applying the accounting policies that have the most significant effect on the amounts of items recognised in the financial statements. For example:
  - whether financial assets are held-to-maturity investments;
  - when substantially all the significant risks and rewards of ownership of financial assets and lease assets are transferred to other entities;
  - whether, in substance, particular sales of goods are financing arrangements and therefore do not give rise to revenue; and
  - whether the substance of the relationship between the entity and a special purpose entity indicates that the entity controls the special purpose entity.

Which policies?

Management must disclose those policies that would assist users in understanding how transactions, other events and conditions are reflected in the reported financial performance and financial position.

If an IFRS allows a choice of policy, disclosure of the policy selected is especially useful.

Some standards specifically require disclosure of particular accounting policies. For example, IAS 16 requires disclosure of the measurement bases used for classes of property, plant and equipment.

It is also appropriate to disclose an accounting policy not specifically required by IFRSs, but selected and applied in accordance with IAS 8.

Key measurement assumptions

An entity must disclose information regarding key assumptions about the future, and other key 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.

In respect of those assets and liabilities, the notes must include details of:

- their nature; and
- their carrying amount as at the reporting date.

Examples of key assumptions disclosed are:

- future interest rates;
- future changes in salaries;
- future changes in prices affecting other costs; and,
- useful lives.

Examples of the types of disclosures made are:

- the nature of the assumption or other measurement uncertainty;
- the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity;
- the expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected; and
- an explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved.

Capital disclosures

An entity must disclose information to enable users to evaluate its objectives, policies and processes for managing capital.

An entity must disclose the following:

- qualitative information including:
  - a description of what it manages as capital;
  - the nature of any externally imposed capital requirements and how they are incorporated into the management of capital;
  - how it is meeting its objectives for managing capital;
- summary quantitative data about what it manages as capital; and
- whether any externally imposed capital requirements have been complied with and if not the consequences of such non-compliance.

These disclosures must be based on information provided internally to key management personnel.

2 ED/2014/1: DISCLOSURE INITIATIVE

Section overview

- Introduction
- Materiality
- Information to be presented in the SOFP or the SOPL & OCI
- Notes
- Disclosure of accounting policies

2.1 Introduction

The objective of this project is to make narrow-focus amendments to IAS 1 Presentation of Financial Statements to address some of the concerns expressed about existing presentation and disclosure requirements, and to ensure that entities are able to use judgement when preparing financial statements

The proposed amendments relate to:

- ❑ materiality and aggregation;
- ❑ statement of financial position and statement of profit or loss and other comprehensive income;
- ❑ notes structure; and
- ❑ disclosure of accounting policies.

2.2 Materiality

The proposed amendments clarify the materiality requirements in IAS 1 and include an emphasis on the potentially detrimental effect of overwhelming useful information with immaterial information.

- ❑ Entities must not aggregate or disaggregate information in a manner that obscures useful information;
- ❑ the materiality requirements apply to the statement(s) of profit or loss and other comprehensive income, statement of financial position, statement of cash flows and statements of changes in equity and to the notes; and
- ❑ An entity need not provide a specific disclosure required by an IFRS in the financial statements, including in the notes, if the information resulting from that disclosure is not material. When a standard requires a specific disclosure, an entity must assess whether all of that information needs to be presented or disclosed, or whether some of the information is immaterial and presenting or disclosing it would reduce the understandability of its financial statements by detracting from the material information.

2.3 Information to be presented in the SOFP or the SOPL & OCI

IAS 1 includes a list of line items that should be shown in the statement of financial position and a list of line items that should be shown the statement of profit or loss. The ED proposes to add the following paragraph below each list.

"These line items must be disaggregated when such presentation is relevant to an understanding of the entity's financial position".

IAS 1 requires that an entity should "*present additional line items, headings and subtotals in the statement of financial position when such presentation is relevant to an understanding of the entity's financial position*". There is a similar requirement for the statement of profit or loss.

The ED proposes to add a requirement that when an entity presents subtotals in accordance with these paragraphs, those subtotals must:

- be made up of items recognised and measured in accordance with IFRS;
- be presented and labelled in a manner that makes what constitutes the subtotal understandable; and
- be consistent from period to period.

In addition any extra subtotal in the statement of profit or loss cannot be displayed with more prominence that the subtotals and totals already required by IAS 1.

2.4 Notes

IAS 1 contains a requirement that notes must be presented in a systematic manner.

The ED clarifies that entities have flexibility as to the order in which they present the notes, but also emphasise that understandability and comparability should be considered by an entity when deciding that order. The ED proposes to provide additional guidance which allows the entity to consider:

- sequence of notes based on importance;
- inter-related disclosures and grouping of notes;
- sequence of notes compared to the primary financial statements sequence; and
- whether accounting policy descriptions should be in a separate section, or as part of other notes

2.5 Disclosure of accounting policies

The ED proposes the removal of potentially unhelpful guidance in IAS 1 for identifying a significant accounting policy.

This is a minor change and is not discussed further.

3 IAS 34: INTERIM FINANCIAL REPORTING

Section overview

- Scope of IAS 34
- Form and content of interim financial statements
- Periods for which interim financial statements must be presented
- Recognition and measurement
- Use of estimates in interim financial statements

3.1 Scope of IAS 34

IAS 1 requires that financial statements should be produced at least annually. Many companies are required by national regulations to produce accounts on a half-yearly basis or sometimes on a quarterly basis. For example, the Listing Regulations of Pakistan requires listed companies whose shares are traded on the Pakistan Stock Exchange to present financial statements on quarterly, half yearly and annual basis.

IAS 34 **Interim financial reporting** does not specify the frequency of interim reporting: this is a matter for national regulations, which may vary between countries. IAS 34 focuses on providing guidance on the form and content of these interim accounts.

It encourages publicly-traded companies to prepare interim accounts and to file them with the national authority no later than 60 days after the end of the interim period.

3.2 Form and content of interim financial statements

IAS 34 requires that, as a minimum, an interim financial report should include:

- a condensed statement of financial position
- a condensed statement of profit or loss and other comprehensive income, presented as either a condensed single statement or a condensed separate statement of profit or loss followed by a condensed statement of other comprehensive income
- a condensed statement of changes in equity
- a condensed statement of cash flows, and
- selected explanatory notes.

In the statement that presents the components of profit or loss an entity should present the basic and diluted EPS for the period.

An entity could provide a full set of financial statements or additional selected information if it wishes to do so. If it chooses to produce a full set of financial statements for its interim accounts, the entity must comply with IAS 1.

The interim statements are designed to provide an update on the performance and position of the entity. It should focus on new activities, events, and circumstances that have occurred since the previous annual financial statements were issued. They should not duplicate information that has already been reported in the past.

3.3 Periods for which interim financial statements must be presented

Interim reports must include the following financial statements (condensed or complete):

- a statement of financial position at the end of the current interim period and a comparative balance sheet at the end of the previous financial year.
- statements of profit or loss and other comprehensive income for the current interim period and cumulatively for the current financial year to date.
- comparative statements of profit or loss and other comprehensive income for the comparable interim period last year, and the comparable cumulative period last year.
- a statement of changes in equity for the current financial year to date, with a comparative statement for the comparable year-to-date period in the previous year.
- a statement of cash flows cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period in the previous year.

Example: Periods for which interim financial statements must be presented

X plc publishes interim financial reports quarterly.

The entity's financial year ends 31 December (calendar year).

The statements that must be presented in the quarterly interim report as of 30 June 2015:

	30th June 2014	31st December 2014	30th June 2015
Statement of financial position	-	✔	✔
Statement of profit or loss and other comprehensive income			
6 months ending	✔	-	✔
3 months ending	✔	-	✔
Statement of cash flows			
6 months ending	✔	-	✔
3 months ending	-	-	-
Statement of changes in equity			
6 months ending	✔	-	✔
3 months ending	-	-	-

Note: the profit and loss statement will have four columns.

3.4 Recognition and measurement

An entity should use the same accounting policies in the interim accounts that it uses in the annual financial statements.

Measurement for interim purposes should be made on a year-to-date basis. For example, suppose that a company uses quarterly reporting and in the first quarter of the year, it writes down some inventory to zero. If it is then able to sell the inventory in the next quarter, the results for the six-month period require no write-down of inventory, and the write-down of inventory should be reversed for the purpose of preparing the interim accounts for the first six months of the year.

An appendix to IAS 34 gives some guidance on applying the general recognition and measurement rules from the IASB Conceptual Framework to the interim accounts. Some examples are given below.

Intangible assets

The guidance in IAS 34 states that an entity should follow the normal recognition criteria when accounting for intangible assets. Development costs that have been incurred by the interim date but do not meet the recognition criteria should be expensed. It is not appropriate to capitalise them as an intangible asset in the belief that the criteria will be met by the end of the annual reporting period.

Tax

Interim period income tax expense is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period.

The following examples illustrate the application of the foregoing principle.

Example: Interim period income tax expense

An entity publishes interim financial reports quarterly.

It expects to earn Rs. 10,000 pre-tax each quarter and operates in a jurisdiction with a tax rate of 20% on the first 20,000 of annual earnings and 30% on all additional earnings.

Actual earnings match expectations.

The following table shows the amount of income tax expense that is reported in each quarter:

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Annual total
Tax expense	2,500	2,500	2,500	2,500	10,000

Rs. 10,000 of tax is expected to be payable for the full year on Rs. 40,000 of pre-tax income.

Example: Interim period income tax expense

An entity publishes interim financial reports quarterly.

The entity earns 15,000 pre-tax profit in the first quarter but expects to incur losses of 5,000 in each of the three remaining quarters (thus having zero income for the year), and operates in a jurisdiction in which its estimated average annual income tax rate is expected to be 20%.

The following table shows the amount of income tax expense that is reported in each quarter:

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Annual total
Tax expense	3,000	(1,000)	(1,000)	(1,000)	nil

3.5 Use of estimates in interim financial statements

The interim financial statements should be reliable and relevant. However IAS 34 recognises that the preparation of interim accounts will generally rely more heavily on estimates than the annual financial statements. An appendix of IAS 34 provides examples.

Pensions

A company is not expected to obtain an actuarial valuation of its pension liabilities at the interim date. The guidance suggests that the most recent valuation should be rolled forward and used in the interim accounts.

Provisions

The calculation of some provisions requires the assistance of an expert. IAS 34 recognises that this would be too costly and time-consuming for the interim accounts. IAS 34 therefore states that the figure included in the annual financial statements for the previous year should be updated without reference to an expert.

Inventories

A full count of inventory may not be necessary at the interim reporting date. It may be sufficient to make estimates based on sales margins to establish a valuation for the interim accounts.

4 IAS 24: RELATED PARTY DISCLOSURES

Section overview

- Impact on the financial statements
- The objective of IAS 24
- Definitions
- Disclosure requirements

4.1 Impact on the financial statements

A user of financial statements will normally expect the financial statements to reflect transactions that have taken place on normal commercial terms ('at arm's length'). The user of the financial statements would want to be informed if:

- ❑ Transactions have taken place that were not at 'arm's length'; or
- ❑ There are parties that could enforce transactions on the entity that are not on an 'arm's length' basis.

For example, in a group of companies, an entity might sell goods to its parent or fellow-subsidiaries on more favourable terms than it would sell to other customers.

In this situation, the financial performance or financial position reported by the financial statements would be misleading. In each situation there is a special relationship between the parties to the business transactions. This is referred to as a 'related party relationship'.

4.2 The objective of IAS 24

The objective of IAS 24 is to ensure that an entity's financial statements contain sufficient disclosures to draw attention to the possibility that the entity's financial position, or profit or loss may have been affected by:

- ❑ the existence of related parties; and
- ❑ transactions and outstanding balances with related parties.

IAS 24 is a **disclosure** standard. It does not require the redrafting of financial statements. Such redrafting would be difficult as without the related party relationship the transactions might never have taken place, and even if they had, it may not be possible to determine at what amount.

Specified disclosures are required of:

- ❑ related party relationships; and
- ❑ related party transactions.

4.3 Definitions

IAS 24 provides a lengthy definition of a related party and also a definition of a related party transaction.

Related party

Definition: Related party

A related party is a person or entity that is related to the entity that is preparing its financial statements (the reporting entity).

a) **A person or a close member of that person's family is related to a reporting entity if that person:**
   - i) **has control or joint control over the reporting entity;**
   - ii) **has significant influence over the reporting entity; or**
   - iii) **is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.**

b) **An entity is related to a reporting entity if any of the following conditions applies:**
   - i) **The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).**
   - ii) **One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).**
   - iii) **Both entities are joint ventures of the same third party.**
   - iv) **One entity is a joint venture of a third entity and the other entity is an associate of the third entity.**
   - v) **The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.**
   - vi) **The entity is controlled or jointly controlled by a person identified in (a).**
   - vii) **A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).**
   - viii) **The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity of to the parent of the reporting entity.**

A parent entity is related to its subsidiary entities (because it controls them) and its associated entities (because it exerts significant influence over them). Fellow subsidiaries are also related parties, because they are under the common control of the parent.

In considering each possible related party relationship the entity must look to the **substance** of the arrangement, and not merely its legal form. Although two entities that have the same individual on their board of directors would not meet any of the above conditions for a related party, a related party relationship would nevertheless exist if influence can be shown.

Some examples are given by IAS 24 of **likely exemptions**, where a related party relationship would usually not exist. However, the substance of the relationship should always be considered in each case.

Examples of **entities that are usually not related parties** are:

- Two venturers that simply share joint control over a joint venture
- Providers of finance (such as a lending bank or a bondholder)
- Trade unions
- Public utilities
- Government departments and agencies
- Customers, suppliers, franchisors, distributors or other agents with whom the entity transacts a significant volume of business.

Close family members

Definition: Close family members

Close family members are those family members who may be expected to influence, or be influenced by that individual.

Close family members include:

- an individual's partner, children and dependants; and
- children or dependants of the individual's partner.

Related party transactions

Definition: Related party transaction

A related party transaction is a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.

The following examples of related party transactions are given in IAS 24. (These are related party transactions when they take place between related parties.)

- Purchases or sales of goods
- Purchases or sales of property and other assets
- Rendering or receiving of services
- Leases
- Transfer of research and development costs
- Finance arrangements (such as loans or contribution to equity)
- Provision of guarantees
- Settlement of liabilities on behalf of the entity or by the entity on behalf of another party.

Example: Related party transactions

In the following examples, identify related party relationships between all parties and state any additional factors to consider in order to form a conclusion:

(a) W Plc holds a controlling interest in X Ltd and Y Ltd. Z Ltd is a wholly owned subsidiary of X Ltd.

(b) Mr Z holds 75% of the voting capital of A Ltd and 40% of the voting capital of B Ltd.

(c) H and W (who are husband and wife) are the directors and majority shareholders of Q Ltd. The company makes purchases from P Ltd, a company jointly controlled by W and their daughter, D. D is a director of P Ltd but holds no share in Q Ltd.

Answer

(a) **W Plc**

W PLC is related to both X Ltd and Y Ltd (both subsidiaries) because of its controlling interest.

X Ltd and Y Ltd are related because they are under the common control of W PLC.

Z Ltd is related to X Ltd because of its subsidiary status.

Z Ltd is also related to W PLC as he is indirectly controlled by W PLC through W PLC's holding of X Ltd.

(b) **Mr Z**

Mr Z is related to A Ltd because of the subsidiary status of A Ltd.

As an associate of Mr Z, B Ltd is also a related party

A Ltd and B Ltd are not related. Although they are both owned by Mr Z, there is no common control because Mr Z only has a 40% stake in B Ltd.

(c) **Q Ltd**

H and W are both related to Q Ltd, because they are key management of the entity

D could be considered to be close family to H and W, but this is only true if it can be shown that she is influenced by them in business dealings (and there is insufficient information in this example to ascertain whether this is true).

P Ltd is related to Q Ltd as it is jointly controlled by a member of the key management of Q Ltd. Therefore any business dealings between the two entities will need to be disclosed.

4.4 Disclosure requirements

IAS 24 requires disclosure in the notes to the financial statements of the following, **whether or not transactions have taken place** between those related parties:

- the name of the entity's parent
- if different, the name of the ultimate controlling party

Where transactions have taken place between the related parties, irrespective of whether a price was charged, the following should be disclosed:

- The nature of the related party relationship

- The amount of the transactions
- In respect of outstanding balances
  - the amount
  - their terms and conditions
  - any guarantees given or received
  - any provision for doubtful/irrecoverable debts
- The expense recognised in the period in respect of irrecoverable debts due from related parties.

The above disclosures should be given separately for each of the following categories of related party:

- The parent
- Entities with joint control or significant influence over the entity
- Subsidiaries
- Associates
- Joint ventures in which the entity is a venturer
- Key management personnel of the entity or its parent
- Other related parties

In addition, IAS 24 requires disclosure of **compensation to key management personnel**, in total, and for each of the following categories:

- Short-term employee benefits
- Post-employment benefits
- Other long-term benefits
- Termination benefits
- Share-based payments.

Illustration: Disclosure note

An example of a note to the financial statements for related party transactions of a large quoted company is shown below:

Trading transactions

	Sales to related parties	Purchases from related parties	Amounts owed by related parties	Amounts owed to related parties
	Rs. m	Rs. m	Rs. m	Rs. m
Associates	-	48	-	17
Joint ventures	57	14	12	-

Non-trading transactions

	Loans to related parties	Loans from related parties
	Rs.m	Rs.m
Associates	-	11
Joint ventures	33	-

5 IFRS 8: OPERATING SEGMENTS

Section overview

- Introduction
- Operating segments

5.1 Introduction

Many companies operate in several different industries (or 'product markets') or diversify their operations across several geographical locations. A consequence of diversification is that companies are exposed to different rates of profitability, different growth prospects and different amounts of risk for each separate 'segment' of their operations.

Objective of IFRS 8

IFRS 8 requires quoted companies to disclose information about their different operating segments, in order to allow users of the financial statements to gain a better understanding of the company's financial position and performance.

Users are able to use the information about the main segments of the company's operations to carry out ratio analysis, identify trends and make predictions about the future. Without segment information, good performance in some segments may 'hide' very poor performance in another segment, and the user of the financial statements will not see the true position of the company.

Scope of IFRS 8

Segment reporting is required for any entity whose debt or equity is **quoted** on a public securities market (stock market) and also entities that are in the process of becoming quoted. If an entity includes some segment information in the annual report that doesn't comply with IFRS 8, it cannot call it 'segmental information.'

5.2 Operating segments

IFRS 8 defines an operating segment as a component of an entity:

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

Not every part of an entity is necessarily an operating segment. For example a corporate head office may not earn revenue and would not be an operating segment.

The standard requires a segment to have its results reviewed by the chief operating decision maker. The reason for this part of the definition of an operating segment is to ensure that an entity reports segments that are used by management of the entity to monitor the business.

Aggregation of segments

Two or more operating segments may be aggregated into a single operating segment if they have similar economic characteristics, and the segments are similar in each of the following respects:

- The nature of the products and services
- The nature of the production process
- The type or class of customer for their products and services
- The methods used to distribute their products or provide their services, and
- If applicable, the nature of the regulatory environment, for example, banking insurance or public utilities.

Quantitative thresholds

An entity must report separately information about an operating segment that meets any of the following quantitative thresholds:

- Its reported revenue, including external sales and intersegment sales is 10% or more of the combined internal and external revenue of all operating segments
- Its reported profit is 10% or more of the greater of the combined profit of all segments that did not report a loss and the combined reporting loss of all segments that reported a loss
- Its assets are 10% or more of the combined assets of all operating segments

Reportable segments

An entity must report separately information about each operating segment that:

- Has been identified in accordance with the definition of an operating segment shown above
- Or is aggregated with another segment
- Or exceeds the quantitative thresholds.

If the total external revenue reported by operating segments constitutes less than 75% of the entity's total revenue, then additional operating segments must be identified as reporting segments, even if they do not meet the criteria, until 75% of revenue is included in reportable segments.

Example:

The following information relates to a quoted company with five divisions of operation:

	Profit	Loss				
	Rs.m	Rs.m	Rs.m	Rs.m	Rs.m	Rs.m
Division 1	10					
Division 2	25					
Division 3		40				
Division 4	35					
Division 5	40					
	110	40				

Which of the divisions are reportable segments under IFRS 8 Operating segments?

Answer

Since Profit figure is higher, we will take 10% of that amount.

	Profit	Loss	Reportable segment (results > Rs. 11m
	Rs.m	Rs.m	
Division 1	10		No
Division 2	25		Yes
Division 3		40	Yes
Division 4	35		Yes
Division 5	40		Yes
	110	40	
Greater of the two	110		
Materiality threshold (10%)	11		

Note: Division 3 is reportable as the loss of Rs. 40m is greater than Rs. 11m (ignoring the sign).

Example:

The following information relates to Oakwood, a quoted company with five divisions of operation:

	Wood sales	Furniture sales	Veneer sales	Waste sales	Other sales	Total
	Rs.m	Rs.m	Rs.m	Rs.m	Rs.m	Rs.m
Revenue from external customers	220	256	62	55	57	650
Inter segment revenue	38	2	-	5	3	48
Reported profit	54	45	12	9	10	130
Total assets	4,900	4,100	200	400	600	10,200

Which of the business divisions are reportable segments under IFRS 8 Operating segments?

Answer

IFRS 8 states that a segment is reportable if it meets any of the following criteria:

1. its internal and external revenue is more than 10% of the total entity internal and external revenue.
2. its reported profit is 10% or more of the greater of the combined profit of all segments that did not report a loss.
3. its assets are 10% or more of the combined assets of all operating segments.

From the table above, only the Wood and Furniture department sales have more than 10% of revenue, assets and profit and meet the requirements for an operating segment. The other three divisions do not meet the criteria: none of them pass the 10% test for assets, profit or revenue.

Additionally IFRS 8 states that if total external revenue reported by operating segments constitutes less than 75% of the entity's revenue then additional operating segments must be identified as reporting segments, until 75% of revenue is included in reportable segments

The total external revenue of Wood and Furniture is Rs.476m and the total entity revenue is Rs.650m, which means that the revenue covered by reporting these two segments is only 73%. This does not meet the criteria so we must add another operating segment to be able to report on 75% of revenue. It doesn't matter that any of the other entities do not meet the original segment criteria.

In this case, we can add on any of the other segments to achieve the 75% target. If we add in Veneer sales, this gives total sales of Rs.538m, which is 83% of the sales revenue of Rs.650m. This is satisfactory for the segmental report.

Disclosure

IFRS 8 states that an entity must disclose information so that users of the financial statements can evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

The information that is to be disclosed is:

- A measure of profit or loss for each reportable segment
- A measure of total assets liabilities for each reportable segment if such an amount is reported regularly to the chief operating decision maker
- Information about the following items if they are specified and included in the measure of segment profit that is reported to the chief operating decision maker:
  - revenues from external customers
  - revenues from transactions with other operating segments of the same entity
  - interest revenue
  - interest expense
  - depreciation and amortisation
  - material items of income and expense in accordance with IAS 1
  - the entity's interest in the profit or loss of associates and joint ventures accounted for by the equity method
  - income tax expense or income
  - material non-cash items other than depreciation and amortisation.
- the amount of investment in associates and joint ventures accounted for by the equity method and the amounts of additions to non-current assets (excluding financial instruments, deferred tax assets, post-employment benefit assets and rights arising under insurance contracts), providing these amounts are included in segment assets.

Additionally, the following reconciliations are required:

- Reconciliation of the totals of segment revenues to the entity's revenue;
- Reconciliation of the total of reported segment profits or losses to the entity's profit before tax and discontinued operations;
- Reconciliation of the total of the assets of the reportable segments to the entity's assets;
- Reconciliation of the total of the liabilities of the reportable segments to the entity's liabilities (but only if segment liabilities are reported); and
- Reconciliation of the total of the assets of the other material items to the entity's corresponding items.

Also, the factors used to identify the entity's reportable segments, including the basis of organisation, (i.e. whether the entity is organised around different products and services or geographical area), and the types of products and service from which the reportable segments derive their income must all be disclosed.

Measurement

IFRS 8 requires that the amount of each segment item reported shall be the measure reported to the chief operating decision maker for the purposes of making decisions about allocating resources to the segment and assessing its performance. This is based on the internal structure of how division of the entity report their results to the chief operating decision maker. Any adjustments and eliminations made in preparing an entity's financial statements shall be included in determining segment results only if they are included in the measure of the segment's results used by the chief operating decision maker.

The minimum amount the entity must disclose is:

- The basis of accounting for any transactions between reportable segments
- The nature of any differences between the measurement of the reportable segments' profit or loss before tax and the entity's profit or loss, for example, the allocation of centrally incurred costs.
- The nature of any differences between the measurement of the reportable segments' assets and the assets of the entity.
- The nature of any differences between the measurement of the reportable segments' liabilities and the liabilities of the entity.
- The nature of any changes from prior periods in measurement methods used to determine segment profit or loss and the effect on profit or loss from those changes.
- The nature of asymmetrical allocations to reportable segments. For example, a reportable segment may be charged the depreciation expense for a particular asset but the depreciable asset might not have been allocated to the segment.

Entity wide disclosures

The reporting entity must also make the following disclosures in the financial statements, even if it only has one reportable segment:

- Revenue from external customers for each product and service or each group of similar products and services.
- Revenue from external customers attributed to the entity's country of domicile and attributed to all foreign countries in total where revenue is made.
- Non-current assets located in the country of domicile and located in all foreign countries in total where the entity holds assets
- If revenue from any customer is more than 10% of total revenue then it must be disclosed along with the total of revenues from these customers and the identity of the segment reporting the revenue.

6 IAS 10: EVENTS AFTER THE REPORTING PERIOD

Section overview

- Purpose of IAS 10
- Accounting for adjusting events after the reporting period
- Disclosures for non-adjusting events after the reporting period
- Dividends
- The going concern assumption

6.1 Purpose of IAS 10

IAS 10 **Events after the reporting period** has two main objectives:

- to specify when a company should adjust its financial statements for events that occur after the end of the reporting period, but before the financial statements are authorised for issue, and
- to specify the disclosures that should be given about events that have occurred after the end of the reporting period but before the financial statements were authorised for issue.

IAS 10 also includes a requirement that the financial statements should disclose when the statements were authorised for issue, and who gave the authorisation.

IAS 10 sets out the following key definitions.

Definitions

Events after the reporting period: Those events, favourable and unfavourable that occur between the end of the reporting period and the date the financial statements are authorised for issue.

Adjusting events: Events that provide evidence of conditions that already existed as at the end of the reporting period.

Non-adjusting events: Events that have occurred due to conditions arising after the end of the reporting period.

6.2 Accounting for adjusting events after the reporting period

IAS 10 states that if a company obtains information about an adjusting event after the reporting period, it should adjust the financial statements to allow for this new information.

IAS 10 gives the following examples of **adjusting events**.

- The settlement of a court case after the end of the reporting period, confirming that the company had a present obligation as at the end of the reporting period as a consequence of the case.
- The receipt of information after the reporting period indicating that an asset was impaired as at the end of the reporting period.
- The discovery of fraud or errors showing that the financial statements are incorrect.

6.3 Disclosures for non-adjusting events after the reporting period

Non-adjusting events after the reporting period are treated differently. A non-adjusting event relates to conditions that did not exist at the end of the reporting period, therefore the financial statements must not be updated to include the effects of the event. IAS 10 states quite firmly: 'A company shall **not** adjust the amounts recognised in the financial statements to reflect non-adjusting events after the reporting period'.

However, IAS 10 goes on to say that if a non-adjusting event is material, a failure by the company to provide a disclosure about it could influence the economic decisions taken by users of the financial statements. For material non-adjusting events IAS 10 therefore requires disclosure of:

- the nature of the event; and
- an estimate of its financial effect or a statement that such an estimate cannot be made.

IAS 10 gives the following examples of non-adjusting events:

- A fall in value of an asset after the end of the reporting period, such as a large fall in the market value of some investments owned by the company, between the end of the reporting period and the date the financial statements are authorised for issue.
- The acquisition or disposal of a major subsidiary.
- The formal announcement of a plan to discontinue a major operation.
- Announcing or commencing the implementation of a major restructuring.
- The destruction of a major plant by a fire after the end of the reporting period.

6.4 Dividends

IAS 10 also contains specific provisions about proposed dividends and the going concern presumption on which financial statements are normally based.

If equity dividends are declared after the reporting period, they should not be recognised, because they did not exist as an obligation at the end of the reporting period.

Dividends proposed after the reporting period (but before the financial statements are approved) should be disclosed in a note to the financial statements, in accordance with IAS 1.

6.5 The going concern assumption

There is one important exception to the normal rule that the financial statements reflect conditions as at the end of the reporting period.

A deterioration in operating results and financial position after the end of the reporting period may indicate that the going concern presumption is no longer appropriate.

There are a large number of circumstances that could lead to going concern problems. For example:

- The financial difficulty of a major customer leading to their inability to pay their debt to the agreed schedule if at all.

- An event leading to the net realisable value of lines of inventory falling to less than cost.
- An event leading to a crucial non-current asset falling out of use. This might cause difficulties in supplying customers and fulfilling contracts.
- A change in market conditions leading to a loss in value of major investments.
- Shortages of important supplies
- The emergence of a highly effective competitor.

If it becomes clear that the company cannot be considered to be a going concern, the financial statements will need to disclose this and the basis for preparing them will change to the 'break-up' basis.

This means that values will have to be adjusted to the amounts expected to be realised through sale.

CHAPTER 4

IAS 8: Accounting policies, changes in accounting estimates and errors

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 13 IAS 8: Accounting policies, changes in accounting estimates and errors

1 ACCOUNTING POLICIES

Section overview

- Introduction to IAS 8
- Accounting policies
- Selection of accounting policies
- Changes in accounting policies
- Retrospective application of a change in accounting policy
- Limitation on retrospective application
- Disclosure of a change in accounting policy
- Judgements- IAS8

1.1 Introduction to IAS 8

The aim of *IAS 8: Accounting policies, changes in accounting estimates and errors* is to enhance comparability of the entity's financial statements to previous periods and to the financial statements of other entities.

It does this by prescribing:

- the criteria for selecting accounting policies; and,
- the accounting treatment and disclosure of:
  - changes in accounting policies;
  - changes in accounting estimates; and
  - errors.

Much of IAS 8 is concerned with how changes or corrections should be reported in the financial statements.

1.2 Accounting policies

Definition: Accounting policies

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

IFRSs set out accounting policies that result in financial statements containing relevant and reliable information about the transactions, other events and conditions to which they apply. Those policies need not be applied when the effect of applying them is immaterial.

Definition: 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. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

1.3 Selection of accounting policies

Selection of accounting policies – Areas covered by IFRS

If an IFRS (or an Interpretation) applies to an item in the financial statements, the accounting policy or policies applied to that item must be determined by applying the Standard or Interpretation and any relevant implementation guidance issued.

Selection of accounting policies – Area not covered by IFRS

If there is no rule in IFRS that specifically applies to an item in the financial statements, management must use its judgement to develop and apply an accounting policy that results in information that is:

- relevant to the decision-making needs of users; and
- reliable in that the financial statements:
- represent faithfully the results and financial position of the entity;
- reflect the economic substance of transactions and other events, and not merely the legal form;
- are neutral, i.e. free from bias;
- are prudent; and
- are complete in all material respects.

In making the judgement management must consider the following sources in descending order:

- the requirements and guidance in IFRS dealing with similar and related issues;
- the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses set out in the "Framework".

Management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to the extent that these do not conflict with the above sources.

Consistency of accounting policies

An entity must apply consistent accounting policies over the periods to deal with similar transactions, and other events and circumstances, unless IFRS specifically requires or permits categorisation of items for which different policies may be appropriate.

Illustration: Consistency

IAS 16: Property, plant and equipment allows the use of the cost model or the revaluation model for measurement after recognition.

This is an example of where IFRS permits categorisation of items for which different policies may be appropriate.

If chosen, each model must be applied to an entire class of assets. Each model must be applied consistently within each class that has been identified.

1.4 Changes in accounting policies

Users of financial statements need to be able to compare financial statements of an entity over time, so that they can identify trends in its financial performance or financial position. Frequent changes in accounting policies are therefore undesirable because they make comparisons with previous periods more difficult.

The same accounting policies must be applied within each period and from one period to the next unless a change in accounting policy meets one of the following criteria. A change in accounting policy is permitted only if the change is:

- required by IFRS; or
- results in the financial statements providing reliable and more relevant financial information.

A new or revised standard usually include specific ***transitional provisions***' to explain how the change required by the new rules should be introduced.

In the absence of specific transitional provisions, a change in policy should be applied retrospectively. This is explained shortly.

Determining when there is a change in accounting policy

A change in accounting policy can be established as follows. The accounting policies chosen by an entity should reflect transactions and events through:

- recognition (e.g. capitalising or writing off certain types of expenditure)
- measurement (e.g. measuring non-current assets at cost or valuation)
- presentation (e.g. classification of costs as cost of sales or administrative expenses)

If at least one of these criteria is changed, then there is a change in accounting policy.

Illustration: Determining when there is a change in accounting policy

IAS 23 requires the capitalisation of borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset.

Previously, IAS 23 allowed companies to expense or capitalise borrowing costs.

The revision to IAS 23 led to a change in accounting policy for some companies as it affected:

- **recognition – the interest cost previously recognised as an expense had to be recognised as an asset; and**
- **presentation – the interest cost previously presented in the statement of comprehensive income had to be presented in the statement of financial position.**

IAS 8 specifies that the application of a new accounting policy to transactions or events that did not occur previously or differ in substance from those that occurred previously, is **not** a change of accounting policy. It is simply the application of a suitable accounting policy to a new type of transaction.

The initial application of a policy to revalue assets in accordance with IAS 16 Property, Plant and Equipment or IAS 38 Intangible Assets is a change in an accounting policy. However, it is accounted for in accordance guidance in those standards rather than in accordance with IAS 8.

1.5 Retrospective application of a change in accounting policy

When a change in accounting policy is required, and there are no transitional provisions relating to the introduction of a new accounting standard, the change in policy should be applied retrospectively.

Definition: Retrospective application

Retrospective application is applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.

The entity should adjust the opening balance for each item of equity affected by the change, for the earliest prior period presented, and the other comparative amounts for each prior period presented, as if the new accounting policy had always been applied.

IAS 1: Presentation of Financial Statements requires a statement of financial position at the beginning of the earliest comparative period when a new accounting policy is applied retrospectively.

Illustration: Retrospective application

A company presents comparatives for the previous year only.

During the year ended 31 December 2015 it changes an accounting policy and this change must be applied retrospectively.

If there were no change in accounting policy the company would present statements of financial position as at December 2015 and December 2014 only.

However, because there is a change in accounting policy the company must also present a statement of financial position as at 1 January 2014 (the beginning of the earliest comparative period).

The change in accounting policy is applied retrospectively. This means that the change should be applied to the balances at as at 1 January 2014 as if the new accounting policy had always been applied.

Similarly, any other comparative amounts in previous periods should be adjusted as if the new accounting policy had always been applied.

If this is impracticable, retrospective application should be applied from the earliest date that is practicable.

1.6 Limitation on retrospective application

It might be impracticable to retrospectively apply the change in accounting policy. This could be because the information necessary for the application of the change in accounting policy to earlier periods is not available because it had not been collected then.

Definition: Impracticable

Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:

(a) the effects of the retrospective application or retrospective restatement are not determinable;

(b) the retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period; or

(c) the retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:

(i) provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed; and

(ii) would have been available when the financial statements for that prior period were authorised for issue from other information.

There are different degrees of impracticability.

Period specific effect

It might be impracticable to determine the effect of changing an accounting policy on comparative information for one or more prior periods presented. For example, it might be impracticable to determine the impact on profit for the prior year.

In this case entity must apply the new accounting policy to the carrying amounts of assets and liabilities (and therefore equity) as at the beginning of the earliest period for which retrospective application is practicable. This may be the current period.

Cumulative effect

It might be impracticable to determine the cumulative effect, at the beginning of the current period, of applying a new accounting policy to all prior periods,

In this case a company must adjust the comparative information to apply the new accounting policy prospectively from the earliest date practicable.

When the cumulative effect of applying the policy to all prior periods cannot be determined, a company must apply the new policy prospectively from the start of the earliest period practicable. This means that it would disregard the portion of the cumulative adjustment to assets, liabilities and equity arising before that date.

Definition: Prospective application

Prospective application of a change in accounting policy and of recognising the effect of a change in an accounting estimate, respectively, are:

(a) **applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed; and**

(b) **recognising the effect of the change in the accounting estimate in the current and future periods affected by the change.**

1.7 Disclosure of a change in accounting policy

When a change in accounting policy has an effect on the current period or any prior period (or would have an affected that period except that it is impracticable to determine the amount of the adjustment) or might have an effect on future periods the following must be disclosed:

Disclosure:	Change due to IFRS	Voluntary change
The title of the Standard or Interpretation	✓	
The nature of the change in accounting policy	✓	✓
A description of any transitional provisions	✓	
The reason why the new accounting policy provides reliable and more relevant information		✓

Disclosure:	Change due to IFRS	Voluntary change
For the current and previous period(s), to the extent practicable, the amount of the adjustment to each item in the financial statements.	✓	✓
To the extent practicable, the adjustment relating to accounting periods before those presented in the financial statements	✓	✓
If retrospective application is impracticable, an explanation of how the accounting policy change has been applied	✓	✓

1.8 Judgements – IAS 8

IAS 8: Areas of judgement and estimate

- Application of this standard requires different judgements and estimates to be made which would have an impact on figures reported in the financial statements.
- These include the following:
- Development of an accounting policy for events, transactions or balances that are not specifically covered by an IFRS
- Categorising items for the purpose of applying policies consistently to like items
- Whether or not a voluntary change in accounting policy provides reliable and more relevant information
- Impracticability arguments

2 ACCOUNTING ESTIMATES

Section overview

- Accounting estimates
- Changes in accounting estimates
- Disclosures

2.1 Accounting estimates

An accounting estimate is made for an item in the financial statements when the item cannot be measured with precision, and there is some uncertainty about it.

An estimate is therefore based, to some extent, on management's judgement. Management estimates might be required, for example, for the following items:

- bad debts;
- inventory obsolescence;
- the fair value of financial assets or liabilities;
- the useful lives of non-current assets;
- the most appropriate depreciation pattern (depreciation method, for example straight line or reducing balance) for a category of non-current assets;
- measurement of warranty provisions.

The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

Accounting policy vs accounting estimate

It is important to distinguish between an accounting policy and an accounting estimate.

Sometimes it can be difficult to distinguish between changes in accounting policy from changes in accounting estimate. In such cases any change is treated as a change in accounting estimate.

Illustration: Accounting policy vs accounting estimate

Accounting policy: Depreciating plant and equipment over its useful life

Accounting estimate: How to apply the policy. For example whether to use the straight line method of depreciation or the reducing balance method is a choice of accounting estimate.

A change in the measurement basis applied is a change in an accounting policy, and is not a change in an accounting estimate.

Illustration: Accounting policy vs accounting estimate

IAS 16: Property, plant and equipment allows the use of the cost model or the revaluation model for measurement after recognition.

This is a choice of accounting policy.

2.2 Changes in accounting estimates

Definition: Change in accounting estimate

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.

A change in accounting estimate may be needed if changes occur in the circumstances on which the estimate was based, or if new information becomes available. A change in estimate is **not** the result of discovering an error in the way an item has been accounted for in the past and it is **not** a correction of an error.

IAS 8 requires a change in an accounting policy to be accounted for retrospectively whereas a change in an accounting estimate is normally recognised from the current period.

The effect of a change in accounting estimate should be recognised prospectively, by including it:

- in profit or loss for the period in which the change is made, if the change affects that period only, or
- in profit or loss for the period of change and future periods, if the change affects both.

To the extent that a change in estimate results in a change in assets and liabilities, it should be recognised by adjusting the carrying amount of the affected assets or liabilities in the period of change.

Example: Change in accounting estimate

A non-current asset was purchased for Rs. 200,000 two years ago, when its expected economic life was ten years and its expected residual value was nil. The asset is being depreciated by the straight-line method.

A review of the non-current assets at the end of year 2 revealed that due to technological change, the useful life of the asset is only six years in total, and the asset therefore has a remaining useful life of four years.

The original depreciation charge was Rs.20,000 per year ($^{Rs.200,000}/_{10\ years}$) and at the beginning of Year 2, its carrying value was Rs.180,000 (Rs.200,000 - Rs.20,000).

The change in the estimate occurs in Year 2. The change in estimate should be applied prospectively, for years 2 onwards (years 2 – 6). From the beginning of year 2, the asset has a revised useful remaining life of five years.

The annual charge for depreciation for year 2 (the current year) and for the future years 3 – 6 will be changed from Rs.20,000 to Rs.36,000 ($^{Rs.180,000}/_{5\ years}$).

2.3 Disclosures

The following information must be disclosed:

- The nature and amount of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods, except for the effect on future periods when it is impracticable to estimate that effect.
- The fact that the effect in future periods is not disclosed because estimating it is impracticable (if this is the case).

Example: Change in accounting estimate

Company ABC acquired equipment on Jan 1. 2014 costing Rs 500,000.

The initial estimate of the useful life of the equipment was 5 years.

The estimate of the useful life was revised to 4 years at the start of 2016.

Required

Draft the disclosure note required in the financial statements for the year ended 31 December 2016

Answer

Disclosure: Profit before tax

Profit before tax is stated after taking the following into account:

Depreciation	2016	2015
Original Estimate	100,000	100,000
change in estimate	50,000	-
	150,000	100,000

Change in estimate

The estimated economic useful life of the equipment was changed from 5 years to 4 years. The increase / (decrease) in profits caused by the change is as follows:

	2016
Current year's profits:	(50,000)
Future profits:	50,000

The total effect on profit zero.

The reason is that it is only the timing of the recognition of the depreciation that has changed. The full, original cost of the asset will be expensed irrespective of the estimated useful life.

Answer (continued)

Working	Rs.
Cost at Jan 1, 2014	500,000
Accumulated depreciation up to 31 Dec 2015	(200,000)
Carrying amount at 31st December 2015	300,000
Remaining useful life (New estimate of 4 years less the two years already used)	2 years
Depreciation in the year ended 31st December 2016	150,000
Carrying amount at 31st December 2016 (Rs. 300,000 b/f less Rs. 150,000)	150,000

Practice question **1**

Example: Change in accounting estimate

Company ABC acquired equipment on Jan 1. 2014 costing Rs 100,000.

The initial estimate of the useful life of the equipment was 5 years with a nil residual value.

The estimate of residual value was revised to Rs. 90,000 at the start of 2016.

Required

Draft the disclosure note required in the financial statements for the year ended 31 December 2016

3 ERRORS

Section overview

- Errors
- The correction of prior period errors
- Limitation on retrospective restatement
- Disclosure of prior period errors

3.1 Errors

Errors might happen in preparing financial statements. If they are discovered quickly, they are corrected before the finalised financial statements are published. When this happens, the correction of the error is of no significance for the purpose of financial reporting.

A problem arises, however, when an error is discovered that relates to a prior accounting period. For example, in preparing the financial statements for Year 3, an error may be discovered affecting the financial statements for Year 2, or even Year 1.

Definition: Prior period errors

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

(a) was available when financial statements for those periods were authorised for issue; and

(b) 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.

3.2 The Correction of prior period errors

All material prior period errors should be corrected retrospectively in the first set of financial statements following the discovery of the error.

Comparative amounts for the previous period should be re-stated at their corrected amount.

If the error occurred before the previous year, the opening balances of assets, liabilities and equity for the previous period should be re-stated at their corrected amount unless that is impracticable.

The correction of a prior period error is excluded from profit or loss in the period when the error was discovered.

Illustration: Correction of prior period errors

In preparing its financial statements for 31 December 2015 Company A discovers an error affecting the 31 December 2014 financial statements.

The error should be corrected in the 31 December 2015 financial statements by re-stating the comparative figures for 31 December 2014 at their correct amount.

If the error had occurred in 31 December 2013, the comparative opening balances for the beginning of 31 December 2014 should be re-stated at their correct amount.

The reported profit for 31 December 2015 is not affected.

Example: Correction of prior period errors

Kasur Transport Company (KTC) is preparing its financial statements for 2015.

The draft statement of changes in equity is as follows:

	Share capital	Share premium	Retained earnings	Total
	Rs.000	Rs.000	Rs.000	Rs.000
Balance at 31/12/13	500	50	90	640
Profit for the year	-	-	150	150
Balance at 31/12/14	500	50	240	790
2015				
Dividends			(100)	(100)
Profit for the year			385	385
Balance at 31/12/15	500	50	525	1,075

KTC has now discovered an error in its inventory valuation. Inventory was overstated by Rs. 70,000 at 31 December 2015 and by Rs. 60,000 at 31 December 2014. The rate of tax on profits was 30% in both 2014 and 2015.

The error in 2015 is corrected against the current year profit.

The error in 2014 is corrected against the prior year profit. (Note that the 2014 closing inventory is the opening inventory in 2015 so the 2014 adjustment will impact both periods statements comprehensive income.

Profit adjustments:	2015	2014
	Rs.000	Rs.000
Profit (2015 draft and 2014 actual)	385	150
Deduct error in closing inventory	(70)	(60)
Add error in opening inventory	60	
	(10)	(60)
Tax at 30%	3	18
	(7)	(42)
Adjusted profit	378	108

The statement of changes in equity as published in 2015 becomes:

	Share capital	Share premium	Retained earnings	Total
	Rs.000	Rs.000	Rs.000	Rs.000
Balance at 31/12/13	500	50	90	640
Profit for the year **(restated)**	-	-	**108**	108
Balance at 31/12/14	500	50	198	748
2015				
Dividends			(100)	(100)
Profit for the year			378	378
Balance at 31/12/15	500	50	476	1,026

3.3 Limitation on retrospective restatement

A prior period error must be corrected by retrospective restatement except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the error.

Period specific effect

It might be impracticable to determine the effect of correcting an error in comparative information for one or more prior periods presented. For example, it might be impracticable to determine the impact on profit for the prior year.

In this case a company must restate the carrying amounts of assets and liabilities (and therefore equity) as at the beginning of the earliest period for which retrospective restatement is practicable. This may be the current period.

Cumulative effect

It might be impracticable to determine the cumulative effect, at the beginning of the current period, of correcting an error in all prior periods,

In this case a company must correct the error prospectively from the earliest date practicable.

3.4 Disclosure of prior period errors

The following information must be disclosed:

- the nature of the prior period error;
- for each period presented in the financial statements, and to the extent practicable, the amount of the correction for each financial statement item and the change to basic and fully diluted earnings per share;
- the amount of the correction at the beginning of the earliest prior period in the statements (typically, the start of the previous year);
- if retrospective re-statement is not practicable for a prior period, an explanation of how and when the error has been corrected.

IAS 8 therefore requires that a note to the financial statements should disclose details of the prior year error, and the effect that the correction has had on 'line items' in the prior year.

Example: Disclosure of prior period errors

Returning to the above example the following note would be needed to the financial statements for the year to 31 December 2015 to explain the adjustments made to figures previously published for the year to 31 December 2014.

Note about statement of comprehensive income.	Rs.000
(Increase) in cost of goods sold	(60)
Decrease in tax	18
(Decrease) in profit	(42)
Note about statement of financial position	**Rs.000**
(Decrease) in closing inventory	(60)
Decrease in tax payable	18
(Decrease) in equity	(42)

Practice questions **2**

Example: Correction of prior period errors

A company processed depreciation of machines as Rs. 70,000 in 2015 instead of as Rs. 170,000.

The following extracts from the draft financial statements for 2016 are before correction of this.

Draft statement of financial position as at 31 December 2016 (extracts)

	2016	2015	2014
Assets			
Property, plant and equipment	400,000	500,000	300,000
Liabilities and equity			
Retained earnings	360,000	205,000	42,000
Deferred tax	100,000	120,000	100,000

Draft statement of changes in equity for the year ended 31 December 2016 (extracts)

	Retained earnings Rs.
Balance: 1 January 2015	42,000
Profit for the year	163,000
Balance: January 2016	205,000
Profit for the year	155,000
Balance: December 2016	360,000

Draft Statement of comprehensive income for the year ended 31 December 2016 (extracts)

	2016 Rs.	2015 Rs.
Profit before tax	200,000	245,000
Taxation	45,000	82,000
Profit for the year	155,000	163,000

The normal tax rate is 30%.

Required:
Correct this error and draft the relevant disclosures for the year ended 31st December 2016.

Practice question **3**

Extracts of the draft financial statements of a company are as follows:

Draft statement of financial position as at 31 December 2016 (extracts)

	2016	2015	2014
Assets			
Plant	600,000	650,000	300,000
Equity and liabilities			
Retained earnings	85,000	25,000	
Deferred tax	100,000	120,000	90,000
Current tax payable	250,000	80,000	70,000

Draft statement of changes in equity for the year ended 31 December 2016 (extracts)

	Retained earnings Rs.
Balance: 1 January 2015	(24,600)
Profit for the year	49,600
Balance: January 2016	25,000
Profit for the year	60,000
Balance: December 2016	85,000

Draft Statement of comprehensive income for the year ended 31 December 2016 (extracts)

	2015 Rs.	2014 Rs.
Profit before tax	100,000	80,000
Taxation	40,000	30,400
Profit for the year	60,000	49,600

During the year it was discovered that the purchase of plant on 1 January 2013 had been written off as a repair expense, (cost: Rs. 120,000). This error affected the tax calculations and forms submitted.

The company writes off depreciation at 25% pa straight-line (not reduced for part of the year). The wear and tear allowed by the tax authorities is the same. The tax rate has been 30% for the past 8 years.

Required:

Correct this error and draft the relevant disclosures for the year ended 31st December 2016.

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

Disclosure: Profit after tax

Profit before tax is stated after taking the following into account:

Depreciation	2016	2015
Original Estimate	100,000	100,000
change in estimate	(30,000)	-
	70,000	100,000

Change in estimate

The estimated residual value of the plant and machinery was changed from nil to Rs. 90,000.

The increase / (decrease) in profits caused by the change is as follows:

	2016
Current year's profits:	30,000
Future profits:	60,000

The total effect on profit is an increase in profit of Rs 90 000 (Rs 30 000 in the current year and Rs 60 000 in future years).

The reason for the net increase in profit owing to the change in estimate is that the residual value was changed. The residual value increased from Rs 0 to Rs 90 000.

This means that instead of expensing the whole cost of Rs 500 000 as depreciation over the life of the asset, only Rs 410 000 will now be expensed as depreciation.

Working	Rs.
Cost at Jan 1, 2014	500,000
Accumulated depreciation up to 31 Dec 2015	(200,000)
Carrying amount at 31st December 2015	300,000
Introduction of residual value	(90,000)
Depreciable amount	210,000
Remaining useful life	3 years
Depreciation in the year ended 31st December 2016	70,000
Carrying amount at 31st December 2016 (Rs. 300,000 b/f less Rs. 150,000)	230,000

Solutions **2**

Retained earnings	2016	2015
As previously reported	205,000	42,000
Correction of Errors	(70,000)	-
Balance at 1st January 2015 (restated)	135,000	42,000
Revised comprehensive income	155,000	93,000
Balance at 1st January 2015 (restated)	290,000	135,000

Statement of comprehensive income	2016	2015 (restated)
Profit before tax as previously stated	200,000	245,000
Correction of error	–	(100,000)
Profit before tax (245-100)	200,000	145,000
Tax expense as previously stated	(45,000)	(82,000)
Adjustment	–	30,000
Tax expense (82-30)	(45,000)	(52,000)
Profit after tax	155,000	93,000

Journal entry in 2016	Debit	Credit
Retained earnings	70,000	
Deferred tax liability	30,000	
Accumulated depreciation		100,000

Correction of error
During year 2015, depreciation was incorrectly recorded as Rs 70,000 instead of Rs 170,000.

Effect on statement of comprehensive income	2015
Increase in expenses	
Depreciation	100,000
Tax expense (30% × 100,000)	(30,000)
Net decrease in profits	70,000

Solution (continued) **2**

Effect on statement of financial position	2015	2014
Decrease in assets		
Machines	(100,000)	–
Decrease in liabilities and equity		
Deferred tax liability	(30,000)	–
Retained earnings	(70,000)	–
	(100,000)	–

Statement of financial position - extracts

	2016	2015	2014
Property, plant and equipment			
As previously stated	400,000	500,000	300,000
Adjustment	(100,000)	(100,000)	–
Restated	300,000	400,000	300,000
Retained earnings			
As previously stated	360,000	205,000	42,000
Adjustment	(70,000)	(70,000)	–
Restated	290,000	135,000	42,000
Deferred taxation			
As previously stated	100,000	120,000	100,000
Adjustment	(30,000)	(30,000)	–
Restated	70,000	90,000	100,000

Solution **3**

Retained earnings	**2016**	**2015**
As previously reported	25,000	(24,600)
Correction of error	21,000	42,000
Balance at 1st January 2014 (restated)	46,000	17,400
Revised comprehensive income	39,000	28,600
Balance at 1st January 2014 (restated)	85,000	46,000

Statement of comprehensive income	**2016**	**2015 (restated)**
Profit before tax as previously stated	100,000	80,000
Correction of error	(30,000)	(30,000)
Profit before tax (245-100)	70,000	50,000
Tax expense as previously stated	(40,000)	(30,400)
Adjustment	9,000	9,000
Tax expense (82-30)	(31,000)	(21,400)
Profit after tax	39,000	28,600

Journal entry in 2016

Rectification of prior year error	**Debit**	**Credit**
Plant	120,000	
Accumulated depreciation		90,000
Retained earnings		21,000
Tax payable		9,000

Current year adjustment	**Debit**	**Credit**
Depreciation	30,000	
Accumulated depreciation		30,000

Effect on statement of comprehensive income	**2016**
Increase in expenses	
Depreciation	30,000
Tax expense (30% × 100,000)	(9,000)
Net decrease in profits	21,000

Solution (continued) **3**

Effect on statement of financial position	**2015**	**2014**
Increase in assets		
Plant (W1)	30,000	60,000
Increase in liabilities and equity		
Current tax payable (W2)	9,000	18,000
Retained earnings (W1)	21,000	42,000
	30,000	60,000

Statement of financial position - extracts

	2016	**2015**	**2014**
Property, plant and equipment			
As previously stated	600,000	650,000	300,000
Adjustment (W1)	–	30,000	60,000
Restated	600,000	680,000	360,000
Retained earnings			
As previously stated	85,000	25,000	(24,600)
Adjustment (W2)	–	21,000	42,000
Restated	85,000	46,000	17,400
Current taxation			
As previously stated	250,000	80,000	70,000
Adjustment (W2)	–	9,000	18,000
Restated	250,000	89,000	88,000

Workings: adjustments

W1: Adjustment to property, plant and equipment by year-end

	2015	**2014**	**2013**
Adjustment – add back incorrectly expensed asset	120,000	120,000	120,000
Adjustment – subsequent depreciation on asset	(90,000)	(60,000)	(30,000
	30,000	60,000	90,000

W2: Adjustment to retained earnings by year end

Net adjustment to PP and E	30,000	60,000	90,000
Tax at 30%	(9,000)	(18,000)	(27,000)
	21,000	42,000	63,000

CHAPTER 5

IFRS 15: Revenue from contracts with customers

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 11 IFRS 15: Revenue from contracts with customers

1 IFRS 15: REVENUE FROM CONTRACTS WITH CUSTOMERS

Section overview

- Introduction
- Core principle and the five step model

1.1 Introduction

The IASB issued IFRS 15: *Revenue from contracts with customers* in May 2014.

IFRS 15 is the end product of a major joint project between the IASB and the US Financial Accounting Standards Board and replaces IAS 18, IAS 11, IFRIC 13, IFRIC 15, IFRIC 18 and SIC 31.

IFRS 15 will have an impact on all entities that enter into contracts with customers with few exceptions. Entities will need to reassess their revenue recognition policies and may need to revise them. The timing and amount of revenue recognised may not change for simple contracts for a single deliverable but will change for more complex arrangements involving more than one deliverable.

This standard is effective for annual accounting periods beginning on or after 1 January 2017 but earlier application is allowed.

Summary

IFRS 15:

- establishes a new control-based revenue recognition model;
- changes the basis for deciding whether revenue is recognised at a point in time or over time;
- provides new and more detailed guidance on specific topics; and
- expands and improves disclosures about revenue.

1.2 Core principle and the five step model

IFRS 15 is based on a core principle that requires an entity to recognise revenue:

- in a manner that depicts the transfer of goods or services to customers
- at an amount that reflects the consideration the entity expects to be entitled to in exchange for those goods or services.

Applying this core principle involves following a five step model as follows:

- **Step 1:** Identify the contract(s) with the customer
- **Step 2:** Identify the separate performance obligations
- **Step 3:** Determine the transaction price
- **Step 4:** Allocate the transaction price
- **Step 5:** Recognise revenue when or as an entity satisfies performance obligations

Definitions

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

A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities.

2 IFRS 15: THE FIVE STEP MODEL

Section overview

- Step 1: Identify the contract(s) with a customer
- Step 2: Identify the separate performance obligations in the contract
- Step 3: Determine the transaction price
- Step 4: Allocate the transaction price to the performance obligations
- Step 5: Recognise revenue when or as an entity satisfies performance obligations

2.1 Step 1: Identify the contract(s) with a customer

The first step in IFRS 15 is to identify the contract. This may be written, oral, or implied by an entity's customary business practices.

Definition

A contract is an agreement between two or more parties that creates enforceable rights and obligations.

The general IFRS 15 model applies only when or if:

- ❑ the parties have approved the contract;
- ❑ the entity can identify each party's rights;
- ❑ the entity can identify the payment terms for the goods and services to be transferred; and
- ❑ the contract has commercial substance (i.e. the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract); and
- ❑ it is probable the entity will collect the consideration.

If a customer contract does not meet these criteria, revenue is recognised only when either:

- ❑ the entity's performance is complete and substantially all of the consideration in the arrangement has been collected and is non-refundable; or
- ❑ the contract has been terminated and the consideration received is non-refundable.

A contract does not exist if each party has an enforceable right to terminate a wholly unperformed contract without compensating the other party.

Combination of contracts

An entity must combine two or more contracts entered into at or near the same time with the same customer (or related parties of the customer) and treat them as a single contract if one or more of the following conditions are present:

- ❑ the contracts are negotiated as a package with a single commercial objective;
- ❑ the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or

- the goods or services promised in the contracts (or some goods or services promised in the contracts) are a single performance obligation

Contract modifications

A contract modification is any change in the scope and/or price of a contract approved by both parties for example changes in design, quantity, timing or method of performance).

If a scope change is approved but the corresponding price change is not yet determined, these requirements are applied when the entity has an expectation that the price modification will be approved.

This requirement interacts with the guidance on determining the transaction price.

A contract modification must be accounted for as a separate contract when:

- the scope of the contract increases because of the addition of promised goods or services that are distinct; and
- the price of the contract increases by an amount of consideration that reflects the entity's stand-alone selling prices of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract.

2.2 Step 2: Identify the separate performance obligations in the contract

Performance obligations are normally specified in the contract but could also include promises implied by an entity's customary business practices, published policies or specific statements that create a valid customer expectation that goods or services will be transferred under the contract.

Definition

A performance obligation is 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.**

At the inception of a contract the entity must assess the goods or services promised in a contract with a customer and must identify as a performance obligation each promise to transfer to the customer either:

- a good or service (or a bundle of goods or services) that is distinct; or
- a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer (described by reference to promises satisfied over time, and progress to completion assessment)

A good or service is distinct if both of the following criteria are met:

- 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; and
- the entity's promise to transfer the good or service is separately identifiable from other promises in the contract.

If a good or service is regularly sold separately, this would indicate that customers generally can benefit from the good/service on its own or in conjunction with other available resources.

If a promised good or service is not distinct, an entity must combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct. In some cases, this would result in the entity accounting for all the goods or services promised in a contract as a single performance obligation

Example: Promised goods and services

Goods produced by an entity for sale

Resale of goods purchased by an entity

Resale of rights to goods or services purchased by an entity

Performing a contractually agreed-upon task for a customer

Standing ready to provide goods or services

Providing a service of arranging for another party to transfer goods or services to the customer

Granting rights to goods or services to be provided in the future that a customer can resell

Constructing, manufacturing or developing an asset on behalf of a customer

Granting licences

Granting options to purchase additional goods/services

An aside

When (or as) a performance obligation is satisfied, an entity will recognise as revenue the amount of the transaction price (excluding estimates of variable consideration that are constrained) allocated to that performance obligation (step 5))

There are two issues to address:

- The amount of the transaction price, including any constraints (step 3))
- The allocation of that price to POs (step 4))

2.3 Step 3: Determine the transaction price

Definition

The transaction price is the amount of consideration an entity expects to be entitled to in exchange for the goods or services promised under a contract, excluding any amounts collected on behalf of third parties (for example, sales taxes).

An entity must consider the terms of the contract and its customary practices in determining the transaction price

The transaction price assumes transfers to the customer as promised in accordance with the existing contract and that the contract will not be cancelled, renewed or modified.

The transaction price is not adjusted for effects of the customer's credit risk, but is adjusted if the entity (e.g. based on its customary business practices) has created a valid expectation that it will enforce its rights for only a portion of the contract price.

An entity must consider the effects of all the following factors when determining the transaction price:

- ❑ variable consideration;
- ❑ the constraint on variable consideration;
- ❑ time value of money;
- ❑ non-cash consideration;
- ❑ consideration payable to the customer.

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

The entity allocates a contract's transaction price to each separate performance obligation within that contract on a relative stand-alone selling price basis at contract inception.

Definition

A stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer.

IFRS 15 suggests, but does not require, the following three methods as suitable for estimating the stand-alone selling price:

- ❑ adjusted market assessment approach
- ❑ expected cost plus margin approach
- ❑ residual approach.

2.5 Step 5: Recognise revenue when or as an entity satisfies performance obligations

Revenue is recognised when or as the promised goods or services are transferred to a customer.

- ❑ A transfer occurs when the customer obtains control of the good or service.
- ❑ A customer obtains control of an asset (good or service) when it can direct the use of and obtain substantially all the remaining benefits from it. Control includes the ability to prevent other entities from directing the use of and obtaining the benefits from an asset. Indicators of control include:
  - The entity has a present right to payment for the asset
  - The customer has legal title
  - The customer has physical possession (exceptions for bill and hold, consignment sales and repos)
  - The customer has the significant risks and rewards of ownership of the asset
  - The customer has accepted the asset

- The benefits of an asset are the potential cash flows that can be obtained directly or indirectly from the asset in many ways.

When goods or services are transferred continuously, a revenue recognition method that best depicts the entity's performance should be applied (updated as circumstances change).

Acceptable methods include:

- Output methods: units produced, units delivered, contract milestones or surveys of work performed; or
- Input methods: costs incurred, labour hours expended, machine hours used.

3 OTHER ASPECTS OF IFRS 15

Section overview

- Contract costs
- Presentation

3.1 Contract costs

Costs might be incurred in obtaining a contract and in fulfilling that contract.

Incremental costs of obtaining a contract

The incremental costs of obtaining a contract with a customer are recognised as an asset if the entity expects to recover those costs.

The incremental costs of obtaining a contract are those costs that would not have been incurred if the contract had not been obtained.

Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained are expensed as incurred (unless they can be recovered from the customer regardless of whether the contract is obtained).

Example: Incremental costs of obtaining a contract

X Limited wins a competitive bid to provide consulting services to a new customer.

X Limited incurred the following costs to obtain the contract:

	Rs.
Commissions to sales employees for winning the contract	10,000
External legal fees for due diligence	15,000
Travel costs to deliver proposal	25,000
Total costs incurred	50,000

Analysis

The commission to sales employees is incremental to obtaining the contract and should be capitalised as a contract asset.

The external legal fees and the travelling cost are not incremental to obtaining the contract because they have been incurred regardless of whether X Plc obtained the contract or not.

An entity may recognise the incremental costs of obtaining a contract as an expense when incurred if the amortisation period of the asset that the entity otherwise would have recognised is one year or less.

Costs to fulfil a contract

Costs incurred in fulfilling a contract might be within the scope of another standard (for example, IAS 2: *Inventories*, IAS 16: *Property, Plant and Equipment* or IAS 38: *Intangible Assets*). If this is not the case, the costs are recognised as an asset only if they meet all of the following criteria:

- ❑ the costs relate directly to a contract or to an anticipated contract that the entity can specifically identify;

- the costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future; and
- the costs are expected to be recovered.

Costs that relate directly to a contract might include:

- direct labour and direct materials;
- allocations of costs that relate directly to the contract or to contract activities;
- costs that are explicitly chargeable to the customer under the contract; and
- other costs that are incurred only because an entity entered into the contract (e.g. payments to subcontractors).

The following costs must be recognised as expenses when incurred:

- general and administrative costs (unless those costs are explicitly chargeable to the customer under the contract);
- costs of wasted materials, labour or other resources to fulfil the contract that were not reflected in the price of the contract;
- costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (i.e. costs that relate to past performance).

Amortisation and impairment

An asset for contract costs recognised in accordance with this standard must be amortised on a systematic basis consistent with the transfer to the customer of the goods or services to which the asset relates.

The amortisation must be updated to reflect a significant change in the entity's expected timing of transfer to the customer of the goods or services to which the asset relates.

An impairment loss must be recognised in profit or loss to the extent that the carrying amount of an asset recognised exceeds:

- the remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates; less
- the costs that relate directly to providing those goods or services and that have not been recognised as expenses.

When the impairment conditions no longer exist or have improved a reversal of the impairment loss is recognised. This will reinstate the asset but the increased carrying amount of the asset must not exceed the amount that would have been determined (net of amortisation) if no impairment loss had been recognised previously.

Example: Amortisation of contract costs

X Limited wins a 5 year contract to provide a service to a customer.

The contract contains a single performance obligation satisfied over time.

X Limited recognises revenue on a time basis

Costs incurred by the end of year 1 and forecast future costs are as follows:

	Rs.
Costs to date	10,000
Estimate of future costs	18,000
Total expected costs	28,000

Analysis

Costs must be recognised in the P&L on the same basis as that used to recognise revenue.

X Limited recognises revenue on a time basis, therefore 1/5 of the total expected cost should be recognised = Rs. 5,600 per annum.

Example: Amortisation of contract costs

X Limited wins a 5 year contract to provide a service to a customer.

The contract is renewable for subsequent one-year periods.

The average customer term is seven years.

The contract contains a single performance obligation satisfied over time.

X Limited recognises revenue on a time basis.

Costs incurred by the end of year 1 and forecast future costs are as follows:

	Rs.
Costs to date	10,000
Estimate of future costs	18,000
Total expected costs	28,000

Analysis

Costs must be recognised in the P&L on the same basis as that used to recognise revenue.

X Limited recognises revenue on a time basis. The asset relates to the services transferred to the customer during the contract term of five years and X Limited anticipates that the contract will be renewed for two subsequent one-year periods.

Therefore 1/7 of the total expected cost should be recognised = Rs. 4,000 per annum.

Example: Amortisation of contract costs

X Limited wins a contract to build an asset for a customer. It is anticipated that the asset will take 2 years to complete

The contract contains a single performance obligation. Progress to completion is measured on an output basis.

At the end of year 1 the assets is 60% complete.

Costs incurred by the end of year 1 and forecast future costs are as follows:

	Rs.
Costs to date	10,000
Estimate of future costs	18,000
Total expected costs	28,000

Analysis

Costs must be recognised in the P&L on the same basis as that used to recognise revenue.

Therefore 60% of the total expected cost should be recognised (Rs. 16,800) at the end of year 1.

3.2 Presentation

This section explains how contracts are presented in the statement of financial position. In order to do this it explains the double entries that might result from the recognition of revenue. The double entries depend on circumstance.

An unconditional right to consideration is presented as a receivable.

The accounting treatment to record the transfer of goods for cash or for an unconditional promise to be paid consideration is straightforward.

Illustration: Possible double entries on recognition of revenue

	Debit	Credit
Cash	X	
Receivable	X	
Revenue		X

Example: Double entry – Unconditional right to consideration

1 January 20X8

X Limited enters into a contract to transfer Products A and B to Y Limited in exchange for Rs. 1,000.

Product A is to be delivered on 28 February.

Product B is to be delivered on 31 March.

The promises to transfer Products A and B are identified as separate performance obligations. Rs.400 is allocated to Product A and Rs.600 to Product B.

X Limited recognises revenue and recognises its unconditional right to the consideration when control of each product transfers to Y Limited.

The following entries would be required to reflect the progress of the contract).

Contract progress

28 February: X Limited transfers Product A to Y Limited.

At 28 February	Dr (Rs.)	Cr (Rs.)
Receivables	400	
Revenue		400

31 March: X Limited transfers Product B to Y Limited

31 March		
Receivables	600	
Revenue		600

In other cases, a contract is presented as a contract asset or a contract liability depending on the relationship between the entity's performance and the customer's payment.

Contract assets

A supplier might transfer goods or services to a customer before the customer pays consideration or before payment is due. In this case the contract is presented as a contract asset (excluding any amounts presented as a receivable).

A contract asset is a supplier's right to consideration in exchange for goods or services that it has transferred to a customer. A contract asset is reclassified as a receivable when the supplier's right to consideration becomes unconditional.

Example: Double entry – Recognition of a contract asset

1 January 20X8

X Limited enters into a contract to transfer Products A and B to Y Limited in exchange for Rs. 1,000.

Product A is to be delivered on 28 February.

Product B is to be delivered on 31 March.

The promises to transfer Products A and B are identified as separate performance obligations. Rs.400 is allocated to Product A and Rs.600 to Product B.

Revenue is recognised when control of each product transfers to Y Plc.

Payment for the delivery of Product A is conditional on the delivery of Product B. (i.e. the consideration of Rs. 1,000 is due only after X Limited has transferred both Products A and B to Y Limited). This means that X Limited does not have a right to consideration that is unconditional (a receivable) until both Products A and B are transferred to Y Limited.

The following entries would be required to reflect the progress of the contract

Contract progress

The following accounting entries would be necessary:

28 February: X Limited transfers Product A to Y Limited

X Plc does not have an unconditional right to receive the Rs.400 so the amount is recognised as a contract asset.

At 28 February	Dr (Rs.)	Cr (Rs.)
Contract asset	400	
Revenue		400

31 March: X Limited transfers Product B to Y Limited

X Limited now has an unconditional right to receive the full Rs. 1,000. The Rs.400 previously recognised as a contract asset is reclassified as a receivable and the Rs.600 for the transfer of product B is also recognised as receivable.

31 March	Dr (Rs.)	Cr (Rs.)
Receivable	1,000	
Contract asset		400
Revenue		600

Contract liabilities

A contract might require payment in advance or allow the supplier a right to an amount of consideration that is unconditional (i.e. a receivable), before it transfers a good or service to the customer.

In these cases, the supplier presents the contract as a contract liability when the payment is made or the payment is due (whichever is earlier).

The contract liability is a supplier's obligation to transfer goods or services to a customer for which it has received consideration (an amount of consideration is due) from the customer.

Example: Double entry – Recognition of a contract liability

1 January 20X8

X Limited enters into a contract to transfer Products A and B to Y Limited in exchange for Rs. 1,000.

X Limited can invoice this full amount on 31 January.

Product A is to be delivered on 28 February.

Product B is to be delivered on 31 March.

The promises to transfer Products A and B are identified as separate performance obligations. Rs.400 is allocated to Product A and Rs.600 to Product B.

Revenue is recognised when control of each product transfers to Y Limited.

The following entries would be required to reflect the progress of the contract

Contract progress

The following accounting entries would be necessary:

At 31 January	Dr (Rs.)	Cr (Rs.)
Receivable	1,000	
Contract liability		1,000

28 February: X Limited transfers Product A to Y Limited

At 28 February	Dr (Rs.)	Cr (Rs.)
Contract liability	400	
Revenue		400

31 March: X Limited transfers Product B to Y Limited

31 March	Dr (Rs.)	Cr (Rs.)
Contract liability	600	
Revenue		600

CHAPTER 6

IAS 16: Property, plant and equipment

Contents

INTRODUCTION

Objective

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FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 17 IAS 16: Property, plant and equipment

B (a) 33 IFRIC 1: Changes in existing decommissioning, restoration and similar liabilities

B (a) 48 IFRIC 20: Stripping costs in the production phase of a surface mine

1 INITIAL MEASUREMENT OF PROPERTY, PLANT AND EQUIPMENT

Section overview

- Introduction
- Bearer plants
- Initial measurement
- Elements of cost
- Exchange of assets
- Subsequent expenditure

1.1 Introduction

Rules on accounting for property, plant and equipment are contained in *IAS 16: Property, plant and equipment.*

Scope

IAS 16 does not apply to property, plant and equipment classified as held for sale in accordance with IFRS 5: *Non-current assets held for sale and discontinued operations*.

Furthermore, IAS 16 does not apply to:

- ❑ biological assets related to agricultural activity (other than bearer plants which are covered by IAS 16) (see IAS 41: *Agriculture*);
- ❑ the recognition and measurement of exploration and evaluation assets (see IFRS 6: *Exploration for and evaluation of mineral resources*); nor
- ❑ mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources.-

Definition

Definition: Property, plant and equipment

Property, plant and equipment are tangible items that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than one period.

Items such as spare parts, stand-by equipment and servicing equipment are recognised as property, plant and equipment when they meet the above definition. If this is not the case they are recognised as inventory.

Initial recognition

The cost of an item of property, plant and equipment must be recognised as an asset if, and only if:

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

Items of property, plant and equipment may be acquired for safety or environmental reasons. At first sight it looks as if such items would not be recognised as property, plant and equipment according to the recognition criteria because they do not directly increase future economic benefits. However, they

may be necessary in order that a company obtain the future economic benefits from its other assets so they do qualify for recognition.

Illustration:

A chemical manufacturer may install new chemical handling processes to comply with environmental requirements for the production and storage of dangerous chemicals.

This would be recognised as an asset because without them the company cannot make and sell chemicals.

1.2 Bearer plants

Definitions

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.**

All living plants used to be accounted for according to the guidance set out in IAS 41 *Agriculture*.

An amendment to IAS 16 and IAS 41 was issued in June 2014 to change this.

Bearer plants are used solely to grow produce. The only significant future economic benefits from bearer plants arise from selling the agricultural produce that they create. Therefore, bearer plants meet the definition of property, plant and equipment in IAS 16 and their operation is similar to that of manufacturing.

Accordingly, the amendments require bearer plants to be accounted for as property, plant and equipment and included within the scope of IAS 16, instead of IAS 41.

Produce growing on bearer plants remains within the scope of IAS 41. For example: grapevines, rubber trees and oil palms.

1.3 Initial measurement

Property, plant and equipment are initially recorded in the accounts of a business at their cost.

Definition: Cost

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 or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs. (For example assets held under finance leases).

The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognised as interest over the period of credit unless it is capitalised in accordance with *IAS 23: Borrowing costs* (covered later).

Example: Deferred consideration

A company buys a machine on 1 January 2015.

The terms of the purchase are that the company will pay Rs.5 million for the machine on 31 December 2015 (1 year later).

An appropriate discount rate is 6%

1 January 2015 – Initial recognition

Initial measurement of the purchase price: $Rs.5m \times \frac{1}{(1+0.06)}$ = Rs.4,716,981

	Debit	Credit
Property, plant and equipment	4,716,981	
Liability		4,716,981

31 December 2015 – Date of payment

Recognition of interest expense Rs.4,716,981 @ 6% = 283,019

	Debit	Credit
Statement of comprehensive income	283,019	
Liability		283,019

Balance on the liability	Rs.
Balance brought forward	4,716,981
Interest expense recognised in the period	283,019
	5,000,000
Cash/bank	(5,000,000)
	–

1.4 Elements of cost

The definition of 'cost' for property, plant and equipment has close similarities with the cost of inventories, although property, plant and equipment will often include more items of 'other expense' within cost.

The cost of an item of property, plant and equipment consists of:

- its purchase price after any trade discount has been deducted, plus any import taxes or non-refundable sales tax; plus
- the directly attributable costs of bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. These directly attributable costs may include:
  - employee costs arising directly from the installation or construction of the asset;
  - the cost of site preparation;
  - delivery costs ('carriage inwards');
  - installation and assembly costs;
  - testing costs to assess whether the asset is functioning properly (net of sale proceeds of items produced during the testing phase).
  - professional fees directly attributable to the purchase.

- When the entity has an obligation to dismantle and remove the asset at the end of its life, its initial cost should also include an estimate of the costs of dismantling and removing the asset and restoring the site where it is located. This will be explained in more detail in chapter 13 which covers *IAS 37: Provisions, contingent liabilities and contingent assets*.

The recognition of costs ceases when the asset is ready for use. This is when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

Cost of self-constructed assets

The cost of a self-constructed asset is determined using the same principles as for an acquired asset.

A company might make similar assets for sale in the normal course of business. The cost of an asset for the company to use itself would normally be the same as the cost of an asset for sale as measured according to *IAS 2: Inventories*.

IAS23: Borrowing costs, deals with whether interest costs on borrowing to finance the construction of a non-current asset should be included in the cost of the asset. This is covered in the next chapter.

Bearer plants are accounted for in the same way as self-constructed assets (where constructed is taken to mean cultivated).

Not part of cost

Only those costs necessary to bring an asset to a condition and location where it is capable of operating in the manner intended by management are recognised.

IAS 16 provides the following list of costs that are not costs of an item of property, plant and equipment:

- costs of opening a new facility;
- costs of introducing a new product or service (including costs of advertising and promotional activities);
- costs of conducting business in a new location or with a new class of customer (including costs of staff training); and
- administration and other general overhead costs.

1.5 Exchange of assets

When an item of property, plant or equipment is purchased for cash, the cash paid is the cost of the asset. However, an item of property, plant and equipment may be paid for using an asset other than cash (e.g. another item of property, plant and equipment or inventories).

The cost of such items is measured at fair value unless:

- the exchange transaction lacks commercial substance; or,
- the fair value of neither the asset received nor the asset given up is reliably measurable.

If the acquired item is not measured at fair value it is measured at the carrying amount of the asset given up.

Fair value

The fair value of the asset given up is used to measure the cost of the asset received unless the fair value of the asset received is more clearly evident.

Fair value may be determinable with reference to comparable market transactions.

If there are no comparable market transactions fair value is reliably measurable if:

- the variability in the range of reasonable fair value estimates is not significant for that asset; or
- the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.

Commercial substance

An exchange transaction has commercial substance if:

- the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or
- the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange; and
- either of the above differences are significant relative to the fair value of the assets exchanged.

Definition

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.

Example: Acquisition of Property, Plant and Equipment in exchange for a non-monetary asset

X Limited acquired a sugar processing line from Y Limited.

The sugar processing line had a fair value of Rs. 1,500,000.

Both parties agreed that the sugar processing line would be paid for with a plot of land owned by X Limited but not currently being used. This plot of land had a carrying value of Rs. 1,000,000. The land was recently valued at Rs. 1,400,000.

Analysis

The exchange has commercial substance. Either of the following points would lead to this conclusion:

a) **The configuration (risk, timing and amount) of the cash flows of a sugar processing line differs from that of an unused plot of land.**

b) **Currently the land is not generating a return. This means that the entity-specific value of the portion of the entity's operations affected by the transaction will change as a result of the exchange.**

X Limited must recognise the new asset at Rs. 1,400,000 (the fair value of the asset given up to pay for the asset).

X Limited would recognise a profit on disposal of the land in the amount of Rs. 400,000 (1,400,000 – 1,00,000)

The double entry made by X Limited is as follows:

	Debit Rs.	Credit Rs.
Property, plant and equipment	1,400,000	
Sugar processing line		1,000,000
Land		
Statement of profit or loss		400.000

1.6 Subsequent expenditure

Expenditure relating to non-current assets, after their initial acquisition, should be capitalised if it meets the criteria for recognising an asset.

In practice, this means that expenditure is capitalised if it:

- improves the asset (for example, by enhancing its performance or extending its useful life); or
- is for a replacement part (provided that the part that it replaces is treated as an item that has been disposed of).

Repairs and maintenance expenditure is revenue expenditure. It is recognised as an expense as it is incurred, because no additional future economic benefits will arise from the expenditure.

A basic rule is that improvements are capitalised but repairs are expensed. You may have to correct situations when an amount spent has not been treated correctly. This is covered in section 6 of this chapter.

Major inspections

A company might only be allowed to operate some assets if those assets are subject to regular major inspections for faults.

The cost of such major inspections is recognised in the carrying amount of the asset as a replacement if the recognition criteria are satisfied.

When a major inspection is carried out any remaining carrying amount of the cost of the previous inspection is derecognised.

Example: Major overhaul

A shipping company is required to put its ships into dry dock every three years for an overhaul, at a cost of Rs. 3,000,000. The ships have a useful life of 20 years. A ship is purchased from a shipbuilder at a cost of Rs.200 million.

Initial recognition

Rs. 3,000,000 of the asset cost should be treated as a separate component and depreciated over three years.

The rest of the cost of the ship (Rs.297 million) should be depreciated over 20 years.

End of year 3

An overhaul is required.

The cost of the overhaul is capitalised and added to the asset's cost.

The cost (Rs. 3,000,000) and accumulated depreciation of the depreciated component is removed from the accounts.

2 DEPRECIATION

Section overview

- Measurement after initial recognition
- Depreciation
- Depreciable amount and depreciation period
- Reviews of the remaining useful life and expected residual value
- Depreciation method

2.1 Measurement after initial recognition

IAS 16 allows a choice of accounting treatments after initial recognition.

All items of property, plant and equipment in a class can be accounted for using one of two models:

- Cost model - Property, plant and equipment is carried at cost less any accumulated depreciation and any accumulated impairment losses.
- Revaluation model - Property, plant and equipment is carried at a revalued amount. This is the fair value at the date of the revaluation less any subsequent accumulated depreciation and any accumulated impairment losses.

The above choice must be applied consistently. A business cannot carry one item of property, plant & equipment at cost and revalue a similar item. However, a business can use different models for different classes of property, plant & equipment. For example, companies might use the cost model for plant and equipment but use the revaluation model for property.

Depreciation is an important component of both models. You should be familiar with the measurement and recognition of depreciation from your previous studies. This section provides a reminder of the key concepts.

2.2 Depreciation

Depreciation is an expense that matches the cost of a non-current asset to the benefit earned from its ownership. It is calculated so that a business recognises the full cost associated with a non-current asset over the entire period that the asset is used.

Definitions

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

Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value.

The **residual value** of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Definitions (continued)

Useful life is:

(a) the period over which an asset is expected to be available for use by an entity; or

(b) the number of production or similar units expected to be obtained from the asset by an entity.

Carrying amount is the amount at which an asset is recognised after deducting any accumulated depreciation and accumulated impairment losses. Net book value (NBV) is a term that is often used instead of carrying amount.

Parts of an asset

Each part of an asset that has a cost that is significant in relation to the total cost of the item must be depreciated separately. This means that the cost of an asset might be split into several different assets and each depreciated separately.

Illustration: Cost

A company has purchased a new Gulf Stream jet for Rs. 5,500 million.

The company has identified the following cost components and useful lives in respect of this jet.

	Rs. million	Useful lives
Engines	2,000	3 years
Airframe	1,500	10 years
Fuselage	1,500	20 years
Fittings	500	5 years
	5,500	

Depreciation is charged as an expense in the statement of comprehensive income each year over the life of the asset unless it relates to an asset being used to construct another asset. In this case the depreciation is capitalised as part of the cost of that other asset in accordance with the relevant standard (For example: *IAS 2: Inventories; IAS 16 Property, plant and equipment; IAS 38; Intangible assets*).

2.3 Depreciable amount and depreciation period

The depreciable amount of an asset must be allocated on a systematic basis over its useful life.

Commencement of depreciation

Depreciation of an asset begins when that asset is available for use. This means when the asset is in the location and condition necessary for it to be capable of operating in the manner intended by management. This might be before the asset is actually used.

Cessation of depreciation

Depreciation ends at the earlier of when an asset is classified as held for sale in accordance with *IFRS 5: Non-current assets held for sale and discontinued operations* and when it is derecognised.

Depreciation does not cease when an asset becomes idle or is withdrawn or retired from active use.

Residual value

In practice, the residual value of an asset is often insignificant and therefore immaterial in the calculation of the depreciable amount.

However, in some cases, the residual value may be equal to or greater than the asset's carrying amount. In this case the depreciation charge would be zero.

Land and buildings

Land and buildings are separable assets and are dealt with separately for accounting purposes, even when they are acquired together.

Land normally has an unlimited life and is therefore not depreciated. However, there are exceptions to this. If land has a physical attribute that is used over a period then the land should be depreciated over this period.

Buildings normally have a limited life and are therefore depreciable assets.

2.4 Reviews of the remaining useful life and expected residual value

Review of useful life

IAS 16 requires useful lives and residual values to be reviewed at each year-end. Any change is a change in accounting estimate. The carrying amount (cost minus accumulated depreciation) of the asset at the date of change is written off over the (revised) remaining useful life of the asset.

Residual value

The residual value of an item of property, plant and equipment must be reviewed at least at each financial year end and if expectations differ from previous estimates the depreciation rate for the current and future periods is adjusted.

A change in the asset’s residual value is accounted for prospectively as an adjustment to future depreciation.

2.5 Depreciation method

The depreciation method used should reflect the way in which the economic benefits of the asset are consumed by the business over time.

That method should be applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits.

IAS 16 has been amended to clarify that a depreciation method based on revenue generated by an activity that includes the use of an asset is not appropriate. This is because revenue would usually reflect factors other than the consumption of the economic benefits of an asset.

Review of depreciation method

The depreciation method applied to property, plant and equipment must be reviewed periodically and, if there has been a significant change in the expected pattern of economic benefits from those assets, the method is changed to reflect the changed pattern.

Where there is a change in the depreciation method used, this is a change in accounting estimate. A change of accounting estimate is applied from the time of the change, and is not applied retrospectively. The carrying amount (cost minus accumulated depreciation) of the asset at the date of the change is written off over the remaining useful life of the asset.

3 REVALUATION OF PROPERTY, PLANT AND EQUIPMENT

Section overview

- Revaluation and the entity's accounting policy
- Companies Ordinance 1984: Rules on revaluation
- Accounting for revaluation
- Changing the carrying amount of the asset
- Depreciation of a re-valued asset
- Realisation of the revaluation surplus
- Revaluation model: the frequency of revaluations

3.1 Revaluation and the entity's accounting policy

An item of property, plant and equipment is recognised at cost when it is first acquired.

IAS 16 allows a business to choose one of two measurement models as its accounting policy for property, plant and equipment after acquisition. The same model should be applied to all assets in the same class.

The two measurement models for property, plant and equipment after acquisition are:

- cost model (i.e. cost less accumulated depreciation); and
- revaluation model (i.e. revalued amount less accumulated depreciation since the most recent revaluation).

For example, a company's policy might be to value all its motor vehicles at cost, but to apply the revaluation model to all its land and buildings.

Revaluation model – Issues

The following accounting issues have to be addressed when using the revaluation model:

	Issue
1	What happens to the other side of the entry when the carrying amount of an asset is changed as a result of a revaluation adjustment? An asset value may increase or decrease. What happens in each case?
2	How the carrying amount of the asset being revalued is changed? The carrying amount is located in two accounts (cost and accumulated depreciation) and it is the net amount that must be changed so how is this done?
3	How often should the revaluation take place?

The Companies Ordinance 1984 contains rules on accounting for revaluation of assets which conflict with those in IAS 16. The rules in the Companies Ordinance take precedence when there is such a conflict. This impacts the answer to issue 1 above.

3.2 Companies Ordinance 1984: Rules on revaluation

Section.235 of the Companies Ordinance 1984 sets out the following rules.

Where a company revalues its fixed assets any increase in the value of such assets must be transferred to an account to be called "Surplus on Revaluation of Fixed Assets Account" and shown in the balance-sheet of the company after Capital and Reserves. This means that the revaluation surplus is recognised outside equity. This has an impact on the revaluation double entry and this will be explained later.

Unless a surplus is subsequently realised on disposal of a revalued asset it cannot be used to reduce a loss or to add to the income, profit or surplus of the company, or used directly or indirectly by way of dividend or bonus. However, it can be used to set a deficit arising from the revaluation of any other fixed asset of the company.

Depreciation of revalued assets is based on the revalued amount of those assets and must be charged to the Profit and Loss Account. However, an amount equal to incremental depreciation for the period must be transferred from "Surplus on Revaluation of Fixed Assets Account" to accumulated profit through the statement of changes in equity to record the realisation of surplus to the extent of the incremental depreciation charge for the period.

Conflict with IAS 16

The requirement to recognise the revalution surplus outside equity causes a conflict with IAS 16.

Revaluation gains under IFRS fall within the definition of income.

Definition: 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.

Under IFRS any gain must be recognised through other comprehensive income and accumulated as a revaluation surplus in equity.

However, under law in Pakistan the surplus is outside equity. Only inflows or enhancements that increase equity are recognised in other comprehensive income. Therefore, gains recognised under the law in Pakistan are recognised directly in the revaluation surplus account.

3.3 Accounting for revaluation

When a non-current asset is revalued, its 'carrying amount' in the statement of financial position is adjusted from carrying amount to its fair value (normally current market value) at the date of the revaluation.

How the carrying amount is changed will be addressed later. This section concentrates on the other side of the entry.

Asset carried at cost revalued upwards

Companies Ordinance 1984: An increase in value is credited to directly to an account outside equity called revalution surplus.

IAS 16: An increase in value is credited to other comprehensive income and accumulated in equity under the heading of revaluation surplus.

Example: Upward revaluation

Land was purchased for Rs. 100 on the first day of the 2015 accounting period.
The business revalues land as permitted by the IAS 16.
The land was revalued to Rs. 130 at the end of the first year of ownership.

Double entry: Companies' Ordinance 1984	Debit	Credit
Land	30	
Revaluation surplus		30

Double entry: IAS 16	Debit	Credit
Land	30	
Other comprehensive income (an accumulated in a revaluation surplus).		30

Extract from the statement of financial position as at 31/12/15

	CO 1984	IFRS
Property, plant and equipment	130	130
Equity (revaluation surplus)		30
Revaluation surplus	30	

Asset carried at cost revalued downwards

A decrease in value is debited as an expense to the statement of profit or loss.

Example: Downward revaluation

Land was purchased for Rs.100 on the first day of the 2015 accounting period.
The business revalues land as permitted by the IAS 16.
The land was revalued to Rs. 90 at the end of the first year of ownership.

Double entry: Companies' Ordinance 1984 and IAS 16

	Debit	Credit
Statement of profit or loss	10	
Land		10

Asset carried at a revaluation deficit is revalued upwards

An asset might be carried at an amount lower than its original cost as a result of being revalued downwards.

If the asset is later revalued upwards, the revaluation increase is recognised in the statement of profit or loss to the extent of the previously recognised expense. That part of any increase above the previously recognised expense is recognised in the usual way, directly in the revaluation surplus account (Companies' Ordinance 1984) or in other comprehensive income (IAS 16).

Asset carried at a revaluation surplus revalued downwards

An asset might be carried at an amount higher than its original cost as a result of being revalued upwards.

Companies Ordinance 1984: If the asset is later revalued downwards, the revaluation decrease is recognised directly in equity to the extent of the previously recognised surplus. That part of any decrease above the previously recognised surplus is recognised in the statement of profit or loss the usual way.

IAS 16: If the asset is later revalued downwards, the revaluation decrease is recognised in other comprehensive income to the extent of the previously recognised surplus. That part of any decrease above the previously recognised surplus is recognised in the statement of profit or loss the usual way.

Example: Downward revaluation – Accounted for under Companies' Ordinance 1984

A business purchased a plot of land on the first day of the 2015 accounting period.

The business applies the IAS 16 revaluation model to the measurement of land after initial recognition. The business has a policy of revaluing land annually.

The initial amount recognised and the year end values are shown below:

	Rs.
Measurement on initial recognition	100
Valuation as at:	
31 December 2015	130
31 December 2016	110
31 December 2017	95
31 December 2018	116

The double entries are as follows:

31 December 2015	Debit	Credit
Land (130 – 100)	30	
Revaluation surplus		30

31 December 2016	Debit	Credit
Revaluation surplus	20	
Land (110 – 130)		20

The fall in value reverses a previously recognised surplus. It is recognised in revaluation surplus to the extent that it is covered by the surplus.

31 December 2017	Debit	Credit
Revaluation surplus	10	
Statement of profit or loss	5	
Land (95 – 110)		15

The fall in value in part reverses a previously recognised surplus. It is recognised in Revaluation surplus to the extent that it is covered by the surplus. This reduces the revaluation surplus to zero.

Any amount not covered by the surplus is recognised as an expense in the statement of profit or loss.

31 December 2018	Debit	Credit
Land (116 – 95)	21	
Statement of profit or loss		5
Revaluation surplus		16

A rise in value that reverses a previously recognised expense is recognised in the statement of profit or loss to the extent that it reverses the expense. Any amount above this is recognised in equity.

Example (continued) – Overview

	Land	Revaluation surplus	Statement of profit or loss
At start	100	–	–
Double entry	30	30Cr	
31/12/15	**130**		
b/f	130		
Adjustment	(20)	20Dr	–
31/12/16	**110**		
b/f	110		
Adjustment	(15)	10Dr	5Dr
31/12/17	**95**		
b/f	95		
Adjustment	21	16Cr	5Cr
31/12/18	**116**		

Example: Downward revaluation – Accounted for under IAS 16

A business purchased a plot of land on the first day of the 2015 accounting period. The business applies the IAS 16 revaluation model to the measurement of land after initial recognition. The business has a policy of revaluing land annually.

The initial amount recognised and the year end values are shown below:

	Rs.
Measurement on initial recognition	100
Valuation as at:	
31 December 2015	130
31 December 2016	110
31 December 2017	95
31 December 2018	116

The double entries are as follows:

31 December 2015	**Debit**	**Credit**
Land (130 – 100)	30	
Other comprehensive income		30
31 December 2016	**Debit**	**Credit**
Other comprehensive income	20	
Land (110 – 130)		20

The fall in value reverses a previously recognised surplus. It is recognised in OCI to the extent that it is covered by the surplus.

31 December 2017	Debit	Credit
Other comprehensive income	10	
Statement of profit or loss	5	
Land (95 – 110)		15

The fall in value in part reverses a previously recognised surplus. It is recognised in OCI to the extent that it is covered by the surplus. This reduces the revaluation surplus to zero.

Any amount not covered by the surplus is recognised as an expense in the statement of profit or loss.

31 December 2018	Debit	Credit
Land (116 – 95)	21	
Statement of profit or loss		5
Other comprehensive income		16

A rise in value that reverses a previously recognised expense is recognised in the statement of profit or loss to the extent that it reverses the expense. Any amount above this is recognised in other comprehensive income.

Example (continued) – Overview

	Land	Other comprehensive income	Statement of profit or loss
At start	100	–	–
Double entry	30	30Cr	
31/12/15	**130**		
b/f	130		
Adjustment	(20)	20Dr	–
31/12/16	**110**		
b/f	110		
Adjustment	(15)	10Dr	5Dr
31/12/17	**95**		
b/f	95		
Adjustment	21	16Cr	5Cr
31/12/18	**116**		

All later examples will follow only Companies' Ordinance 1984. This will also be the case in the exam where the Companies Ordinance will also be followed.

3.4 Changing the carrying amount of the asset

In the previous example land was revalued. Land is not depreciated so the carrying amount of land is represented in a single account. This made it easy to change:

The carrying amount of depreciable assets is the net of balances on two separate accounts. The double entry to revalue the asset must take this into account.

IAS 16 allows a choice of two approaches which differ in the treatment of the accumulated depreciation account.

When an item of property, plant and equipment is revalued, any accumulated depreciation at the date of the revaluation is treated in one of the following ways:

Method 1

Restate accumulated depreciation proportionately with the change in the gross carrying amount of the asset so that the carrying amount of the asset after revaluation equals its revalued amount.

Method 2

Step 1: Transfer the accumulated depreciation to the asset account. The result of this is that the balance on the asset account is now the carrying amount of the asset and the accumulated depreciation account in respect of this asset is zero.

Step 2: Change the balance on the asset account to the revalued amount.

Example: Method 1

A building owned by a company is carried at Rs. 20 million (Cost of Rs. 25 million less accumulated depreciation of Rs. 5 million. The company's policy is to apply the revaluation model to all of its land and buildings.

A current valuation of this building is now Rs. 26 million.

	Before		After
Cost	25	$\times 26/20$	32.5
Accumulated depreciation	(5)	$\times 26/20$	(6.5)
Carrying amount	20	$\times 26/20$	26

Journals	Rs. m	Rs. m
Asset	7.5	
Accumulated depreciation		1.5
Revaluation surplus		6

Example: Method 2

A building owned by a company is carried at Rs. 20 million (Cost of Rs. 25 million less accumulated depreciation of Rs. 5 million. The company's policy is to apply the revaluation model to all of its land and buildings.

A current valuation of this building is now Rs. 26 million.

Step 1	**Rs. m**	**Rs. m**
Accumulated depreciation	5	
Asset		5
Step 2		
Asset (Rs. 26 – Rs. 20m)	6	
Revaluation surplus		6
Alternatively this could be done with a single journal		
Asset (Rs. 26 – Rs. 25m)	1	
Accumulated depreciation	5	
Revaluation surplus		6

	Before	**1**	**2**	**After**
Cost	25	(5)	6	26
Accumulated depreciation	(5)	5		–
Carrying amount	20			26

Example:

An office building was purchased four years ago for Rs.3 million.

The building has been depreciated by Rs. 100,000.

It is now re-valued to Rs.4 million. Show the book-keeping entries to record the revaluation.

Answer

Building account

	Rs.		Rs.
Opening balance b/f	3,000,000	Accumulated depreciation	100,000
Revaluation account	1,100,000	Closing balance c/f	4,000,000
	4,100,000		4,100,000
Opening balance b/f	4,000,000		

Accumulated depreciation of building account

	Rs.		Rs.
Building account	100,000	Opening balance b/f	100,000

Revaluation surplus

	Rs.		Rs.
		Revaluation account	1,100,000

3.5 Depreciation of a revalued asset

After a non-current asset has been revalued, depreciation charges are based on the new valuation.

Example:

An asset was purchased three years ago, at the beginning of Year 1, for Rs. 100,000.

Its expected useful life was six years and its expected residual value was Rs. 10,000.

It has now been re-valued to Rs. 120,000. Its remaining useful life is now estimated to be three years and its estimated residual value is now Rs. 15,000.

The straight-line method of depreciation is used.

Required

(a) What is the transfer to the revaluation surplus at the end of Year 3?

(b) What is the annual depreciation charge in Year 4?

(c) What is the carrying amount of the asset at the end of Year 4?

Answer

Original annual depreciation (for Years 1 – 3) = $^{Rs.(100,000 - 10,000)}/_{6\ years}$ = Rs.15,000.

	Rs.
Cost	100,000
Less: Accumulated depreciation at the time of revaluation (= 3 years x Rs.15,000)	(45,000)
Carrying amount at the time of the revaluation	55,000
Revalued amount of the asset	120,000
Transfer to the revaluation surplus	65,000

Revised annual depreciation = $^{Rs.(120,000 - 15,000)}/_{3\ years}$ = Rs.35,000.

The annual depreciation charge in Year 4 will therefore be Rs. 35,000.

	Rs.
Revalued amount	120,000
Less: depreciation charge in Year 4	(35,000)
Carrying amount at the end of Year 4	85,000

3.6 Realisation of the revaluation surplus

All assets eventually disappear from the statement of financial position either by becoming fully depreciated or because the company sells them.

If nothing were done this would mean that there was a revaluation surplus on the face of the statement of financial position that related to an asset that was no longer owned.

- IAS 16 allows (but does not require) the transfer of a revaluation surplus to retained earnings when the asset to which it relates is derecognised (realised).
- Section 235 Companies Ordinance 1984 requires this.

This might happen over several years as the asset is depreciated or at a point in time when the asset is sold.

Revalued assets being depreciated

Revaluation of an asset causes an increase in the annual depreciation charge. The difference is known as excess depreciation (or incremental depreciation):

Excess depreciation is the difference between:

- the depreciation charge on the re-valued amount of the asset, and
- the depreciation that would have been charged on historical cost.

Each year a business might make a transfer from the revaluation surplus to the retained profits equal to the amount of the excess depreciation.

Illustration:

	Debit	Credit
Revaluation surplus	X	
Retained earnings		X

Revalued assets being sold

When a revalued asset is sold the business might transfer the balance on the revaluation surplus in respect of the asset into retained earnings. The journal entry would be the same as above.

Example:

An asset was purchased two years ago at the beginning of Year 1 for Rs. 600,000. It had an expected life of 10 years and nil residual value.

Annual depreciation is Rs. 60,000 ($^{Rs.\ 600,000}/_{10\ years}$) in the first two years.

At the end of Year 2 the carrying value of the asset was Rs. 480,000.

After two years it is re-valued to Rs. 640,000.

Double entry: Revaluation

	Debit	Credit
Asset (Rs.640,000 – Rs.600,000)	40	
Accumulated depreciation	120	
Revaluation surplus		160

Each year the business is allowed to make a transfer between the revaluation surplus and retained profits:

Double entry: Transfer

	Debit	Credit
Revaluation surplus ($^{160}/_{8}$)	20	
Retained profits		20

The above can also be calculated as follows:

Depreciation after revaluation	80
Depreciation if asset were not revalued	60
Incremental depreciation to be transferred from the revaluation surplus account to retained earnings	20

3.7 Revaluation model: the frequency of revaluations

When the revaluation model is applied to the measurement of property, plant and equipment, revaluations must be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.

The frequency of revaluations should depend on the volatility in the value of the assets concerned. When the value of assets is subject to significant changes (high volatility), annual revaluations may be necessary.

However, such frequent revaluations are unnecessary for items subject to only insignificant changes in fair value. In such cases it may be necessary to revalue the item only every three or five years.

4 DERECOGNITION OF PROPERTY, PLANT AND EQUIPMENT

Section overview

- Gain or loss on disposal of a non-current asset

4.1 Gain or loss on disposal of a non-current asset

Property, plant and equipment are eventually disposed of:

- by sale, or
- if they have no sale value, through disposal as scrap.

Disposal can occur at any time, and need not be at the end of the asset's expected useful life.

There is a gain or loss on disposal of the asset, as follows:

Illustration: Gain or loss on disposal

		Rs.
Sale proceeds on disposal		X
Less disposal costs		(X)
Net disposal value		X
Asset at cost	X	
Less: Accumulated depreciation	(X)	
Carrying amount at date of disposal		(X)
Gain /loss on disposal		X

5 DISCLOSURE REQUIREMENTS OF IAS 16

Section overview

- Disclosure requirements of IAS 16
- Accounting policies

5.1 Disclosure requirements of IAS 16

IAS 16 requires the following disclosures in the notes to the financial statements, for each major class of property, plant and equipment.

- The measurement bases used (cost or revaluation model);
- The depreciation methods used;
- The useful lives or depreciation rates used;
- Gross carrying amounts and the accumulated depreciation at the beginning and at the end of the period;
- A reconciliation between the opening and closing values for gross carrying amounts and accumulated depreciation, showing:
  - Additions during the year;
  - Disposals during the year;
  - Depreciation charge for the year;
  - Assets classified as held for sale in accordance with IFRS 5;
  - Acquisitions of assets through business combinations;
  - Impairment losses;
  - The effect of revaluations.

The following is an example of how a simple table for tangible non-current assets may be presented in a note to the financial statements.

Illustration:

	Property	Plant and equipment	Total
Cost	**Rs.m**	**Rs.m**	**Rs.m**
At the start of the year	7,200	2,100	9,300
Additions	920	340	1,260
Disposals	(260)	(170)	(430)
At the end of the year	7,860	2,270	10,130
Accumulated depreciation			
At the start of the year	800	1,100	1,900
Depreciation expense	120	250	370

Accumulated depreciation on disposals	(55)	(130)	(185)
At the end of the year	865	1,220	2,085
Carrying amount			
At the start of the year	6,400	1,000	7,400
At the end of the year	6,995	1,050	8,045

5.2 Accounting policies

IAS 1 requires the disclosure of accounting policies used that are relevant to an understanding of the financial statements. Property, plant and equipment often includes the largest numbers in the statement of financial position and results in significant expense in the statement of comprehensive income.

One of the learning outcomes in this area is that you be able to formulate accounting policies for property, plant and equipment.

6 INTERPRETATIONS INVOLVING ACCOUNTING FOR NON-CURRENT ASSETS

Section overview

- IFRIC 1: Changes in existing decommissioning, restoration and similar liabilities
- IFRIC 20: Stripping costs in the production phase of a surface mine
- Core inventories

6.1 IFRIC 1: Changes in existing decommissioning, restoration and similar liabilities

Scope

IFRIC 1 applies to changes in the measurement of an existing decommissioning cost that is recognised both as:

- part of the cost of an item of property plant and equipment in accordance with IAS 16; and
- a liability in accordance with IAS 37

The issue

Decommissioning costs are recognised as part of the initial cost of PPE if an obligation has been recognised for these costs. This will be the case when the costs satisfy the IAS 37 recognition criteria.

The provision is measured in accordance with IAS 37 rules. IAS 37 requires that provisions are reviewed at each reporting date and adjusted to reflect the best estimate of the expected outcome.

The carrying amount of a provision might need to change in order to reflect:

- unwinding of the discount; and
- change in estimates including:
  - timing of the cash flows;
  - size of the cash flows; or
  - discount rate.

IFRIC 1 gives guidance on the location of the other side of the entry when a provision is adjusted.

Consensus: Unwinding of a discount

A movement on a provision due to the unwinding of a discount is a finance cost and must be recognised in the statement of profit or loss. Capitalisation in accordance with the rules in IAS 23 is not permitted.

Consensus: Other causes of a movement

The accounting treatment for an increase or decrease in a provision due to other causes depends how the related asset is measured.

Related asset carried at cost less accumulated depreciation

A change in the liability is added to/deducted from the carrying amount of the related asset if it is measured using the cost model:

- A decrease in the provision (Dr Provision) reduces the carrying amount of the related asset (Cr Asset). Once the carrying amount of the related asset is reduced to zero any further decrease is recognised as an expense in the statement of profit or loss
- An increase in the provision (Cr Provision) increases the carrying amount of the related asset (Dr Asset). However, an increase in a provision might indicate that the related asset might not be fully recoverable. If this is the case the asset must be tested for impairment by estimating its recoverable amount. Any impairment loss must be recognised in accordance with IAS 36.

Example: Accounting for movements on a provision related to an asset accounted for using the cost model

1 January 2015

X Limited purchased and installed an asset on 1st January 2015 at a cost of Rs.10m.

X Limited made the following estimates with respect to the asset and future decommissioning costs to which it was committed at this date:

Useful life	40 Years
Decommission cost at end of useful life	Rs.2,000,000
Discount rate	5%

1 January 2015

Amount recognised for the provision

$$\text{Rs. } 2{,}000{,}000 \times \frac{1}{(1.05)^{40}} = Rs.\ 284{,}091$$

The double entry is as follows:

	Debit	Credit
Asset	284,091	
Provision		284,091

Thus the carrying amount of the asset on initial recognition is:

	Rs.
Cash cost	10,000,000
Initial estimate of decommission costs	284,091
Initial estimate of decommission costs	10,284,091

Example (continued): Accounting for movements on a provision related to an asset accounted for using the cost model

31 December 2015

The asset must be depreciated over its estimated useful life.

In addition the company must recognise the unwinding of the discount inherent in initial measurement of the provision.

	Debit	Credit
Depreciation expense (10,284,091 ÷ 40)	Rs.257,102	
Provision		Rs.257,102

The company must recognise the unwinding of the discount inherent in initial measurement of the provision.

	Debit	Credit
Finance Cost (5% × 284,091)	Rs.14,205	
Provision		Rs.14,205

The company must review the provision in accordance with IAS 37.

The provision was reviewed in accordance with IAS 37 and the following revised estimates made:

Useful life (from this date)	41 years
Decommission cost at end of useful life	Rs.2,200,000
Discount rate	6%

Provision must be remeasured at:

$$\text{Rs. } 2{,}200{,}000 \times \frac{1}{(1.06)^{41}} = Rs. 201{,}782$$

The provision is remeasured as follows:

	Rs.
Provision as at 1 January 2015	284,091
Unwinding of the discount	14,205
Provision as at 31 December 2015 before adjustment to reflect change in estimates	298,296
Change due to change in estimates (balancing figure)	(96,514)
Provision as at 31 December 2015	201,782

Example (continued): Accounting for movements on a provision related to an asset accounted for using the cost model

31 December 2015 (continued)

The double entry is as follows:

	Debit	Credit
Provision	Rs.96,514	
Asset		Rs.96,514

Thus the carrying amount of the asset on initial recognition is:

	Rs.
Cash cost	2,000,000
Initial estimate of decommission costs	284,091
	2,284,091

The double entries during 2015 can be summarised as follows:

		Debit/(credit)	
	Asset	Provision	P&L
	Rs.	Rs.	Rs.
1 January 2015			
Cash	10,000,000		
Decommissioning cost	284,091	(284,091)	
	10,284,091		
31st December 2015			
Depreciation	(257,102)		257,102
Unwinding of the discount		(14,205)	14,205
Change due to review of provision	(96,514)	96,514	
	9,930,475	201,782	

Related asset carried at fair value

The related asset might be accounted for at a revalued amount using the IAS 16 revaluation model.

In this case, any change in the estimate of dismantling cost does not affect the carrying amount of the asset but is recognised in the revaluation surplus account. However, any such adjustment cannot result in the balance on the revaluation surplus account becoming negative. The maximum such adjustment reduces the balance on the revaluation surplus account to zero with any further in profit or loss.

6.2 IFRIC 20: Stripping costs in the production phase of a surface mine

Background

A company involved in surface mining operations may find it necessary to remove mine waste materials ('overburden') to gain access to mineral ore deposits. This waste removal activity is known as 'stripping'.

The interpretation describes the period before production begins as the development phase of the mine. Stripping costs incurred in the development phase are usually capitalised as part of the depreciable cost of building, developing and constructing the mine. Those capitalised costs are depreciated or amortised on a systematic basis, usually by using the units of production method, once production begins.

Once production begins, a mining company may continue to remove overburden and to incur stripping costs. The material removed in the production phase will not necessarily be all waste but will often be a combination of ore and waste. Therefore, there might be two benefits accruing to the company from the stripping activity:

- usable ore that can be used to produce inventory; and
- improved access to ore that will be mined in future periods.

IFRIC 20 applies to waste removal costs that are incurred in surface mining activity during the production phase of the mine. It explains how to account for these two benefits and how to measure them both initially and subsequently.

Issues

IFRIC 20 addresses the following issues:

- recognition of production stripping costs as an asset;
- initial measurement of the stripping activity asset; and
- subsequent measurement of the stripping activity asset.

Consensus: Recognition of production stripping costs as an asset

A company must account for stripping costs as inventory to the extent that a benefit from the stripping activity is realised in the form of inventory produced

A company must account for stripping costs as a non-current asset (a stripping activity asset) to the extent that the benefit is improved access to ore as long as the following criteria are met:

- it is probable that the future economic benefit (improved access to the ore body) associated with the stripping activity will flow to the company
- the company can identify the component of the ore body for which access has been improved; and
- the costs relating to the stripping activity associated with that component can be measured reliably.

The stripping activity asset must be accounted for as part of an existing asset either as an addition to, or as an enhancement of, that asset. Therefore, the nature of this existing asset will determine whether the stripping activity asset is classified as tangible or intangible.

Consensus: Initial measurement of the stripping activity asset

The stripping activity asset is initially measured at cost.

Cost is those costs directly incurred that improves access to the identified component of ore, plus an allocation of directly attributable overhead costs.

If the costs of the stripping activity asset and the inventory produced are not separately identifiable, the company must allocate the production stripping costs between the inventory produced and the stripping activity asset by using an allocation basis that is based on a relevant production measure for example, volume of waste extracted compared with expected volume, for a given volume of ore production.

Consensus: Subsequent measurement of the stripping activity asset

After initial recognition, the stripping activity asset is measured in the same way as the existing asset of which it is a part. This could be either at cost or revalued amount less depreciation or amortisation and less impairment losses.

The stripping activity asset must be depreciated on a systematic basis, over the expected useful life of the identified component of the ore body that becomes more accessible as a result of the stripping activity. The units of production method must be applied unless another method is more appropriate.

The expected useful life of the identified component of the ore body that is used to depreciate or amortise the stripping activity asset will differ from the expected useful life that is used to depreciate or amortise the mine itself and the related life-of-mine assets.

The exception to this are those limited circumstances when the stripping activity provides improved access to the whole of the remaining ore body. For example, this might occur towards the end of a mine's useful life when the identified component represents the final part of the ore body to be extracted.

6.3 Core inventories

The subject matter of this section was a question submitted to IFRSIC to see if they would include it on their agenda with a view to issuing an interpretation on the topic.

When IFRSIC receive such a submission they consider in detail, whether it should become part of their agenda. When they decide not to include a topic that has been submitted for consideration, they issue a paper to explain their decision. They declined to include this topic.

The following discussion is a summary of their explanation.

The issue

Some production facilities require the presence of a minimum amount of inventory in order to function. This means that a minimum amount of inventory must be present at all times. This is described as core inventory. Examples include oil or gas in a pipeline (line fill) or an amount of gas in cavern storage facilities (cushion gas).

Core inventories are a minimum amount of material that:

- is necessary to permit a production facility to start operating and to maintain subsequent production;
- cannot be physically separated from other inventories; and

- can be removed only when the production facility is finally decommissioned.

The question is whether core inventory held in an entity's own facilities are accounted for as inventories or as property, plant and equipment.

Analysis

Arguments supporting the rational for classification as inventory:

- Core inventories meet the definition of inventories as 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.
- Core inventories are ordinarily interchangeable with other inventories, and thus core inventories held at a particular reporting date will be either consumed or sold in the next period.
- Core inventories do not meet the definition of PP&E in IAS 16 because they are not "expected to be used during more than one period".

Arguments supporting the rational for classification as an element of property, plant and equipment:

- Core inventories are not held for sale or consumption; instead their intended use is to ensure that a production facility is operating. Even though core inventories are ordinarily interchangeable with other inventories, the characteristics and intended use of a particular part of the inventories remain the same at each individual reporting date. Thus these core inventories need to be accounted for separately.
- Core inventories are necessary to bring a PP&E asset to its required operating condition.
- IAS 16 (paragraph 16b) states that the cost of an item of property, plant and equipment comprises any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
- IAS 2 (paragraph 35) states that "Some inventories may be allocated to other asset accounts, for example, inventory used as a component of self-constructed property, plant or equipment. Inventories allocated to another asset in this way are recognised as an expense during the useful life of that asset".

Conclusion

The classification of core inventories should be based on their primary intended use rather than on their physical form.

Core inventories as described above are primarily held for making a production facility operational. Thus, they would normally be classified as an element of the cost of property, plant and equipment.

CHAPTER 7

Non-current assets: sundry standards

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 21 IAS 20: Accounting for government grants and disclosure of government assistance

B (a) 23 IAS 23: Borrowing costs

B (a) 31 IAS 40: Investment property

B (a) 51 SIC 10: Government assistance – no specific relation to operating activities

1 IAS 23: BORROWING COSTS

Section overview

- Introduction
- Borrowing costs eligible for capitalisation
- Period of capitalisation
- Disclosures

1.1 Introduction

A company might incur significant interest costs if it has to raise a loan to finance the purchase or construction of an asset. *IAS 23: Borrowing costs* defines borrowing costs and sets guidance on the circumstances under which they are to be capitalised as part of the cost of qualifying assets.

Definition: Borrowing costs

Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds.

Definition: Qualifying asset

A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Any of the following may be qualifying assets depending on circumstances:

- inventories;
- items of property, plant and equipment;
- intangible assets.

The following are not qualifying assets:

- 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 acquired.

Qualifying assets are usually self-constructed non-current assets.

1.2 Borrowing costs eligible for capitalisation

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset must be capitalised as part of the cost of that asset. All other borrowing costs are recognised as an expense in the period in which they are incurred.

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those that would have been avoided if the expenditure on the qualifying asset had not been made.

This includes the costs associated with specific loans taken to fund the production or purchase of an asset and general borrowings. General borrowings are included because if an asset were not being constructed it stands to reason that there would have been a lower need for cash.

Funds specifically borrowed to obtain a qualifying asset

When a specific loan is taken in order to obtain a qualifying asset the borrowing costs eligible for capitalisation are the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.

Example: Specific borrowings

On 1 January 2016 Okara Engineering issued a bond to raise Rs. 25,000,000 to fund a capital project which will take three years to complete.

Amounts not yet needed for the project are invested on a temporary basis.

During the year to 31 December 2016, Okara Engineering spent Rs. 9,000,000 on the project.

The cost of servicing the bond was Rs. 1,250,000 during this period and the company was able to earn Rs. 780,000 through the temporary reinvestment of the amount borrowed.

The amounts recognised as capital work in progress in the period was:

	Rs.
Costs incurred (labour, material, overhead etc.)	9,000,000
Interest capitalised:	
Actual interest cost	1,250,000
Less: return on temporary investment	(780,000)
	470,000
Additions to capital work in progress	9,470,000

General funds used for the purpose of obtaining a qualifying asset.

When general borrowings are used the amount of borrowing costs eligible for capitalisation is obtained by applying a capitalisation rate to the expenditures on that asset.

The capitalisation rate is the weighted average of the borrowing costs applicable to the borrowings that are outstanding during the period except for borrowings made specifically for the purpose of obtaining a qualifying asset.

The amount of borrowing costs capitalised cannot exceed the amount of borrowing costs it incurred during a period.

Example: General borrowings: Capitalisation rate

Sahiwal Construction has three sources of borrowing:

	Average loan in the year (Rs.)	Interest expense incurred in the year (Rs.)
7 year loan	8,000,000	800,000
10 year loan	10,000,000	900,000
Bank overdraft	5,000,000	900,000

The 7 year loan has been specifically raised to fund the building of a qualifying asset.

A suitable capitalisation rate for other projects is found as follows:

	Average loan in the year (Rs.)	Interest expense incurred in the year (Rs.)
10 year loan	10,000,000	900,000
Bank overdraft	5,000,000	900,000
	15,000,000	1,800,000

Capitalisation rate = $^{1,800,000}/_{15,000,000} \times 100 = 12\%$

Alternatively:

Rate on 10 year loan = $^{900,000}/_{10,000,000} \times 100 = 9\%$

Rate on bank overdraft = $^{900,000}/_{5,000,000} \times 100 = 18\%$

Weighted average: $9\% \times {}^{10,000,000}/_{15,000,000} + 18\% \times {}^{5,000,000}/_{15,000,000}$

$6\% + 6\% = 12\%$

The capitalisation rate is applied from the time expenditure on the asset is incurred.

Example: General borrowings: Capitalisation rate

Continuing the example above, Sahiwal Construction has incurred the following expenditure on a project funded from general borrowings for year ended 31 December 2016.

Date incurred:	Amount (Rs.)
31st March	1,000,000
31st July	1,200,000
30th October	800,000

The amount capitalised in respect of capital work in progress during 2016 is as follows:

	Rs.
31st March – Expenditure	1,000,000
Interest (1,000,000 × 12% × 9/12)	90,000
31st July – Expenditure	1,200,000
Interest (1,200,000 × 12% × 5/12)	60,000
30th October – Expenditure	800,000
Interest (800,000 × 12% × 2/12)	16,000
	3,166,000

1.3 Period of capitalisation

Commencement of capitalisation

Capitalisation of borrowing costs should start only when:

- ❑ expenditures for the asset are being incurred; and
- ❑ borrowing costs are being incurred, and
- ❑ activities necessary to prepare the asset have started.

Suspension of capitalisation

Capitalisation of borrowing costs should be suspended if development of the asset is suspended for an extended period of time.

Cessation of capitalisation

Capitalisation of borrowing costs should cease when the asset is substantially complete. The costs that have already been capitalised remain as a part of the asset's cost, but no additional borrowing costs may be capitalised.

Example: Commencement and suspension of capitalisation

Company A borrowed Rs. 9,000 @ 15% per annum to fund a project on 1st Jan 2015.

The following expenditures were made on the project during the year ending 31 December 2016

Date: 1st March 2016: Rs. 2,500

Date: 1st Oct 2016: Rs. 4,200

Work on the project was suspended during the month of August and resumed in September.

The IAS 23 rules apply as follows:

The total interest cost of the borrowing is:

$$\text{Rs. } 9{,}000 \times 15\% \times 10/12 = 1{,}125$$

The project commenced on 1st March resulting in a period of 10 months up to the year end.

However, interest cannot be capitalised during the period of suspension. Therefore, interest is capitalised only for 9 months.

The borrowing is specific to the project so interest on whole amount (principal) is capitalised in the amount of:

$$9{,}000 \times 15\% \times 9/12 = 1{,}012.5$$

The double entry to reflect the above is as follows:

	Debit	Credit
Asset in the course of construction	1,012.5	
Statement of profit or loss (finance costs)	112.5	
Cash/interest liability		1,125

1.4 Disclosures

IAS 23 requires disclosure of the following:

- the amount of borrowing costs capitalised during the period; and
- the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

2 IAS 20: ACCOUNTING FOR GOVERNMENT GRANTS AND DISCLOSURE OF GOVERNMENT ASSISTANCE

Section overview

- Introduction and definitions
- Accounting treatment of government grants
- Repayment of government grants
- Government assistance
- Disclosure requirements
- SIC 10 Government assistance – no specific relation to operating activities

2.1 Introduction and definitions

In many countries the government provides financial assistance to industry. The most common form of such assistance is a grant of cash from local or national government.

Definitions

Government assistance is action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria. Government assistance does not include benefits provided only indirectly through action affecting general trading conditions, such as the provision of infrastructure in development areas or the imposition of trading constraints on competitors.

Government grants are 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.

IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* identifies two types of government grants:

- grants related to assets, or
- grants related to income.

Definitions

Grants related to assets are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term 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 are government grants other than those related to assets.

Government grants are sometimes called by other names such as subsidies, subventions, or premiums.

Forgivable loans

Definition: Forgivable loans

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

A forgivable loan from government is treated as a government grant when there is reasonable assurance that the entity will meet the terms for forgiveness of the loan.

Loans at below market rates of interest

The benefit of a government loan at a below-market rate of interest is treated as a government grant.

The benefit of the below-market rate of interest is measured as the difference between the initial carrying value of the loan determined in accordance with IAS 39 (IFRS 9) and the proceeds received.

The benefit is accounted for in accordance with IAS 20.

2.2 Accounting treatment of government grants

IAS 20 states that grants should not be recognised until there is reasonable assurance that:

- the entity will comply with any conditions attaching to the grant, and
- the grant will be received.

Once these recognition criteria are met, the grants should be recognised in profit or loss over the periods necessary to match them with their related costs.

Neither type of grant should be credited directly to shareholders' interests in the statement of financial position. They must be reported on a systematic basis through the statement of profit or loss (profit or loss).

Grants related to income

For grants related to income, IAS 20 states that an 'income approach' should be used, and the grant should be taken to income over the periods necessary to match the grant with the costs that the grant is intended to compensate.

IAS 20 allows two methods of doing this:

- **Method 1**. Include the grant for the period as 'other income' for inclusion in profit or loss for the period
- **Method 2**. Deduct the grant for the period from the related expense.

Example: Grant related to income

A company receives a cash grant of Rs. 30,000 on 31 December Year 0.

The grant is towards the cost of training young apprentices, and the training programme is expected to last for 18 months from 1 January Year 1.

Actual costs of the training were Rs. 50,000 in Year 1 and Rs. 25,000 in Year 2.

The grant would be accounted for as follows:

At 31 December Year 0 the grant would be recognised as a liability and presented in the statement of financial position split between current and non-current amounts. Rs. 20,000 (12 months/18 months × Rs. 30,000) is current and would be recognised in profit for Year 1.The balance is non-current.

At the end of year 1 there would be a current balance of Rs. 10,000 (being the non-current balance at the end of Year 0 reclassified as current) in the statement of financial position. This would be recognised in profit in Year 2.

Extracts from the financial statements are as follows:

Statement of financial position (extracts)

	31 December Year 0	31 December Year 1	31 December Year 2
Current liabilities			
Deferred income	20,000	10,000	–
Non-current liabilities			
Deferred income	10,000	–	–

Statement of profit or loss (extracts)

	31 December Year 1	31 December Year 2
Method 1		
Training costs	(50,000)	(25,000)
Government grant received	20,000	10,000
Method 2		
Training costs (50,000 – 20,000)	30,000	
Training costs (25,000 – 10,000)		15,000

Grants related to assets

For grants related to assets, IAS 20 allows two methods of doing this:

- **Method 1**. Deduct the grant from the cost of the related asset. The asset is included in the statement of financial position at cost minus the grant. Depreciate the net amount over the useful life of the asset.
- **Method 2**. Treat the grant as deferred income and recognise it as income on a systematic basis over the useful life of the asset.

Both methods achieve the same effective result.

Example: Grant related to an asset

A company receives a government grant of Rs. 400,000 towards the cost of an asset with a cost of Rs. 1,000,000.

The asset has an estimated useful life of 10 years and no residual value.

The amounts could be reflected in the financial statements prepared at the end of Year 1 in accordance with IAS 20 in the following ways:

Method 1:

Statement of financial position (extract)

Property, plant and equipment	Rs.
Cost (1,000,000 – 400,000)	600,000
Accumulated depreciation	(60,000)
Carrying amount	540,000

Included in statement of profit or loss (extract)	Rs.
Depreciation charge (Rs. 600,000/10 years)	60,000

Method 2:

Statement of financial position (extract)

Property, plant and equipment	Rs.
Cost	1,000,000
Accumulated depreciation	(100,000)
Carrying amount	900,000
Current liabilities	
Deferred income	40,000
Non-current liabilities	
Deferred income	320,000

At the end of year 1 there would be Rs. 360,000 of the grant left to recognise in profit in the future at Rs. 40,000 per annum. Rs. 40,000 would be recognised in the next year and is therefore current. The balance is non-current

Included in statement of profit or loss (extract)	Rs.
Expense: Depreciation charge (Rs. 1,000,000/10 years)	(100,000)
Income: Government grant (Rs. 400,000/10 years)	40,000

Practice question **1**

On January Year 1 Entity O purchased a non-current asset with a cost of Rs. 500,000 and received a grant of Rs. 100,000 in relation to that asset.

The asset is being depreciated on a straight-line basis over five years.

Required

Show how the asset and the grant would be reflected in the financial statements at the end of the first year under both methods of accounting for the grant allowed by IAS 20.

Grants as compensation for expenses or losses

A government grant may be awarded for the purpose of giving immediate financial support to an entity rather than as an incentive to undertake specific expenditures.

The circumstances under which the grant is made may warrant immediate recognition of the grant in profit or loss in the period in which the entity qualifies to receive it with disclosure to ensure that its effect is clearly understood.

A government grant may become receivable by an entity as compensation for expenses or losses incurred in a previous period. Such a grant is recognised in profit or loss of the period in which it becomes receivable, with disclosure to ensure that its effect is clearly understood.

2.3 Repayment of government grants

A government gran might become repayable by the entity (e.g. when the entity fails to meet the underlying conditions for the grant).

When a government grant becomes repayable it is accounted for as a change in accounting estimate (*IAS 8: Accounting policies, changes in accounting estimates and errors*).

Repayment of a grant related to income

Repayment of a grant related to income is applied in the first instance against any unamortised deferred credit recognised in respect of the grant. If the repayment exceeds any such deferred credit any excess is recognised immediately in profit or loss.

Example: Repayment of grant related to income

On 1 January Year 1 X Limited received a cash grant of Rs. 500,000 towards the cost of employing an environmental impact analyst on a new project for a 5 year period.

The grant is repayable in full if the project is not completed.

The analyst was employed and the project commenced from the 1 January Year 1.

On 1 January Year 3 the project was abandoned and the grant became repayable in full.

The grant and its subsequent repayment is accounted for as follows:

Year 1

	Debit	Credit
Cash	500,000	
Deferred income		500,000
Statement of profit or loss (reduction of employment cost)		100,000
Deferred income	100,000	

Year 2

Statement of profit or loss (reduction of employment cost)		100,000
Deferred income	100,000	

The balance on the deferred income account at the end of Year 2 is Rs. 300,000 (Rs. 500,000 – Rs. (2 × Rs. 100,000).

The double entry to reflect the repayment is as follows

	Debit	Credit
Deferred income	300,000	
Statement of profit or loss	200,000	
Cash		500,000

Repayment of a grant related to an asset

Accounting for a repayment of a grant related to an asset depends on how the grant was accounted for originally.

If the grant was accounted for as reduction of the carrying amount of the related asset, its repayment is recognised by increasing the carrying amount of the asset.

If the grant was accounted for as deferred income, its repayment is recognised by reducing the deferred income balance by the amount repayable.

The cumulative additional depreciation that would have been recognised in profit or loss to date in the absence of the grant must be recognised immediately in profit or loss.

Also note that the circumstances giving rise to repayment of the grant might indicate the possible impairment of the new carrying amount of the asset.

2.4 Government assistance

The definition of government grants (see earlier) excludes:

- certain forms of government assistance which cannot reasonably have a value placed upon them (e.g. free advice and the provision of guarantees); and
- transactions with government which cannot be distinguished from the normal trading transactions of the entity (e.g. a government procurement policy that is responsible for a portion of the entity's sales).

There is no specified accounting treatment for either of these. However, the significance of the benefit may require disclosure of the nature, extent and duration of the assistance in order to prevent the financial statements being misleading.

2.5 Disclosure requirements

IAS 20 requires the following disclosures in the notes to the financial statements:

- the accounting policy adopted for government grants, including the method of presentation in the financial statements
- the nature and extent of government grants recognised in the financial statements and an indication of other forms of government assistance from which the entity has directly benefitted.
- unfulfilled conditions and other contingencies attaching to government assistance (if this assistance has been recognised in the financial statements).

Government assistance may be significant so that disclosure of the nature, extent and duration of the assistance is necessary in order that the financial statements may not be misleading.

2.6 SIC 10 Government assistance – no specific relation to operating activities

A company might receive a grant or other assistance that is not linked to operating activities.

Issue

The issue is whether such government assistance is "a government grant" within the scope of IAS 20 and should therefore be accounted for in accordance with this Standard.

Consensus

Such assistance meets the definition of government grants in IAS 20. Such grants should therefore not be credited directly to shareholders' interests.

3 IAS 40: INVESTMENT PROPERTY

Section overview

- Definitions
- Accounting treatment of investment property
- Why investment properties are treated differently from other properties
- Transfers and disposals of investment property
- Disclosure requirements

3.1 Definitions

IAS 40: Investment Property, defines and sets out the rules on accounting for investment properties.

Definition: Investment property

An investment property is property (land or a building, part of a building or both) held to earn rentals or for capital appreciation or both.

Investment property differs from other property, which is:

- used in the production or supply of goods, or for administrative purposes (which is covered by *IAS 16; Property, plant and equipment*); or
- held for sale in the ordinary course of business (which is covered by *IAS 2: Inventories*).

The property could be held by:

- the owner; or
- the lessee under a finance lease or an operating lease.

Examples of investment property

The following are examples of investment property:

- land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business.
- land held for a currently undetermined future use. (If an entity has not determined that it will use the land as owner-occupied property or for short-term sale in the ordinary course of business,
- a building owned by the entity (or held by the entity under a finance lease) and leased out under one or more operating leases.
- a building that is vacant but is held to be leased out under one or more operating leases.
- property that is being constructed or developed for future use as investment property.

Not investment property

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

- property intended for sale in the ordinary course of business;
- property being constructed or developed on behalf of third parties;
- owner-occupied property including (among other things) property held for future use as owner-occupied property, property held for future development and subsequent use as owner-occupied property, property occupied by employees (whether or not the employees pay rent at market rates) and owner-occupied property awaiting disposal;
- property being leased to another entity under a finance lease.

Scope limitation

IAS 40 does not apply to:

- biological assets related to agricultural activity (*IAS 41: Agriculture* and *IAS 16: Property, plant and equipment*); and
- mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources.

Property held under an operating lease

A property interest that is held by a lessee under an operating lease may be classified and accounted for as investment property if, and only if, the property would otherwise meet the definition of an investment property and the lessee accounts for it using the IAS 40 fair value model.

This classification alternative is available on a property-by-property basis. However, once this classification alternative is selected for one such property interest held under an operating lease, all property classified as investment property must be accounted for using the fair value model.

This means that a company might lease two properties under operating leases and account for each differently.

Example: Property held under an operating lease

A Limited rents a property from B Limited under an operating lease.

A Limited sublets this property and it satisfies the IAS 40 definition of investment properties from A's view.

A Limited has a choice of accounting treatment:

1. **A Limited could apply IAS 17 accounting for it as a lessee from B Limited and a lessor to other parties.**
2. **A Limited could account for its interest in the property as an investment property as alternative to the IAS 17 treatment as a lessee from B Limited. It would still use IAS 17 as a lessor to the third parties.**

Example: Property held under an operating lease

A Limited rents two properties from B Limited under operating leases.

A Limited sublets these properties and they satisfy the IAS 40 definition of investment properties from A's view.

A Limited has a choice of accounting treatment for its interests in these properties:

1. A Limited could use IAS 17 operating lessee accounting for both properties.
2. A Limited could use IAS 40 investment property accounting for both properties.
3. A Limited could use IAS 17 operating lessee accounting for one property and IAS 40 investment property accounting for the other.

If it applies IAS 40 it must apply the IAS 40 fair value model to the property and to all other investment properties that it might hold.

In summary, not all operating leases that would qualify to be investment properties have to be treated in the same way, but once an operating lease is treated as an investment property, the fair value model must be used for all investment properties.

Property leased within a group

In some cases, an entity owns property that is leased to, and occupied by, its parent or another subsidiary.

- The property could qualify as investment property from the perspective of the entity that owns it (if it meets the IAS 40 definition). In that case the lessor must account for the property as investment property in its individual financial statements.
- The property does not qualify as investment property in the consolidated financial statements, because the property is owner-occupied from the perspective of the group.

Partly occupied buildings

An entity might use part of a property for the production or supply of goods or services or for administrative purposes and hold another part of the same property to earn rentals or for capital appreciation. In other words, part of a property might be owner occupied and part held as an investment.

The two parts are accounted for separately if they could be sold separately (or leased out separately under a finance lease).

If this is not the case the property is investment property only if an insignificant portion is owner occupied.

3.2 Accounting treatment of investment property

The **recognition criteria** for investment property are the same as for property, plant and equipment under IAS 16. An investment property should be recognised as an asset only when:

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

Measurement at recognition

Investment property should be measured initially at cost plus any directly attributable expenditure (e.g. legal fees, property transfer taxes and other transaction costs) incurred to acquire the property.

A property held under an operating lease may be classified as an investment property. The initial cost of such a property is found by capitalising the operating lease as if it were a finance lease according to *IAS 17 Leases*.

The cost of an investment property is not increased by:

- start-up costs (unless necessary to bring the property to the condition necessary for it to be capable of operating in the manner intended by management);
- operating losses incurred before the investment property achieves the planned level of occupancy; or
- abnormal waste incurred in constructing or developing the property.

Measurement after recognition

After initial recognition an entity may choose as its accounting policy:

- the fair value model; or
- the cost model.

The chosen policy must be applied to all the investment property of the entity.

Once a policy has been chosen it cannot be changed unless the change will result in a more appropriate presentation. IAS 40 states that a change from the fair value model to the cost model is unlikely to result in a more appropriate presentation.

Fair value model for investment property

Definition: Fair value

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.

Under the **fair value model** the entity should:

- revalue all its investment property to 'fair value' (open market value) at the end of each financial year; and
- recognise any resulting gain or loss in profit or loss for the period.

The property would not be depreciated.

This is different to the revaluation model of IAS 16, where gains are reported as other comprehensive income and accumulated as a revaluation surplus.

If it is not possible to arrive at a reliable fair value figure then the cost model should be adopted for that property. This is an exception to the rule that **all** investment property must be valued under either one model or the other.

If an entity's policy is to measure investment properties at fair value but it measures an investment property at cost because its fair value cannot be measured reliably then that property must continue to be measured at cost even if its fair value can be determined subsequently. In this particular case IAS 40 prohibits the move from cost to fair value.

Cost model for investment property

The **cost model** follows the provisions of IAS 16. The property is measured at cost less accumulated depreciation (related to the non-land element) and less impairment loss if any.

Example: Accounting for investment property

On 1 January Year 1 Entity P purchased a building for its investment potential. The building cost Rs. 1 million with transaction costs of Rs. 10,000.

The depreciable amount of the building component of the property at this date was Rs. 300,000.

The property has a useful life of 50 years.

At the end of Year 1 the property's fair value had risen to Rs. 1.3 million.

The amounts which would be included in the financial statements of Entity P at 31 December Year 1, under the cost model are as follows:

Cost model

The property will be included in the statement of financial position as follows:

	Rs.
Cost (1,000,000 + 10,000)	1,010,000
Accumulated depreciation (300,000 ÷ 50 years)	(6,000)
Carrying amount	1,004,000

The statement of profit or loss will include depreciation of Rs. 6,000.

The amounts which would be included in the financial statements of Entity P at 31 December Year 1, under the fair value model are as follows:

Fair value model

The property will be included in the statement of financial position at its fair value of Rs. 1,300,000.

The statement of profit or loss will include a gain of Rs. 290,000 (Rs. 1,300,000 – Rs. 1,010,000) in respect of the fair value adjustment.

3.3 Why investment properties are treated differently from other properties

Most properties are held to be used directly or indirectly in the entity's business. For example, a factory houses plant and equipment which is used to produce goods for sale. The property is being consumed and it is appropriate to depreciate it over its useful life.

An investment property is held primarily because it is expected to increase in value. It generates economic benefits for the entity because it will eventually be sold at a profit. An investment property also differs from other properties because it generates revenue and cash flows largely independently of other assets held by an entity.

The most relevant information about an investment property is its fair value (the amount for which it could be sold). Depreciation is largely irrelevant. Therefore it is appropriate to re-measure an investment property to fair value each year and to recognise gains and losses in profit or loss for the period.

3.4 Transfers and disposals of investment property

If a property is transferred into or out of this category it must be reclassified as an investment property or as no longer being an investment property. A transfer of investment property can only be made where there is a change of use as illustrated below.

Circumstance	Transfer from/to	Deemed transfer value
Commencement of owner-occupation	Transfer from investment property to owner-occupied property	Fair value at the date of change of use becomes the deemed cost for future accounting purposes
End of owner-occupation	Transfer from owner-occupied property to investment property	Where investment properties are measured at fair value, revalue in accordance with IAS 16 prior to the transfer
Commencement of development with a view to sale	Transfer from investment property to inventories	Fair value at the date of change of use becomes the deemed cost for future accounting purposes
Commencement of an operating lease to another party	Transfer from inventories to investment property	Fair value at the date of the transfer, and any difference compared to previous carrying amount is recognised in profit or loss

Gain or loss on disposal

Gains or losses on disposals of investment properties are included in profit or loss in the period in which the disposal occurs.

Example: Disposal of investment property

The investment property in the previous example was sold early in Year 2 for Rs. 1,550,000,

Selling costs were Rs. 50,000.

The amount that would be included in the statement of profit or loss for Year 2 in respect of this disposal under the cost model is as follows:

Cost model	Rs.
Sale value	1,550,000
Selling costs	(50,000)
Net disposal proceeds	1,500,000
Minus: Carrying amount	(1,004,000)
Gain on disposal	496,000

The amount that would be included in the statement of profit or loss for Year 2 in respect of this disposal under the fair value model is as follows:

(Fair value model	Rs.
Sale value	1,550,000
Selling costs	(50,000)
Net disposal proceeds	1,500,000
Minus: Carrying amount	(1,300,000)
Gain on disposal	200,000

3.5 Disclosure requirements

The following disclosures are required by IAS 40 in the notes to the accounts.

Disclosure requirements applicable to both the fair value model and the cost model

- ❑ whether the fair value model or the cost model is used
- ❑ the methods and assumptions applied in arriving at fair values
- ❑ the extent to which the fair value of investment property was based on a valuation by a qualified, independent valuer with relevant, recent experience
- ❑ amounts recognised in income or expense in the statement of profit or loss for:
  - rental income from investment property
  - operating expenses in relation to investment property

- ❑ details of any restrictions on the ability to realise investment property or any restrictions on the remittance of income or disposal proceeds
- ❑ the existence of any contractual obligation to purchase, construct or develop investment property or for repairs, maintenance or enhancements.

Disclosure requirements applicable to the fair value model only

There must be a reconciliation, in a note to the financial statements, between opening and closing values for investment property, showing:

- ❑ additions during the year
- ❑ assets classified as held for sale in accordance with IFRS 5
- ❑ net gains or losses from fair value adjustments
- ❑ acquisitions through business combinations

This reconciliation should show separately any amounts in respect of investment properties included at cost because their fair values cannot be estimated reliably.

For investment properties included at cost because fair values cannot be estimated reliably, the following should also be disclosed:

- ❑ a description of the property
- ❑ an explanation as to why fair values cannot be determined reliably
- ❑ if possible, the range within which the property's fair value is likely to lie.

Disclosure requirements applicable to the cost model only

- ❑ the depreciation methods used
- ❑ the useful lives or depreciation rates used
- ❑ gross carrying amounts and accumulated depreciation at the beginning and at the end of the period
- ❑ A reconciliation between opening and closing values showing:
    - additions
    - depreciation
    - assets classified as held for sale in accordance with IFRS 5
    - acquisitions through business combinations
    - impairment losses
    - transfers.

When the cost model is used, the fair value of investment property should also be disclosed. If the fair value cannot be estimated reliably, the same additional disclosures should be made as under the fair value model.

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

The amounts could be reflected in the financial statements prepared at the end of Year 1 in accordance with IAS 20 in the following ways:

Method 1:

Statement of financial position

Property, plant and equipment	Rs.
Cost (500,000 – 100,000)	400,000
Accumulated depreciation	(80,000)
Carrying amount	320,000

Included in statement of profit or loss	Rs.
Depreciation charge (Rs. 400,000/5 years)	80,000

Method 2:

Statement of financial position

	Rs.
Property, plant and equipment	
Cost	500,000
Accumulated depreciation	(100,000)
Carrying amount	400,000
Current liabilities	
Deferred income	20,000
Non-current liabilities	
Deferred income	60,000

At the end of year 1 there would be Rs. 80,000 of the grant left to recognise in profit in the future at Rs. 20,000 per annum. Rs. 20,000 would be recognised in the next year and is therefore current. The balance is non-current.

Included in statement of profit or loss	Rs.
Expense: Depreciation charge (Rs. 500,000/5 years)	(100,000)
Income: Government grant $^{(Rs.\ 100,000}/_{5\ years})$	20,000

CHAPTER 8

IAS 38: Intangible assets

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 29 IAS 38: Intangible assets

B (a) 57 SIC 32: Intangible Assets – web site costs

1 IAS 38: INTANGIBLE ASSETS - INTRODUCTION

Section overview

- Introduction
- Scope of IAS 38
- Definition of an intangible asset
- Recognition criteria for intangible assets
- Separate acquisition
- Exchange transactions
- Granted by government
- Subsequent expenditure on intangible assets

1.1 Introduction

IAS 38: Intangible assets sets out rules on the recognition, measurement and disclosure of intangible assets.

IAS 38 establishes similar rules for intangible assets to those set out elsewhere (mainly in IAS 16) for tangible assets. It was developed from the viewpoint that an asset is an asset so there should be no real difference in how tangible and intangible assets are accounted for. However, there is an acknowledgement that it can be more difficult to identify the existence of an intangible asset so IAS 38 gives broader guidance on how to do this when an intangible asset is acquired through a variety of means.

IAS 38:

- requires intangible assets to be recognised in the financial statements if, and only if, specified criteria are met and explains how these are applied however an intangible asset is acquired.
  - A key issue with expenditure on 'intangible items' is whether it should be treated as an expense and included in full in profit or loss for the period in which incurred, or whether it should be capitalised and treated as a long-term asset.
  - IAS 38 sets out criteria to determine which of these treatments is appropriate in given circumstances.
- explains how to measure the carrying amount of intangibles assets when they are first recognised and how to measure them at subsequent reporting dates;
  - Most types of long-term intangible asset are 'amortised' over their expected useful life. (Amortisation of intangible assets is the equivalent of depreciation of tangible non-current assets.)
- sets out disclosure requirements for intangible assets in the financial statements.

1.2 Scope of IAS 38

IAS 38 applies to all intangible assets, except those that are within the scope of another standard. For example, IAS 38 does not apply to the following:

- intangible assets held by an entity for sale in the ordinary course of business (*IAS 2: Inventories*);
- deferred tax assets (*IAS 12: Income taxes*);
- leases that are within the scope of *IAS 17: Leases*;
- assets arising from employee benefits (*IAS 19: Employee Benefits*);
- financial assets (*as defined in IAS 32: Financial assets: presentation*);
- financial assets recognised and measured in accordance with *IFRS 10: Consolidated financial statements, IAS 27: Separate financial statements* and *IAS 28: Investments in associates and joint ventures*;
- goodwill acquired in a business combination (IFRS 3: Business combinations);
- deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance contracts within the scope of *IFRS 4: Insurance contracts* (but note that the IAS 38 disclosure requirements do apply to those intangible assets);
- non-current intangible assets classified as held for sale (or included in a disposal group that is classified as held for sale) (*IFRS 5: Non-current assets held for sale and discontinued operations*); and
- assets arising from contracts with customers that are recognised in accordance with *IFRS 15: Revenue from contracts with customers*.

In addition the following are also excluded specifically from the scope of IAS 38:

- the recognition and measurement of exploration and evaluation assets (see *IFRS 6: Exploration for and evaluation of mineral resources*); and
- expenditure on the development and extraction of minerals, oil, natural gas and similar non-regenerative resources.

1.3 Definition of an intangible asset

Definitions

An asset: A resource controlled by the company as a result of past events and from which future economic benefits are expected to flow.

Intangible asset: An identifiable, non-monetary asset without physical substance'

An intangible asset is a type of asset. Therefore expenditure on an intangible item must satisfy both definitions before it can be considered to be an asset.

Commentary on the definitions

Control

Control means that a company has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits.

Control would usually arise where there are legal rights, for example legal rights over the use of patents or copyrights. Ownership of legal rights would indicate control over them. However, legal enforceability is not a necessary condition for control.

For tangible assets such as property, plant and equipment the asset physically exists and the company controls it. However, in the case of an intangible asset, control may be harder to achieve or prove.

Some companies have tried to capitalise intangibles such as the costs of staff training or customer lists on the basis that they provide access to future economic benefits. However, these would not be assets as they are not controlled.

- Staff training: Staff training creates skills that could be seen as an asset for the employer. However, staff could leave their employment at any time, taking with them the skills they have acquired through training.
- Customer lists: Similarly, control is not achieved by the acquisition of a customer list, since most customers have no obligation to make future purchases. They could take their business elsewhere.

Future economic benefits

These may include revenues and/or cost savings.

Evidence of the probability that economic benefits will flow to the company may come from:

- market research;
- feasibility studies; and,
- a business plan showing the technical, financial and other resources needed and how the company will obtain them.

Need to be identifiable

An intangible asset must also be ‘identifiable’. Intangibles, by their very nature, do not physically exist. It is therefore important that this ‘identifiability test’ is satisfied.

IAS 38 states that to be identifiable an intangible asset:

- must be separable; or
- must arise from contractual or other legal rights.

To be separable, the intangible must be capable of being separated or divided from the company, and sold, transferred, licensed, rented or exchanged.

Many typical intangibles such as patent rights, copyrights and purchased brands would meet this test, (although they might fail other recognition criteria for an intangible asset).

Without physical substance

Non-physical form increases the difficulty of identifying the asset.

Certain intangible assets may be contained in or upon an article which has physical substance (e.g. floppy disc). Whether such assets are treated as tangible or intangible requires judgement. This judgement is based on which element is the most significant.

- Computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related

hardware and it is treated as property, plant and equipment. The same applies to the operating system of a computer.

- Computer software, other than the operating system, is an intangible asset. The same applies to licences, patents or motion picture films acquired or internally generated by the reporting company.

Identifiable assets that result from research and development activities (such as a prototype) are intangible assets because any physical (tangible) element of those assets is secondary to the knowledge (intangible element) that is the primary outcome of those activities.

1.4 Recognition criteria for intangible assets

Introduction

If an intangible item satisfies the definitions it is not necessarily recognised in the financial statements. In order to be recognised it must satisfy the recognition criteria for intangible assets.

If an item meets the definitions of being an asset, and being intangible, certain recognition criteria must be applied to decide whether the item should be recognised as an intangible asset.

Recognition

An intangible asset is recognised when it:

- complies with the definition of an intangible asset; and,
- meets the recognition criteria set out in the standard.

Recognition criteria

An intangible asset must be recognised if (and only if):

- it is probable that future economic benefits specifically attributable to the asset will flow to the company; and,
- the cost of the asset can be measured reliably.

The probability of future economic benefits must be assessed using reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset.

These recognition criteria are broadly the same as those specified in IAS 16 for tangible non-current assets.

Measurement

An intangible asset must be measured at cost when first recognised.

Means of acquiring intangible assets

A company might obtain control over an intangible resource in a number of ways. Intangible assets might be:

- purchased separately;
- acquired in exchange for another asset;
- given to a company by way of a government grant.
- internally generated; or
- acquired in a business combination;

IAS 38 provides extra guidance on how the recognition criteria are to be applied and/or how the asset is to be measured in each circumstance.

1.5 Separate acquisition

Recognition guidance

The probability recognition criterion is always satisfied for separately acquired intangible assets.

The price paid to acquire separately an intangible asset normally reflects expectations about the probability that the future economic benefits embodied in the asset will flow to the company. The effect of the probability is reflected in the cost of the asset.

Also the cost of a separately acquired intangible asset can usually be measured reliably especially when the purchase consideration is in the form of cash or other monetary assets.

Cost guidance

Cost is determined according to the same principles applied in accounting for other assets.

The cost of a separately acquired intangible asset comprises:

- its purchase price, including any import duties and non-refundable purchase taxes, after deducting any trade discounts and rebates; and
- any directly attributable expenditure on preparing the asset for its intended use. For example:
  - costs of employee benefits (as defined in IAS 19, Employee Benefits) arising directly from bringing the asset to its working condition;
  - professional fees for legal services; and
  - costs of testing whether the asset is functioning properly.

The recognition of costs ceases when the intangible asset is in the condition necessary for it to be capable of operating in the manner intended by management.

Deferred payments are included at the cash price equivalent and the difference between this amount and the payments made are treated as interest.

1.6 Exchange transactions

An intangible asset may be acquired in exchange or part exchange for another intangible asset or another asset.

The cost of such items is measured at fair value unless:

- the exchange transaction lacks commercial substance; or,
- the fair value of neither the asset received nor the asset given up is reliably measurable.

If the acquired item is not measured at fair value it is measured at the carrying amount of the asset given up.

Note, that these rules are the same as those described for tangible assets in an earlier chapter.

1.7 Granted by government

A government might transfer or allocate an intangible asset to an entity. Examples of such assets include airport landing rights, licences to operate radio

or television stations, import licences or quotas or rights to access other restricted resources.

An intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant.

IAS 20: Accounting for Government Grants and Disclosure of Government Assistance, allows the intangible asset and the grant to be recorded at fair value initially or at a nominal amount plus any expenditure that is directly attributable to preparing the asset for its intended use.

1.8 Subsequent expenditure on intangible assets

Subsequent expenditure is only capitalised if it can be measured and attributed to an asset and enhances the value of the asset. This would rarely be the case:

- The nature of intangible assets is such that, in many cases, there are no additions to such an asset or replacements of part of it.
- Most subsequent expenditure is likely to maintain the expected future economic benefits embodied in an existing intangible asset rather than meet the definition of an intangible asset and the recognition criteria.
- Also it is often difficult to attribute subsequent expenditure directly to a particular intangible asset rather than to the business as a whole.

Maintenance expenditure is expensed.

2 INTERNALLY GENERATED INTANGIBLE ASSETS

Section overview

- Internally-generated intangible items
- Research and development
- Accounting treatment of development costs
- SIC 32: Intangible assets – Web site costs

2.1 Internally-generated intangible items

An internally-generated intangible asset is an asset created by a company through its own efforts. (An internally-generated asset differs from an acquired asset that has been purchased from an external seller.) For example, a publishing company may build up legal copyrights by publishing books.

It can sometimes be difficult for a company to assess whether an internally-generated asset qualifies for recognition as an asset in the financial statements because:

- it is not identifiable: or
- its cost cannot be determined reliably.

Recognition prohibited

IAS 38 prohibits the recognition of the following internally-generated intangible items:

- goodwill;
- brands;
- mastheads (Note: a masthead is a recognisable title, usually in a distinctive typographical form, appearing at the top of an item. An example is a newspaper masthead on the front page of a daily newspaper);
- publishing titles; and
- customer lists.

Recognition of these items as intangible assets when they are generated internally is prohibited because the internal costs of producing these items cannot be distinguished separately from the costs of developing and operating the business as a whole.

Note that any of these items would be recognised if they were purchased separately.

Other internally generated intangibles

IAS 38 provides further guidance on how to assess whether other internally generated intangibles assets meet the criteria for recognition.

2.2 Research and development

The term 'research and development' is commonly used to describe work on the innovation, design, development and testing of new products, processes and systems.

Assessment of whether an internally generated intangible asset meets the criteria for recognition requires a company to classify the generation of the asset into:

- a research phase; and
- a development phase.

If the research phase cannot be distinguished from the development phase the expenditure on the project is all treated as that incurred on the research phase.

Research phase

Definition: Research

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

Examples of research activities include:

- Activities aimed at obtaining new knowledge.
- The search for and evaluation of applications of knowledge obtained from research.
- The search for alternative materials, products or processes.
- The formulation and testing of possible alternatives for new materials, products or processes.

Research costs cannot be an intangible asset. Expenditure on research should be recognised as an expense as it is incurred and included in profit or loss for the period.

Development phase

Definition: Development

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

Examples of development activities include:

- The design, construction and testing of pre-production prototypes and models.
- The design of tolls involving new technology.
- The construction and operation of a pilot plant that is not large enough for economic commercial production.
- The design, construction and testing of new materials, products or processes.

2.3 Accounting treatment of development costs

Development costs are capitalised when they meet certain further criteria. (These comprise more detailed guidance on whether it is probable that future economic benefits from the asset will flow to the entity and whether the cost can be measured reliably).

Development costs must be recognised as an intangible asset, but only if all the following conditions can be demonstrated.

- It is technically feasible to complete the development project.
- The company intends to complete the development of the asset and then use or sell it.
- The asset that is being developed is capable of being used or sold.
- Future economic benefits can be generated. This might be proved by the existence of a market for the asset's output or the usefulness of the asset within the company itself.
- Resources are available to complete the development project.
- The development expenditure can be measured reliably (for example, via costing records).

If any one of these conditions is not met, the development expenditure must be treated in the same way as research costs and recognised in full as an expense when it is incurred.

Only expenditure incurred after all the conditions have been met can be capitalised.

Once such expenditure has been written off as an expense, it cannot subsequently be reinstated as an intangible asset.

Example: Accounting treatment of development costs

Company Q has undertaken the development of a new product. Total costs to date have been Rs. 800,000. All of the conditions for recognising the development costs as an intangible asset have now been met.

However, Rs. 200,000 of the Rs. 800,000 was spent before it became clear that the project was technically feasible, could be resourced and the developed product would be saleable and profitable.

Development costs.

The Rs. 200,000 incurred before all of the conditions for recognising the development costs as an intangible asset were met must be written off as an expense.

The remaining Rs. 600,000 should be capitalised and recognised as an intangible asset (development costs).

Initial measurement

The cost of an internally generated intangible asset is the sum of expenditure incurred from the date when the intangible asset first meets the recognition criteria for such assets.

Expenditure recognised as an expense in previous annual financial statements or interim financial reports may not be capitalised.

The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, and is necessary to creating, producing, and preparing the asset for it to be capable of operating in the manner intended by management.

Where applicable cost includes:

- expenditure on materials and services used or consumed;
- the salaries, wages and other employment related costs of personnel directly engaged in generating the asset; and

- any expenditure that is directly attributable to generating the asset.

In addition, IAS 23 specifies criteria for the recognition of interest as an element of the cost of an internally generated intangible asset. The IAS 23 guidance was covered in the previous chapter.

Costs that are not components of cost of an internally generated intangible asset include:

- selling and administration overhead costs;
- initial operating losses incurred;
- costs that have previously been expensed, (e.g., during a research phase) must not be reinstated; and,
- training expenditure.

2.4 SIC 32: Intangible assets – Web site costs

Issue

An entity may incur expenditure on the development and operation of its own web site for internal or external access.

The issues are:

- whether the web site is an internally generated intangible asset that is subject to the requirements of IAS 38; and
- the appropriate accounting treatment of such expenditure.

SIC 32 does not apply to expenditure on

- purchasing, developing, and operating hardware (e.g. web servers, staging servers, production servers and internet connections). IAS 16 applies.
- an internet service provider hosting the entity's web site. (This expenditure is recognised as an expense as and when the services are received).
- the development or operation of a web site for sale to another entity.

SIC 32 must be applied by the:

- lessor of web site when it is leased under an operating lease, and
- lessee of the web site when it is leased under a finance lease.

The operating stage begins once development of a web site has been completed. During this stage, an entity maintains and enhances the applications, infrastructure, graphical design and content of the web site.

Consensus

An entity's own web site is an internally generated intangible asset that is subject to the requirements of IAS 38. It should be recognised as an intangible asset if it satisfies the IAS 38 recognition criteria.

If a web site is developed solely (or primarily) for promoting and advertising its own products and services then an entity will not be able to demonstrate how it will generate probable future economic benefits. All expenditure on developing such a web site should be recognised as an expense when incurred.

The nature of each activity for which expenditure is incurred (e.g. training employees and maintaining the web site) and the web site's stage of development or post development should be evaluated to determine the appropriate accounting treatment

The best estimate of a web site's useful life should be short.

SIC 32 identifies several stages in the development of a website and provides guidance on the accounting treatment that is appropriate for each stage.

Stage	Activities	Accounting treatment
Planning (This stage is similar in nature to the research phase)	Feasibility studies Defining hardware and software specifications Evaluating alternative products and suppliers Selecting preferences	Expense when incurred
Application and infrastructure development* (This stage is similar in nature to the development phase)	Obtaining a domain name Developing operating software (e.g. operating system and server software) Developing code for the application Installing developed applications on the web server Stress testing	Expense when incurred, unless the expenditure meets the IAS 38 recognition criteria.
Graphical design development*	Designing the appearance of web pages	See above
Content development*	Creating, purchasing, preparing and uploading information on the web site before the completion of the web site's development.	See above
Operating	Updating graphics and revising content Adding new functions, features and content Registering the web site with search engines Backing up data Reviewing security access Analysing usage of the web site	Expense when incurred, unless it meets the IAS 38 criteria for the capitalisation of subsequent expenditure (this will only occur in rare circumstances).
Other	Selling, administrative and other general overhead expenditure unless it can be directly attributed to preparing the web site for use Inefficiencies and initial operating losses incurred Training employees to operate the web site	Expense when incurred

* These will be capitalised only when the purpose of building a website is solely promotion of the business (marketing purpose).

3 INTANGIBLE ASSETS ACQUIRED IN A BUSINESS COMBINATION

Section overview

- Recognition guidance
- Cost guidance
- In-process research and development

This section relates to intangible assets acquired when a company (the acquirer) buys a controlling interest in another company (the acquiree). The section largely relates to the recognition of intangibles in the consolidated financial statements of the parent.

3.1 Recognition guidance

Any intangible asset identified in a business combination will be recognised as both recognition criteria are deemed to be met.

The probability recognition criterion always considered to be satisfied for intangible assets acquired in business combinations. This is because the fair value of an intangible asset reflects expectations about the probability that the expected future economic benefits embodied in the asset will flow to the company. In other words, the entity expects there to be an inflow of economic benefits.

The reliable measurement criterion is always considered to be satisfied for intangible assets acquired in business combinations. If an asset acquired in a business combination is separable or arises from contractual or other legal rights, sufficient information exists to measure reliably the fair value of the asset.

Commentary

This means that an intangible asset that was not recognised in the financial statements of the new subsidiary might be recognised in the consolidated financial statements.

Illustration: Recognition

Company X buys 100% of Company Y.

Company Y owns a famous brand that it launched several years ago.

Analysis

The brand is not recognised in Company Y's financial statements (IAS 38 prohibits the recognition of internally generated brands).

From the Company X group viewpoint the brand is a purchased asset. Part of the consideration paid by Company X to buy Company Y was to buy the brand and it should be recognised in the consolidated financial statements. (This will reduce the amount of goodwill that would otherwise have been recognised).

Examples of intangible assets

The following are all items that would meet the definition of an intangible asset if acquired in a business combination.

- Market related intangibles

- Trademarks, trade names, service marks, collective marks and certification marks;
- Internet domain names;
- Newspaper mastheads; and
- Non-competition agreements

❑ Customer related intangibles

- Customer lists;
- Order or production backlog;
- Customer contracts and the related customer relationships; and

❑ Artistic related intangibles

- Plays, operas and ballets;
- Books, magazines, newspapers and other literary works;
- Musical works (compositions, song lyrics and advertising jingles);
- Pictures and photographs; and
- Video and audio visual material:
- Music videos; and
- Television programmes

❑ Contract based intangibles

- Licensing and royalty agreements;
- Construction permits;
- Franchise agreements
- Operating and broadcasting rights;
- Use rights such as drilling, water, air, mineral, timber-cutting and route authorities;

❑ Technology based intangibles

- Patented and unpatented technology;
- Computer software and databases; and
- Trade secrets (secret formulas, processes, recipes)

3.2 Cost guidance

If an intangible asset is acquired in a business combination, its cost is the fair value at the acquisition date.

If cost cannot be measured reliably then the asset will be subsumed within goodwill.

3.3 In-process research and development

Another similar example involves in-process research and development

The acquiree might have a research and development project in process. Furthermore, it might not recognise an asset for the project because the recognition criteria for internally generated intangible assets have not been met.

However, the acquirer would recognise the in-process research and development as an asset in the consolidated financial statements as long as it:

- meets the definition of an asset; and
- is identifiable, i.e. is separable or arises from contractual or other legal rights.

Illustration: In-process research and development

Company X buys 100% of Company Y.

Company Y has spent Rs. 600,000 on a research and development project. This amount has all been expensed as the IAS 38 criteria for capitalising costs incurred in the development phase of a project have not been met. Company Y has knowhow as the result of the project.

Company X estimates the fair value of Company Y's knowhow which has arisen as a result of this project to be Rs. 500,000.

Analysis

The in-process research and development is not recognised in Company Y's financial statements because the recognition criteria have not been met.

From the Company X group viewpoint the in-process research and development is a purchased asset. Part of the consideration paid by Company X to buy Company Y was to buy the knowhow resulting from the project and it should be recognised in the consolidated financial statements at its fair value of Rs. 500,000.

Subsequent expenditure on an acquired in-process research and development project

Subsequent expenditure incurred on an in-process research or development project acquired separately or in a business combination and recognised as an intangible asset is accounted for in the usual way by applying the IAS 38 recognition criteria.

This means that further expenditure on such a project would not be capitalised unless the criteria for the recognition of internally generated intangible assets were met.

Illustration: Subsequent expenditure on acquired in-process R and D

Continuing the previous example.

Company X owns 100% of Company Y and has recognised an intangible asset of Rs. 500,000 as a result of the acquisition of the company.

Company Y has spent a further Rs. 150,000 on the research and development project since the date of acquisition. This amount has all been expensed as the IAS 38 criteria for capitalising costs incurred in the development phase of a project have not been met.

Analysis

The Rs. 150,000 expenditure is not recognised in Company Y's financial statements (IAS 38 prohibits the recognition of internally generated brands).

From the Company X group viewpoint, further work on the in-process research and development project is research and the expenditure of Rs. 150,000 must be expensed.

4 MEASUREMENT AFTER INITIAL RECOGNITION

Section overview

- Choice of policy
- Revaluation model
- Amortisation of intangible assets
- Disposals of intangible assets

4.1 Choice of policy

Intangible assets are recognised at cost when first acquired.

IAS 38 allows a business to choose one of two measurement models as its accounting policy for intangible assets after acquisition. The same model should be applied to all assets in the same class.

The two measurement models for intangible assets after acquisition are:

- cost model (i.e. cost less accumulated amortisation and accumulated impairment losses); and
- revaluation model (i.e. revalued amount less accumulated amortisation and accumulated impairment losses since the most recent revaluation).

Class of assets

The same model should be applied to all assets in the same class. A class of intangible assets is a grouping of assets of a similar nature and use in an entity's operations. Examples of separate classes may include:

- brand names;
- mastheads and publishing titles;
- computer software;
- licences and franchises;
- copyrights, patents and other industrial property rights, service and operating rights;
- recipes, formulae, models, designs and prototypes; and
- intangible assets under development.

Cost model

An intangible asset is carried at its cost less any accumulated amortisation and any accumulated impairment losses after initial recognition.

4.2 Revaluation model

Intangible assets can be revalued according to the same rules as those applied to the revaluation of property, plant and equipment. These were explained in detail in the previous chapter so will be covered in less detail here.

An intangible asset is carried at a revalued amount which is its fair value at the date of the revaluation less any subsequent accumulated amortisation and any accumulated impairment losses.

This is only allowed if the fair value can be determined by reference to an active market in that type of intangible asset.

Definition: Active market

An active market is a market in which all the following conditions exist:

(a) the items traded in the market are homogeneous;

(b) willing buyers and sellers can normally be found at any time; and

(c) prices are available to the public.

Active markets for intangible assets are rare. Very few companies revalue intangible assets in practice.

The requirement that intangible assets can only be revalued with reference to an active market is a key difference between the IAS 16 revaluation rules for property, plant and equipment and the IAS 38 revaluation rules for intangible assets.

An active market for an intangible asset might disappear. If the fair value of a revalued intangible asset can no longer be measured by reference to an active market the carrying amount of the asset going forward is its revalued amount at the date of the last revaluation less any subsequent accumulated amortisation and impairment losses.

Frequency of revaluations

Revaluations must be made with sufficient regularity so that the carrying amount does not differ materially from its fair value at the reporting date.

The frequency of revaluations should depend on the volatility in the value of the assets concerned. When the value of assets is subject to significant changes (high volatility), annual revaluations may be necessary.

However, such frequent revaluations are unnecessary for items subject to only insignificant changes in fair value. In such cases it may be necessary to revalue the item only every three or five years.

Changing the carrying amount of the asset

When an intangible asset is revalued, any accumulated amortisation at the date of the revaluation is treated in one of the following ways:

Method 1: Restate accumulated amortisation proportionately with the change in the gross carrying amount of the asset so that the carrying amount of the asset after revaluation equals its revalued amount.

Method 2:

- **Step 1:** Transfer the accumulated amortisation to the asset account. The result of this is that the balance on the asset account is now the carrying amount of the asset and the accumulated amortisation account in respect of this asset is zero.
- **Step 2:** Change the balance on the asset account to the revalued amount.

Accounting for the revaluation

The revaluation is carried out according to the same principles applied in accounting for other assets.

IAS 38	
Upwards revaluations	Recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus.
However:	An increase is recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.
Downward revaluations	Recognised in profit or loss.
However:	A decrease is recognised in other comprehensive income to the extent of any credit balance in the revaluation surplus in respect of that asset thus reducing the amount accumulated in equity under the heading of revaluation surplus.

Realisation of the revaluation surplus

Most intangible assets eventually disappear from the statement of financial position either by becoming fully amortised or because the company sells them.

If nothing were done this would mean that there was a revaluation surplus on the face of the statement of financial position that related to an asset that was no longer owned.

IAS 38 allows (but does not require) the transfer of a revaluation surplus to retained earnings when the asset to which it relates is derecognised (realised).

This might happen over several years as the asset is depreciated or at a point in time when the asset is sold.

Revaluation of an asset causes an increase in the annual amortisation charge. The difference is known as excess amortisation (or incremental amortisation):

Excess amortisation is the difference between:

- the amortisation charge on the re-valued amount of the asset, and
- the amortisation that would have been charged on historical cost.

Each year a business might make a transfer from the revaluation surplus to the retained profits equal to the amount of the excess amortisation.

4.3 Amortisation of intangible assets

A company must assess whether the useful life of an intangible asset is:

- finite: or
- indefinite.

If the useful life of an intangible asset is assessed as being finite the company must assess its useful life.

An intangible asset is assessed as having an indefinite useful life when (based on an analysis of all of the relevant factors) there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows.

Intangibles with a finite useful life

The depreciable amount of an intangible asset with a finite useful life is allocated on a systematic basis over its useful life.

Amortisation begins when the asset is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

Amortisation ends at the earlier of the date that the asset is classified as held for sale in accordance with IFRS 5 and the date that the asset is derecognised.

The amortisation method used must reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. If that pattern cannot be determined reliably, the straight-line method must be used.

There is a rebuttable presumption that an amortisation method based on revenue generated by an activity that includes the use of an intangible asset is inappropriate.

The residual value of an intangible asset must be assumed to be zero unless:

- there is a commitment by a third party to purchase the asset at the end of its useful life; or
- there is an active market for the asset and:
  - residual value can be determined by reference to that market; and
  - it is probable that such a market will exist at the end of the asset's useful life.

The amortisation period and the amortisation method must be reviewed at least at each financial year-end.

- Where there is a change in the useful life, the carrying amount (cost minus accumulated amortisation) of the asset at the date of change is written off over the (revised) remaining useful life of the asset.
- Where there is a change in the amortisation method used, this is a change in accounting estimate. A change of accounting estimate is applied from the time of the change, and is not applied retrospectively. The carrying amount (cost minus accumulated amortisation) of the asset at the date of the change is written off over the remaining useful life of the asset.

Intangibles with an indefinite useful life

Where the useful life is assessed as indefinite:

- the intangible asset should not be amortised; but
- impairment reviews should be carried out annually (or even more frequently if there are any indications of impairment).

The useful life of an intangible asset that is not being amortised must be reviewed each period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset.

If they do not, the change in the useful life assessment from indefinite to finite is accounted for as a change in an accounting estimate in accordance with IAS 8. This means that the carrying amount at the date of the change is amortised over the estimated useful life from that date.

4.4 Disposals of intangible assets

The rules for de-recognition of intangible assets (accounting for their 'disposal') are the same as for property, plant and equipment under IAS 16. There is a gain or loss on disposal equal to the difference between the net disposal proceeds and the carrying value of the asset at the time of disposal.

5 DISCLOSURE REQUIREMENTS

Section overview

- Disclosure requirements
- Accounting policies

5.1 Disclosure requirements

In the financial statements, disclosures should be made separately for each class of intangible asset. (Within each class, disclosures must also be made by internally-generated intangibles and other intangibles, where both are recognised.)

Most of the disclosure requirements are the same as for tangible non-current assets in IAS 16. The only additional disclosure requirements are set out below.

- Whether the useful lives of the assets are finite or indefinite.
- If the useful lives are finite, the useful lives or amortisation rates used.
- If the useful lives are indefinite, the carrying amount of the asset and the reasons supporting the assessment that the asset has an indefinite useful life.
- For any intangible asset that is individually material to the financial statements, the following disclosure is required:
  - a description
  - its carrying amount
  - the remaining amortisation period.
- The total amount of research and development expenditure written off (as an expense) during the period must also be disclosed.

5.2 Accounting policies

IAS 1 requires the disclosure of accounting policies used that are relevant to an understanding of the financial statements. Property, plant and equipment is often includes the largest numbers in the statement of financial position and the results in significant expense in the statement of comprehensive income.

There are several areas that are important to explain to users of financial statements.

Amortisation policy

The depreciable amount of an intangible asset must be written off over its useful life.

Formulating a policy in this area involves estimating the useful lives of different categories of intangible assets.

Under the guidance in IAS 38 the estimated residual values of an asset would usually be zero and the straight line method would usually be used.

CHAPTER 9

IAS 36: Impairment of assets

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 27 IAS 36: Impairment of assets

B (a) 39 IFRIC 10: Interim financial reporting and impairment

1 IMPAIRMENT OF ASSETS

Section overview

- Objective and scope of IAS 36
- Identifying impairment or possible impairment
- Measuring recoverable amount
- Accounting for impairment
- Summary of the approach

1.1 Objective and scope of IAS 36

An asset is said to be impaired when its recoverable amount is less than its carrying amount in the statement of financial position.

From time to time an asset may have a carrying value that is greater than its fair value but this is not necessarily impairment as the situation might change in the future. Impairment means that the asset has suffered a permanent loss in value.

The objective of ***IAS 36 Impairment of assets*** is to ensure that assets are 'carried' (valued) in the financial statements at no more than their recoverable amount.

Scope of IAS 36

IAS 36 applies to accounting for impairment of all assets except the following:

- inventories (*IAS 2: Inventories*);
- assets arising from contracts with customers that are recognised in accordance with *IFRS 15: Revenue from contracts with customers*.
- deferred tax assets (*IAS 12: Income taxes*);
- assets arising from employee benefits (*IAS 19: Employee Benefits*);
- financial assets (IAS 39*: Financial assets: recognition and measurement; IFRS 9: Financial instruments*);
- Financial assets recognised and measured in accordance with *IFRS 10: Consolidated financial statements, IAS 27: Separate financial statements* and *IAS 28: Investments in associates and joint ventures*;
- investment property that is measured at fair value (IAS 40: *Investment property*);
- biological assets related to agricultural activity within the scope of *IAS 41: Agriculture* that are measured at fair value less costs to sell;
- deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance contracts within the scope of *IFRS 4: Insurance contracts* (but note that the IAS 38 disclosure requirements do apply to those intangible assets); and

- non-current assets classified as held for sale (or included in a disposal group that is classified as held for sale) (*IFRS 5: Non-current assets held for sale and discontinued operations*).

IAS 36 **does** apply to financial assets classified as:

- subsidiaries (*IFRS 10: Consolidated financial statements*);
- associates (*IAS 28: Investments in associates and joint ventures*); and
- joint ventures (*IFRS 11: Joint arrangements*).

Recoverable amount of assets

Definitions

The recoverable amount of an asset is defined as the higher of its fair value minus costs of disposal, and its value in use.

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.

Value in use is the present value of future cash flows from using an asset, including its eventual disposal.

Impairment loss is the amount by which the carrying amount of an asset (or a cash-generating unit) exceeds its recoverable amount.

Cash-generating units will be explained later.

Stages in accounting for an impairment loss

There are various stages in accounting for an impairment loss:

Stage 1: Establish whether there is an indication of impairment.

Stage 2: If so, assess the recoverable amount.

Stage 3: Write down the affected asset (by the amount of the impairment) to its recoverable amount.

Each of these stages will be considered in turn.

1.2 Identifying impairment or possible impairment

An entity must carry out an impairment review when there is evidence or an indication that impairment may have occurred. At the end of each reporting period, an entity should assess whether there is any indication that impairment might have occurred. If such an indication exists, the entity must estimate the recoverable amount of the asset, in order to establish whether impairment has occurred and if so, the amount of the impairment.

Indicators of impairment

The following are given by IAS 36 as possible **indicators of impairment**. These may be indicators outside the entity itself (external indicators), such as market factors and changes in the market. Alternatively, they may be internal indicators relating to the actual condition of the asset or the conditions of the entity's business operations.

When assessing whether there is an indication of impairment, IAS 36 requires that, at a minimum, the following sources are considered:

External sources	Internal sources
An unexpected decline in the asset's market value.	Evidence that the asset is damaged or no longer of use to the entity.
Significant changes in technology, markets, economic factors or laws and regulations that have an adverse effect on the company.	There are plans to discontinue or restructure the operation for which the asset is currently used.
An increase in interest rates, affecting the value in use of the asset.	There is a reduction in the asset's expected remaining useful life.
The company's net assets have a higher carrying value than the company's market capitalisation (which suggests that the assets are over-valued in the statement of financial position).	There is evidence that the entity's expected performance is worse than expected.

If there is an indication that an asset (or cash-generating unit) is impaired then it is tested for impairment. This involves the calculating the recoverable amount of the item in question and comparing this to its carrying amount.

Additional requirements for testing for impairment

The following assets must be reviewed for impairment at least annually, even when there is no evidence of impairment:

- an intangible asset with an indefinite useful life; and
- goodwill acquired in a business combination.

1.3 Measuring recoverable amount

It has been explained that recoverable amount is the higher of an asset's:

- fair value less costs of disposal; and
- its value in use.

If either of these amounts is higher than the carrying value of the asset, there has been no impairment.

IAS 36 sets out the requirements for measuring 'fair value less costs of disposal' and 'value in use'.

Measuring fair value less costs of disposal

Fair value is normally market value. If no active market exists, it may be possible to estimate the amount that the entity could obtain from the disposal.

Direct selling costs normally include legal costs, taxes and costs necessary to bring the asset into a condition to be sold. However, redundancy and similar

costs (for example, where a business is reorganised following the disposal of an asset) are not direct selling costs.

Calculating value in use

Value in use is a value that represents the present value of the expected future cash flows from use of the asset, discounted at a suitable discount rate or cost of capital.

Estimates of future cash flows should be based on reasonable and supportable assumptions that represent management's best estimate of the economic conditions that will exist over the remaining useful life of the asset.

Estimates of future cash flows must include:

- cash inflows from the continuing use of the asset;
- cash outflows that will be necessarily incurred to generate the cash inflows from continuing use of the asset; and
- net disposal proceeds at the end of the asset's useful life.

Estimates of future cash flows must not include:

- cash inflows or outflows from financing activities; or
- income tax receipts or payments.

Also note that future cash flows are estimated for the asset in its current condition. Therefore, any estimate of future cash flows should not include estimated future cash flows that are expected to arise from:

- a future restructuring to which an entity is not yet committed; or
- improving or enhancing the asset's performance.

The discount rate must be a pre-tax rate that reflects current market assessments of:

- the time value of money; and
- the risks specific to the asset for which the future cash flow estimates have not been adjusted.

However, both the expected future cash flows and the discount rate might be adjusted to allow for uncertainty about the future – such as the business risk associated with the asset and expectations of possible variations in the amount or timing of expected future cash benefits from using the asset.

Example: Measurement of recoverable amount

A company has a machine in its statement of financial position at a carrying amount of Rs. 300,000.

The machine is used to manufacture the company's best-selling product range, but the entry of a new competitor to the market has severely affected sales.

As a result, the company believes that the future sales of the product over the next three years will be only Rs. 150,000, Rs. 100,000 and Rs. 50,000. The asset will then be sold for Rs. 25,000.

An offer has been received to buy the machine immediately for Rs. 240,000, but the company would have to pay shipping costs of Rs. 5,000.The risk-free market rate of interest is 10%.

Market changes indicate that the asset may be impaired and so the recoverable amount for the asset must be calculated.

Fair value less costs of disposal	Rs.
Fair value	240,000
Costs of disposal	(5,000)
	235,000

Year	Cash flow (Rs. 000)	Discount factor	Present value
1	150,000	$1/1.1$	136,364
2	100,000	$1/1.1^2$	82,645
3	50,000 + 25,000	$1/1.1^3$	56,349
			275,358

The recoverable amount is the higher of Rs. 235,000 and Rs. 275,358, i.e. Rs. 275,358.

The asset must be valued at the lower of carrying value and recoverable amount.

The asset has a carrying value of Rs. 300,000, which is higher than the recoverable amount from using the asset.

It must therefore be written down to the recoverable amount, and an impairment of Rs. 24,642 (Rs. 300,000 – Rs. 275,358) must be recognised.

1.4 Accounting for impairment

The impairment loss is normally recognised immediately in profit or loss.

Example: Measurement of recoverable amount

A company has a machine in its statement of financial position at a carrying amount of Rs. 300,000.

The machine has been tested for impairment and found to have recoverable amount of Rs. 275,358 meaning that the company must recognise an impairment loss of Rs. 24,642.

This is accounted for as follows:

	Debit	Credit
Statement of profit or loss	24,642	
Accumulated impairment loss		24,642

(Property, plant and equipment would be presented net of the balance on this account on the face of the statement of financial position).

Practice question **1**

On 1 January Year 1 Entity Q purchased for Rs. 240,000 a machine with an estimated useful life of 20 years and an estimated zero residual value.

Depreciation is on a straight-line basis.

On 1 January Year 4 an impairment review showed the machine's recoverable amount to be Rs. 100,000 and its remaining useful life to be 10 years.

Calculate:

a) The carrying amount of the machine on 31 December Year 3 (immediately before the impairment).

b) The impairment loss recognised in the year to 31 December Year 4.

c) The depreciation charge in the year to 31 December Year 4.**c)**

However, an impairment loss recognised in respect of an asset carried at a previously recognised revaluation surplus is recognised in other comprehensive income to the extent that it is covered by that surplus. Thus it is treated in the same way as a downward revaluation, reducing the revaluation reserve balance relating to that asset.

Impairment not covered by a previously recognised surplus on the same asset is recognised in profit or loss.

Example: Measurement of recoverable amount

A company has a machine in its statement of financial position at a carrying amount of Rs. 300,000 including a previously recognised surplus of Rs. 20,000.

The machine has been tested for impairment and found to have recoverable amount of Rs. 275,358 meaning that the company must recognise an impairment loss of Rs. 24,642.

This is accounted for as follows:

	Debit	Credit
Statement of profit or loss	4,642	
Other comprehensive income	20,000	
Property, plant and equipment		24,642

Following the recognition of the impairment, the future depreciation of the asset must be based on the revised carrying amount, minus the residual value, over the remaining useful life.

Practice question **2**

On 1 January Year 1 Entity Q purchased for Rs. 240,000 a machine with an estimated useful life of 20 years and an estimated zero residual value.

Depreciation is on a straight-line basis.

The asset had been re-valued on 1 January Year 3 to Rs. 250,000, but with no change in useful life at that date.

On 1 January Year 4 an impairment review showed the machine's recoverable amount to be Rs. 100,000 and its remaining useful life to be 10 years.

Calculate:

a) The carrying amount of the machine on 31 December Year 2 and hence the revaluation surplus arising on 1 January Year 3.

b) The carrying amount of the machine on 31 December Year 3 (immediately before the impairment).

c) The impairment loss recognised in the year to 31 December Year 4.

d) The depreciation charge in the year to 31 December Year 4.

1.5 Summary of the approach

Impairment of an asset should be identified and accounted for as follows:

(1) At the end of each reporting period, the entity should assess whether there are any indications that an asset may be impaired.

(2) If there are such indications, the entity should estimate the asset's **recoverable amount**.

(3) When the recoverable amount is less than the carrying value of the asset, the entity should reduce the asset's carrying value to its recoverable amount. The amount by which the value of the asset is written down is an **impairment loss**.

(4) This impairment loss is recognised as a loss for the period.

(5) However, if the impairment loss relates to an asset that has previously been re-valued upwards, it is first offset against any remaining revaluation surplus for that asset. When this happens it is reported as other comprehensive income for the period (a negative value) and not charged against profit.

(6) Depreciation charges for the impaired asset in future periods should be adjusted to allocate the asset's revised carrying amount, minus any residual value, over its remaining useful life (revised if necessary).

2 CASH GENERATING UNITS

Section overview

- Cash-generating units
- Allocating an impairment loss to the assets of a cash-generating unit

2.1 Cash-generating units

It is not always possible to calculate the recoverable amount of individual assets. Value in use often has to be calculated for groups of assets because assets may not generate cash flows in isolation from each other. An asset that is potentially impaired may be part of a larger group of assets which form a cash-generating unit.

IAS 36 defines a cash-generating unit (CGU) as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

Goodwill

The existence of cash-generating units may be particularly relevant to goodwill acquired in a business combination. Purchased goodwill must be reviewed for impairment annually, and the value of goodwill cannot be estimated in isolation. Often, goodwill relates to a whole business.

It may be possible to allocate purchased goodwill across several cash-generating units. If allocation is not possible, the impairment review is carried out in two stages:

1 Carry out an impairment review on each of the cash-generating units (excluding the goodwill) and recognise any impairment losses that have arisen.

2 Then carry out an impairment review for the entity as a whole, including the goodwill.

This is explained in more detail in *Chapter 18: Business combinations and consolidation* (Section 6.2).

2.2 Allocating an impairment loss to the assets of a cash-generating unit

When an impairment loss arises on a cash-generating unit, the impairment loss is allocated across the assets of the cash-generating unit in the following order:

- first, to the goodwill allocated to the cash-generating unit; then
- to the other assets in the cash-generating unit, on a pro-rata basis (i.e. in proportion to the carrying amount of the assets of the cash-generating unit).

However, the carrying amount of an asset cannot be reduced below the highest of:

- its fair value less costs of disposal (if determinable);

- its value in use (if determinable); and
- zero.

Example: Allocation of impairment loss in cash-generating unit

A cash-generating unit is made up of the following assets.

	Rs. m
Property, plant and equipment	90
Goodwill	10
Other assets	60
	160

The recoverable amount of the cash-generating unit has been assessed as Rs. 140 million.

The impairment loss would be allocated across the assets of the cash-generating unit as follows:

There is a total impairment loss of Rs. 20 million (= Rs. 160m – Rs. 140m). Of this, Rs. 10 million is allocated to goodwill, to write down the goodwill to Rs. 0. The remaining Rs. 10 million is then allocated to the other assets pro-rata.

Therefore:

Rs. 6 million (= Rs. 10m × 90/150) of the impairment loss is allocated to property, plant and equipment, and

Rs. 4 million (= Rs. 10m × 60/150) of the loss is allocated to the other assets in the unit.

The allocation has the following result:

	Before loss	Impairment loss	After loss
	Rs. m	Rs. m	Rs. m
Property, plant and equipment	90	(6)	84
Goodwill	10	(10)	–
Other assets	60	(4)	56
	160	(20)	140

3 OTHER ISSUES

Section overview

- Reversal of an impairment loss
- IFRIC 10: Interim financial reporting and impairment
- IAS 36 disclosure requirements for the impairment of assets

3.1 Reversal of an impairment loss

A company must make an assessment at the end of each reporting period as to whether a previously recognised impairment should be increased or may no longer exist. If the loss no longer exists it is reversed subject to the following guidance.

Any reversal:

- must be justifiable, by reference to an improvement in the indicators of impairment; and
- should not lead to a carrying amount in excess of what the carrying amount of the asset would have been without the recognition of the original impairment loss.

In allocating a reversal of an impairment loss the carrying amount of an asset must not be increased above the lower of:

- its recoverable amount (if determinable); and
- the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior periods.

A reversal should be:

- recognised immediately in profit or loss; unless
- the original impairment was charged to the revaluation reserve, in which case the reversal should be credited to the revaluation reserve (and reported in the same way as a revaluation in 'other comprehensive income' for the period).

Depreciation charges for future periods should be adjusted to allocate the asset's revised carrying amount, minus any residual value, over its remaining useful life.

An impairment loss that has arisen on purchased goodwill **cannot** be reversed. This is because any reversal of an impairment loss to goodwill is likely to be caused by an increase in internally-generated goodwill rather than a reversal of the impairment of purchased goodwill. Internally-generated goodwill must not be reported as an asset.

Example: Reversal of impairment loss

1st January Year 1

An asset was purchased at a cost of Rs. 100,000 and is being written off over 10 years on a straight line basis. Annual depreciation is Rs. 10,000 per annum.

31st December Year 2

The asset has a carrying amount of Rs. 80,000 (Rs. 100,000 – (2 years × Rs. 10,000).

There are indications that the asset is impaired and its recoverable amount is estimated at Rs. 64,000. The resultant impairment loss of Rs. 16,000 is recognised.

The carrying amount of the asset after the recognition of the impairment loss (Rs. 64,000) is written off over the remaining useful life of 8 years resulting in an annual depreciation charge of Rs. 8,000.

31st December Year 4

The carrying amount of the asset is Rs. 48,000 (Rs. 64,000 – (2 years × Rs. 8,000).

There are indications that the impairment loss might have decreased and the company estimates the recoverable amount of the asset to be Rs. 70,000.

This implies a reversal of Rs. 22,000 (Rs. 70,000 – Rs. 48,000).

However, the carrying amount of the asset cannot be increased to above what it would have been had no impairment loss been recognised in the first place. This is an amount of Rs. 60,000 (Rs. 100,000 – (4 years × Rs. 10,000).

Therefore a reversal of Rs. 12,000 is recognised.

The carrying amount of the asset after the recognition of the reversal of the impairment loss (Rs. 60,000) is written off over the remaining useful life of 6 years resulting in an annual depreciation charge of Rs. 10,000.

Reversal of impairment of a cash-generating unit

A reversal of an impairment loss for a cash-generating unit must be allocated to the assets of the unit (except for goodwill) on a pro rata basis.

These increases in carrying amounts must be treated as reversals of impairment losses for individual assets.

3.2 IFRIC 10: Interim financial reporting and impairment

Background

IAS 34 requires application of the same accounting policies in interim financial statements as are applied in annual financial statements and states that "the frequency of an entity's reporting (annual, half-yearly, or quarterly) shall not affect the measurement of its annual results".

It also requires that measurement for interim reporting purposes must be made on a year-to-date basis.

IAS 36 – prohibits reversal of impairment loss for goodwill

IAS 39 – prohibits reversal of impairment loss recognised in P&L for available for sale (AFS) equity instruments and for financial assets carried at cost.

This leads to an apparent conflict

An impairment loss on goodwill recognised in the interim financial statements might not have been recognised at the next year end (due to change in circumstances).

- IAS 34 would seem to require reversal; but
- IAS 36 prohibits reversal.

The issue

Should an impairment loss on goodwill (and certain investments) recognised in an interim period, be reversed if a loss would not have been recognised (or a smaller loss would have been recognised) if the assessment had been made only at a later reporting date?

Consensus

The impairment principle overrides the interim measurement rule.

An impairment loss recognised in a previous interim period in respect of goodwill (or certain investments) must not be reversed when circumstances change by a later reporting date.

Example: IFRIC 10: Interim financial reporting and impairment

Entity X is a listed company that is required to produce quarterly financial statements in accordance with IAS 34.

End of Q1

There were indications of impairment of one of Entity X's cash-generating units (CGU).

The carrying amount of the CGU was Rs. 120,000 including goodwill of Rs. 30,000).

The recoverable amount of the CGU was estimated to be Rs. 100,000.

Therefore, an Impairment of Rs. 20,000 was booked in the Q1 financial statements. This was allocated to goodwill included within the CGU.

End of Q4 (year-end)

At the year-end the recoverable amount is unchanged at Rs. 100,000.

The carrying amount of the CGU that would have been determined if no impairment had been booked in Q1 was Rs. 90,000 (accounting for depreciation charge for the three quarters).

Therefore, if interim financial statements had not been prepared at Q1 and the impairment test was carried out for the purpose of preparing the annual financial statements there would be no impairment loss.

Application of the IAS 34 (year-to-date) approach would suggest reversal of the loss previously recognised. However since that impairment was allocated to goodwill, the impairment loss cannot be reversed.

3.3 IAS 36 disclosure requirements for the impairment of assets

For all impairments, the following disclosures should be made for each class of assets:

- The amount of impairment losses recognised in profit or loss for the period and the line item in which those items are included.
- Similar information about reversals of impairment losses recognised in profit or loss for the period.
- The amount of impairment losses on revalued assets that have been recognised (or reversed) in other comprehensive income for the period (and in the revaluation reserve).
- If the recognition or reversal of an individual impairment loss is material to the financial statements, there should be additional disclosure of:
  - the events that led to the recognition or reversal of the impairment loss
  - the amount of the impairment loss recognised or reversed
  - the nature of the asset
  - whether the recoverable amount is fair value less costs of disposal or value in use, and how the figure for the recoverable amount was calculated.
- There are additional disclosures in aggregate for impairment losses (reversals) that are not individually material, and extensive disclosures for CGUs that include goodwill or intangible assets with an indefinite useful life, including estimated sensitivities for changes in assumptions used to derive a value in use or fair value less costs of disposal (“headroom” disclosures)

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

On 31 December Year 3 the machine was stated at the following amount:

a) Carrying amount of the machine on 31 December Year 3

	Rs
Cost	240,000
Accumulated depreciation (3 × (240,000 ÷ 20 years))	(36,000)
Carrying amount	204,000

b) Impairment loss at the beginning of Year 4 of Rs. 104,000 (Rs. 204,000 – Rs. 100,000). This is charged to profit or loss.

c) Depreciation charge in Year 4 of Rs. 10,000 (= Rs. 100,000 ÷ 10). The depreciation charge is based on the recoverable amount of the asset.

Solution **2**

a) Carrying amount on

	Rs.
Cost	240,000
Accumulated depreciation at 1 January Year 3 (2 years × (240,000 ÷ 20))	(24,000)
Carrying amount	216,000
Valuation at 1 January Year 3	250,000
Revaluation surplus	34,000

b) When the asset is revalued on 1 January Year 3, depreciation is charged on the revalued amount over its remaining expected useful life.

On 31 December Year 3 the machine was therefore stated at:

	Rs.
Valuation at 1 January (re-valued amount)	250,000
Accumulated depreciation in Year 3 (= Rs. 250,000 ÷ 18))	(13,889)
Carrying amount	236,111

Note: The depreciation charge of Rs. 13,889 is made up of Rs. 12,000 (being that part of the charge that relates to the original historical cost) and Rs. 1,889 being the incremental depreciation.

Rs. 1,889 would be transferred from the revaluation surplus into retained earnings.

c) On 1 January Year 4 the impairment review shows an impairment loss of Rs. 136,111 (Rs. 236,111 – Rs. 100,000).

An impairment loss of Rs. 32,111 (Rs. 34,000 – Rs. 1,889) will be taken to other comprehensive income (reducing the revaluation surplus for the asset to zero).

The remaining impairment loss of Rs. 104,000 (Rs. 136,111 – Rs. 34,000) is recognised in the statement of profit or loss for Year 4.

d) Year 4 depreciation charge is Rs. 10,000 (Rs. 100,000 ÷ 10 years).

CHAPTER 10

IFRS 5: Non-current assets held for sale and discontinued operations

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with international pronouncements and under the Companies Ordinance, 1984.**

PRESENTATION OF FINANCIAL STATEMENTS INCLUDING PUBLIC SECTOR ACCOUNTING

A 9 IFRS 5: Non-current assets held for sale and discontinued operations

1 SALE OF NON-CURRENT ASSETS

Section overview

- General rules on derecognition
- Assets that are held for sale

1.1 General rules on derecognition

When an asset is derecognised, its carrying amount is removed from the statement of financial position. IAS 16 states that the carrying amount of an item of property, plant and equipment should be derecognised in the following circumstances:

- on disposal of the asset; or
- when no future economic benefits are expected to arise from its use or from its disposal.

If a non-current asset is disposed of, the gain or loss on the disposal should be included in profit or loss in the period in which the disposal occurs. The gain or loss should **not** be included in sales revenue.

The gain or loss on the disposal is calculated as:

Illustration: Gain or loss on disposal

	Rs.	Rs.
Sale proceeds on disposal		X
Less disposal costs		(X)
Net disposal value		X
Asset at cost/revalued amount	X	
Less: Accumulated depreciation	(X)	
Carrying amount at date of disposal		(X)
Gain /loss on disposal		X

1.2 Assets that are held for sale

Sometimes, a company might hold an asset at the year-end that it has the intention of selling.

IFRS 5 Non-current assets held for sale and discontinued operations contain rules which impact the measurement and presentation of such assets.

In summary:

Non-current assets (and groups of non-current assets) that meet certain strict criteria are classified as being held for sale.

Non-current assets that are held for sale are:

- subject to an impairment test at the date of its classification as 'held for sale';
- presented on a separate category on the face of the statement of financial position; and
- are no longer depreciated.

Any loss recognised on a non-current asset carried at cost as a result of the impairment test at the date of its classification as 'held for sale' is recognised in the statement of profit or loss.

Any loss recognised on a non-current asset carried at a revalued amount as a result of the impairment test at the date of its classification as 'held for sale' is recognised in other comprehensive income (to the extent that it is covered by the previously recognised surplus on the same asset) with the balance being recognised in the statement of profit or loss.

The above rules will be explained in more detail in the following sections.

2 INTRODUCTION TO IFRS 5

Section overview

- Objective of IFRS 5
- Scope of IFRS 5

2.1 Objective of IFRS 5

IFRS 5 sets out requirements that specify the accounting treatment for assets held for sale, and the presentation and disclosure of discontinued operations.

IFRS 5 requires assets that meet the criteria to be classified as held for sale are:

- measured at the lower of carrying amount and fair value less costs to sell;
- not depreciated; and
- presented separately on the face of the statement of financial position.

Additionally the results of discontinued operations must be presented separately in the statement of profit or loss.

IFRS 5 identifies three classes of item that might be described as held for sale. These classes are of an increasing level of sophistication:

- non-current assets;
- disposal groups; and
- discontinued operations.

Disposal group

Definition

Disposal group – a group of assets to be disposed of in a single transaction, and any liabilities directly associated with those assets that will be transferred in the transaction.

A disposal group may be a group of cash-generating units, a single cash-generating unit, or part of a cash-generating unit.

Some disposal groups might fall into the definition of a discontinued operation.

2.2 Scope of IFRS 5

Classification and presentation

The classification and presentation requirements of IFRS 5 apply to all recognised non-current assets and to all disposal groups.

Measurement

The measurement requirements of IFRS 5 apply to all recognised non-current assets and disposal groups except for:

- deferred tax assets (IAS 12 Income Taxes).
- assets arising from employee benefits (IAS 19 Employee Benefits).
- financial assets within the scope of IAS 39 Financial Instruments: Recognition and Measurement.
- non-current assets that are accounted for in accordance with the fair value model in IAS 40 Investment Property.
- non-current assets that are measured at fair value less estimated point-of-sale costs in accordance with IAS 41 Agriculture.
- contractual rights under insurance contracts as defined in IFRS 4 Insurance Contracts.

Comment on the scope of IFRS 5

The scope of IFRS 5 is a little complicated.

A non-current asset that is scoped out of IFRS 5 for measurement purposes may fall within the classification and presentation rules.

Such a non-current asset might be part of a disposal group. In this case the measurement rules of IFRS 5 apply to the disposal group as a whole but not to the scoped out assets within the group which are measured individually according to the rules set out in their own standards.

Abandonment of non-current assets

Non-current assets (or disposal groups) to be abandoned include non-current assets (or disposal groups) that are to be:

- used to the end of their economic life; or
- closed rather than sold.

A non-current asset (or disposal group) that is to be abandoned must not be classified as held for sale in accordance with IFRS 5.

Reclassification of non-current assets

Assets classified as non-current in accordance with *IAS 1: Presentation of financial statements* cannot be reclassified as current assets until they meet the criteria to be classified as held for sale.

This also applies to assets that would normally be regarded as non-current that are acquired exclusively with a view to resale. Such assets cannot be classified as current unless they meet the criteria to be classified as held for sale in accordance with IFRS 5.

3 CLASSIFICATION OF NON-CURRENT ASSETS (OR DISPOSAL GROUPS) AS HELD FOR SALE

Section overview

- Rule
- Criteria
- Sale expected in over 1 year

3.1 Rule

A non-current asset (or disposal group) must be classified as held for sale when its carrying amount will be recovered principally through a sale transaction rather than through continuing use.

3.2 Criteria

The following conditions must apply at the reporting date for an asset (or disposal group) to be classified as held for sale:

- ❑ it must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups);
- ❑ the sale must be highly probable, i.e.:
  - the appropriate level of management must be committed to a plan to sell the asset (or disposal group);
  - an active programme to locate a buyer and complete the plan must have been initiated; and
  - the asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value;
- ❑ the sale must be expected to be completed within one year from the date of classification (except in limited circumstances) and actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

If the criteria are met for a non-current asset (or disposal group) after the reporting date but before the authorisation of the financial statements for issue, that asset must not be classified as held for sale as at the reporting date.

However the entity is required to make certain disclosures in respect of the non-current asset (or disposal group).

Example: Classification of asset as held for sale

Entity R had the following asset at 31 March Year 4.

A property that it offered for sale for Rs. 5 million during June Year 3.

The market for this type of property has deteriorated and at 31 March Year 4 a buyer had not yet been found.

Management does not wish to reduce the price because it hopes that the market will improve.

Shortly after the year end (after 31 March Year 4) the entity received an offer of Rs. 4 million and the property was eventually sold for Rs. 3.5 million during May Year 4, before the financial statements were authorised for issue.

Analysis as at 31 March Year 4

The property cannot be classified as 'held for sale'.

A non-current asset qualifies as 'held for sale' if it is available for immediate sale in its present condition and actively marketed for sale at a price that is reasonable in relation to its current fair value.

The property had not been sold at the year-end although it had been on the market for some time. It appears that the reason for this was that management were asking too high a price; therefore the price is not reasonable in relation to its current fair value.

Example: Classification of asset as held for sale

Entity R had the following asset at 31 March Year 4.

Plant with a carrying value of Rs. 2.5 million.

At 31 March Year 4 the entity had ceased to use the plant but was still maintaining it in working condition so that it could still be used if needed.

Entity R sold the plant on 14 May Year 4.

Analysis as at 31 March Year 4

The plant cannot be classified as 'held for sale'.

At the year-end management had not made a firm commitment to sell the plant. Even though the plant was sold just after the year-end, IFRS 5 prohibits the classification of non-current assets as 'held for sale' if the criteria are met after the end of the reporting period and before the financial statements are signed.

3.3 Sale expected in over 1 year

Sometimes circumstances might extend the period to complete the sale beyond a year. This does not preclude an asset (or disposal group) from being classified as held for sale as long as:

- the delay is caused by events or circumstances beyond the entity's control; and
- there is sufficient evidence that the entity remains committed to its plan to sell the asset (or disposal group).

IFRS 5 sets out detailed guidance on when this is deemed to be the case.

Costs to sell that are to be paid after one year should be discounted with the unwinding of the discount recognised subsequently as finance cost in the statement of profit or loss.

4 MEASUREMENT OF NON-CURRENT ASSETS (OR DISPOSAL GROUPS) CLASSIFIED AS HELD FOR SALE

Section overview

- Measurement of non-current assets and disposal groups held for sale
- Allocation of an impairment loss on a disposal group
- Subsequent remeasurement
- Changes to a plan of sale

4.1 Measurement of non-current assets and disposal groups held for sale

Assets held for sale and disposal groups should be measured at the lower of:

- their carrying amount (i.e. current values in the statement of financial position, as established in accordance with accounting standards and principles), and
- fair value less costs to sell.

If the value of the 'held for sale' asset is adjusted from carrying amount to fair value less costs to sell, any impairment should be recognised as a loss in the statement of profit or loss for the period unless the asset to which it relates is carried at a previously recognised revaluation surplus. In this case the loss is taken to other comprehensive income to the extent that it is covered by the previously recognised surplus on that asset. Any amount not covered is recognised in the statement of profit or loss.

A non-current asset must not be depreciated (or amortised) while it is classified as 'held for sale' or while it is part of a disposal group that is held for sale.

Example: Impact of classification as held for sale

An asset is reclassified as 'held for sale', when its carrying amount is Rs. 20 million.

Its fair value less estimated costs to sell is Rs. 17 million.

The asset should be revalued at Rs. 17 million and a loss of Rs. 3 million should be reported in the period.

If the carrying amount is less than the fair value less costs to sell there is no impairment. In this case there is no adjustment to the carrying amount of the asset. (A gain is not recognised on reclassification as held for sale).

Example: Impact of classification as held for sale

An asset is reclassified as 'held for sale', when its carrying amount is Rs. 20 million.

Its fair value less estimated costs to sell is Rs. 24 million.

The asset 'held for sale' should not be remeasured and should continue to be carried at Rs. 20 million.

A gain on disposal will be included in profit for the period when the disposal actually occurs.

Example: Accounting on reclassification and subsequent disposal

A machine was purchased on 1 January Year 1 for Rs. 80,000. It had a useful life of 8 years and no residual value.

On 31 December Year 4 the machine was classified as held for sale. On this date the machine's fair value was estimated at Rs. 50,000 and the costs to sell were estimated at Rs. 1,000

The machine was sold for Rs. 48,000 on 30 June Year 5.

This would be accounted for as follows:

Year 4

The asset held for sales is carried at the lower of:

Carrying amount:	Rs.
Cost	80,000
Depreciation up to the point of reclassification 80,000 × 4 years/8years	(40,000)
	40,000
Fair value less costs to sell (Rs. 50,000 – Rs. 1,000)	49,000

The machine therefore remains at its carrying value of Rs. 40,000.

The machine would be reclassified to the held for sale category.

The necessary double entry is as follows:

	Debit	Credit
Non-current asset held for sale	40,000	
Cost (plant)		80,000
Accumulated depreciation	40,000	

Year 5

The asset is sold to give the following profit on disposal:

	Rs.
Proceeds	48,000
Carrying amount	(40,000)
Gain	8,000

The necessary double entry is as follows:

	Debit	Credit
Cash	48,000	
Non-current asset held for sale		40,000
Statement of profit or loss (gain on disposal)		8,000

Example: Accounting on reclassification and subsequent disposal

A machine was purchased on 1 January Year 1 for Rs. 80,000. It had a useful life of 8 years and no residual value.

On 31 December Year 4 the machine was classified as held for sale. On this date the machine's fair value was estimated at Rs. 41,000 and the costs to sell were estimated at Rs. 2,000

The machine was sold for Rs. 37,500 on 30 June Year 5.

This would be accounted for as follows:

Year 4

The asset held for sales is carried at the lower of:

Carrying amount:	Rs.
Cost	80,000
Depreciation up to the point of reclassification 80,000 × 4 years/8years	(40,000)
	40,000
Fair value less costs to sell (Rs. 41,000 – Rs. 2,000)	39,000

The machine is therefore written down to Rs. 39,000.

The statement of profit or loss for Year 4 will include an impairment loss of Rs. 1,000 (Rs. 40,000 – Rs. 39,000).

The necessary double entry is as follows:

	Debit	Credit
Non-current asset held for sale	39,000	
Impairment loss	1,000	
Cost (plant)		80,000
Accumulated depreciation	40,000	

Year 5

The asset is sold to give the following loss on disposal:

	Rs.
Proceeds	37,500
Carrying amount	(39,000)
Loss	1,500

The necessary double entry is as follows:

	Debit	Credit
Cash	37,500	
Non-current asset held for sale		39,000
Statement of profit or loss (loss on disposal)	1,500	

4.2 Allocation of an impairment loss on a disposal group

IFRS 5 requires that if an impairment loss is recognised for a disposal group, the loss should be allocated to reduce the carrying amounts of those non-current assets in the disposal group (that are within the scope of the IFRS 5 measurement rules) in the following order:

- goodwill; then
- other non-current assets pro-rated on the basis of their carrying values.

Example: Allocation of impairment loss in a disposal group

An entity has decided to dispose of a group of its assets.

The carrying amount of the assets immediately before the classification as held to sale were as follows:

	Rs.
Goodwill	20,000
Property, plant and equipment (carried at revalued amounts)	52,000
Property, plant and equipment (carried at cost)	80,000
Inventory	21,000
Financial assets	17,000
Total	190,000

The entity estimates that the 'fair value less costs to sell' of the disposal group is Rs. 160,000.

This means that the entity must recognise an impairment loss of Rs. 30,000 (Rs. 190,000 - Rs. 160,000).

Allocation of the impairment loss:

The first Rs. 20,000 of the impairment loss reduces the goodwill to zero.

The remaining Rs. 10,000 of the impairment loss should be allocated to the non-current assets in the disposal group pro rata to their carrying value.

	Carrying amount before allocation	Impairment loss	Carrying amount after allocation
	Rs.	Rs.	Rs.
Goodwill	20,000	20,000	–
Property, plant and equipment (carried at revalued amounts)	52,000	3,399	48,601
Property, plant and equipment (carried at cost)	80,000	5,228	74,772
Inventory	21,000	1,373	19,627
Financial assets	17,000	–	17,000
Total	190,000	30,000	160,000

This impairment loss of Rs. 30,000 will be included in the reported profit or loss from discontinued operations.

4.3 Subsequent remeasurement

Subsequent remeasurement of the non-current asset (or disposal group) might lead to:

- a further impairment loss - which must be recognised; or
- a gain - which is recognised but only to the extent that it is covered by a previously recognised impairment loss.

4.4 Changes to a plan of sale

If an asset (or disposal group) has been classified as held for sale, but the criteria are no longer met, it must be removed from this classification.

Such an asset is measured at the lower of:

- the amount at which it would have been carried if it had never been classified as held for sale (i.e.: its carrying amount before it was classified as held for sale as adjusted for any depreciation, amortisation or revaluations that would have been recognised if it had not been so classified); and
- its recoverable amount at the date of the subsequent decision not to sell.*

Any necessary adjustment to the carrying amount is recognised in income from continuing operations, in the same statement of profit or loss caption used to present a gain or loss on assets held for sale.

5 PRESENTATION AND DISCLOSURE

Section overview

- Assets (or disposal groups) held for sale

5.1 Assets (or disposal groups) held for sale

Statement of financial position presentation

Non-current assets classified as held for sale are presented separately from other assets in the statement of financial position.

The assets and liabilities of a disposal group classified as held for sale are presented separately from other assets and liabilities in the statement of financial position. These assets and liabilities must not be offset and presented as a single amount.

The major classes of assets and liabilities classified as held for sale must be separately disclosed either on the face of the statement of financial position or in the notes.

This disclosure is not required for disposal groups that are newly acquired subsidiaries that are classified as held for sale on acquisition.

Comparatives are not restated to reflect the classification in the statement of financial position for the latest period presented.

Gains or losses

Any gain or loss on the remeasurement of a non-current asset (or disposal group) classified as held for sale that does not meet the definition of a discontinued operation is included in profit or loss from continuing operations.

The gain or loss recognised on measuring or remeasuring a non-current asset (or disposal group) classified as held for sale is disclosed. If it is not presented separately on the face of the statement of profit or loss, the caption that includes that gain or loss must also be disclosed.

Other disclosures

The following information must be disclosed in the notes in the period in which a non-current asset (or disposal group) has been either classified as held for sale or sold:

- a description of the non-current asset (or disposal group);
- a description of the facts and circumstances of the sale, or leading to the expected disposal, and the expected manner and timing of that disposal;
- if applicable, the segment in which the non-current asset (or disposal group) is presented in accordance with ***IFRS 8 Operating segments***.

Changes to a plan of sale

When this occurs the following must be disclosed:

- a description of the facts and circumstances leading to the decision; and
- the effect of the decision on the results of operations for the period and any prior periods presented.

6 DISCONTINUED OPERATIONS

Section overview

- Discontinued operation
- Definition of discontinued operations
- Presentation and disclosure of discontinued operations
- Other disclosures

6.1 Discontinued operation

IFRS 5 Non-current assets held for sale and discontinued operations sets out requirements for disclosure of financial information relating to discontinued operations.

The reason for requiring disclosure of information about discontinued operations is as follows:

- ❑ Closing down some operations will affect the future financial prospects of the entity.
- ❑ It is therefore appropriate that users of the financial statements should be provided with relevant information about the discontinuation. This will help them to make a more reliable prediction of the future performance of the entity.

This information can be produced by providing information about discontinued operations separately from information about continuing operations.

6.2 Definition of discontinued operations

A discontinued operation is a disposal group that satisfies extra criteria. (IFRS 5 does not say as much but this is a helpful way to think of it).

Definition: Discontinued operation

Discontinued operation - A component of an entity that either has been disposed of or is classified as held for sale and:

1. **represents a separate major line of business or geographical area of operations,**
2. **is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or**
3. **is a subsidiary acquired exclusively with a view to resale.**

A component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

If an entity disposes of an individual non-current asset, or plans to dispose of an individual asset in the immediate future, this is not classified as a discontinued

operation unless the asset meets the definition of a 'component of an entity'. The asset disposal should simply be accounted for in the 'normal' way, with the gain or loss on disposal included in the operating profit for the year.

An operation cannot be classified as discontinued in the statement of financial position if the criteria for classifying it as discontinued are met after the end of the reporting period.

For example, suppose that an entity with a financial year ending 30 June shuts down a major line of business in July and puts another major line of business up for sale. It cannot classify these as discontinued operations in the financial statements of the year just ended in June, even though the financial statements for this year have not yet been approved and issued.

A disposal group might be, for example, a major business division of a company.

For example a company that operates in both shipbuilding and travel and tourism might decide to put its shipbuilding division up for sale. If the circumstances meet the definition of 'held for sale' in IFRS 5, the shipbuilding division would be a disposal group held for sale.

6.3 Presentation and disclosure of discontinued operations

Presentation in the statement of profit or loss

The following must be disclosed for discontinued operations:

- a single amount on the face of the statement of profit or loss comprising the total of:
  - the post-tax profit or loss of discontinued operations; and
  - the post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation.
- an analysis of this single amount:
  - the revenue, expenses and pre-tax profit or loss of discontinued operations;
  - the related income tax expense;
  - the gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation; and
  - the related income tax expense.
- the net cash flows attributable to the operating, investing and financing activities of discontinued operations.
- The analysis may be presented in the notes or on the face of the statement of profit or loss. (If presented on the face of the statement of profit or loss it must be presented in a section identified as relating to discontinued operations).

The analysis is not required for disposal groups that are newly acquired subsidiaries that are classified as held for sale on acquisition.

These disclosures are not required for disposal groups that are newly acquired subsidiaries that are classified as held for sale on acquisition.

Comparatives

Comparatives must be restated for these disclosures so that the disclosures relate to all operations that have been discontinued by the reporting date for the latest period presented.

Example: Presentation of discontinued operations in the statement of financial position

Information relating to discontinued operations might be presented as follows.

Statement of profit or loss

X Limited: Statement of profit or loss for the year ended 31 December 20X9

	20X9 Rs. 000	20X8 Rs. 000
Continuing operations		
Revenue	9,000	8,500
Cost of sales	(5,100)	(4,700)
Gross profit	3,900	3,800
Other income	50	100
Distribution costs	(1,200)	(1,000)
Administrative expenses	(1,400)	(1,200)
Other expenses	(150)	(200)
Finance costs	(300)	(300)
Profit before tax	900	1,200
Income tax expense	(300)	(400)
Profit for the period from continuing operations	600	800
Discontinued operations		
Profit for the period from discontinued operations	250	180
Profit for the period	850	980

Note

The single figure of Rs. 250,000 for after-tax profit or loss from discontinued operations should be analysed in a note to the accounts. Alternatively, the analysis could be given on the face of the statement of profit or loss.

Presentation in the statement of financial position

Non-current assets classified as held for sale must be disclosed separately from other assets in the statement of financial position.

Similarly, assets and liabilities that are part of a **disposal group held for sale** must be disclosed separately from other assets and liabilities in the statement of financial position.

This also applies to the assets and liabilities of a discontinued operation.

Example: Presentation of discontinued operations in the statement of financial position

An entity has two disposal groups held for sale:

	Disposal group		
	Group 1	Group 2	Total
	Rs. 000	Rs. 000	Rs. 000
Property, plant and equipment	600	300	900
Liabilities	(50)	(20)	(70)

Information relating to discontinued operations might be presented as follows.

Statement of financial position

	Rs. 000
Assets	
Non-current assets	2,000
Current assets	720
Non-current assets classified as held for sale (see above)	900
Total assets	3,620
Equity and liabilities	
Share capital	1,000
Reserves	1,950
Total equity	2,950
Non-current liabilities	400
Current liabilities	200
Liabilities directly associated with non-current assets classified as held for sale (see above)	70
Total liabilities	670
Total equity and liabilities	3,620

Note: In this summarised statement of financial position, the non-current assets classified as 'held for sale' are the sum of the non-current assets of disposal groups 1 and 2 (Rs. 600,000 + Rs. 300,000).

Similarly the 'liabilities directly associated with non-current assets classified as held for sale' are the sum of the liabilities for disposal groups 1 and 2.

In the statement of financial position, the comparative figures for the previous year are not restated. The amount for discontinued operations in the previous year does not include discontinued items for the current year. The presentation in the statement of financial position therefore differs from the presentation in the statement of profit or loss.

6.4 Other disclosures

Adjustments to carrying amounts of discontinued operations

Sometimes there is a need to adjust amounts previously presented in discontinued operations that are directly related to the disposal of a discontinued operation in a prior period.

For example, circumstances in which these adjustments may arise include the resolution of uncertainties relating to:

- the disposal (e.g. purchase price adjustments; or
- obligations retained by the seller (e.g. environmental and product warranty obligations).

Such adjustments are classified separately in discontinued operations and the nature and amount of the adjustments are disclosed.

Note on discontinued operations and the statement of cash flows

IFRS 5 states that in the **statement of cash flows**, there should be separate disclosure of the net cash flows in the period attributable to operating activities, investing activities and financing activities of the discontinued operations.

These disclosures may be presented either on the face of the statement of cash flows or in the notes to the financial statements.

Additional disclosures

Additional disclosures about discontinued operations must be included in the notes to the financial statements. These include:

- a description of the non-current asset or disposal group;
- a description of the facts and circumstances of the sale; and
- in the case of operations and non-current assets 'held for sale', a description of the facts and circumstances leading to the expected disposal and the expected manner and timing of the disposal.

CHAPTER 11

IFRS 16: Leases

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 18 IFRS 16: Leases

1 INTRODUCTION AND DEFINITIONS

Section overview

- Introduction
- Leases
- Types of lessor
- Inception and commencement
- Defined periods
- Residual values
- Lease payments
- Interest rate implicit in the lease
- Initial direct costs
- Lessee's incremental borrowing rate of interest

1.1 Introduction

The previous accounting model for leases as per IAS 17 required lessees and lessors to classify their leases as either finance leases or operating leases and account for those two types of leases differently. That model was criticised for failing to meet the needs of users of financial statements because it did not always provide a faithful representation of leasing transactions. In particular, it did not require lessees to recognise assets and liabilities arising from operating leases.

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. A lessee is required to recognise a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments.

1.2 Leases

IFRS 16 prescribes the accounting treatment of leased assets in the financial statements of lessees and lessors.

Definition: 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.

A lease is a way of obtaining a use of an asset, such as a machine, without purchasing it outright. The company that owns the asset (the lessor) allows another party (the lessee) to use the asset for a specified period of time in return for a series of rental payments.

Types of lease

IFRS 16 identifies two types of lease.

Definitions

A lease that transfers substantially all the risks and rewards incidental to ownership of an underlying asset is known as finance lease.

A lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset is known as operating lease.

The identification of a lease as a finance lease or an operating lease is crucial as it determines how a lease is accounted for by the lessor.

This is explained in more detail in later sections.

1.3 Types of lessors

Companies might be lessors as a result of a variety of business models.

Finance companies (often banks and their subsidiaries)

Finance companies provide finance for the purchase of assets. In addition they might finance the use of assets through leases.

Finance companies are often associated with finance leases but they also fund large operating leases. Many airlines have use of aircraft through operating leases through finance companies.

Hire companies

These companies own a stock of capital assets which they will lease out for varying periods.

They include:

- tool hire companies;
- plant hire companies; and
- car hire companies

Hire companies are usually involved in operating leases.

Manufacturer/dealer lessors

Some companies make or buy assets to sell. They may offer to lease the asset out as an alternative to outright sale.

Many motor vehicle manufacturers and dealers do this. Such leases would usually be finance leases (but not necessarily).

Property companies

Many companies own properties which they lease out to others. These companies might apply *IAS 40: Investment Properties* to these assets.

1.4 Inception and commencement

Definitions: Inception date of the lease

The earlier of the date of a lease agreement and the date of commitment by the parties to the principal terms and conditions of the lease.

The type of lease in a contract (finance or operating) is identified at the date of inception. This is where the parties to the lease contract commit to the terms of the contract.

Definition: Commencement date of the lease

The date on which a lessor makes an underlying asset available for use by a lessee.

The accounting treatment required is applied to a lease at the date of commencement. This is the date that a lessee starts to use the asset or, at least, is entitled to start to use the asset.

A lease agreement may allow for an adjustment to the terms of the lease contract during the period between the inception of the lease and the commencement of the lease term. Such adjustments might be to take account of unexpected changes in costs (for example the lessor's costs of making the asset that is the subject of the lease).

In such cases, the effect of any such changes is deemed to have taken place at the inception of the lease.

1.5 Defined periods

IFRS 16 refers to different periods when describing its rules.

Definition: 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 that option.

A lease may be split into a primary period followed by an option to extend the lease for a further period (a secondary period).

In some cases, the lessee might be able to exercise such an option with a small rental or even for no rental at all. If such an option exists and it is reasonably certain that the lessee will exercise the option, the second period is part of the lease term.

Definitions: Economic and useful life

Economic life is either:

(a) the period over which an asset is expected to be economically usable by one or more users; or

(b) the number of production or similar units expected to be obtained from the asset by one or more users.

Useful life is the period over which an asset is expected to be available for use by an entity; or the number of production or similar units expected to be obtained from an asset by an entity.

Economic life relates to the life of the asset whereas useful life relates to the period that a party will obtain benefits from that asset.

1.6 Residual values

When a company that owns an asset leases it to another party they have two interests in that asset:

- It gives them a right to receive a series of rentals over the lease term; and
- They own the asset at the end of the lease.

The value of the asset at the end of the lease is called its residual value. This figure might be guaranteed by the lessee. This means that if the asset is not worth the amount guaranteed, the lessee must pay the lessor the shortfall.

On the other hand, the residual value might not be guaranteed.

Definition: Unguaranteed residual value and residual value 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.

Residual value guarantee is a guarantee made to a lessor by a party unrelated to the lessor that the value (or part of the value) of an underlying asset at the end of a lease will be at least a specified amount.

1.7 Lease payments

In essence, the term ***lease payments*** refers to the payments that a lessee expects to make over a lease term or to the receipts that a lessor expects over the economic life of the asset.

In a straight forward example the lease payments that a lessee expects to make and a lessor expects to receive are same. However, this is not always the case. The definition of lease payments takes that into account.

Definition: Lease payments

Payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following:

(a) fixed payments (including in-substance fixed payments), less any lease incentives;

(b) variable lease payments that depend on an index or a rate;

(c) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and

(d) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

1.8 Interest rate implicit in the lease

Definition: Interest rate implicit in the lease

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

The interest rate implicit in the lease is the IRR of the cash flows from the lessor's viewpoint. It is the rate that equates the future cash inflows for the lessor to the amount that the lessor invested in the asset.

Example: Interest rate implicit in the lease

A finance company has purchased an asset for Rs. 50,000 and will lease it out in a series of leases as follows:

The first lease is to Company A for a period of 5 years at an annual rental of Rs. 10,000.

After the end of the lease to Company A the asset will be leased to Company B for 1 year at a rental of Rs. 10,000. Company B is a party related to Company A.

After the end of the lease to Company B the asset will be leased to Company C for 1 year at a rental of Rs. 10,000. Company C is not related to Companies A and B.

At the end of this lease the asset is expected to have an unguaranteed residual value of Rs. 2,573.

The interest rate implicit in the lease is 10%.

Proof

Time	Narrative	Lessor's cash flows	Discount factor (10%)	Present value
0	Fair value of the asset	(50,000)	1	(50,000)
1 to 7	Lessor's MLPs	10,000	4.868	48,680
7	Unguaranteed residual value	2,573	0.513	1,320
				50,000
				nil

The interest rate implicit in the lease (its IRR) was given in the above example. In an exam question you might have to calculate it in the usual way.

1.9 Initial direct costs

The definition of interest rate implicit in the lease makes reference to incremental initial direct costs.

Definition: Initial direct costs

Initial direct costs are incremental costs for obtaining a lease that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a finance lease.

The accounting treatment for initial direct costs will be explained later.

1.10 Lessee's incremental borrowing rate of interest

The interest rate implicit in the lease might be important in deciding whether a lease is a finance lease or an operating lease.

It is calculated from the lessor's viewpoint. Sometimes, the lessee might not be able to ascertain the interest rate implicit in the lease. In that case, it would use the lessee's incremental borrowing cost instead.

Definition: Lessee's incremental borrowing rate of interest

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

Further definitions important to finance lessor accounting will be provided in that section.

2 LEASE CLASSIFICATION

Section overview

- Finance leases and operating leases
- Identifying a finance lease
- Commentary on finance lease indicators

2.1 Finance leases and operating leases

IFRS 16 describes two types of lease (with each type being accounted for in a different way):

- finance leases and
- operating leases

A lessor shall classify each of its leases as either an *operating lease or a finance lease*.

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

Risks may be represented by the possibility of losses from:

- idle capacity;
- technological obsolescence;
- variations in return caused by changes in economic conditions.

Rewards may be represented by the expectation of;

- profitable use of the asset over its economic life;
- gains from increases in value or profits on disposal.

Substance over form

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.

The legal form of a finance lease is that the lessor is the legal owner of the underlying asset.

The economic substance of a finance lease is that the lessee has all the benefits and costs associated with ownership of the asset. The finance lessee is in the same position as it would have been if it had borrowed money to buy the asset itself. That is why such leases are called finance leases; they provide finance for the use of an asset.

Example – Substantive substitution right

ABC Ltd enters into a 5 year contract with a freight carrier (XYZ Ltd.) to transport a specified quantity of goods. XYZ Ltd. uses rail cars of a particular specification, and has a large pool of similar rail cars that can be used to fulfil the requirements of the contract. The rail cars and engines are stored at XYZ Ltd. premises when they are not being used to transport goods. Costs associated with substituting the rail cars are minimal for XYZ Ltd.

In this case, because the rail cars are stored at XYZ Ltd. premises, it has a large pool of similar rail cars and substitution costs are minimal, the benefits to XYZ Ltd. of substituting the rail cars would exceed the costs of substituting the cars.

Therefore, XYZ Ltd. substitution rights are substantive and the arrangement does not contain a lease.

2.2 Identifying a finance lease

At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. 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.

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

(a) the lease transfers ownership of the underlying asset to the lessee by the end of the lease term;

(b) the lessee has the option to purchase the underlying asset at a price that is expected to be sufficiently lower than the *fair value* at the date the option becomes exercisable for it to be reasonably certain, at the *inception date*, that the option will be exercised;

(c) the lease term is for the major part of the *economic life* of the underlying asset even if title is not transferred;

(d) at the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset; and

(e) the underlying asset is of such a specialised nature that only the lessee can use it without major modifications.

Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:

(a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

(b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equaling most of the sales proceeds at the end of the lease); and

(c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

In all these situations, it can normally be concluded that substantially all the risks and rewards incidental to ownership are transferred to the lessee.

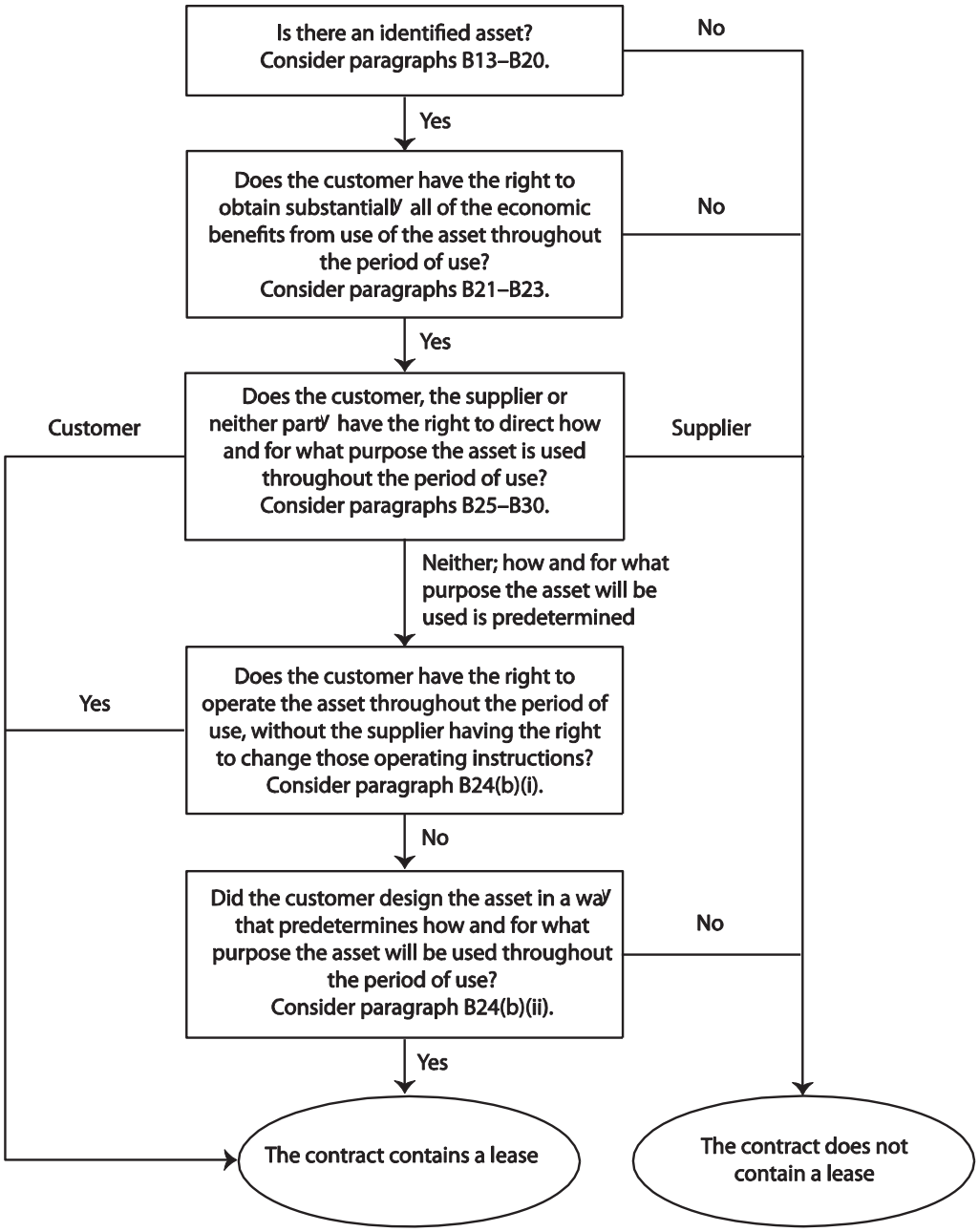
These indicators are not always conclusive. Classification should always be based on the substance of the agreement taking account of all information.

Leases are classified at the inception of the lease. Sometimes, a lessee and lessor agree to change the provisions of a lease and the changes might be of a sort that would have changed the lease classification if the new terms had been in

effect at the inception of the lease. In these cases, the revised agreement is regarded as a new agreement over its term.

However, changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property), or changes in circumstances (for example, default by the lessee), do not give rise to a new classification of a lease for accounting purposes.

The following flowchart may assist entities in making the assessment of whether a contract is, or contains, a lease.



2.3 Commentary on finance lease indicators

It is not always obvious why the above circumstances indicate that a lease is a finance lease. This section provides an explanation on some of these.

To understand these, it is useful to think of the terms from the lessor's viewpoint.

Purchase option

If a lease includes a term whereby the lessee can buy the underlying asset at a bargain price at the end of the lease that lease is a finance lease.

If the lessor includes this term in the lease, the lessor would expect the lessee to take advantage of it. Therefore, the lessor knows that it needs to make sure to recover the cost of the asset together with any related interest during the lease term. The rentals and final sale price are set at a level which allows it to do this.

If the lease transfers ownership of the underlying asset to the lessee by the end of the lease term or if the cost of the right-of-use asset reflects that the lessee will exercise a purchase option, the lessee shall depreciate the right-of-use asset from the commencement date to the end of the useful life of the underlying asset.

Therefore, the lessee will pay the full cash price of the asset together with related finance expense over the lease term.

- The lessee would only do this if it had access to the risks and benefits of ownership
- In substance, this is just like borrowing the cash and buying the asset

Therefore, the lease is a finance lease.

If there is a change in the assessment of an option to purchase the underlying asset, a lessee shall determine the revised lease payments to reflect the change in amounts payable under the purchase option.

Lease is for a major part of the expected economic life of the asset

If the lessor includes this term in the lease, the lessor knows that when the asset is given back to it at the end of the lease, the asset will only have a small value.

Therefore, the lessor knows that it needs to make sure to recover the cost of the asset together with any related interest during the lease term. The rentals are set at a level which allows it to do this.

Therefore, the lessee will pay the full cash price of the asset together with related finance expense over the lease term.

- The lessee would only do this if it had access to the risks and benefits of ownership
- In substance, this is just like borrowing the cash and buying the asset

Therefore, the lease is a finance lease.

Specialised nature of the asset

If the lessor includes this term in the lease, the lessor knows that when the lease comes to an end, it will be unable to lease the asset on to another party.

Therefore, the lessor knows that it needs to make sure to recover the cost of the asset together with any related interest during the lease term. The rentals are set at a level which allows it to do this.

Therefore, the lessee will pay the full cash price of the asset together with related finance expense over the lease term.

- The lessee would only do this if it had access to the risks and benefits of ownership.
- In substance, this is just like borrowing the cash and buying the asset.

Therefore, the lease is a finance lease.

PV of future lease payments amounts to substantially all of the fair value of the underlying asset

A lease is a finance lease if at the inception of the lease, the present value of all the future lease payments amounts to substantially all of the fair value of the underlying asset, or more. (The discount rate to be used in calculating the present value of the lease payments is the interest rate implicit in the lease).

In this case, the lessee is paying the full cash price of the asset together with related finance expense over the lease term.

Example: PV of future lease payments

A finance company has purchased an asset to lease out to a manufacturing company.

The asset cost for Rs. 500,000 and has an economic life of 10 years.

The lease is for 9 years at an annual rental (in arrears) of Rs. 87,000 per annum.

The interest rate implicit in the lease is 10%.

Analysis: Lessor's view

Time	Narrative	Cash flows	Discount factor (10%)	Present value
1 to 9	Lessor's LPs	87,000	5.759	501,033

This is more than the fair value of the asset. This lease is a finance lease (also note that the lease is for the major part of the expected economic life of the asset which is another finance lease indicator).

Time	Narrative	Cash flows	Discount factor (10%)	Present value
1 to 9	Lessee's LPs	87,000	5.759	501,033

This is more than the fair value of the asset. This lease is a finance lease (also note that the lease is for the major part of the expected economic life of the asset which is another finance lease indicator).

In the above example the lessee and the lessor have the same view of the lease. This is not necessarily the case.

Example: PV of future lease payments

A finance company has purchased an asset for Rs. 50,000 and will lease it out in a series of leases as follows:

The first lease is to Company A for a period of 4 years at an annual rental of Rs. 10,000.

After the end of the lease to Company A the asset will be leased to Company B for 3 years at a rental of Rs. 10,000. Company B is not related to Company A.

At the end of this lease the asset is expected to have an unguaranteed residual value of Rs. 2,573.

The Interest rate implicit in the lease is 10%.

Analysis: Lessor's view

Time	Narrative	Cash flows	Discount factor (10%)	Present value
1 to 7	Lessor's MLPs	10,000	4.868	48,680

This is 97.4% ($^{48,680}/_{50,000} \times 100$) of the fair value of the asset.

Most would agree that this was substantially all of the fair value of the asset (though IFRS 16 does not give a numerical benchmark).

This lease is a finance lease.

Time	Narrative	Cash flows	Discount factor (10%)	Present value
1 to 4	Lessor's MLPs	10,000	3.170	31,700

This is 63.4% ($^{31,700}/_{50,000} \times 100$) of the fair value of the asset.

Most would agree that this is not substantially all of the fair value of the asset (though IFRS 16 does not give a numerical benchmark).

This lease is an operating lease.

Practice question **1**

Jhang Construction has leased a cement lorry.

The cash price of the lorry would be Rs. 3,000,000.

The lease is for 6 years at an annual rental (in arrears) of Rs. 600,000. The asset is believed to have an economic life of 7 years.

The interest rate implicit in the lease is 7%.

Jhang Construction is responsible for maintaining and insuring the asset.

Required

State with reasons the kind of lease Jhang has entered into.

3 ACCOUNTING FOR LEASE BY LESSEE

Section overview

- Substance over form
- Lease accounting: Initial recognition
- Lease accounting: Subsequent measurement of the asset
- Lease accounting: Subsequent measurement of the liability
- Calculating and allocating finance charges (interest)
- Current and non-current elements of the finance lease liability
- Lease payments made in advance
- Disclosure

3.1 Substance over form

An earlier section explained that whether a lease is a finance lease or an operating lease depends on the substance of the contract rather than its form.

The economic substance of a finance lease is that the lessee in effect has all the benefits and costs associated with ownership of the asset. In substance it is as if the lessee borrowed money to buy the asset.

Similarly, the lessor no longer has the benefits and costs associated with ownership. The lessor should not account for the asset in its books. In substance, the lessor has lent money to another party to enable them to buy the asset. The lessor accounts for a receivable in its books being the right to receive a future flow of rentals.

3.2 Lease accounting: Initial recognition

A lease is capitalised at the commencement of the lease term. This involves the recognition of the asset that is subject to the lease and a liability for the future lease payments.

At the commencement date, a lessee should recognise a right-of-use asset and a lease liability. It is the date on which a lessor makes an underlying asset available for use by a lessee.

At the commencement date, a lessee should measure the right-of-use asset at cost.

The cost of the right-of-use asset should comprise:

(a) the amount of the initial measurement of the lease liability;

(b) any lease payments made at or before the commencement date, less any *lease incentives* received;

(c) any *initial direct costs* incurred by the lessee;

(d) an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories.

At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments that are not paid at that date. The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate.

Lease liability + Initial direct costs + Prepaid lease payments + Estimated costs to dismantle, remove or restore, measured - Lease incentives received = Right-of-use asset

Illustration: Double entry on initial recognition of a lease

(Assumes that the leased asset is an item of property, plant and equipment)

	Debit	Credit
Property, plant and equipment – (at cost)	X	
Liabilities: lease obligations		X

Initial direct costs are often incurred in connection with specific leasing activities, such as negotiating and securing leasing arrangements.

Any initial direct costs of the lessee are added to the amount recognised as an asset.

Typical **initial direct costs** of a lessee includes;

– Commissions

– Legal fees*

– Costs of negotiating lease terms and conditions*

– Costs of arranging collateral

– Payments made to existing tenants to obtain the lease

* If they are contingent on origination of the lease

Illustration:

	Debit	Credit
Property, plant and equipment – (at cost)	X	
Cash/bank		X

Example:

Jhang Construction enters into a 6 year lease of a machine on 1 January Year 1.

The fair value of the machine at the commencement of the lease was Rs. 80,000 and Jhang Construction incurred initial direct costs of Rs. 2,000 when arranging the lease.

Double entry:

	Debit	Credit
Property, plant and machinery – (at cost)	80,000	
Liabilities: lease obligations		80,000
Property, plant and machinery – (at cost)	2,000	
Cash/bank		2,000

Recognition exemptions

A lessee may elect not to apply the requirements to recognise and measurment the right-of-use the leased asset and liability to:

(a) *short-term leases*; and
(b) leases for which the *underlying asset* is of low value

Short-term lease

A lease that, at the commencement date, has a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease.

Example - Applying the short term lease exemption

Lessee ABC enters into a 8-year lease of a machine to be used in manufacturing parts for a plane that it expects to remain popular with consumers until it completes development and testing of an improved model. The cost to install the machine in DEF manufacturing facility is not significant. ABC and DEF each have the right to terminate the lease without a penalty on each anniversary of the lease commencement date.

The lease term consists of a one-year non-cancellable period because both ABC and DEF have a substantive termination right

ABC and DEF have a substantive termination right

– both can terminate the lease without penalty

– and the cost to install the machine in DEF manufacturing facility is not significant.

As a result, the lease qualifies for the short-term lease exemption.

Example – Applying the leases of low value exemption

Lessee A is in the pharmaceutical manufacturing and distribution industry and has the following leases:

– leases of real estate: both office building and warehouse;

– leases of office furniture;

– leases of company cars, both for sales personnel and for senior management and of varying quality, specification and value;

– leases of trucks and vans used for delivery; and

– leases of IT equipment such as laptops.

A determines that the leases of office furniture and laptops qualify for the recognition exemption on the basis that the underlying assets, when they are new, are individually of low value. B elects to apply the exemption to these leases.
As a result, it applies the recognition and measurement requirements in IFRS 16 to its leases of real estate, company cars, trucks and vans.

3.3 Lease accounting: Subsequent measurement of the asset

After the commencement date, a lessee should measure the right-of-use asset applying a cost model, unless it applies either of the measurement models described below

Cost model

To apply a cost model, a lessee should measure the right-of-use asset at cost:
(a) less any accumulated depreciation and any accumulated impairment losses; and
(b) adjusted for any re-measurement of the lease liability.

A lessee should apply the depreciation requirements in IAS 16 *Property, Plant and Equipment* in depreciating the right-of-use asset

If the lease transfers ownership of the underlying asset to the lessee by the end of the lease term or if the cost of the right-of-use asset reflects that the lessee will exercise a purchase option, the lessee should depreciate the right-of-use asset from the commencement date to the end of the useful life of the underlying asset.

Otherwise, the lessee should depreciate the right-of-use asset from the commencement date to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term.

Other measurement models

If a lessee applies the fair value model in IAS 40 Investment Property to its investment property, the lessee shall also apply that fair value model to right-of use assets that meet the definition of investment property in IAS 40.

If right-of-use assets relate to a class of property, plant and equipment to which the lessee applies the revaluation model in IAS 16, a lessee may elect to apply that revaluation model to all of the right-of-use assets that relate to that class of property, plant and equipment.

Illustration:

	Debit	Credit
Statement of comprehensive income (depreciation expense)	X	
Accumulated depreciation		X

Example:

Jhang Construction enters into a 6 year lease of a machine on 1 January Year 1.

The fair value of the machine at the commencement of the lease was Rs. 80,000 and Jhang Construction incurred initial direct costs of Rs. 2,000 when arranging the lease.

The estimated residual value of the asset at the end of the lease is Rs. 8,000.

The estimated useful life of the asset is 5 years.

The accounting policy for similar owned machines is to depreciate them over their useful life on a straight line basis.

Annual depreciation charge:

	Rs.
Initial cost:	
Fair value of the machine	80,000
Initial direct costs	2,000
	82,000
Residual value	(8,000)
Depreciable amount	74,000
Useful life (shorter of the lease term and the useful life)	5 years
Annual depreciation charge	14,800

The underlying asset is included in the statement of financial position at its carrying amount (cost less accumulated depreciation less any accumulated impairment loss (if any)) in the same way as similar assets.

Example:

	Year 1	Year 2	Year 3	Year 4	Year 5
	Rs.	Rs.	Rs.	Rs.	Rs.
Cost	82,000	82,000	82,000	82,000	82,000
Accumulated depreciation:					
Brought forward	nil	14,800	29,600	44,400	59,200
Charge for the year	14,800	14,800	14,800	14,800	14,800
Carried forward	14,800	29,600	44,400	59,200	74,000
Carrying amount	67,200	52,400	37,600	22,800	8,000

The asset is depreciated down to a carrying amount at the end of the asset's useful life that is the estimated residual value

3.4 Lease accounting: Subsequent measurement of the liability

After the commencement date, a lessee should measure the lease liability by:

(a) increasing the carrying amount to reflect interest on the lease liability;

(b) reducing the carrying amount to reflect the lease payments made; and

(c) re-measuring the carrying amount to reflect any reassessment or lease modifications

After initial recognition, the lease liability is measured at amortised cost using the effective interest method.

After the commencement date, a lessee should recognise in profit or loss, unless the costs are included in the carrying amount of another asset applying other applicable Standards, both:

(a) interest on the lease liability; and

(b) variable lease payments not included in the measurement of the lease liability in the period in which the event or condition that triggers those payments occurs.

Reassessment of the lease liability

After the commencement date, a lessee should re-measure the lease liability by using either unchanged discount rate or should re-measure the lease liability by discounting the revised discount rate to reflect changes to the lease payments. A lessee should recognise the amount of the re-measurement of the lease liability as an adjustment to the right-of-use asset.

However, if the carrying amount of the right-of-use asset is reduced to zero and there is a further reduction in the measurement of the lease liability, a lessee should recognise any remaining amount of the re-measurement in profit or loss.

During each year, the lessee makes one or more lease payments. The payment is recorded in the ledger account as follows.

Illustration:

	Debit	Credit
Liabilities: lease obligations	X	
Cash/bank		X

A lease liability is measured in the same way as any other liability. The balance at any point in time is as follows:

Illustration:

	Rs.
Amount borrowed at the start of the lease (the amount recognised on initial recognition of the lease)	X
Plus: Interest accrued	X
Minus: Repayments (lease payments or rentals)	(X)
Repayment of loan principal	(X)
Amount owed now.	X

In effect, each lease payment consists of two elements:

- a finance charge (interest charge) on the liability to the lessor, and
- a partial repayment of the liability (the lease obligation).

The finance charge is treated as a finance cost in profit or loss for the period. The partial repayment of the lease obligation reduces the amount of the liability that remains unpaid.

A lessee shall re-measure the lease liability by discounting the revised lease payments using a revised discount rate, if either:

(a) there is a change in the lease term. A lessee shall determine the revised lease payments on the basis of the revised lease term; or

(b) there is a change in the assessment of an option to purchase the underlying asset, assessed considering the events and circumstances in the context of a purchase option. A lessee shall determine the revised lease payments to reflect the change in amounts payable under the purchase option.

Finance charge

The total rental payments over the life of the lease will be more than the amount initially recognised as a liability. The difference is finance charge.

The total finance charge that arises over the life term is the difference between the amount initially recognised as the lease liability and the sum of the lease payments from the standpoint of the lessee.

Illustration: Total finance charge

	Rs.
Lessee's lease payments (sum of all payments made by the lessee to the lessor)	X
Amount on initial recognition	(X)
Total finance charge	X

Example: Total finance charge

Jhang Construction enters into a 6 year lease of a machine on 1 January Year 1.

The fair value of the machine at the commencement of the lease was Rs. 80,000 and Jhang Construction incurred initial direct costs of Rs. 2,000 when arranging the lease.

The annual lease payments are Rs. 18,000, payable at the end of each year.

The estimated residual value of the asset at the end of the lease is Rs. 8,000 and Jhang Construction has guaranteed this amount.

The interest rate implicit in the lease is 11.176751%.

Total finance charge

Lessee's lease payments:	Rs.
Annual rentals (6 × 18,000)	108,000
Guaranteed residual value	8,000
	116,000
Amount on initial recognition	(80,000)*
Total finance charge (interest)	36,000

* This is the amount of the liability, The asset is recognised at Rs. 82,000

The finance charge (interest) is recognised over the life of the lease by adding a periodic charge to the liability for the lease obligation with the other side of the entry as an expense in profit or loss for the year.

Illustration:	Debit	Credit
Statement of comprehensive income: interest expense	X	
Liabilities: lease obligations		X

Lease modification

Definition: Lease modification

A change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term).

A lessee should account for a lease modification as a separate lease if both:

(a) the modification increases the scope of the lease by adding the right to use one or more underlying assets; and

(b) the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

For a lease modification that is not accounted for as a separate lease, at the effective date of the lease modification a lessee should:

(a) allocate the consideration in the modified contract. Following is the guidance for allocating the consideration received;

i. For a contract that contains a lease component and one or more additional lease or non-lease components, a lessee should allocate the consideration in the contract to each lease component on the basis of the relative stand-alone price of the lease component and the aggregate stand-alone price of the non-lease components.

ii. The relative stand-alone price of lease and non-lease components should be determined on the basis of the price the lessor, or a similar supplier, would charge an entity for that component, or a similar component, separately. If an observable stand-alone price is not readily available, the lessee should estimate the stand-alone price, maximising the use of observable information.

However, as a practical expedient, a lessee may elect, by class of underlying asset, not to separate non-lease components from lease components, and instead account for each lease component and any associated non-lease components as a single lease component.

(b) determine the lease term of the modified lease; and

(c) remeasure the lease liability by discounting the revised lease payments using a revised discount rate. The revised discount rate is determined as the interest rate implicit in the lease for the remainder of the lease term, if that rate can be readily determined, or the lessee's incremental borrowing rate at the effective date of the modification, if the interest rate implicit in the lease cannot be readily determined.

For a lease modification that is not accounted for as a separate lease, the lessee should account for the re-measurement of the lease liability by:

(a) decreasing the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease for lease modifications that decrease the scope of the lease. The lessee should recognise in profit or loss any gain or loss relating to the partial or full termination of the lease.

(b) making a corresponding adjustment to the right-of-use asset for all other lease modifications.

Lease term

An entity should determine the lease term as the non-cancellable period of a lease, 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 that option.

(c) re-measure the lease liability by discounting the revised lease payments using a revised discount rate. The revised discount rate is determined as the interest rate implicit in the lease for the remainder of the lease term, if that rate can be readily determined, or the lessee's incremental borrowing rate at the effective date of the modification, if the interest rate implicit in the lease cannot be readily determined.

3.5 Calculating and allocating finance charges (interest)

The total finance charge for a leased asset is allocated "so as to provide a constant rate of charge on the outstanding obligation".

This means that as the lease liability decreases at each year-end, the interest charge for the next year will be lower than it was for the previous year.

The method implied by the IFRS 16 guidance is to use an interest rate to allocate the interest. This method is called the actuarial method. (The sum of digits method usually gives an acceptable approximation to the actuarial method).

Questions in your exam are likely to require the use of an interest rate (which you may have to calculate as the interest rate implicit in the lease).

Actuarial method

The actuarial method uses discounting arithmetic to establish the interest rate that is implicit in the lease. This interest rate is then applied to the opening balance of the lease liability at the start of each period, in order to calculate the finance charge.

Example: Allocation of the finance charge

Jhang Construction enters into a 6 year lease of a machine on 1 January Year 1.

The fair value of the machine at the commencement of the lease was Rs. 80,000 and Jhang Construction incurred initial direct costs of Rs. 2,000 when arranging the lease.

The annual lease payments are Rs. 18,000, payable at the end of each year.

The estimated residual value of the asset at the end of the lease is Rs. 8,000 and Jhang Construction has guaranteed this amount.

The interest rate implicit in the lease is 11.176751%.

Lease liability:

Year	Opening liability	Interest (11.176751%)	Lease payments	Closing liability
1	80,000	8,941	(18,000)	70,941
2	70,941	7,929	(18,000)	60,870
3	60,870	6,803	(18,000)	49,674
4	49,674	5,552	(18,000)	37,226
5	37,226	4,161	(18,000)	23,386
6	23,386	2,614	(26,000)	0
		36,000		

The interest expense is calculated by multiplying the opening liability by 11.176751% in each year (so as to provide a constant rate of charge on the outstanding obligation).

The lease obligation consists of the capital balance outstanding. This can be shown as follows:

Example:

Lease liability:

Year	Opening balance	Lease payments	Interest	Capital repayments	Closing balance
1	80,000	(18,000)	8,941	(9,059)	70,941
2	70,941	(18,000)	7,929	(10,071)	60,870
3	60,870	(18,000)	6,803	(11,197)	49,674
4	49,674	(18,000)	5,552	(12,448)	37,226
5	37,226	(18,000)	4,161	(13,839)	23,386
6	23,386	(26,000)	2,614	(23,386)	0

The final payment

In the above example the final payment by the lessee is Rs. 26,000. This is in fact made up of two amounts, the final rental of Rs. 18,000 and the guaranteed residual value of Rs. 8,000.

It is worth considering the payment in respect of the guaranteed residual value in a little more detail.

At the end of the lease, the asset that is the subject of the lease is transferred back to the lessor. It has been depreciated down to its estimated residual value of Rs. 8,000.

The transfer is recorded as follows:

Example: Final payment in respect of the guaranteed residual value

	Debit	Credit
Liabilities: lease obligations	8,000	
Leased Asset		8,000

In other words, the Rs. 8,000 part of the final year payment to the lessor of Rs. 26,000 is not cash but the transfer of the asset.

If the asset is worth less that Rs. 8,000 the lessee must make good any shortfall. In this case the asset is written down to its value at the date of the transfer (as agreed between the lessee and the lessor) and the lessee will pay cash to the lessor to compensate for any difference.

Example (continued): Final payment in respect of the guaranteed residual value

The asset has a carrying amount of Rs. 8,000 at the end of the lease but is only worth Rs. 5,000.

The lessee would make the following double entries.

Write down the asset	Debit	Credit
Statement of comprehensive income	3,000	
Leased Asset		3,000
Pay the lessor the guaranteed residual value		
Liabilities: lease obligations	8,000	
Leased Asset		5,000
Cash/bank		3,000

Example:

A company leases an asset (as lessee) on 1 January 20X1. The terms of the lease are to pay:

- A non-refundable deposit of Rs. 5,800 on inception.
- Six annual instalments of Rs. 16,000 payable in arrears.

The fair value of the asset (equivalent to the present value of minimum lease payments) on 1 January 20X1 is Rs. 80,000. Its useful life to the company is five years.

As part of the lease agreement the company guaranteed to the lessor that the asset could be sold for Rs. 8,000 at the end of the lease term. It also incurred Rs. 2,000 of costs in setting up the lease agreement.

The interest rate implicit in the lease has been calculated as 10.0%.

Requirements

(a) Prepare the relevant extracts from the financial statements (excluding notes) in respect of the above lease for the year ended 31 December 20X1.

(b) Explain what would happen at the end of the lease if the asset could be sold by the lessor:

i. For Rs. 10,000

ii. For only Rs. 6,000

(a) Financial statement extracts

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X1 (EXTRACT)

	Rs.
Depreciation [(80,000 + 2,000 - 8,000)/5)]	14,800
Finance costs (Working)	7,420

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X1 (EXTRACT)

Non-current assets	Rs.
Leased asset [(80,000 + 2,000) - ((80,000 + 2,000 - 8,000)/5)]	67,200
Finance lease liability (Working)	56,182
Current liabilities	
Finance lease liability (Working) (65,620 - 56,182)	9,438

WORKING	Bal b/f Rs.	Interest accrued at 10% Rs.	Payment 31 Dec Rs.	Bal c/f 31 Dec Rs.
	80,000			
	(5,800)			
20X1	74,200	7,420	(16,000)	65,620
20X2	65,620	6,562	(16,000)	56,182

(b) Treatment of guaranteed residual value

At the end of the lease, the lessee will have an asset at residual value of Rs. 8,000 in its statement of financial position and a finance lease liability of Rs. 8,000 representing the residual value guaranteed to the lessor.

i. If the lessor is able to sell the asset for more than the value guaranteed by the lessee, the lessee has no further liability and derecognises the asset and lease liability:

Dr Finance lease liability	Rs. 8,000
Cr Asset carrying amount	Rs. 8,000

ii. If the lessor is unable to sell the asset for the value guaranteed by the lessee, the lessee has a liability to make up the difference of Rs. 8,000 - Rs. 6,000 = Rs. 2,000:

Recognise impairment loss on asset (as soon as known during the lease term):

Dr Profit or loss	Rs. 2,000
Cr Asset carrying amount	Rs. 2,000

Make guaranteed payment to lessor and derecognise the asset and lease liability:

Dr Finance lease liability	Rs. 8,000
Cr Cash	Rs. 2,000
Cr Asset carrying amount	Rs. 6,000

3.6 Current and non-current elements of the lease liability

The total liability must be divided between:

- the current liability (amount payable within the next 12 months), and
- the non-current liability.

The easy way to do it is to use the tables to identify the current liability or the non-current liability and then find the other as a balancing figure.

Example: Split of current and non-current liability at the end of year 1

Year	Opening balance	Lease payments	Interest	Capital repayments	Closing balance
1	80,000	(18,000)	8,941	(9,059)	70,941
2	70,941	(18,000)	7,929	(10,071)	60,870
				↑	↑
				This is the current liability	This is the non-current liability

Liability:	Rs.
Current liability	10,071
Non-current liability	60,870
Total liability (for proof)	70,941

3.7 Lease payments made in advance

When the lease payments for a lease are made at the start of each period instead of the end of the period, the total finance charge is the same (because neither the amount borrowed nor the total rentals have changed) but the interest must be recognised over a shorter period. This is because the liability is paid off one period earlier.

This means that the interest rate used for payments in advance will be bigger than that used for the same payments in arrears.

Also note that when the lease payments for a lease are made at the start of each period, the opening liability for the lease obligation is reduced by the lease payment at the beginning of the year, and the interest charge must be applied to the remaining balance.

Example: Allocation of finance charge

Jhang Construction enters into a 6 year lease of a machine on 1 January Year 1.

The fair value of the machine at the commencement of the lease was Rs. 80,000 and Jhang Construction incurred initial direct costs of Rs. 2,000 when arranging the lease.

The annual lease payments are Rs. 18,000, payable at the start of each year.

The estimated residual value of the asset at the end of the lease is Rs. 8,000 and Jhang Construction has guaranteed this amount.

The interest rate implicit in the lease is 16.1434%.

Lease liability:

(Note: "Year 0" is the first day of year 1. It would be better to think of it as time 0).

Year	Opening liability	Lease payments	Liability after day 1 payment	Interest at 16.1434%.	Closing liability
0	80,000	(18,000)	62,000	10,009	72,009
1	72,009	(18,000)	54,009	8,719	62,728
2	62,728	(18,000)	44,728	7,221	51,948
3	51,948	(18,000)	33,948	5,480	39,429
4	39,429	(18,000)	21,429	3,459	24,888
5	24,888	(18,000)	6,888	1,112	8,000
6	8,000	(8,000)	0		
				36,000	

The interest expense is calculated by multiplying the opening liability by 16.1434% in each year (so as to provide a constant rate of charge on the outstanding obligation).

In the above example the first payment of Rs. 18,000 is made on the first day of the lease term. Therefore it does not include any interest and is a repayment of capital.

The year 1 interest of Rs. 10,009 is recognised at the end of year 1 (31 December Year 1). It is paid the next day by the payment of Rs. 18,000 made on 1 January Year 2.

The closing liability at the end of year 1 is made up of the interest accrued in year 1 and an amount of capital which will be paid off in year 2.

This can be shown for all of the years below.

Example: Capital repayments

Schedule to show repayment of capital:

Year	Opening balance	Lease payments	Interest	Capital repayments	Closing balance
1	80,000	(18,000)	-	(18,000)	62,000
2	62,000	(18,000)	10,009	(7,991)	54,009
3	51,948	(18,000)	8,719	(9,281)	44,728
4	39,429	(18,000)	7,221	(10,779)	33,948
5	24,888	(18,000)	5,480	(12,520)	21,429
6 (start)	8,000	(18,000)	3,459	(14,541)	6,888
6 (end)	6,888	(8,000)	1,112	(6,888)	0

Current and non-current liability

If payments are made annually in advance, the next payment is a current liability. Therefore in the above example the Rs. 18,000 paid on 1 January Year 2 is a current liability.

However, this is made up of two elements, interest of Rs. 10,009 and a capital repayment of Rs. 7,991. These elements could be shown separately.

This means that the closing liability at the end of year 1 as identified on the previous page (Rs. 72,009) is made up of three parts:

- the interest recognised in year 1 but unpaid at the year-end (Rs. 10,009);
- the current element of the capital owed on the lease (Rs. 7,991); and
- the non-current element of the capital owed on the lease (Rs. 54,009).

Example: Current and non-current liability

Year	Opening balance	Lease payments	Interest	Capital repayments	Closing balance
1	80,000	(18,000)	-	(18,000)	62,000
2	62,000	(18,000)	10,009	(7,991)	54,009

	Interest expense current liability	lease current liability	lease non-current liability

Liability:	**Rs.**
Current liabilities	
Interest expense	10,009
Current part of lease liability	7,991
Non-current liability	
Non-current part of lease liability	54,009
Total lease liability (for proof)	62,000
Total liability (for proof)	72,009

Practice question **2**

The fair value of aleased asset, lease commencing on 1 January Year 1 is Rs. 10,000.

The lease is for three years with payments of Rs. 4,021 annually on 1 January Year 1, Year 2 and Year 3.

The interest rate implicit in the lease is 22.25%.

Required

Complete the lease payment table for all three years 1 to 3, and calculate the current liability and the non-current liability at 31 December Year 1 under the actuarial method.

3.8 Disclosures

A lessee shall disclose information about its leases for which it is a lessee in a single note or separate section in its financial statements. However, a lessee need not duplicate information that is already presented elsewhere in the financial statements, provided that the information is incorporated by cross-reference in the single note or separate section about leases.

A lessee shall disclose the following amounts for the reporting period:

(a) depreciation charge for right-of-use assets by class of underlying asset;

(b) interest expense on lease liabilities;

(c) the expense relating to short-term leases. This expense need not include the expense relating to leases with a lease term of one month or less;

(d) the expense relating to leases of low-value assets. This expense shall not include the expense relating to short-term leases of low-value assets;

(e) the expense relating to variable lease payments not included in the measurement of lease liabilities;

(f) income from subleasing right-of-use assets;

(g) total cash outflow for leases;

(h) additions to right-of-use assets;

(i) gains or losses arising from sale and leaseback transactions; and

(j) the carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset.

A lessee shall provide the disclosures specified in paragraph 53 in a tabular format, unless another format is more appropriate. The amounts disclosed shall include costs that a lessee has included in the carrying amount of another asset during the reporting period.

A lessee shall disclose the amount of its lease commitments for short-term leases accounted for applying paragraph 6 if the portfolio of short-term leases to which it is committed at the end of the reporting period is dissimilar to the portfolio of

short-term leases to which the short-term lease expense disclosed applying paragraph 53(c) relates.

If right-of-use assets meet the definition of investment property, a lessee shall apply the disclosure requirements in IAS 40. In that case, a lessee is not required to provide the disclosures in paragraph 53(a), (f), (h) or (j) for those right-of-use assets.

If a lessee measures right-of-use assets at revalued amounts applying IAS 16, the lessee shall disclose the information required by paragraph 77 of IAS 16 for those right-of-use assets.

ABC Ltd. is a retailer of men apparel. They have entered into a 5 year lease of shop premises with a XYZ Ltd. on 1 July 2015.

The lease requires 5 yearly payments in advance of Rs. 100,000 (the first payment is 1 July 2015 and subsequent payments are 30 June).

The interest rate implicit in the lease is 10%

The ABC Ltd. uses straight line depreciation method

IFRS 16 treatment

Years	0	1	2	3	4	5	TOTAL
				Rs			
Payments	100,000	100,000	100,000	100,000	100,000	-	500,000
PV	100,000	90,909	82,645	75,131	68,301	-	416,987
Lease liability (CY = Prior year PV - Payment during the year + Interest exp)	316,987	248,685	173,554	90,909	-	-	
Right to use asset (CY = Preceding year lease liability - CY depreciation)	416,987	333,630	250,273	166,917	83,560	-	
Intest expense - A (CY = Preceding year lease liability * Int. rate)	-	31,699	24,869	17,355	9,091	-	83,013
Depreciation - B (Right to use at year 0/ useful life)	-	83,357	83,357	83,357	83,357	83,357	416,783
P&L Impact = A+B		115,055	108,225	100,712	92,448	83,357	499,796

Journal Enteries		
At 1 July 2015	**Debit**	**Credit**
Right to use asset	416,987	
Lease liabilty		416,987
Lease Liabilty	100,000	
Cash		100,000
At 30 June 2016		
Depreciation expense	83,357	
Acc. Depreciation		83,357
Intest expense	31,699	
Lease Liability	68,301	
Cash		100,000

4 ACCOUNTING FOR A FINANCE LEASE: LESSOR ACCOUNTING

Section overview

- Definitions
- Finance lease accounting
- Manufacturer/dealer leases
- Finance lessor disclosures

4.1 Definitions

The lessor does not record the leased asset in his own financial statements because he has transferred the risks and rewards of ownership of the leased asset to the lessee. Instead, he records the amount due to him under the terms of the finance lease as a receivable.

The receivable is described as the net investment in the lease.

Definitions: Gross and net investment in the lease

Gross investment in the lease is the aggregate 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.

An earlier section explained that the interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes:

- the present value of the lease payments and the unguaranteed residual value; to be equal to
- the sum of the fair value of the underlying asset and any initial direct costs of the lessor.

Therefore the net investment in the lease is the sum of the fair value of the asset plus the initial direct costs.

Definitions:

Unearned finance income	**The difference between:**
	(a) the gross investment in the lease; and
	(b) the net investment in the lease.

4.2 Finance lease accounting

Many of the entries to be made in the ledger accounts of the lessor are a 'mirror image' of those made by the lessee in respect of his lease liability.

	Lessee	Lessor
Initial recognition & measurement	lease payments payable	Finance lease receivable (net investment in the lease)

	Lessee	Lessor
Subsequent measurement	Finance cost	Finance income
Pattern of recognition	So as to provide a constant periodic rate of charge on the outstanding obligation	So as to provide a constant periodic rate of return on the net investment in the lease.

Initial recognition

The lessor records a receivable for the capital amount owed by the lessee. This should be stated at the amount of the 'net investment in the lease'.

Illustration: Double entry on initial recognition of a finance lease

	Debit	Credit
Net investment in the lease	X	
Cash/bank		X

For finance leases other than those involving manufacturer or dealer lessors, initial direct costs are included in the initial measurement of the finance lease receivable thus reducing the amount of income recognised over the lease term to below what it would have been had the costs not been treated in this way. The result of this is that the initial direct costs are recognised over the lease term as part of the income recognition process.

Initial direct costs of manufacturer or dealer lessors in connection with negotiating and arranging a lease are excluded from the definition of initial direct costs. As a result, they are excluded from the net investment in the lease.

The treatment of similar costs incurred by manufacturers and dealers is explained later.

Subsequent measurement of the receivable

During each year, the lessor receives payments from the lessee. Each receipt is recorded in the ledger account as follows.

Illustration: Lessor receipts

	Debit	Credit
Cash/bank	X	
Net investment in the lease		X

A finance lease receivable (net investment in the lease) is measured in the same way as any other financial asset. The balance at any point in time is as follows:

Illustration: Net investment in the lease

	Rs.
Amount of loan at the start of the lease (the amount recognised on initial recognition of the lease)	X
Plus: Interest accrued	X
Minus: Repayments (lease payments or rentals)	(X)
Repayment of loan principal	(X)
Amount owed to the lessor now.	X

In effect, each lease receipt consists of two elements:

- finance income on the receivable; and
- a partial repayment of the receivable (net investment in the lease).

The finance charge is recognised as income in profit or loss for the period. The partial repayment of the lease receivable reduces the amount owed to the lessor.

Finance income

The total rental receipts over the life of the lease will be more than the amount initially recognised as a receivable. The difference is finance income.

The total finance income that arises over the life of the lease is the difference between the amount invested in the lease (the amount loaned plus the initial direct costs) and the sum of all receipts.

Illustration: Total finance income

	Rs.
Lessor's lease payments	X
Initial direct costs	X
	X
Amount on initial recognition	(X)
Total finance income	X

Example: Total finance income

Sialkot Finance agreed to lease a machine to Jhang Construction commencing on 1 January Year 1.

The lease was a 6 year finance lease of a machine on 1 January Year 1 with annual lease payments of Rs. 18,000, payable in arrears.

The fair value of the machine at the commencement of the lease was Rs. 80,000 and Sialkot Finance incurred initial direct costs of Rs. 2,000 when arranging the lease.

The estimated residual value of the asset at the end of the lease is Rs. 10,000. The lessee has guaranteed an amount of Rs. 8,000.

The interest rate implicit in the lease is 10.798%.

Total finance income

Lessor's lease payments:	Rs.
Annual rentals (6 × 18,000)	108,000
Guaranteed residual value	8,000
Unguaranteed residual value	2,000
	118,000
Amount on initial recognition	(80,000)
Initial direct costs	(2,000)
	(82,000)
Total finance income	36,000

The finance income is recognised over the life of the lease by adding a periodic return to the net investment in the lease with the other side of the entry as income in profit or loss for the year.

Illustration:

	Debit	Credit
Net investment in the lease	X	
Statement of comprehensive income: finance income		X

Calculating and allocating finance income

Finance income is recognised so as to give a constant periodic rate of return on the lessor's net investment in the finance lease.

Example: Calculating and allocating finance income

Sialkot Finance agreed to lease a machine to Jhang Construction commencing on 1 January Year 1.

The lease was a 6 year finance lease of a machine on 1 January Year 1 with annual lease payments of Rs. 18,000, payable in arrears.

The fair value of the machine at the commencement of the lease was Rs. 80,000 and Sialkot Finance incurred initial direct costs of Rs. 2,000 when arranging the lease.

The estimated residual value of the asset at the end of the lease is Rs. 10,000. The lessee has guaranteed an amount of Rs. 8,000.

The interest rate implicit in the lease is 10.798%.

Proof that interest rate implicit in the lease is 10.798%

Year	Narrative	Cash flow	Discount factor (10.798%)	Present value
	lease payments			
1 to 6	Annual rentals	18,000	4.2553	76,595
6	Guaranteed residual value	8,000	0.54052	4,324
6	Unguaranteed residual value	2,000	0.54052	1,081
				82,000
	Fair value of the asset			80,000
	Initial direct costs			2,000
				82,000

Example: Calculating and allocating finance income

Sialkot Finance agreed to lease a machine to Jhang Construction commencing on 1 January Year 1.

The lease was a 6 year finance lease of a machine on 1 January Year 1 with annual lease payments of Rs. 18,000, payable in arrears.

The fair value of the machine at the commencement of the lease was Rs. 80,000 and Sialkot Finance incurred initial direct costs of Rs. 2,000 when arranging the lease.

The estimated residual value of the asset at the end of the lease is Rs. 10,000 and the lessee has guaranteed Rs. 8,000 of this amount.

The interest rate implicit in the lease is 10.798%.

Net investment in the lease

Year	Opening net investment	Interest (10.798%)	Lease receipts	Closing net investment
1	82,000	8,854	(18,000)	72,854
2	72,854	7,867	(18,000)	62,721
3	62,721	6,773	(18,000)	51,494
4	51,494	5,560	(18,000)	39,054
5	39,054	4,217	(18,000)	25,271
6	25,271	2,729	(26,000)	2,000
		36,000		

The interest income is calculated by multiplying the opening receivable by 10.798% in each year (so as to provide a constant rate of return on the net investment in the lease).

The final balance on the account is the unguaranteed residual value.

Finance lease accounting – alternative double entry

There is an alternative approach to finance lessor double entry. Instead of recognising "net investment in a lease" as an asset, a company could recognise the "gross investment in a lease" as an asset and "unearned finance income" as a liability. The balances on these two accounts would be netted off to give the net investment in a lease at each reporting date.

Illustration: Double entry on initial recognition of a finance lease

	Debit	Credit
Gross investment in the lease	X	
Unearned finance income		X
Cash/bank (or payable)		X

The rental receipts reduce the "gross investment in the lease". In addition, the interest income in the period is transferred from the unearned finance income account to the statement of profit or loss.

Illustration: Double entry on receipt date

	Debit	Credit
Cash	X	
Gross investment in the lease		X
Unearned finance income	X	
Statement of profit or loss		X

It is still necessary to construct an amortisation table in order to identify the interest income.

Example: Finance lessor accounting – alternative double entry

Facts as before (key points reproduced for your convenience)

Lease commences on 1 January Year 1.

The lease was a 6 year finance lease of a machine on 1 January Year 1 with annual lease payments of Rs.18,000, payable in arrears.

The fair value of the machine at the commencement of the lease was Rs. 80,000 and the lessor incurred initial direct costs of Rs. 2,000 when arranging the lease.

The estimated residual value of the asset at the end of the lease is Rs. 8,000 and the lessee has guaranteed this amount.

The interest rate implicit in the lease is 10.798%.

Gross investment in the lease

	Rs.
Annual rentals (6 × 18,000)	108,000
Guaranteed residual value	9,000
Unguaranteed residual value	1,000
	118,000
Amount on initial recognition	(80,000)
Initial direct costs	(2,000)
	(82,000)
Total finance income	36,000

The double entry at the start of the lease would be as follows:

Start of year 1	Debit	Credit
Lease receivable (gross investment in the lease)	118,000	
Unearned finance income		36,000
Cash (or payable)		82,000
Being the initial recognition of the lease		

End of year 1

Cash	18,000	
Lease receivable (gross investment in the lease)		18,000

Being the receipt of the year 1 rental

Unearned finance income	8,854	
Finance income (statement of profit or loss) **W**		8,854

Being the recognition of finance income

Year	Opening net investment	Interest (10.798%)	Lease receipts	Closing net investment
1	82,000	8,854	(18,000)	72,854
2	72,854	7,867	(18,000)	62,721

The net investment in the lease is found be netting the unearned finance income against the lease receivable (gross investment in the lease) at each point in time.

The following table shows the balance on the two accounts at the start and at each year end and the resulting net figures.

Year	Finance lease receivable	Unearned finance income	Net investment in the lease
0	118,000	36,000	82,000
	(18,000)	(8,854)	
1	100,000	27,146	72,854
	(18,000)	(7,867)	
2	82,000	19,279	62,721
	(18,000)	(6,773)	
3	64,000	12,506	51,494
	(18,000)	(5,560)	
4	46,000	6,946	39,054
	(18,000)	(4,217)	
5	28,000	2,729	25,271
	(27,000)	(2,729)	
6	1,000	–	1,000

Note that the net investment in the lease is the same as before.

Example:

A company leased an asset to another company on 1 January 20X1 on the following terms.

Lease term	4 years
Inception of lease	1.1.X1
Annual instalments in advance	Rs. 22,000
Residual value of asset as guaranteed by lessee	Rs. 10,000
Expected residual value at end of lease	Rs. 12,000
Fair value of the asset	Rs. 82,966
Initial direct costs incurred by the lessor	Rs. 700
Interest rate implicit in the lease	11%

Requirements

a) Calculate the unguaranteed residual value and the net investment in the lease as at 1 January 20X1
b) Prepare extracts from the financial statements of the lessor for the year ended 31.12.X1 (excluding notes)

a) Unguaranteed residual value and net investment in the lease at 1 January 20X1

Date		Gross investment	Discount factor	Net investment	
		Rs.	*(11%)*	Rs.	
1.1.X1	Instalment	22,000	1	22,000	
1.1.X2	Instalment	22,000	0.901	19,822	
1.1.X3	Instalment	22,000	0.812	17,864	
1.1.X4	Instalment	22,000	0.731	16,082	
31.12.X4	Guaranteed residual value	10,000	0.659	6,590	
	Minimum lease payments	98,000		82,358	Lessee's liability
31.12.X4	Unguaranteed residual value	2,000	0.659	1,318	
	Investment in the lease	100,000		83,676	Lessor's asset

Note: The net investment in the lease is equal to the fair value of the asset of Rs. 82,966 plus the lessor's costs of Rs. 700. In this instance there is a rounding difference of Rs. 10.

b) Financial statement extracts

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X1 (EXTRACT)

	Rs.
Finance income (Working)	6,784

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X1 (EXTRACT)

	Rs
Non-current assets	
Net investment in finance lease (Working)	46,460
Current assets	
Net investment in finance lease (Working) (68,460 - 46,460)	22,000

WORKING

Net investment in finance lease

	Bal b/f	Instalments in advance	c/f	Interest income at 11%	Bal c/f 31 Dec
	Rs.	Rs.	Rs.	Rs.	Rs.
20X1	83,676	(22,000)	61,676	6,784	68,460
20X2	68,460	(22,000)	46,460		

For many years an entity has owned a freehold building which it has recognised as an investment property under the fair value model of IAS 40. This requires that the property is revalued to fair value at each reporting date with any gains or losses recognised in profit or loss. At 31 December 20X4, the carrying amount of the building was Rs. 5 million.

On 1 January 20X5, the entity leased it out under a 40-year finance lease. The lease included a clause transferring title to the lessee at the end of the lease; the lease was therefore recognised as a single finance lease comprising both the land and building elements.

The annual rental is Rs. 400,000 payable in advance and the interest rate implicit in the lease has been calculated as 8.3%.

Requirement

How should the transaction be recognised on 1 January 20X5 and in the year ending 31 December 20X5?

The transaction will be recognised by the entity as follows.

1 January 20X5	Derecognise Rs. 5 million investment property asset
	Recognise Rs. 5 million finance lease receivable
	Recognise Rs. 400,000 cash received as a reduction in the receivable

Note that the net investment in the lease is equal to the fair value of the asset plus any costs incurred by the lessor. In this case there were no such costs and therefore the fair value of the asset is the net investment in the lease.

31 December 20X5	Increase the receivable by Rs. 381,800 (8.3% x (Rs. 5,000,000 - Rs. 400,000))
	Recognise finance income of Rs. 381,800 in profit or loss

Lease modifications

A lessor shall account for a modification to a finance lease as a separate lease if both:

a. the modification increases the scope of the lease by adding the right to use one or more underlying assets; and

b. the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

For a modification to a finance lease that is not accounted for as a separate lease, a lessor shall account for the modification as follows:

a. if the lease would have been classified as an operating lease had the modification been in effect at the inception date, the lessor shall:

   i. account for the lease modification as a new lease from the effective date of the modification; and

   ii. measure the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the lease modification.

b. otherwise, the lessor shall apply the requirements of IFRS 9.

4.3 Manufacturer/dealer lessors

Manufacturers or dealers often offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to two types of income:

- profit or loss equivalent to the profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts; and
- finance income over the lease term.

Revenue

The sales revenue recognised at the commencement of the lease term is the lower of:

- the fair value of the underlying asset; and
- the present value of the lease payments accruing to the lessor discounted at market rate of interest.

Cost of sale

The cost of sale recognised at the commencement of the lease term is the carrying amount of the underlying asset less the present value of the unguaranteed residual value.

The deduction of the present value of the unguaranteed residual value recognises that this part of the asset is not being sold. This amount is transferred to the lease receivable. The balance on the lease receivable is then the present value of the amounts which the lessor will collect off the lessee plus the present value of the unguaranteed residual value. This is the net investment in the lease as defined in section 5.2.

Costs incurred by manufacturer or dealer lessors in connection with negotiating and arranging a lease must be recognised as an expense when the selling profit is recognised.

Profit or loss on the sale

The difference between the sales revenue and the cost of sale is the selling profit or loss. Profit or loss on these transactions is recognised in accordance with the policy followed for recognising profit on outright sales.

The manufacturer or dealer might offer artificially low rates of interest on the finance transaction. In such cases the selling profit is restricted to that which would apply if a market rate of interest were charged.

Example: Manufacturer or dealer leases

Multan Motors is a car dealer.
It sells cars and offers a certain model for sale by lease.
The following information is relevant:

Price of the car in a cash sale	Rs. 2,000,000
Cost of the car	Rs. 1,500,000
Finance option:	
Annual rental	Rs. 804,230
Lease term	3 years
Interest rate	10%
Estimated residual value	nil
Lessor's cost of setting up the lease	Rs. 20,000

Discount factor	
t1 to t3 @ 10%	2.486852 (written as 2.487)

Working: Revenue – lower of:	Rs.
Fair value of the asset	2,000,000
Present value of the lease payments	
804,230 × 2.487	2,000,000

Initial double entry:

Revenue	**Debit**	**Credit**
Lease receivable (Net investment in the lease)	2,000,000	
Statement of comprehensive income		2,000,000
Cost of sale		
Statement of comprehensive income	1,500,000	
Asset (Inventory)		1,500,000
Cost of setting up the lease		
Statement of comprehensive income	20,000	
Cash/bank		20,000

Example: Manufacturer or dealer lease (continued)

Net investment in the lease (over its life):

Year	Opening net investment	Interest (10%)	Lease receipts	Closing net investment
1	2,000,000	200,000	(804,230)	1,395,770
2	1,395,770	139,577	(804,230)	731,117
3	731,117	73,113	(804,230)	nil

The interest income is calculated by multiplying the opening receivable by 10% in each year (so as to provide a constant rate of return on the net investment in the lease).

Summary of double entry in year 1:

	Bank	Inventory	Net investment in the lease	Profit or loss
B/f		1,500,000Dr		
Revenue			2,000,000Dr	2,000,000Cr
Cost of sales		(1,500,000)Cr		(1,500,000)Dr
Set up cost	(20,000)Cr			(20,000)Dr
Profit on sale				480,000Cr
Lease income			200,000Dr	200,000Cr
Lease rental	804,230Dr		(804,230)Cr	
			1,395,770Dr	680,000Cr

Example: Manufacturer or dealer leases with unguaranteed residual value

The following information is relevant:

Price of the car in a cash sale	Rs. 2,000,000
Cost of the car	Rs. 1,500,000
Finance option:	
Annual rental	Rs. 764,018
Lease term	3 years
Interest rate	10%
Estimated residual value	Rs. 133,100
Lessor's cost of setting up the lease	Rs. 20,000

Discount factors:	
t3 @ 10%	0.7513148 (written as 0.751)
t1 to t3 @ 10%	2.486852 (written as 2.487)

Workings

W1: Revenue – lower of:	Rs.
Fair value of the asset	2,000,000
Present value of the lease payments	
764,018× 2.487	1,900,000

W2: Present value of the unguaranteed residual value	Rs.
Present value of the lease payments	
133,156 × 0.751	100,000

Initial double entry:

Revenue	**Debit**	**Credit**
Lease receivable (Net investment in the lease)	1,900,000	
Statement of comprehensive income		1,900,000
Cost of sale		
Statement of comprehensive income	1,400,000	
Asset (Inventory)		1,400,000
Transfer		
Lease receivable (Net investment in the lease)	100,000	
Asset (Inventory)		100,000
Cost of setting up the lease		
Statement of comprehensive income	20,000	
Cash/bank		20,000

Year	**Opening net investment**	**Interest (10%)**	**Lease receipts**	**Closing net investment**
1	1,900,000			
	100,000			
	2,000,000	200,000	(764,018)	1,435,982
2	1,435,982	143,598	(764,018)	815,562
3	815,562	81,556	(764,018)	133,100

The interest income is calculated by multiplying the opening receivable by 10% in each year (so as to provide a constant rate of return on the net investment in the lease).

The balance on the account at the end of the lease term is the unguranteed residual value.

Example: Manufacturer or dealer lease (continued)

Net investment in the lease (over its life):

Summary of double entry in year 1:

	Bank	Inventory	Net investment in the lease	Profit or loss
B/f		1,500,000Dr		
Revenue			1,900,000Dr	1,900,000Cr
Cost of sales		(1,400,000)Cr		(1,400,000)Dr
Set up cost	(20,000)Cr			(20,000)Dr
Profit on sale				480,000Cr
Transfer		(100,000)Cr	100,000Dr	
Lease income			200,000Dr	200,000Cr
Lease rental	764,018Dr		(764,018)Cr	
			1,435,982Dr	680,000Cr

A motor dealer acquires vehicles of a particular model from the manufacturer for Rs. 21,000, a 20% discount on the recommended retail price of Rs. 26,250. It offers them for sale at the recommended retail price with 0% finance over three years, provided three annual payments of Rs. 8,750 are made in advance. The market rate of interest is 8%.

A sale transaction made on 1 January 20X5 is recognised as a combination of an outright sale and a finance lease. The present value of the minimum lease payments is treated as the consideration for the outright sale and at 8% is calculated as follows:

Year	*Cash flow*	*Discount factor at 8%*	*Present value*
	Rs.		Rs.
20X5	8,750	1.000	8,750
20X6	8,750	$\frac{1}{(1.08)} = 0.926$	8,102
20X7	8,750	$\frac{1}{(1.08)^2} = 0.857$	7,499
			24,351

Requirement

How should the transaction be recognised by the dealer in the year ending 31 December 20X5?

Statement of comprehensive income

Revenue (lower of FV Rs. 26,250 and PV of MLPs Rs. 24,351)	24,351
Cost of sales (lower of cost and CV — PV of unguaranteed residual value)	(21,000)
Profit	3,351
Finance income: (Working)	1,248
Statement of financial position	
Receivable (Working)	16,849

WORKING

	Bal b/f	Instalments in advance	c/f	Interest income at	Bal c/f 8% 31 Dec
	Rs.	Rs.	Rs.	Rs.	Rs.
20X5	24,351	(8,750)	15,601	1,248	16,849

4.4 Finance lessor disclosures

A finance lessor must disclose the following:

- selling profit or loss;
- finance income on the net investment in the lease; and
- income relating to variable lease payments not included in the measurement of the net investment in the lease.
- a reconciliation between the gross investment in the lease at the end of the reporting period, and the present value of lease payments receivable at the end of the reporting period;
- the gross investment in the lease and the present value of lease payments receivable at the end of the reporting period, for each of the following periods:
  - not later than one year;
  - later than one year and not later than five years;
  - later than five years;
- unearned finance income;
- the unguaranteed residual values accruing to the benefit of the lessor;
- the accumulated allowance for uncollectible lease payments receivable;
- contingent rents recognised as income in the period;
- a general description of the lessor's material leasing arrangements.
- Maturity analysis of lease payment receivables

A lessor shall provide a qualitative and quantitative explanation of the significant changes in the carrying amount of the net investment in finance leases.

A lessor shall disclose additional qualitative and quantitative information about;

- the nature of the lessor's leasing activities; and
- how the lessor manages the risk associated with any rights it retains in underlying assets. In particular, a lessor shall disclose its risk management strategy for the rights it retains in underlying assets, including any means by which the lessor reduces that risk.

5 ACCOUNTING FOR AN OPERATING LEASE

Section overview

- Operating leases in the financial statements of the lessor
- Operating lessor disclosures

5.1 Operating leases in the financial statements of the lessor

Because the lessor has not transferred the risks and rewards of ownership of the physical asset to the lessee, the lessor shows the leased asset as a non-current asset in its statement of financial position.

It will be shown in an appropriate category of property, plant and equipment as an investment property at its carrying value (cost/valuation minus accumulated depreciation).

In respect of the leased asset, the lessor's annual statement of comprehensive income will include in profit or loss:

- depreciation on the asset as an expense, and
- rental income (as for the lessee, this is usually calculated on a straight-line basis).

Lease income from operating leases is recognised in income on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished.

Initial direct costs incurred by lessors in negotiating and arranging an operating lease are added to the carrying amount of the leased asset and recognised as an expense over the lease term on the same basis as the lease income.

The depreciation policy for depreciable leased assets must be consistent with the lessor's normal depreciation policy for similar assets, and calculated in accordance with IAS 16 and IAS 38.

A lessor shall apply IAS 36 to determine whether an underlying asset subject to an operating lease is impaired and to account for any impairment loss identified.

Manufacturer/dealer leases

A manufacturer or dealer lessor must not recognise any selling profit on entering into an operating lease. It is not the equivalent of a sale as the risks and benefits of ownership do not pass.

A lessor shall account for a modification to an operating lease as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease.

5.2 Operating lessor presentation and disclosures

A lessor shall present underlying assets subject to operating leases in its statement of financial position according to the nature of the underlying asset.

Operating lessors must disclose the following:

- the future lease payments under non-cancellable operating leases in the aggregate and for each of the following periods:
  - not later than one year;
  - later than one year and not later than five years;
  - later than five years.
- total contingent rents recognised as income in the period.
- a general description of the lessor's leasing arrangements.

6 SALE AND LEASEBACK TRANSACTIONS AND SUB-LEASE

Section overview

- Sale and leaseback transactions
- Sale and finance leaseback (finance lease)
- Sale and operating leaseback (operating lease)
- Sub-lease

6.1 Sale and leaseback transactions

Sale and leaseback transactions involve one entity selling an asset, normally to a bank or finance company, and then immediately leasing it back. The main purpose is to allow the entity to release cash that is 'tied up' in the asset, whilst retaining use of the asset.

For example, a company may own an office building that it uses for its administrative operations. It may decide to sell and lease back the building, to raise cash. By selling the building, it raises cash. By leasing back the building, it retains the use of the building for its operational activities.

The leaseback could be arranged either as a finance lease or an operating lease, and this will affect the accounting treatment of the transaction.

6.2 Sale and finance leaseback (finance lease)

To determine how to account for a sale-and-leaseback transaction, a company first considers whether the initial transfer of the underlying asset from the seller-lessee to the buyer-lessor is a sale. The company applies IFRS 15 to determine whether a sale has taken place. This assessment determines the accounting by both the seller-lessee and the buyer-lessor, as follows.

	Lessee (Seller)	Lessor (Buyer)
Transfer to buyer-lessor is a sale	– Derecognise the underlying asset and apply the lessee accounting model to the leaseback – Measure the ROU asset at the retained portion of the previous carrying amount (i.e. at cost) – Recognise a gain or loss related to the rights transferred to the lessor	– Recognise the underlying asset and apply the lessor accounting model to the leaseback
Transfer to buyer-lessor is not a sale	– Continue to recognise the underlying asset – Recognise a financial liability under IFRS 9 for any amount received from the buyer-lessor	– Do not recognise the underlying asset – Recognise a financial asset under IFRS 9 for any amount paid to the seller-lessee

Before the transaction, the owner has the risks and rewards of ownership. The owner sells the asset and then leases it back under a finance lease. The owner has retained the risks and rewards of ownership. In substance this is not a sale so profit should not be recognised. The accounting treatment is as follows.

There are two stages, the disposal (sale) and the finance leaseback:

- The sale:
  - On disposal, the asset should be removed from the seller's statement of financial position.
  - Any surplus from the sale in excess of the carrying amount should be deferred and amortised over the term (life) of the lease.
  - Any deficit from the sale in shortage of the carrying amount should also be deferred and amortised over the term (life) of the lease. (IFRS 16 does not prescribe any treatment for a loss on such transactions but in practice it is also deferred).
- The leaseback: The normal finance lease rules are then applied, to reintroduce the asset to the statement of financial position of the lessee at its fair value, and to establish a leasing obligation.

Example: Sale and finance leaseback

In 20X6 a company sold an asset and leased it back under a finance lease. The asset had a carrying value of Rs. 70,000 and was sold for its market value of Rs. 120,000.

At the date of sale it had a remaining life of five years and was leased back for the whole of this period at a rental of Rs. 28,000 per annum in arrears.

	Debit	Credit
The sale	Rs.	Rs.
Cash	120,000	
Asset		70,000
Deferred income		50,000
The leaseback		
Asset	120,000	
Lease obligation		120,000

6.3 Sale and operating leaseback (operating lease)

Again, there are two stages to the transaction, the sale and the operating leaseback. The substance and legal form of the transaction are the same. The asset has been sold by the lessee (known as the seller/lessee) and the risks and rewards have been permanently transferred to the lessor as the leaseback is an operating lease in nature.

On sale, the asset should be removed from the seller/lessee's statement of financial position.

- The gain or loss on disposal should be recognised in profit or loss. (See below for details of how the gain is calculated).
- The normal operating lease rules are then applied to account for the rental payments.

IFRS 16 outlines specifies treatments for accounting for the profit or on the sale of the asset, depending on whether the asset was sold for its fair value, for more than fair value or for less than fair value and depending on whether the fair value is less than the carrying amount of the asset that is the subject of the transaction.

Sale at fair value

This is just a normal sale. If an asset is sold at fair value, the gain or loss on disposal is recognised immediately in profit or loss in the usual way.

Example: Sale and operating leaseback – Sale at fair value

In early 20X7 a company sold an asset for Rs. 1.5 million and leased it back under a five-year operating lease.

The asset had a carrying value of Rs. 1 million.

	Debit	Credit
	Rs.	Rs.
Cash	1,500,000	
Asset		1,000,000
Statement of comprehensive income		500,000

Sale at more than fair value (fair value greater that carrying amount)

If an asset is sold at more than fair value, the normal gain or loss on disposal (based on the difference between the carrying amount and fair value) is recognised immediately in profit or loss.

The excess profit (based on the difference between the fair value and actual sale value) should be deferred and released to profit or loss over the expected period of use (the lease period).

Example: Sale and operating leaseback – Sale above fair value

In early 20X7 a company sold an asset for Rs. 1.5 million and leased it back under a five-year operating lease.

The asset had a carrying value of Rs. 1 million and a remaining useful life of ten years.

The fair value of the asset at the date of sale was Rs. 1.2 million.

	Debit	Credit
	Rs.	Rs.
Cash	1,500,000	
Asset		1,000,000
Statement of comprehensive income (Normal profit of Rs. 1.2m – Rs. 1m)		200,000
Cr Deferred income (Excess profit: this is Rs. 1.5m – Rs. 1.2m)		300,000

Note: The deferred income will be released to profit or loss over the lease term of 5 years.

Sale at less than fair value (fair value greater that carrying amount)

If an asset is sold at less than fair value, the gain or loss on disposal is recognised immediately in profit or loss.

However, if the sale makes a loss and this is compensated for by future lease payments at below market price, the loss should not be recognised immediately, but deferred and then released to profit or loss over the expected period of use (the lease period).

Example: Sale and operating leaseback – Sale below fair value

In early 20X7 a company sold an asset for Rs. 1.5 million and leased it back under a five-year operating lease.

The asset had a carrying value of Rs. 2 million and a remaining useful life of ten years.

The fair value of the asset was Rs. 2.1 million.

	Debit	Credit
	Rs.	Rs.
Cash	1,500,000	
Asset		2,000,000
Statement of comprehensive income	500,000	

Example: Sale and operating leaseback – Sale below fair value compensated by lower future rentals

In early 20X7 a company sold an asset for Rs. 1.5 million and leased it back under a five-year operating lease.

The asset had a carrying value of Rs. 2 million and a remaining useful life of ten years.

The fair value of the asset was Rs. 2.1 million.

The company accepted an offer below the fair value of the asset because it was able to negotiate rentals at below the market rate in compensation.

	Debit	Credit
	Rs.	Rs.
Cash	1,500,000	
Asset		2,000,000
Deferred loss (on the statement of financial position)	500,000	

The deferred loss amortised in proportion to the lease payments over the period for which the asset is expected to be used.

In each case above the difference between the fair value of the asset and the carrying amount is not recognised.

Sale where fair value is less than carrying amount

If the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, the difference must be recognised immediately as a loss. This means that the asset is written down to its fair vale before accounting for the sale and operating leaseback. The earlier rules concerning the recognition of a profit or loss on disposal then apply.

This only applies to sale and operating leaseback transactions.

Example: Sale and operating leaseback – Fair value less than carrying amount and sale at more than fair value.

In early 20X7 a company sold an asset for Rs. 1.8 million and leased it back under a five-year operating lease.

The asset had a carrying value of Rs. 2 million and a remaining useful life of ten years.

The fair value of the asset was Rs. 1.7 million.

	Debit	Credit
	Rs.	Rs.
Step 1: Write down the asset:		
Statement of comprehensive income (Rs. 2m – Rs. 1.7m)	300,000	
Asset		300,000
Step 2: Sale and leaseback:		
Cash	1,800,000	
Asset		1,700,000
Cr Deferred income (Excess profit: this is Rs. 1.8m – Rs. 1.7m)		100,000

(Profit is deferred as the sale proceeds are above fair value)

Example: Sale and operating leaseback – Fair value less than carrying amount and sale at less than fair value.

In early 20X7 a company sold an asset for Rs. 1.6 million and leased it back under a five-year operating lease.

The asset had a carrying value of Rs. 2 million and a remaining useful life of ten years.

The fair value of the asset was Rs. 1.7 million.

	Debit	Credit
	Rs.	Rs.
Step 1: Write down the asset:		
Statement of comprehensive income (Rs. 2m – Rs. 1.7m)	300,000	
Asset		300,000
Step 2: Sale and leaseback:		
Cash	1,600,000	
Asset		1,700,000
Statement of comprehensive income	100,000	

(The loss would be deferred if it were compensated by lower future rentals)

6.4 Sub-lease

A sub-lease is a transaction in which a lessee (or 'intermediate lessor') grants a right to use the underlying asset to a third party, and the lease (or 'head lease') between the original lessor and lessee remains in effect.

A company applies IFRS 16 to all leases of right-of-use assets in a sub-lease. The intermediate lessor accounts for the head lease and the sub-lease as two different contracts.

Head Office

↓

Original lessee/intermediate lessor

↓

Sub-lessee

An intermediate lessor classifies the sub-lease as a finance lease or as an operating lease with reference to the right-of-use asset arising from the head lease. That is, the intermediate lessor treats the right-of-use asset as the underlying asset in the sub-lease, not the item of property, plant or equipment that it leases from the head lessor.

At the commencement date of the sub-lease, if the intermediate lessor cannot readily determine the rate implicit in the sub-lease, then it uses the discount rate that it uses for the head lease to account for the sub-lease, adjusted for any initial direct costs associated with the sub-lease.

However, if the head lease is a short-term lease for which the company, as a lessee, has elected the short-term lease exemption, then as an intermediate lessor the company classifies the sub-lease as an operating lease.

Example – Sub-lease classified as a finance lease with reference to the right-of-use asset in the head lease

Head lease: Intermediate lessor L enters into a five-year lease for 5,000 million of office space (the head lease) with Company M (the head lessor).

Sub-lease: At the beginning of Year 3, L sub-leases the 5,000 M of office space for the remaining three years of the head lease to Sub-lessee N.office

L classifies the sub-lease with reference to the right-of-use asset arising from the head lease. Because the sub-lease is for the whole of the remaining term of the head lease – i.e. the sub-lease is for the major part of the useful life of the right-of-use asset – L classifies it as a finance lease.

At the commencement date of the sub-lease, L:

- derecognises the right-of-use asset relating to the head lease that it transfers to N and recognises the net investment in the sub-lease;
- recognises any difference between the carrying amounts of the right-of-use asset and the net investment in the sub-lease in profit or loss; and
- continues to recognise the lease liability relating to the head lease, which represents the lease payments owed to the head lessor.

During the term of the sub-lease, L recognises both interest income on the sublease and interest expense on the head lease.

7 IMPACT ON PRESENTATION

Section overview

- The effect of classifying a lease incorrectly

7.1 The effect of classifying a lease incorrectly

If a finance lease is treated as an operating lease, the financial statements do not fairly present the financial position of the entity:

- The leased asset is not recognised in the statement of financial position, even though the substance of the lease is that the entity owns it.
- The liability for the lease payments is not recognised in the statement of financial position.

Therefore both assets and liabilities are understated. The lease becomes a form of 'off balance sheet finance', hidden from the users of the financial statements. The entity's (lessee's) liabilities can appear to be much lower than they actually are.

Classifying a lease incorrectly affects the numbers in the financial statements.

An example seen earlier in the chapter is used to illustrate this.

Example:

The fair value of a leased asset, commencing on 1 January Year 1 is Rs. 12,886.

The lease is for three years with payments of Rs. 5,000 annually in arrears on 31 December Year 1, Year 2 and Year 3. The interest rate implicit in the lease is 8%.

Lease liability (given again for your convenience)

Year	Opening balance	Interest (8%)	Lease payment	Closing balance
1	12,886	1,031	(5,000)	8,917
2	8,917	713	(5,000)	4,630
3	4,630	370	(5,000)	–
		2,114		

The numbers that would appear in the financial statements for year 1 if the lease were treated as finance lease or as an operating lease are shown below:

Statement of financial position	**Finance lease**	**Operating lease**
Non-current asset	**Rs.**	
Leased Asset [(12,886 – (1/3 of 12,866= 4,289)]	8,597	–

Example:

The fair value of a leased asset, commencing on 1 January Year 1 is Rs. 12,886.

The lease is for three years with payments of Rs. 5,000 annually in arrears on 31 December Year 1, Year 2 and Year 3. The interest rate implicit in the lease is 8%.

Lease liability (given again for your convenience)

Liability:	**Rs.**	
Non-current liability	4,630	–
Current liability	4,287	–
Total liability	8,917	–

Statement of comprehensive income		
Depreciation charge (1/3 of 12,866)	4,289	–
Finance charge	1,013	–
Rental	–	5,000
	5,302	5,000

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

The lease is a finance lease.

Reasons

The lease is for a major part of the life of the asset (6 out of 7 years).

Jhang Construction must ensure the asset. It is exposed to one of the major risks of ownership of the asset (its loss).

The present value of the lease payments is 95.3% ($4.767 \times 600{,}000 / 3{,}000{,}000$) of the fair value of the asset at the inception of the lease.

Solution **2**

	Rs.
Total lease payments (3 × Rs. 4,021)	12,063
Minus: Cash price of the asset	(10,000)
Total finance charge	2,063

Actuarial method

Year ended 31 December	Opening balance	Lease payment	Capital outstanding	Interest at 22.25%	Closing balance
	Rs.	Rs.	Rs.	Rs.	Rs.
Year 1	10,000	(4,021)	5,979	1,330	7,309
Year 2	7,309	(4,021)	3,288	733	4,021
Year 3	4,021	(4,021)	–	–	–

The year-end liability at the end of Year 1 is Rs. 7,309 in total.

- The non-current liability is the liability at the start of the next year after deducting the first payment (Rs. 3,288).
- The current liability is the payment in year 2 less any interest contained in it that has not yet accrued.

	Rs.
Current liability, end of Year 1	4,021*
Non-current liability, end of Year 1	3,288
Total liability, end of Year 1	7,309

* 4,021 can be divided into 1,330 of interest payable and 2691 of principal payable

CHAPTER 12

IAS 37: Provisions, contingent liabilities and contingent assets

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 28 IAS 37: Provisions, contingent liabilities and contingent assets

B (a) 36 IFRIC 5: Rights to interests arising from decommissioning, restoration and environmental rehabilitation funds

B (a) 37 IFRIC 6: Liabilities arising from participating in a specific market – waste electrical and electronic equipment

B (a) 49 IFRIC 21: Levies

1 PROVISIONS: RECOGNITION

Section overview

- Introduction
- Recognition criteria for provisions
- Present obligation
- Obligation arising out of a past event
- Probable outflow of economic benefits

1.1 Introduction

The first five sections of this chapter explain rules set out in *IAS 37: Provisions, contingent liabilities and contingent assets*.

Definitions

Provisions are liabilities of uncertain timing or amount.

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

An obligating event is an event that creates a legal or constructive obligation that results in an enterprise having no realistic alternative to settling that obligation.

Provisions differ from other liabilities because there is uncertainty about the timing or amount of the future cash flows required to settle the liability.

Accruals are liabilities to pay for goods or services that have been received or supplied but not yet invoiced. There is often a degree of estimation in the measurement of accruals but any inherent uncertainty is much less than for provisions.

IAS 37 applies to all provisions and contingencies apart from those covered by the specific requirements of other standards.

In some countries the term "provision" is also used to describe the reduction in the value of an asset. For example accountants might talk of provision for depreciation, provision for doubtful debts and so on. These "provisions" are not covered by this standard which is only about provisions that are liabilities.

Major accounting issues

There are three issues to address in accounting for provisions:

- ❑ whether or not a provision should be recognised;
- ❑ how to measure a provision that is recognised; and
- ❑ what is the double entry on initial recognition of a provision and how is it remeasured on subsequent reporting dates.

1.2 Recognition criteria for provisions

A provision should be recognised when:

- ❑ a company has a present obligation (legal or constructive) as a result of a past event;

- it is probable that an outflow of economic benefits will be required to settle the obligation; and
- a reliable estimate can be made of the amount of the obligation.

If any of these conditions is not met then a provision cannot be recognised.

1.3 Present obligation

An obligation must exist in order for a provision to be recognised.

An obligation may be legal or constructive.

- A **legal obligation** is one arising from a contract, or some other aspect of the law.
- A **constructive obligation** is one arising from the company's actions, whereby
  - through established past practice, published policies, or a specific current statement, the company has indicated to other parties that it will accept certain responsibilities; and
  - as a result, the company has created a valid expectation that it will discharge those responsibilities.

Example: Constructive obligation

A clothing retailer has a policy of taking back items of clothing that customers have purchased, and refunding the purchase price, simply because the purchaser has changed his or her mind about the item.

The retailer does not have a legal obligation to do this under the consumer protection legislation that applies in the jurisdiction in which it operates.

If this is the usual practice of a particular retailer, and the retailer's policy is well-known or has been made known to customers, then a constructive obligation exists whenever a sale is made.

A provision would be recognised for sales returns subject to the other two criteria being satisfied.

In most cases it will be clear that a past event has given rise to a present obligation. However, in rare cases this may not be the case. In these cases, the past event is deemed to give rise to a present obligation if it is more likely than not that a present obligation exists at the end of the reporting period. This determination must be based on all available evidence,

1.4 Obligation arising out of a past event

A past event that leads to a present obligation is called an obligating event. For this to be the case it is necessary that the company has no realistic alternative to settling the obligation created by the event.

This is the case only:

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

The event leading to the obligation must be **past**, and must have occurred before the end of the reporting period when the provision is first recognised. No provision is made for costs that may be incurred in the future but where no obligation yet exists.

Illustration:

A company is planning a reorganisation. These plans are in an early stage.

There is no obligation (legal or constructive) to undertake the reorganisation. The company cannot create a provision for reorganisation costs.

Only obligations arising from past events that exist independently of a company's future actions are recognised as provisions.

Example:

Shan Properties owns a series of high rise modern office blocks in several major cities in Pakistan.

The government introduces legislation that requires toughened safety glass to be fitted in all windows on floors above the ground floor. The legislation only applies initially to new buildings but all buildings will have to comply within 5 years.

Analysis:

There is no obligating event.

Even though Shan Properties will have to comply within 5 years it can avoid the future expenditure by its future actions, for example by selling the buildings. There is no present obligation for that future expenditure and no provision is recognised.

Example:

Jhang Energy Company operates in a country where there is no environmental legislation. Its operations cause pollution in this country.

Jhang Energy Company has a widely published policy in which it undertakes to clean up all contamination that it causes and it has a record of honouring this published policy.

Analysis:

There is an obligating event. Jhang Energy Company has a constructive obligation which will lead to an outflow of resources embodying economic benefits regardless of the future actions of the company. A provision would be recognised for the clean-up subject to the other two criteria being satisfied.

An obligation always involves another party to whom the obligation is owed.

However, it is not necessary to know the identity of that party. It is perfectly possible to have an obligation to the public at large or to a group of people.

Example:

Shekhupura Household Appliances Corporation gives warranties at the time of sale to purchasers of its products. Under the terms of the sale contract the company undertakes to make good any manufacturing defects that become apparent within three years from the date of sale.

In the period it has sold 250,000 appliances and estimates that about 2% will prove faulty.

Analysis:

There is an obligating event being the sale of an item with the promise to repair it as necessary. The fact that Shekhupura Household Appliances Corporation does not know which of its customers will seek repairs in the future is irrelevant to the existence of the obligation.

A provision would be recognised for the future repairs subject to the other two criteria being satisfied.

Note that the estimate that only 2% will be faulty is irrelevant in terms of recognising a provision. However, it would be important when it came to measuring the size of the provisions. This is covered in the next section.

An obligation always involves a commitment to another party. Therefore, a management decision does not give rise to a constructive obligation unless it has been communicated before the end of the reporting period to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the company will discharge its responsibilities.

Example:

On 13 December Kasur Engineering decided to close a factory. The closure will lead to 100 redundancies at a significant cost to the company.

At 31 December no news of this plan had been communicated to the workforce.

Analysis:

There is no obligating event. This will only come into existence when communication of the decision and its consequences are communicated to the workforce.

An event may not give rise to an obligation immediately but may do so at a later date due to a change in circumstances. These include:

- changes in the law; or
- where an act of the company (for example, a sufficiently specific public statement) gives rise to a constructive obligation.

If details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted or is enacted

1.5 Probable outflow of economic benefits

The outflow of benefits must be probable. 'Probable' is defined by IAS 37 as 'more likely than not to occur'.

Illustration:

A company may have given a guarantee but may not expect to have to honour it.

No provision arises because a payment under the guarantee is not probable.

More likely than not implies a greater than 50% chance but be careful to think about this in the right way.

Example:

Shekhupura Household Appliances Corporation gives warranties at the time of sale to purchasers of its products. Under the terms of the sale contract the company undertakes to make good any manufacturing defects that become apparent within three years from the date of sale.

In the period it has sold 250,000 appliances and estimates that about 2% will prove faulty.

Analysis:

The outflow of benefits is probable. It is more likely than not that 2% will be faulty. (In other words there is more than a 50% chance that 2% of items will prove to be faulty).

2 PROVISIONS: MEASUREMENT

Section overview

- Introduction
- Uncertainties
- Time value
- Future events
- Reimbursements

2.1 Introduction

The amount recognised as a provision must be the best estimate, as at the end of the reporting period, of the future expenditure required to settle the obligation. This is the amount that the company would have to pay to settle the obligation at this date. It is the amount that the company would have to pay a third party to take the obligation off its hands.

The estimates of the outcome and financial effect of an obligation are made by management based on judgement and experience of similar transactions and perhaps reports from independent experts.

Risks and uncertainties should be taken into account in reaching the best estimate. Events after the reporting period will provide useful evidence. (Events after the reporting period are dealt with in more detail later.)

2.2 Uncertainties

Uncertainties about the amount to be recognised as a provision are dealt with by various means according to the circumstances.

In measuring a single obligation, the best estimate of the liability may be the most likely outcome. However, other possible outcomes should be considered. If there are other possibilities which are mostly higher or mostly lower than the most likely outcome, then the best estimate will be a higher or lower amount.

Example:

Gujrat Prefabricators Limited (GPL) has won a contract to provide temporary accommodation for workers involved in building a new airport. The contract involves the erection of accommodation blocks on a public park and two years later the removal of the blocks and the reinstatement of the site.

The blocks have been built and it is now GPL's year-end.

GPL estimates that the task of removing the blocks and reinstating the park to its present condition might be complex, resulting in costs with a present value of Rs. 2,000,000, or straightforward, resulting in costs with a present value of Rs. 1,300,000.

GPL estimates that there is a 60% chance of the job being straightforward.

Should a provision be recognised and if so at what value?

Analysis

Should a provision be recognised?

Is there a present obligation as a result of a past event?	**Yes. A present obligation arises due to the existence of a contractual term and the building of the block.**

Is it probable that there will be an outflow of economic benefits to settle the obligation	Yes. This is certain.
Can a reliable estimate be made of the amount of the obligation?	Yes. Data is available.

A provision should be recognised.

How should the provision be measured? (What is the best estimate of expenditure required to settle the obligation?)

The most likely outcome is that the job will be straightforward. In this case the provision would be recognised at Rs. 1,300,000.

However there is a significant chance that the job will be complex so perhaps GPL should measure the liability at the higher amount. This may sound a little vague but in practice this comes down to a matter of judgement.

When there is a large population of potential obligations (for example, a provision for multiple claims under guarantees) the obligation should be estimated by calculating an expected value of the cost of the future obligations. This is done by weighting all possible outcomes by their associated probabilities.

Example:

Sahiwal Manufacturing has sold 10,000 units in the year. Sales accrued evenly over the year.

It estimates that for every 100 items sold, 20 will require small repairs at a cost of Rs. 100, 10 will require substantial repairs at a cost of Rs. 400 each and 5 will require major repairs or replacement at a cost of Rs. 800 each.

On average the need for a repair becomes apparent 6 months after a sale.

What is the closing provision?

A provision will be required for the sales in the second six months of the year as presumably the repairs necessary in respect of the sales in the first six months have been completed by the year end.

Sales accrue evenly, therefore, the sales in the second six months are 5,000 units ($^{6}/_{12} \times 10{,}000$).

Repair	Number	Cost per repair (Rs.)	Total (Rs.)
Small	20% × 5,000 = 1,000	100	100,000
Substantial	10% × 5,000 = 500	400	200,000
Major	5% × 5,000 = 250	800	200,000
Provision			500,000

Note that this would be reduced by the repairs already made by the year end

2.3 Time value

Where the effect of the time value of money is material, a provision is measured at the present value of the expenditures expected to be required to settle the obligation.

The discount rate used should be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability.

The need to discount is often found when accounting for decommissioning liabilities. These are discussed in section 4.4.

Example:

Gujrat Prefabricators Limited (GPL) has won a contract to provide temporary accommodation for workers involved in building a new airport. The contract involves the erection of accommodation blocks on a public park and two years later the removal of the blocks and the reinstatement of the site.

The blocks have been built and it is now 31 December 2015 (GPL's year-end).

GPL estimates that in two years it will have to pay Rs. 2,000,000 to remove the blocks and reinstate the site.

The pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the liability is 10%.

The provision that should be recognised at 31 December 2015 is as follows:

$$\text{Rs. } 2{,}000{,}000 \times \frac{1}{(1.1)^2} = \text{Rs. } 1{,}652{,}893$$

2.4 Future events

Expected future events may be important in measuring provisions. For example, a company may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology.

The measurement of an obligation must take expected future changes into account where there is sufficient objective evidence that they will occur. In such cases the measurement of the provision should be based on the reasonable expectations of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up.

This means that a company might include expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out.

One future event might be the effect of possible new legislation.

The measurement process should take this into account when there is sufficient objective evidence that the legislation is virtually certain to be enacted.

In practice, the proceeds of the sale of an asset in the future might be used to pay for an event for which a provision is recognised today. However, gains from the expected disposal of assets must not be taken into account in measuring a provision.

2.5 Reimbursements

In some cases, a part or all of a company's provision may be recoverable from a third party. For example, a company paying out to a customer under the terms of a guarantee may itself be able to claim money back from one of its own suppliers.

IAS 37 requires that such a reimbursement:

- should only be recognised where receipt is virtually certain; and
- should be treated as a separate asset in the statement of financial position (i.e. not netted off against the provision) at an amount no greater than that of the provision.

However, IAS 37 allows the expense relating to a provision to be presented net of the amount recognised for a reimbursement in the statement of comprehensive income.

3 PROVISIONS: DOUBLE ENTRY AND DISCLOSURES

Section overview

- Introduction
- Measurement on initial recognition
- Use of provisions
- Subsequent measurement
- Disclosures about provisions

3.1 Introduction

IAS 37 is about the recognition and measurement of provisions which are of course a credit balance. It gives little guidance on the recognition of the debit entry on initial recognition of a provision saying that whether an expense or asset is recognised is left to guidance in other standards.

3.2 Measurement on initial recognition

In most cases the debit entry that arises when a provision is recognised is an expense. There is one important case where it is capitalised as an asset (on recognition of a decommissioning liability) and this is discussed later.

Illustration: Usual double entry on initial recognition of a provision

	Debit	Credit
Profit or loss (expense)	X	
Provision		X

3.3 Use of provisions

A provision is set up to recognise an expense (usually) that exists at the reporting date. When the expense is paid the following double entry is used:

Illustration: Using a provision.

	Debit	Credit
Provision	X	
Cash		X

If the provision is more than the amount needed to settle the liability the balance is released as a credit back through the income statement.

If the provision is insufficient to settle the liability an extra expense is recognised.

IAS 37 also states that a provision may be used only for expenditures for which the provision was originally recognised.

Example: Use of provisions

A company has created a provision of Rs. 300,000 for the cost of warranties and guarantees.

The company now finds that it will probably have to pay Rs. 250,000 to settle a legal dispute.

It cannot use the warranties provision for the costs of the legal dispute. An extra Rs. 250,000 expense must be recognised.

3.4 Subsequent measurement

Each provision must be reviewed at the end of each reporting period. This might result in derecognition of a provision that no longer meets the recognition criteria or in the re-measurement of a provision. An increase in a provision would result in the recognition of a further expense or a reduction in expense as the previously recognised provision is reduced through a credit to profit or loss.

Illustration: Subsequent re-measurement of provisions.

	Debit	Credit
Derecognition of a provision that is no longer needed.		
Provision	X	
Income statement		X
Increase in a provision:		
Profit or loss (expense)	X	
Provision		X
Decrease in a provision:		
Provision	X	
Profit or loss		X

Example: Subsequent measurement

31 December 2014

A company was sued by a customer in the year ended 31 December 2014.

Legal advice is that the customer is virtually certain to win the case as several similar cases have already been decided in the favour of the injured parties.

At 31 December 2014, the company's lawyer was of the opinion that, the cost of the settlement would be Rs. 1,000,000.

A provision is recognised in the amount of Rs. 1,000,000 as follows (reducing profit for the year by that amount).

	Debit (Rs.)	Credit (Rs.)
Expenses	1,000,000	
Provision		1,000,000

31 December 2015

The claim has still not been settled. The lawyer now advises that the claim will probably be settled in the customer's favour at Rs. 1,200,000.

The provision is increased to Rs. 1,200,000 as follows.

	Debit (Rs.)	Credit (Rs.)
Expenses	200,000	
Provision		200,000

31 December 2016

The claim has still not been settled. The lawyer now believes that the claim will be settled at Rs. 900,000.

The provision is reduced to Rs. 900,000 as follows.

	Debit (Rs.)	Credit (Rs.)
Provision	300,000	
Expenses		300,000

The reduction in the provision increases profit in the year and the provision in the statement of financial position is adjusted down to the revised estimate of Rs. 900,000.

31 December 2016

The claim is settled for Rs. 950,000. On settlement, the double entry in the ledger accounts will be:

	Debit (Rs.)	Credit (Rs.)
Expenses	50,000	
Provision	900,000	
Cash		950,000

The charge against profit on settlement of the legal claim is Rs. 50,000.

The provision no longer exists. The total amount charged against profit over the four years was the final settlement figure of Rs. 950,000.

When a provision is included in the statement of financial position at a discounted value (at present value) the amount of the provision will increase over time, to reflect the passage of time. In other words, as time passes the amount of the discount gets smaller, so the reported provision increases. This increase in value is included in **borrowing costs** for the period.

3.5 Disclosures about provisions

IAS 37 requires the following disclosures about provisions in notes to the financial statements.

For each class of provision:

- the opening and closing balances and movements in the provision during the year;
- a brief description of:
  - the nature of the obligation;
  - the expected timing of any settlement; and
  - an indication of the uncertainties surrounding the amount and timing of any settlement.

4 GUIDANCE ON SPECIFIC PROVISIONS

Section overview

- Onerous contracts
- Future operating losses
- Restructuring
- Decommissioning liabilities and similar provisions
- Future repairs to assets

IAS 37 explains how its rules apply in given circumstances. Some of the guidance is in the body of the standard and some in an appendix to the standard.

4.1 Onerous contracts

Definition

An onerous contract is a contract where the unavoidable costs of fulfilling/completing the contract now exceed the benefits to be received (the contract revenue).

A provision should be made for the additional unavoidable costs of an onerous contract. (The 'additional unavoidable costs' are the amount by which costs that cannot be avoided are expected to exceed the benefits).

The example in IAS 37 relates to an operating lease.

Example: Onerous contract

On 31 December 2015, Company H is half way through an eight year operating lease on its factory when it moves to a new factory due to an expansion of demand for its products.

It cannot cancel the lease or sub-let the factory and there is no prospect of being able to sub-let it.

Annual lease payments are Rs. 60,000.

Analysis

A present legal obligation exists as a result of a past event (the signing of the lease).

An outflow of resources is probable. (These are the rentals for the remainder of the term of the lease, which cannot be avoided.)

The amount can be measured reliably (Rs. 60,000 × 4 years, discounted to a present value).

The discounted value of the future lease payments for four years may therefore be recognised as a provision.

Other circumstances that might lead to the recognition of a provision in respect of an onerous contract relate to supply contracts.

Example: Onerous contract

Nawabasha Clothing has a contract to buy 300 metres of silk from a supplier each month for Rs. 3,000 per metre.

Nawabasha Clothing had a contract with a Dubai retailer to sell each dress for Rs. 5,000 only. The retailer has fallen into administration and the administrators have cancelled the contract, as they were entitled to do this under one of its clauses.

Nawabasha Clothing cannot sell the dresses to any other customer.

The contract to buy the silk can be cancelled with three months' notice.

Analysis

The company can cancel the contract but must pay for the next three months deliveries:

Cost (300m × Rs. 3,000 × 3 months)	Rs. 2,700,000

A provision should be recognised for this amount.

4.2 Future operating losses

A company may forecast that it will make a substantial operating loss in the next year or several years. If so, its directors might want to take all the bad news immediately, and create a provision for the future losses.

Provisions cannot be made for future operating losses. This is because they arise from future events, not past events.

4.3 Restructuring

A company may plan to restructure a significant part of its operations. Examples of restructuring are:

- the sale or termination of a line of business
- the closure of business operations in a country or geographical region, or relocation of operations from one region or country to another
- major changes in management structure, such as the removal of an entire 'layer' of management from the management hierarchy
- fundamental reorganisations changing the nature and focus of the company's operations.

A provision is recognised for the future restructuring costs only if a present obligation exists.

A constructive obligation to restructure arises only when a company:

- has a detailed formal plan for the restructuring identifying at least:
  - the business or part of a business concerned;
  - the principal locations affected;
  - the location, function, and approximate number of employees who will be compensated for terminating their services;
  - the expenditures that will be undertaken; and
  - when the plan will be implemented; and

- has 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.

A restructuring decision made before the end of the reporting period does not give rise to a constructive obligation unless the company has:

- started to implement the plan; or
- announced the main features of the plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the restructuring will occur.

A company might start to implement a restructuring plan, or announces its main features to those affected, after the reporting period but before the financial statements are authorised for issue.

Disclosure is required *under IAS 10 Events after the Reporting Period* if the restructuring is material.

A restructuring provision must only include the direct expenditures arising from the restructuring. These are those that are both:

- necessarily entailed by the restructuring; and
- not associated with the ongoing activities of the company.

A restructuring provision would not include costs that are associated with ongoing activities such as:

- retraining or relocating continuing staff;
- marketing; or
- investment in new systems etc.

4.4 Decommissioning liabilities and similar provisions

A company may be required to 'clean up' a location where it has been working when production ceases.

This is often the case in industries where companies are only granted licenses to operate on condition that they undertake to perform future clean-up operations.

Such industries include, oil and gas, mining and nuclear power.

For example, a company that operates an oil rig may have to repair the damage it has caused to the sea bed once the oil has all been extracted.

The normal rules apply for the recognition of a provision: a company recognises a provision only where it has an obligation to rectify environmental damage as a result of a past event.

A company has an obligation to 'clean-up' a site if:

- it is required to do so by law (a legal obligation); or
- its actions have created a constructive obligation to do so.

A constructive obligation might exist if (for example) a company has actually promised to decontaminate a site or if it has adopted environmentally friendly policies and has made the public aware of this.

Accounting for a provision for a decommissioning liability

IAS 16 Property, plant and equipment identifies the initial estimate of the costs of dismantling and removing an item and restoring the site upon which it is located as part of the cost of an asset.

Future clean-up costs often occur many years in the future so any provision recognised is usually discounted to its present value.

Illustration: Initial recognition of a provision for a decommissioning liability

	Debit	Credit
Non-current asset	X	
Provision		X

The asset is depreciated over its useful life in the same way as other non-current assets.

The provision is remeasured at each reporting date. If there has been no change in the estimates (i.e. the future cash cost, the timing of the expenditure and the discount rate) the provision will increase each year because the payment of the cash becomes one year closer. This increase is described as being due to the unwinding of the discount.

The amount due to the unwinding of the discount must be expensed.

Example: Deferred consideration

A company has constructed an oil rig which became operational on 1 January 2015.

The company has contracted to remove the oil rig and all associated infrastructure and to restore the site to repair any environmental damage to the site on completion of drilling activity. This is estimated to be at a cost of Rs. 8,000,000 in 10 years' time.

The pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability is 10%.

1 January 2015 – Initial measurement

$$\text{Rs. } 8{,}000{,}000 \times \frac{1}{(1.1)^{10}} = \text{Rs. } 3{,}084{,}346$$

	Debit	Credit
Asset	3,084,346	
Provision		3,084,346

31 December 2015

The provision is remeasured as:

$$\text{Rs. } 8{,}000{,}000 \times \frac{1}{(1.1)^{9}} = \text{Rs. } 3{,}392{,}781$$

Provision:	Rs.
Balance b/f	3,084,346
Interest expense (the unwinding of the discount)	308,435
Balance c/f	3,392,781

The asset is depreciated (say on a straight line)

Asset:	Rs.

Cost		8,000,000
Depreciation ($^{Rs.8,000,000}/_{10\ years}$)		(800,000)
Carrying amount		7,200,000

Double entry:

	Debit	Credit
Profit or loss (interest expense)	308,435	
Provision		308,435
Profit or loss (depreciation expense)	800,000	
Accumulated depreciation		800,000

A provision for making good environmental damage might be recognised both on when an asset is installed and then increased as the asset is used.

Example:

A company is about to begin to operate a coal mine. At the end of the reporting period, the mineshaft has been prepared and all the necessary equipment has been constructed and is in place, but no coal has yet been extracted.

Under local law, the company is obliged to rectify all damage to the site once the mining operation has been completed (this is expected to be several years from now).

Management estimates that 20% of the eventual costs of performing this work will relate to plugging the mine and removing the equipment and various buildings and the remaining 80% will relate to restoring the damage caused by the actual extraction of coal.

Analysis

The company has a legal obligation to rectify the environmental damage caused by the actual digging of the mineshaft and construction of the site. An outflow of economic benefits is probable.

Therefore the company should recognise a provision for the best estimate of removing the equipment and rectifying other damage which has occurred to date. This is expected to be about 20% of the total cost of restoring the site.

Because no coal has yet been extracted, the company has no obligation to rectify any damage caused by mining. No provision can be recognised for this part of the expenditure (estimated at about 80% of the total).

4.5 Future repairs to assets

Some assets need to be repaired or to have parts replaced at intervals during their lives.

For example, suppose that a furnace has a lining that has to be replaced every five years. If the lining is not replaced, the furnace will break down.

Before IAS 37 was issued, companies would often recognise provisions for the cost of future repairs or replacement parts. These might be built up in instalments over the life of the asset or the relevant part of the asset.

IAS 37 effectively prohibits this treatment. The reasoning behind this is that a company almost always has an alternative to incurring the expenditure, even if it is required by law (for example, for safety reasons). For example, the company

which has to replace the lining of its furnace could sell the furnace or stop using it, although this is unlikely in practice.

IAS 37 states that a provision cannot be recognised for the cost of future repairs or replacement parts unless the company has an obligation to incur the expenditure, which is unlikely. The obligating event is normally the actual repair or purchase of the replacement part.

Instead of recognising a provision, a company should capitalise expenditure incurred on replacement of an asset and depreciate this cost over its useful life. This is the period until the part needs to be replaced again. For example, the cost of replacing the furnace lining should be capitalised, so that the furnace lining is a non-current asset; the cost should then be depreciated over five years. (Note: *IAS 16: Property, plant and equipment* states that where an asset has two or more parts with different useful lives, each part should be depreciated separately.)

Normal repair costs, however, are expenses that should be included in profit or loss as incurred.

5 INTERPRETATIONS

Section overview

- IFRIC 21: Levies
- IFRIC 5: rights to interests arising from decommissioning, restoration and environmental rehabilitation funds
- IFRIC 6: Liabilities arising from participating in a specific market: waste electrical and electronic equipment

5.1 IFRIC 21: Levies

Background

A public authority (national/regional/local government and their agencies) may impose a levy on entities that operate in a specific market.

IFRIC 21 provides guidance on the recognition of such liabilities under IAS 37

Scope

IFRIC 21 provides guidance on the accounting for levies recognised in accordance with the definition of a liability provided in IAS 37 (even allowing for the fact the amount may be certain).

Typical characteristics of levies within scope of this interpretation include the following:

- ❑ they require a transfer of resources to a public authority in accordance with law/regulations (e.g. money);;
- ❑ they are paid by entities that operate in a specific market identified by the legislation (e.g. the entity is a bank);
- ❑ they are non-exchange transactions (i.e. the paying entity receives no goods/asset in exchange);
- ❑ they are triggered when a specific activity occurs (e.g. the entity operates as a retail bank) or threshold is passed;
- ❑ the amount is calculated based on current or preceding period data (e.g. gross revenues).

The following transactions are not within the scope of this interpretation:

- ❑ taxes under IAS 12;
- ❑ fines/penalties for breaching legislation; and
- ❑ contracts between a public authority and a private entity
- ❑ liabilities arising under emissions trading schemes

Issues

IFRIC 21 addresses the following issues:

- ❑ What constitutes the obligating event for the recognition of a levy liability?
- ❑ Does the economic compulsion to continue to operate in a future period create a constructive obligation to pay a levy that will arise from operating in that future period?

- Does the going concern principle imply the need for a discounted present value obligation for future operating?
- Can the liability arise at a point in time, or over time?
- What is the obligating event when the liability is triggered by exceeding a minimum threshold?
- How should the demand for interim reporting affect the accounting – deferral or anticipation?

Consensus

The obligating event is the activity that triggers the payment of the levy as defined in the legislation. For example, the obligating event may be "the generation of revenue from signing customers to an insurance contract".

Even though the obligating event may be the generation of revenue in the current period from the "prescribed activity", the amount may be calculated by reference to revenue generated in the previous period.

An entity does not have a constructive obligation to pay a levy that will arise in a future period as a result of being economically compelled to operate in that period.

The going concern principle does not imply that an entity has a present obligation to continue to operate in the future and therefore does not lead to the entity recognising a liability at a reporting date for levies that will arise in a future period (discounted or not!).

The liability is recognised progressively if the obligating event occurs over time. For example, the liability to pay a levy from banking activity is based on the revenue earned over time from that activity. However, if the obligating event is "earning revenue from banking on 31 December 2016", then the liability is recognised at that instant based on the fact that the prescribed activity was going on at 31 Dec 2016

If an obligation to pay is triggered by the passing of a threshold, then the obligating event is the passing of that threshold (for example a minimum activity threshold such as revenue or output produced)

The other side of the double entry for the recognition of a liability is typically to expenses, but an asset might be recognised if an entity prepays the liability before it has a present obligation.

The same recognition principle is applied to interim reporting. There is no:

- anticipation of the liability/expense if there is no obligating event at the end of the interim period; or
- deferral if a present obligation exists at the end of the interim period

5.2 IFRIC 5: Rights to interests arising from decommissioning, restoration and environmental rehabilitation funds

Background

An entity facing future decommissioning cost might segregate assets to fund this cost.

Contributions to these funds may be voluntary or required by regulation or law.

The funds may be established by a single contributor to fund its own decommissioning obligations or by multiple contributors to fund their individual or joint decommissioning obligations.

Contributors retain the obligation to pay decommissioning costs but are able to obtain reimbursement of the costs from the fund.

Typical features of decommissioning funds include the following:

- they are separately administered by independent trustees;
- contributions to the fund are invested to help pay decommissioning costs of contributors; and
- contributors may have restricted access (if any) to any fund surplus

Scope

IFRIC 5 applies to accounting by a contributor for interests arising from decommissioning funds that have both of the following features:

- the assets are administered separately (either by being held in a separate legal entity or as segregated assets within another entity); and
- a contributor's right to access the assets is restricted.

A residual interest in a fund that extends beyond a right to reimbursement may be an equity instrument within the scope of IAS 39 and not IFRIC 5

The issue

The issues are as follows:

- How should a contributor account for its interest in a fund?
- When a contributor has an obligation to make additional contributions (e.g. in the event of the bankruptcy of another contributor) how should that obligation be accounted for?

Consensus: Accounting for an interest in a fund

A contributor must recognise its obligation to pay decommissioning costs as a liability and recognise its interest in the fund separately.

A contributor must determine whether it has control, joint control or significant influence over the fund by reference to IFRS 10 and IFRS 11 and account for any interest accordingly.

Otherwise the interest in the fund is recognised as the right to receive reimbursement (IAS 37) and measured at the lower of:

- the amount of the decommissioning obligation recognised; and
- the contributor's share of the fair value of the net assets of the fund attributable to contributors.

Change in carrying value of this right (other than contributions to and payments from the fund) is recognised in P&L.

Consensus: Obligations to make additional contributions

A contributor may have an obligation to make additional contributions in certain circumstances, e.g.:

- bankruptcy of another contributor; or
- value of fund assets being insufficient to fulfil the fund's reimbursement obligations.

Such an obligation is a contingent liability within the scope of IAS 37.A liability is recognised only if it is probable that additional contributions will be made.

Disclosure

The nature of an interest in a fund and any restrictions on access to its assets must be disclosed.

Also the disclosure requirements of IAS 37 apply when:

- an interest in a fund is accounted for as a right to receive reimbursement; or
- an obligation to make potential additional contributions is not recognised as a liability.

5.3 IFRIC 6: Liabilities arising from participating in a specific market: waste electrical and electronic equipment

Background

This interpretation was written to give guidance on how companies trading in electrical appliances in the European Union should account for a new legal requirement.

The EU Directive on Waste Electrical and Electronic Equipment (WE&EE) requires that the cost of waste management for historical household equipment must be borne by producers of that type of equipment who are in the market during a measurement period. This means that if a person buys a new cooker, the supplier must take the old cooker away and dispose of it.

Each member state must:

- define the measurement period; and
- establish a mechanism for producers to contribute costs proportionately

This will affect the measurement of any obligation

IAS 37 defines an obligating event as a past event that leads to a present obligation that an entity has no realistic alternative to settling. A provision is recognised only for 'obligations arising from past events existing independently of an entity's future actions'.

Although the following rules were written with the EU in mind remember that they would apply to a Pakistani business making supplies in the EU and they would also apply to similar legislation (if enacted) elsewhere.

Scope

IFRIC 6 provides guidance on the recognition of waste management liabilities under the EU directive in respect of sales of historical household equipment

The issue

When should the liability for the decommissioning of WE&EE be recognised?

What constitutes the obligating event for the recognition of WE&EE liability by producers?

- The manufacture or sale of the historical household equipment?
- Participation in the market during the measurement period?
- The incurrence of costs in the performance of waste management activities?

Consensus

No liability arises for waste management costs for household electrical equipment following from manufacture or sale

There is no obligation unless (and until) a market share exists during the measurement period.

The obligating event is participation in the market during the measurement period.

6 CONTINGENT LIABILITIES AND CONTINGENT ASSETS

Section overview

- Definitions
- Recognising contingent liabilities or contingent assets
- Disclosures about contingent liabilities and contingent assets
- Summary: liabilities, provisions, contingent liabilities and contingent assets

6.1 Definitions

'Contingent' means 'dependent on something else happening'.

Contingent liability

A contingent liability is one that does not exist at the reporting date but may do so in the future or it is a liability that exists at the reporting date but cannot be recognised because it fails one of the IAS 37 recognition criteria.

Definition: Contingent liability

A contingent liability is either of the following:

A contingent liability is 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

A contingent liability is a present obligation that arises from past events but is not recognised because it is not probable that an outflow of economic benefits will be required to settle the obligation or the amount of the obligation cannot be measured with sufficient reliability.

IAS 37 makes a distinction between:

- provisions – which are recognised as liabilities (assuming that a reliable estimate can be made) because they are present obligations and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations; and
- contingent liabilities – which are not recognised as liabilities because they are either:
  - possible obligations;
  - present obligations that do not meet the recognition criteria for provisions because either:
    - it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
    - a sufficiently reliable estimate of the amount of the obligation cannot be made).

Example:

Company G is involved in a legal dispute with a customer, who is making a claim against Company G for losses it has suffered as a consequence of a breach of contract.

If Company G's lawyers believe that the likelihood of the claim succeeding is **possible** rather than probable, then the claim should be treated as a contingent liability and not as a provision.

Contingent asset

Definition: Contingent asset

A contingent asset is a possible asset that arises from past events 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.

An example of a contingent asset might be a possible gain arising from an outstanding legal action against a third party. The existence of the asset (the money receivable) will only be confirmed by the outcome of the legal dispute.

6.2 Recognising contingent liabilities or contingent assets

Contingent liabilities and contingent assets **are not recognised** in the financial statements.

In some circumstances, information about the existence of a contingent asset or a contingent liability should be **disclosed** in the notes to the financial statements.

- **Contingent liabilities** should be disclosed unless the possibility of any outflow in settlement is remote (the meaning of 'remote' is not defined in IAS 37).
- **Contingent assets** should be **disclosed only if** an inflow in settlement is **probable**. 'Probable' is defined by IAS 37 as 'more likely than not'. (And if an inflow is certain, the item is an actual asset that should be recognised in the statement of financial position.)

6.3 Disclosures about contingent liabilities and contingent assets

Where disclosure of a contingent liability or a contingent asset is appropriate, the following disclosures are required:

- A brief description of the nature of the contingent liability/asset
- Where practicable:
  - an estimate of its financial effect
  - an indication of the uncertainties.
- For contingent liabilities, the possibility of any reimbursement.

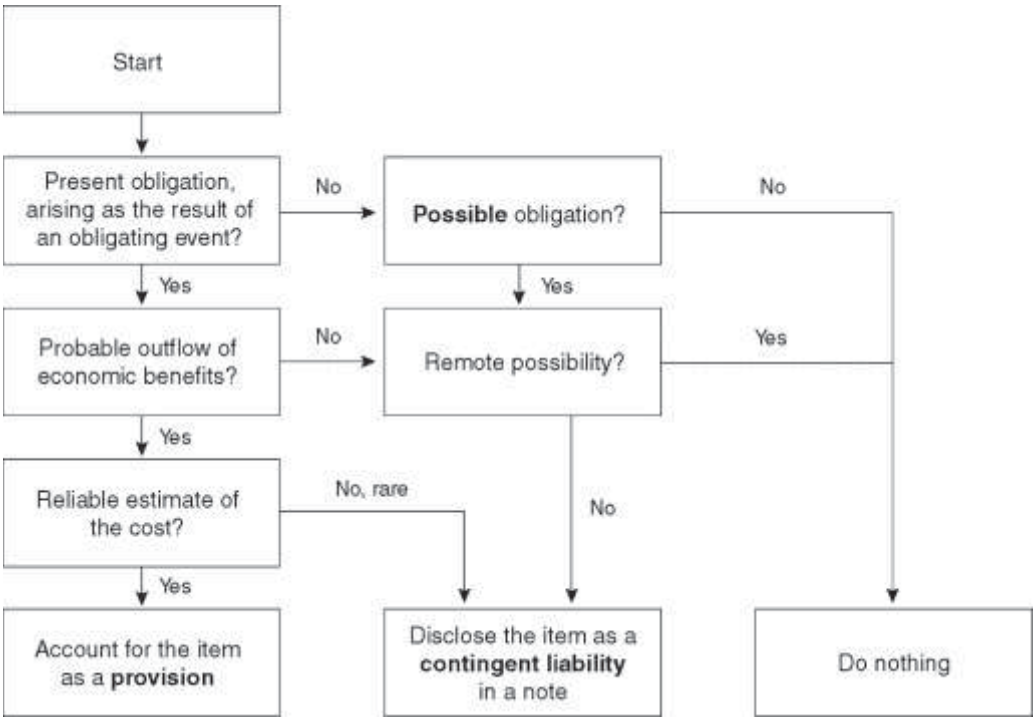
6.4 Summary: liabilities, provisions, contingent liabilities and contingent assets

The following table provides a summary of the rules about whether items should be treated as liabilities, provisions, contingent liabilities or contingent assets.

Criteria	Provision	Contingent liability		Contingent asset
Present obligation/ asset arising from past events?	Yes	Yes	No (but may come into existance in the future)	Only a possible asset
Will settlement result in outflow/ inflow of economic benefits?	Probable outflow – and a reliable estimate **can** be made of the obligation	Not probable outflow – or a reliable estimate **cannot** be made of the obligation	Outflow to be confirmed by uncertain future events	Inflow to be confirmed by uncertain future events
Treatment in the financial statements	Recognise a provision	Disclose as a contingent liability (unless the possibility of outflow is remote)	Disclose as a contingent liability (unless the possibility of outflow is remote)	Only disclose if inflow is probable

Decision tree

An Appendix to IAS 37 includes a decision tree, showing the rules for deciding whether an item should be recognised as a provision, reported as a contingent liability, or not reported at all in the financial statements.



Practice question **1**

Sahiwal Transformers Ltd (STL) is organised into several divisions.

The following events relate to the year ended 31 December 2015.

1 A number of products are sold with a warranty. At the beginning of the year the provision stood at Rs. 750,000.

A number of claims have been settled during the period for Rs. 400,000.

As at the year-end there were unsettled claims from 150 customers. Experience is that 40% of the claims submitted do not fulfil warranty conditions and can be defended at no cost.

The average cost of settling the other claims will be Rs. 7,000 each.

2 A transformer unit supplied to Rahim Yar Khan District Hospital exploded during the year.

The hospital has initiated legal proceedings for damages of Rs. 10 million against STL.

STL's legal advisors have warned that STL has only a 40% chance of defending the claim successfully. The present value of this claim has been estimated at Rs. 9 million.

The explosion was due to faulty components supplied to STL for inclusion in the transformer. Legal proceedings have been started against the supplier. STL's legal advisors say that STL have a very good chance of winning the case and should receive 40% of the amount that they have to pay to the hospital.

3 On 1 July 2015 STL entered into a two-year, fixed price contract to supply a customer 100 units per month.

The forecast profit per unit was Rs. 1,600 but, due to unforeseen cost increases and production problems, each unit is anticipated to make a loss of Rs. 800.

4 On 1 July 2014 one of STL's divisions has commenced the extraction of minerals in an overseas country. The extraction process causes pollution progressively as the ore is extracted.

There is no environmental clean-up law enacted in the country.

STL made public statements during the licence negotiations that as a responsible company it would restore the environment at the end of the licence.

STL has a licence to operate for 5 years. At the end of five years the cost of cleaning (on the basis of the planned extraction) will be Rs. 5,000,000.

Extraction commenced on 1 July 2015 and is currently at planned levels.

Required

Prepare the provisions and contingencies note for the financial statements for the year ended 31 December 2015, including narrative commentary.

SOLUTION TO PRACTICE QUESTION

Solution: Provisions and contingencies **1**

	Warranty	Legal claim	Onerous contract	Clean-up costs	Total
	Rs. 000	Rs. 000	Rs. 000	Rs. 000	Rs. 000
At 1 January 2015	750	nil	nil	500	1,250
Used in the year	(400)				(400)
Statement of comprehensive income (balance)	280	9,000	1,440	1,000	11,720
At 31 December 2015	630	9,000	1,440	1,500	12,570
	W1		W2	W3	W4

Warranty: The company grants warranties on certain categories of goods. The measurement of the provision is on the company's experience of the likelihood and cost of paying out under the warranty.

Legal claim: The legal claim provision is in respect of a claim made by a customer for damages as a result of faulty equipment supplied by the company. It represents the present value of the amount at which the company's legal advisors believe the claim is likely to be settled.

Onerous contract: The provision for the onerous contract is in respect of a two-year fixed-price contract which the company entered into on 1 July 2015. Due to unforeseen cost increases and production problems, a loss on this contract is now anticipated. The provision is based on the amount of this loss up to the end of the contract.

Clean-up costs: The provision for clean-up costs is in respect of the company's overseas mineral extraction operations.

The company is 18 months into a five year operating licence. The estimated cost of cleaning up the site at the end of the five years is Rs.5,000,000. A provision of Rs.1,000,000 per annum is recognised.

Contingent asset: The company is making a claim against a supplier of components. These components led in part to the legal claim against the company for which a provision has been made above. Legal advice is that this claim is likely to succeed and should amount to around 40% of the total damages (Rs.3.6 million).

W1 Warranty provision: 150 × Rs.7,000 × 60% = Rs.630,000.

W2 Onerous contract: 18 months × 100 units × Rs.800 = Rs.1,440,000.

W3 Clean up costs: Rs.1,000,000 per annum as it is the extraction that causes the cost.

CHAPTER 13

IAS 19: Employee benefits

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 20 IAS 19: Employee benefits

B (a) 42 IFRIC 14: IAS 19 – The limit on a defined benefit asset, minimum funding requirements and their interaction

1 IAS 19: EMPLOYEE BENEFITS

Section overview

- The scope and basic principles of IAS 19
- Short-term employee benefits
- Termination benefits
- Other long term benefits

1.1 The scope and basic principles of IAS 19

Definition

Employee benefits are all forms of consideration given by an entity in exchange for service rendered by employees or for the termination of employment.

A company may reward its employees in ways other than payment of a basic salary. Employers often provide entitlements to paid holidays, or pay an annual cash bonus to some employees, or provide employees with a company car, medical insurance and pension benefits. (Some employees also receive share options under company pension schemes: these are classified as share-based payments.)

IAS 19 provides guidance on accounting for all forms of employee benefits, except for share-based payments. Share-based payments are dealt with by IFRS 2.

IAS 19 sets out rules of accounting and disclosure for:

- short term employee benefits;
  - wages, salaries and social security contributions;
  - paid annual leave and paid sick leave;
  - profit-sharing and bonuses; and
  - non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;
- post-employment benefits, such as the following:
  - retirement benefits (e.g. pensions and lump sum payments on retirement); and
  - other post-employment benefits, such as post-employment life insurance and post-employment medical care;
- other long-term employee benefits, such as the following:
  - long-term paid absences such as long-service leave or sabbatical leave;
  - jubilee or other long-service benefits; and
  - long-term disability benefits; and
- termination benefits.

Accounting principle

The basic principle in IAS 19 is that the cost of providing benefits to employees should be matched with the period during which the employees work to earn the benefits. This principle applies even when the benefits are payable in the future, such as pension benefits.

IAS 19 requires an entity:

- to recognise a liability when an employee has provided a service in exchange for a benefit that will be paid in the future, and
- to recognise an expense when the entity makes use of the service provided by the employee.

The basic double entry may therefore be (depending on the nature of the employee benefits):

- Debit: Employment cost (charged as an expense in the statement of profit or loss)
- Credit: Liability for employee benefits

1.2 Short-term employee benefits

Definition

Short-term employee benefits are employee benefits that expected to be settled wholly within twelve months after the end of the period in which the employee provides the service.

Short-term employee benefits include:

- wages, salaries and social security contributions
- paid annual holiday and paid absences due to sickness
- profit-sharing payments and bonuses
- other benefits not in a monetary form, such as medical insurance, free accommodation in a house or flat owned by the entity and company cars.

The expense must be accounted for on an accruals basis and any unpaid entitlement should be recognised as a short-term liability. Discounting the liability to a present value is not required, because it is payable within 12 months.

Short-term paid absences

Sometimes an entity may pay employees for absence for various reasons. These include holidays, sickness and maternity leave.

Entitlement to paid absences falls into two categories:

- accumulating
  - carried forward for use in future periods if the current period's entitlement is not used in full;
  - expense and liability is recognised when employees render service that increases their entitlement to future paid absences

- measured at the additional amount expected to be paid as a result of the unused entitlement that has accumulated at the end of the reporting period.

❑ non-accumulating.

- unused amounts cannot be carried forward;
- expense and liability is recognised when the absences occur.

Profit-sharing and bonus plans

The expected cost of profit-sharing and bonus payments must be recognised when, and only when:

❑ the entity has a present legal or constructive obligation to make such payments as a result of past events; and

❑ a reliable estimate of the obligation can be made.

A reliable estimate of its legal or constructive obligation under a profit-sharing or bonus plan can be made when, and only when:

❑ the formal terms of the plan contain a formula for determining the amount of the benefit;

❑ the entity determines the amounts to be paid before the financial statements are authorised for issue; or

❑ past practice gives clear evidence of the amount of the entity's constructive obligation.

A present obligation exists when, and only when, the entity has no realistic alternative but to make the payments.

1.3 Termination benefits

Definition

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.

Recognition

An entity must recognise a liability and expense for termination benefits at the earlier of the following dates:

❑ when the entity can no longer withdraw the offer of those benefits; and

❑ when the entity recognises costs for a restructuring within the scope of IAS 37 that involves the payment of termination benefits.

Measurement

Termination benefits are measured in accordance with the nature of the employee benefit, that is to say short term benefits, other long term benefits or post-employment benefits.

1.4 Other long term benefits

Definition

Other long-term employee benefits are all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits.

An entity must recognise a net liability (asset) for any other long term benefit. This is measured as:

- the present value of the obligation for the benefit; less
- the fair value of assets set aside to meet the obligation (if any).

Movements in the amount from one year to the next are recognised in P&L.

2 POST-EMPLOYMENT BENEFITS

Section overview

- Post-employment benefits
- Defined contribution pension plans
- Defined benefit pension plans
- Introduction to accounting for defined benefit pension plans
- Accounting for defined benefit pension plans
- Accounting for defined benefit pension plans – Alternative approach
- Asset ceiling example
- Multi-employer plans

2.1 Post-employment benefits

Definition

Post-employment benefits are employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment.

The most significant post-employment benefit is a retirement pension, but there may also be post-employment life insurance and medical care.

Definition

Post-employment benefit plans are formal or informal arrangements under which an entity provides post-employment benefits for one or more employees.

There are two types of post-employment benefit plan:

- defined contribution plans; and
- defined benefit plans.

Definitions

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.

2.2 Defined contribution pension plans

In a defined contribution pension plan, the employer pays an agreed amount of money ('defined contributions') at regular intervals into a pension fund for the employee. The amount of money that the employer contributes is usually a fixed percentage of the employee's wages or salary (e.g. 5% of the employee's basic salary).

The contributions to the fund are invested to earn a return and increase the value of the fund. When an employee retires, he or she is paid a pension out of the fund. The amount of pension received by the employee is not pre-determined, but depends on the size of the employee's share of the fund at retirement.

As the name 'defined contribution' implies, the company's obligation to pay a pension to the employee is limited to the agreed amounts of contribution. The company is not required to make good any shortfalls if the pension fund does not have enough assets to pay the pension benefits that the employee would like to have. In effect, the employee bears the risk of a poor-performing fund, not the employer.

Accounting treatment: contributions to defined contribution schemes

Accounting for the employer's contributions to a defined contribution scheme is straightforward. Using the accruals concept:

- the contributions payable for the reporting period are charged to profit or loss as an expense (an employee cost) in the statement of profit or loss.
- any unpaid contributions at the end of the year will be shown in the statement of financial position as an accrual/liability and any prepaid contributions will be shown as an asset (a prepayment).

2.3 Defined benefit pension plans

Under a defined benefit plan, the employer guarantees the amount of pension that its employees will receive after they retire. A company might save cash into a separate fund (just as for defined contribution plans) in order to build up an asset that can be used to pay the pensions of employees when they retire. This would be known as a funded plan. If an employer does not save up in this way the plan is described as being unfunded.

The amount that an employee will receive is usually linked to the number of years that he or she has worked for the company, and the size of his/her annual salary at retirement date (or on leaving the company). Defined benefit plans are often known as "final salary schemes"

If there are insufficient funds in the plan to provide employees with the guaranteed pensions then the employer must make up the shortfall. The risk remains with the employer.

Role of an actuary

An actuary is a highly qualified specialist in the financial impact of risk and uncertainty. They advise companies on the conduct of their pension plans.

An actuary will advise the company how much to pay in contributions into the pension plan each year, in order to ensure there are sufficient funds to cover the company's obligation to make the pension payments. This involves making a large number of estimates. For example, the actuary has to estimate the average life expectancy of retired employees, the expected number of years of service that retired employees will have given when they retire, their final salary and the expected returns on investments in the pension fund.

It is very unlikely that the actuary's estimates will be 100% accurate so whenever the value of the pension fund assets and the employer's pension obligations are measured, the company may find that there is a deficit or a surplus.

- When the amount of the employer's future pension obligations is more than the value of the investments in the pension fund, the fund is in deficit.
- When the value of the investments in the pension fund is higher than the value of the employer's obligations to make future pension payments, the fund is in surplus.

When a surplus or deficit occurs an employer might take no action. This would be the case when the company believes that the actuarial assumptions may not be true in the short term but will be true over the long term. Alternatively, the company might decide to eliminate a deficit (not necessarily immediately) by making additional contributions into the fund.

When the fund is in surplus, the employer might stop making contributions into the fund for a period of time (and 'take a pension holiday'). Alternatively, in some jurisdictions the company may withdraw the surplus from the fund for its own benefit though this is not allowed in Pakistan.

2.4 Introduction to accounting for defined benefit pension plans

Pensions are paid by the defined benefit plan which is a separate legal entity from the company. However, the company has the legal obligation to pay the pensions.

The defined benefit plan is a special entity set up in order to handle a large number of complex and long term transactions for the company and to separate the plan's assets from those of the company (the pensions of the employees are protected if the company runs into difficulties).

Statement of financial position

IAS 19 requires that an entity must recognise a defined benefit item (net liability due to a deficit or net asset due to a surplus) in the statement of financial position.

The net defined benefit liability (asset) is the deficit or surplus and is measured as:

- the present value of the defined benefit obligation; less
- the fair value of plan assets (if any).

A surplus in a defined benefit plan is measured at the lower of:

- the surplus in the defined benefit plan; and
- the asset ceiling (which 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).

Definition

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.

The obligation is estimated by an actuary, and is based on actuarial estimates and assumptions. IAS 19 requires that it must be measured using the projected unit credit method (you may need to know this term but do not need to apply it) using a discount rate available on high quality corporate bonds.

Movement for the period

The movements on the defined benefit item are due to:

- ❑ cash contributions to the plan
- ❑ current service cost (to P&L);
- ❑ past service cost (to P&L);
- ❑ gains or loss on settlement (to P&L);
- ❑ net interest (expense or income) (to P&L); and
- ❑ remeasurement (to OCI);

Note that the benefit paid has no effect as it reduces the plan assets and plan obligations by the same amount.

Definitions – Movements recognised through P&L

Definitions

Current service cost is the increase in the present value of the defined benefit obligation resulting from employee service in the current period;

Past service cost is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment (the introduction or withdrawal of, or changes to, a defined benefit plan) or a curtailment (a significant reduction by the entity in the number of employees covered by a plan).

Net interest on the net defined benefit liability (asset) is the change during the period in the net defined benefit liability (asset) that arises from the passage of time.

A settlement is a transaction that eliminates all further legal or constructive obligations for part or all of the benefits provided under a defined benefit plan, other than a payment of benefits to, or on behalf of, employees that is set out in the terms of the plan and included in the actuarial assumptions.

Definitions – Movements recognised through OCI

Definitions

Remeasurements of the net defined benefit liability (asset) comprise:

a. actuarial gains and losses;

b. any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset).

Actuarial gains and losses are changes in the present value of the defined benefit obligation resulting from:

a. experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred); and

b. the effects of changes in actuarial assumptions.

2.5 Accounting for defined benefit pension plans

Step 1

Construct a note to show the net liability (net asset) that is recognised on the face of the statement of financial position. This note should include both amounts for the current year and comparatives.

Illustration: Defined benefit net liability (asset)

	Opening	Closing
Present value of plan obligation	X	X
Fair value of plan assets	X	X
	X	X

This is used to identify the movement on the defined benefit liability (asset) which is journalised at step 2

Step 2

Construct the following journal and enter the movement on the defined benefit liability (asset) and the cash paid to the plan by the company (contributions).

Illustration: Journal

	Debit	Credit
Profit or loss	X	
Other comprehensive income (remeasurement)	X	
Cash (contributions)		X
Defined benefit net liability		X

The above illustration assumes an increase in the liability. This would not be the case in all examples. (In other words, the movement might be a debit or a credit, depending on circumstance).

Step 3

Identify the profit and loss entries. These comprise:

- ❑ current service cost;
- ❑ past service cost (if any);
- ❑ interest (an interest rate applied to the opening net liability (asset); and
- ❑ settlement gain/loss

Enter the total into the journal.

Step 4

Calculate the remeasurement as a balancing figure.

Example: Defined benefit accounting

The following information relates to the defined benefit plan of Company X for the year to 31 December 20X6.

At 1 January 20X6:	**Rs. 000**
Fair value of the plan assets	900
Present value of the plan obligations	1,850
During 20X6:	**Rs. 000**
Current service cost	90
Contributions paid into the plan	150
Benefits paid out by the plan	60
Actuarial assumptions:	
Discount rate	10%
New actuarial valuation at 31 December 20X6:	**Rs. 000**
Fair value of the plan assets	850
Present value of the plan obligations	1,960

Construct a journal to show the movement on the defined benefit account.

Answer: Defined benefit accounting

Step 1: The opening position

	1 January 20X6	31 December 20X6
	Rs. 000	Rs. 000
Present value of plan obligation	1,850	1,960
Fair value of plan assets	(900)	(850)
	950	1,110

Note that the movement on the defined benefit liability is an increase of Rs. 160,000 (1,110,000 – 950,000)

Step 2: Construct the journal and fill in the blanks as far as possible

	Debit	Credit
	Rs. 000	Rs. 000
Profit or loss		
Other comprehensive income (remeasurement)		
Cash (contributions)		150
Defined benefit net liability		160

Step 3: Identify amounts to be recognised in profit or loss

	Rs. 000
Current service cost	90
Interest (10% × Rs. 950,000)	95
	185

Step 4: Complete the journal by calculating the remeasurement as a balancing figure

	Debit	Credit
	Rs. 000	Rs. 000
Profit or loss	185	
Other comprehensive income (remeasurement as a balancing figure)	125	
Cash (contributions)		150
Defined benefit net liability		160
	310	310

2.6 Accounting for defined benefit pension plans – Alternative approach

Steps 1 and 2 are as before. The difference is in the calculation of the remeasurement.

This involves rolling the opening figures forward to the year end. The approach is to calculate what the closing defined benefit net liability (net asset) should be by adjusting the opening defined benefit net liability (asset) by what has happened in the period and by applying the actuarial assumptions.

This balance can then be compared with the actual closing balance and the remeasurement identified as a balancing figure.

This accounting treatment can best be explained using an example:

Example: Defined benefit accounting

The following information relates to the defined benefit plan of Company X for the year to 31 December 20X6.

At 1 January 20X6:	**Rs. 000**
Fair value of the plan assets	900
Present value of the plan obligations	1,850
During 20X6:	**Rs. 000**
Current service cost	90
Contributions paid into the plan	150
Benefits paid out by the plan	60
Actuarial assumptions:	
Discount rate	10%
New actuarial valuation at 31 December 20X6:	**Rs. 000**
Fair value of the plan assets	850
Present value of the plan obligations	1,960

Construct a journal to show the movement on the defined benefit account.

Answer: Defined benefit accounting

Step 1: The opening position (as before)

	1 January 20X6	31 December 20X6
	Rs. 000	Rs. 000
Present value of plan obligation	1,850	1,960
Fair value of plan assets	(900)	(850)
	950	1,110

Step 2: Construct the journal and fill in the blanks as far as possible (as before)

	Debit	Credit
	Rs. 000	Rs. 000
Profit or loss		
Other comprehensive income (remeasurement)		
Cash (contributions)		150
Defined benefit net liability		160

Step 3: Construct a working to identify the movements on the defined benefit net liability (asset)

	Rs. 000
At start of year	(950)
1 Net interest (10% × 950,000)	(95)
2 Contributions paid (given)	150
3 Current service cost (given)	(90)
4 Benefits paid out (given)	0
Expected year end position	(985)
Remeasurement (balancing figure)	(125)
Actual year end position	(1,110)

Step 4: Complete the journal by entering in the profit and loss amounts and the remeasurement from the above working.

	Debit	Credit
	Rs. 000	Rs. 000
Profit or loss (Rs. 95,000 + Rs. 90,000)	185	
Other comprehensive income	125	
Cash (contributions)		150
Defined benefit net liability		160
	310	310

Possible complication

In the above illustration the opening defined benefit net liability (asset) was rolled forward.

IAS 19 requires disclosure of reconciliations of the present value of the defined benefit obligation and the fair value of the defined benefit assets.

This is done by constructing a similar working to that shown in step 3 above but including further columns for both the defined benefit liability and the defined benefit asset.

Example:

Using the facts from the previous example the working would be as follows:

Step 3: Construct a working to identify the movements on the defined benefit net liability (asset)

	Fund position		Company position
	Liability	Assets	Net
	Rs. 000	Rs. 000	Rs. 000
At start of year	(1,850)	900	(950)
1 Interest expense (10% × 1,850,000)	(185)		(185)
1 Interest earned (10% × 900,000)		90	90
1 Net interest (10% × 950,000)			(95)
2 Contributions paid (given)		150	150
3 Current service cost (given)	(90)		(90)
4 Benefits paid out (given)	60	(60)	0
Expected year end position	(2,065)	1,080	(985)
Remeasurement (balancing figure)	105	(230)	(125)
Actual year end position	(1,960)	850	(1,110)

Note, that this explains why the benefits paid do not figure in the double entry. When benefit is paid it reduces both the asset and the liability and in consequence has no impact on the net position.

2.7 Asset ceiling example

IAS 19 requires that an entity must recognise a defined benefit item (net liability due to a deficit or net asset due to a surplus) in the statement of financial position.

The net defined benefit liability (asset) is the deficit or surplus and is measured as:

- the present value of the defined benefit obligation; less
- the fair value of plan assets (if any).

However, if the net item is a surplus it is subject to a test which puts a ceiling on the amount that can be recognised. This is known as the “asset ceiling” test.

A surplus in a defined benefit plan is measured at the lower of:

- the surplus in the defined benefit plan; and
- the asset ceiling (which 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 approach is exactly the same as before except that net defined benefit assets recognised at step 1 must be adjusted downwards to the asset ceiling.

Example: Defined benefit accounting with asset ceiling

The following information relates to the defined benefit plan of Company X for the year to 31 December 20X6.

At 1 January 20X6:	**Rs. 000**
Fair value of the plan assets	1,150
Present value of the plan obligations	1,100
Present value of economic benefits available due to rules in the jurisdiction	40
During 20X6:	**Rs. 000**
Current service cost	125
Contributions paid into the plan	80
Benefits paid out by the plan	130
Actuarial assumptions:	
Discount rate	10%
New actuarial valuation at 31 December 20X6:	**Rs. 000**
Fair value of the plan assets	1,395
Present value of the plan obligations	1,315
Present value of economic benefits available due to rules in the jurisdiction	65

Construct a journal to show the movement on the defined benefit account.

Answer: Defined benefit accounting with asset ceiling

Step 1: The opening position

	1 January 20X6	31 December 20X6
	Rs. 000	Rs. 000
Fair value of plan assets	1,150	1,395
Present value of plan obligation	(1,100)	(1,315)
	50	80
Asset ceiling adjustment (balancing figure)	(10)	(15)
Asset ceiling (PV of economic benefits available	40	65

Note that the movement on the defined benefit asset is an increase of Rs. 25,000 (65,000 – 40,000)

Step 2: Construct the journal and fill in the blanks as far as possible (as before)

	Debit	Credit
	Rs. 000	Rs. 000
Profit or loss		
Other comprehensive income (remeasurement)		
Cash (contributions)		80
Defined benefit net asset	25	

Step 3: Identify amounts to be recognised in profit or loss

	Rs. 000
Current service cost	(125)
Interest credit (10% × 40,000)	4
	121

Step 4: Complete the journal by calculating the remeasurement as a balancing figure

	Debit	Credit
	Rs. 000	Rs. 000
Profit or loss	121	
Other comprehensive income (remeasurement as a balancing figure)		66
Cash (contributions)		80
Defined benefit net asset	25	
	146	146

2.8 Multi-employer plans

Multi-employer plans are defined contribution plans (other than state plans) or defined benefit plans that:

- pool the assets contributed by various entities that are not under common control; and
- use those assets to provide benefits to employees of more than one entity, on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employs the employees.

Any multi-employer plan must be classified as a defined contribution plan or a defined benefit plan.

If an entity participates in a multi-employer defined benefit plan it must account for its proportionate share of the defined benefit obligation, plan assets and cost associated with the plan in the same way as for any other defined benefit plan.

If sufficient information is not available to use defined benefit accounting for a multi-employer defined benefit plan, an entity must account for it as if it were a defined contribution plan.

Group plans

Defined benefit plans that share risks between entities under common control (e.g. a parent and its subsidiaries) are not multi-employer plans.

Any entity participating in a defined benefit plan that shares risks between entities under common control must disclose:

- the contractual agreement or stated policy for charging the net defined benefit cost or the fact that there is no such policy.
- the policy for determining the contribution to be paid by the entity.

3 IFRIC 14: IAS19 – THE LIMIT ON A DEFINED BENEFIT ASSET, MINIMUM FUNDING REQUIREMENTS AND THEIR INTERACTION

Section overview

- IFRIC 14: IAS 19 – The limit on a defined benefit asset, minimum funding requirements and their interaction
- Consensus – Availability of benefits
- Consensus – Impact of minimum funding requirement and future benefits available in the form of refunds
- Consensus – Impact of minimum funding requirement and future benefits available in the form of a reduction in future contributions

3.1 IFRIC 14: IAS 19 – The limit on a defined benefit asset, minimum funding requirements and their interaction

Background

As explained above, IAS 19 limits the measurement of a net defined benefit asset to the lower of the surplus in the defined benefit plan and the asset ceiling (the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan).

However, IAS 19 does not give guidance on when refunds or reductions in future contributions should be regarded as available, particularly when a minimum funding requirement exists.

Minimum funding requirement

The law in a jurisdiction might result in a minimum funding requirement. This is a requirement for a company to make contributions to fund a defined benefit plan.

- The existence of a minimum funding requirement might result in a legal requirement to make a payment to a plan that is an asset according to IAS 19.
- A minimum funding requirement might result in a payment to a plan that would turn a plan deficit into a plan surplus as discussed in IAS 19.

The interaction of a minimum funding requirement and the limit in the IAS 19 asset ceiling test has two possible effects:

- it might restrict the economic benefits available as a reduction in future contributions;
- may give rise to a liability if the contributions required under the minimum funding requirement will not be available to the entity once they have been paid (either as a refund or as a reduction in future contributions). The minimum funding requirement becomes onerous

Issues

The issues addressed by IFRIC 14:

- when refunds or reductions in future contributions should be regarded as available;
- how a minimum funding requirement might affect the availability of reductions in future contributions; and
- when a minimum funding requirement might give rise to a liability

3.2 Consensus – Availability of benefits

An economic benefit (as a refund or reduction in future contributions) is available if the entity can realise it at some point during the life of the plan or when the plan liabilities are settled.

It does not have to be realisable immediately at the reporting date.

Economic benefit available as a refund:

Economic benefit is only available as a refund if a company has an unconditional right to that refund.

An unconditional right to a refund:

- can exist whatever the funding level of a plan at the reporting date; but
- cannot exist subject to occurrence or non-occurrence of one or more uncertain future events not wholly within its control.

Any such right should be measured as the amount of the surplus at the reporting date that the entity has a right to receive as a refund, less any associated costs.

Economic benefit available as a reduction in future contributions:

Economic benefit available as a reduction in future contributions is measured with reference to the amount that the entity would have been required to pay had there been no surplus. This is represented by the future IAS 19 service cost.

There are three situations to consider:

- availability if there is no minimum funding requirement;
- whether the minimum funding requirement may give rise to a liability; and
- availability if there is a minimum funding requirement.

No minimum funding requirement

Where there is no minimum funding requirement the economic benefit available is the lower of:

- the surplus in the plan; and
- the present value of the future service cost to the entity (excluding any part borne by employees) for each year over the shorter of the expected life of the plan and the expected life of the entity

Minimum funding requirement

If an entity has an obligation to pay contributions to cover an existing shortfall (on the minimum funding basis) in respect of services already received, it must determine whether these contributions will be available as a refund or reduction in future contributions after they are paid into the plan.

3.3 Consensus – Impact of minimum funding requirement and future benefits available in the form of refunds

A minimum funding requirement might result in cash being owed to a plan.

Whether a liability should be recognised depends on the recoverability of the amounts that are to be paid.

A liability is recognised for any amounts not available after they are paid into the plan. Any such liability would reduce the net defined benefit asset or increase the net defined benefit liability.

Example: Recognition of liability for a minimum funding requirement

X Limited has a post-employment plan subject to a minimum funding requirement (MFR) as a result of which it has a statutory obligation to contribute Rs. 200m to the plan as at the reporting date.

The plan rules permit a full refund of any surplus to the entity at the end of the life of the plan.

Year-end valuation of the plan is set out below:

	2015 Rs. m
Market value of plan assets	1,200
Present value of plan obligations	(1,100)
Defined benefit asset (before accounting for the MFR in accordance with IFRIC 14).	100
Liability recognised for MFR	nil
Defined benefit net asset	100

The amounts in the plan will be available for refund in the future so there is no need to recognise a liability in respect of the minimum funding requirement.

Example: Recognition of liability for a minimum funding requirement

X Limited has a post-employment plan subject to a minimum funding requirement (MFR) as a result of which it has a statutory obligation to contribute Rs. 200m to the plan as at the reporting date.

The plan rules do not allow the refund of surplus.

Year-end valuation of the plan is set out below:

	2015 Rs. m
Market value of plan assets	1,200
Present value of plan obligations	(1,100)
	100
Adjustment for asset ceiling	(100)
Defined benefit balance (before accounting for the MFR in accordance with IFRIC 14).	nil
Liability recognised for MFR	(200)
Defined benefit net liability	(200)

The amounts in the plan are not available for refund in the future so there a liability in respect of the minimum funding requirement is required.

Example: Recognition of liability for a minimum funding requirement

X Limited has a post-employment plan subject to a minimum funding requirement (MFR) as a result of which it has a statutory obligation to contribute Rs. 200m to the plan as at the reporting date.

The plan rules allow for the refund of 60% of any IAS 19 surplus arising.

Year-end valuation of the plan is set out below:

	2015 Rs. m
Market value of plan assets	1,200
Present value of plan obligations	(1,100)
	100
Adjustment for asset ceiling	(40)
Defined benefit balance (before accounting for the MFR in accordance with IFRIC 14).	60
Liability recognised for MFR	(80)
Defined benefit net liability	(20)

The plan rules allow for a refund of 60% of a surplus. Therefore 40% is not refundable.

X Limited must recognise a liability of Rs. 80m (40% of Rs. 200m). This is netted against the defined benefit asset of Rs. 60m that would have been recognised in the absence of the minimum funding requirements.

The amounts in the plan are not available for refund in the future so a liability in respect of the minimum funding requirement is required.

The impact of paying the MFR amount is as follows:

	2015 Rs. m
Defined benefit net liability	(20)
Asset arising from payment of MFR	200
Defined benefit net asset	180

Payment of the MFR results in a defined benefit net asset of Rs. 180m.

This is 60% of the original asset of Rs. 100m and the cash introduced (Rs. 200m) as a result of the MFR.

A defined benefit net liability (indicating a shortfall) might be turned into a net asset by a minimum funding requirement.

Example: Recognition of liability for a minimum funding requirement

X Limited has a post-employment plan subject to a minimum funding requirement (MFR) as a result of which it has a statutory obligation to contribute Rs. 300m to the plan as at the reporting date.

The plan rules allow for the refund of 60% of any IAS 19 surplus arising.

Year-end valuation of the plan is set out below:

	2015 Rs. m
Market value of plan assets	1,000
Present value of plan obligations	(1,100)
Defined benefit balance (before accounting for the MFR in accordance with IFRIC 14).	(100)
Liability recognised for MFR	(80)
Defined benefit net liability	(180)

Payment of the 300 will change the deficit of 100 into a surplus of 200 of which only 120 (60%) is refundable. Therefore, Rs. 80m (40% of Rs. 200m) must be recognised as a liability resulting in a total defined benefit liability of Rs. 180m.

The impact of paying the MFR amount is as follows:

	2015 Rs. m
Defined benefit net liability	(180)
Asset arising from payment of MFR	300
Defined benefit net asset	120

Payment of the MFR results in a defined benefit net asset of Rs. 120m.

This is 60% of the surplus that will come into existence when the amount is paid.

3.4 Consensus – Impact of minimum funding requirement and future benefits available in the form of a reduction in future contributions

A minimum funding requirement might affect the economic benefit available as a reduction in future contributions.

When this is the case the minimum funding requirement at a given date must be analysed into contributions that are required to cover:

- any existing shortfall for past service on the minimum funding basis; and
- future accrual of benefits.

The economic benefit available as a reduction in future contributions when there is a minimum funding requirement for contributions relating to future service, is the sum of:

- any prepayment that reduces future minimum funding requirement contributions for future service; and
- the estimated future service cost in each period less the estimated minimum funding requirement contributions that would be required for future service in those periods if there were no prepayment as described above.

Example: Recognition of liability for a minimum funding requirement

X Limited has a post-employment plan subject to a minimum funding requirement.

X Limited is required to make contributions over the next three years in respect of an existing shortfall. The present value of these contributions is Rs. 300m.

It is also required to make further minimum funding payments in the future. The present value of the difference between these cash flows and the IAS 19 service costs is Rs. 56m.

Year-end valuation of the plan is set out below:

	2015 Rs. m
Market value of plan assets	1,000
Present value of plan obligations	(1,000)
Defined benefit balance (before accounting for the MFR in accordance with IFRIC 14).	0
Liability recognised for MFR (300 – 56)	(244)
Defined benefit net liability	(244)

The liability for the shortfall is Rs. 300m and this should be recognised as a liability. However, this is reduced by the PV of the economic benefit available in the form of a reduction in future contributions of Rs. 56m.

CHAPTER 14

IFRS 2: Share-based payments

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 3 IFRS 2: Share-based payment

1 INTRODUCTION

Section overview

- Introduction
- Scope
- Types of share-based payments
- Recognition
- Grants of share options to employees: the accounting problem

1.1 Introduction

IFRS *2 Share-based payment* explains the accounting treatment for share-based payment transactions.

Definition

A share-based payment transaction is defined as a transaction in which an entity:

a. **receives goods or services as consideration for equity instruments of the entity, or**

b. **receives goods or services from a supplier by incurring a liability to the supplier for an amount that is based on the entity's share price.**

1.2 Scope

Included in scope

The IFRS applies to share-based payment transactions in which an entity acquires or receives goods or services unless the transaction is specifically excluded from its scope.

Excluded from the scope

Transfers of an entity's equity instruments by its shareholders to parties that have supplied goods or services to the entity when such a transfer is clearly for a purpose other than payment for goods or services supplied (in which case it is within the scope of IFRS 2)

Transactions with an employee (or other party) in their capacity as a shareholder.

Transactions where equity instruments are issued in exchange for control of an acquiree in a business combination.

Share-based payment transactions in which the entity receives or acquires goods or services under a "contract to buy or sell a non-financial item" that is within the scope of IFRS on financial instruments. (IAS 32 *Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*).

1.3 Types of share-based payments

IFRS 2 identifies three types of share-based payment transaction:

- ❑ equity-settled share-based payment transactions
  - where the entity pays for goods or services by issuing equity instruments including both:

- shares; and,
- share options;

- ❑ cash-settled share-based payment transactions
  - where an entity incurs a liability for goods or services and the settlement amount is based on the price (or value) of the entity's shares or other equity instruments.
- ❑ transactions where an entity acquires goods or receives services and either the entity or the supplier can choose payment to be:
  - a cash amount based on the price (or value) of the entity's shares or other equity instruments, or
  - equity instruments of the entity

IFRS 2 uses the generic term ***equity instruments***. In most cases the equity instruments in question are either shares or share options.

IFRS 2 uses the term fair value in a way that differs in some respects from the IFRS 13 definition. When applying IFRS 2, fair value is measured in accordance with the guidance in IFRS 2 not that in IFRS 13.

1.4 Recognition

Goods and services must be recognised when the goods and services are received.

This might result in the recognition of an asset or expense depending on the nature of the transaction. If the goods or services received or acquired in a share-based payment transaction do not qualify for recognition as assets (determined by rules in other standards), they must be recognised as expenses:.

- ❑ if the goods or services are received or acquired through an equity-settled share-based payment transaction the credit entry to match the recognition of the debit is to equity.
- ❑ if the goods or services are received or acquired through a cash-settled share-based payment transaction the credit entry to match the recognition of the debit is to a liability.

1.5 Grants of share options to employees: the accounting problem

The nature of employee share options

Occasionally shares may be used instead of cash to pay suppliers for goods or services. These are described as share-based payments, and until IFRS 2, there was no accounting standard addressing the recognition and measurement of these transactions.

However, the main reason for the publication of IFRS 2 was to introduce rules of accounting for employee share options.

In an employee share option scheme, an employee is given the right to subscribe for new shares in the company at a future date, at a price that is usually fixed when the share options are awarded.

The accounting problem

The award of share options to an employee is a reward for services given by the employee.

- If the employee is rewarded with a cash bonus, the cost of the cash bonus would be included in total employment costs and charged as an expense in the relevant accounting period.
- A problem in the past with accounting for share options was that although share options are a similar type of reward for service, the cost of the options were not charged as an expense in the statement of profit or loss.

An award of share options to an employee is consideration given by the entity to the employee in return for the employee's services. Before IFRS 2 was published this was not accounted for.

As the following sections explain in detail, the IFRS 2 rules on share-based payment result in the recognition of an expense in profit or loss.

Controversy

When the standard was in its development phase, many argued that there was no expense because no cash passes hands. However, IFRS 2 is based on the concept that the expenses represent a consumption of benefit that usually happens to be measured in terms of a cash cost but need not be in all cases.

The IFRS 2 expense represents the consumption of the benefit of the employees' service.

2 EQUITY-SETTLED SHARE-BASED PAYMENT TRANSACTIONS: MEASUREMENT

Section overview

- Introduction
- Direct or indirect measurement
- Measurement date
- Measurement of fair value of equity instruments granted

2.1 Introduction

When an entity acquires goods or receives services it must measure them at fair value with a corresponding increase in equity.

This raises several issues:

- how should the fair value be measured?
- when should the fair value be measured?
- when should the transaction be recognised?

In answering these questions IFRS 2 distinguishes between:

- transactions with employees (and others providing similar services); and
- transactions with other parties.

The IFRS 2 approach is summarised in the following table:

	Transactions with other parties	Transactions with employees
How is the fair value of the transaction measured?	With reference to the fair value of the goods and services received	With reference to the fair value of the equity instrument granted
When is the transaction measured?	At the date when the goods and services are received	At the date when the equity instruments are granted
When is the transaction recognised?		
No vesting conditions	At date the goods and services are received	At grant date (there is a presumption that the services have been received in full)
Vesting conditions	As the service is rendered over the vesting period	As the service is rendered over the vesting period

2.2 Direct or indirect measurement

There are two possible approaches which could be followed to measure the fair value of the transaction:

- ❑ estimate the fair value of the debit:
  - this is known as direct measurement;
  - this uses the fair value of the goods and services themselves;
  - there is a rebuttable presumption that this can be estimated reliably;
  - it must be used except for:
    - those rare cases in which the fair value of goods and services received cannot be estimated reliably; and,
    - transactions with employees.
- ❑ estimate the fair value of the equity instrument credit:
  - this is known as indirect measurement;
  - this uses the fair value of the equity instruments themselves;
  - it must be used:
    - when the fair value of goods and services received cannot be estimated reliably; or
    - for transactions with employees.

2.3 Measurement date

The measurement date is the date at which the fair value of the equity instruments granted is measured for the purposes of this IFRS.

The measurement date is:

- ❑ the grant date for transactions with employees (and others providing similar services);
- ❑ the date on which goods are obtained or services received for transactions with parties other than employees (and those providing similar services).

2.4 Measurement of fair value of equity instruments granted

This is needed when the indirect method is being used (i.e. when shares or share options are granted to employees).

Fair value is measured taking into account all relevant terms and conditions upon which the equity instruments are granted.

Grant of shares

The market price of the shares is used.

If the shares are not publicly traded an estimated market price should be used adjusted to take into account the terms and conditions upon which those shares were granted.

Options

The fair value of options granted is measured at the market price of traded options with similar terms and conditions.

In most cases there will not be a traded option with similar terms and conditions because the options granted are subject to terms and conditions that do not apply to traded options. For example, typically, employee share options are:

- non-transferable and
- subject to vesting conditions.

Fair value is then estimated by applying an option pricing model, for example:

- the Black-Scholes-Merton model; or,
- a binomial model.

In applying the model the entity must take into account all relevant factors. These include:

- the exercise price of the option;
- the life of the option;
- the current price of the underlying shares;
- the expected volatility of the share price;
- the dividends expected on the shares;
- the risk-free interest rate for the life of the option;
- vesting conditions that are market conditions.

3 EQUITY-SETTLED SHARE-BASED PAYMENT TRANSACTIONS: EXPENSE RECOGNITION

Section overview

- Introduction
- Vesting conditions
- Basic recognition model
- Recognition when there are changes in estimates over the vesting period
- No reversal after equity instruments have vested
- Market conditions

3.1 Introduction

Often, when equity instruments are granted they are subject to conditions that must be satisfied before the counterparty becomes unconditionally entitled to the instrument.

- These are known as vesting conditions.
- The period during which the vesting conditions are met is called the vesting period.

No vesting conditions

If the counterparty is not required to complete a specified period of service before becoming unconditionally entitled to the equity instruments they are said to vest immediately.

In the absence of evidence to the contrary, the entity must presume that services rendered by the counterparty as consideration for the equity instruments have been received.

In this case the entity must recognise the services received in full on the grant date.

3.2 Vesting conditions

IFRS 2 distinguishes different categories of "vesting condition". These are:

- service conditions which require the counterparty to complete a specified period of service before the option vests; and
- performance conditions which require the counterparty to complete a specified period of service **and** specified performance targets to be met.

There are two broad categories of performance targets:

- market conditions; and
- non-market conditions

This distinction is very important. The probability of achieving each type of condition affects the accounting treatment of equity-settled share-based payments but in different ways.

	Market conditions	Non-market conditions
Definition	Any condition that relates to share price.	Any other condition.
Examples	Increase in share price to a specified value. Total shareholder return to a specified percentage (total shareholder return refers to dividends and share value)	Increase in profitability to a specified amount. Launch of a new product. Achieving quality improvement.
How the probability of achieving the condition affects the accounting treatment.	Probability of meeting the condition is a measurement attribute. Probability of meeting the condition is taken into account when measuring the fair value of the instrument at the grant date. Subsequent changes in the probability of meeting the condition have no impact and are ignored.	Probability of meeting the condition is a recognition attribute. Probability of meeting the condition plays no part in measuring the fair value of the instrument at the grant date. Subsequent changes in the probability of meeting the condition have no impact and are ignored.
Impact of the probability of achieving the condition on the accounting treatment.	Probability of meeting the condition is a measurement attribute. Probability of meeting the condition is taken into account when measuring the fair value of the instrument at the grant date. Subsequent changes in the probability of meeting the condition have no impact and are ignored.	Probability of meeting the condition is a recognition attribute. Probability of meeting the condition plays no part in measuring the fair value of the instrument at the grant date. Subsequent changes in the probability of meeting the condition are taken into account in estimating the expense to be recognised.

For clarity

A market condition is any condition that relates to share price. Any other type of condition is non-market.

For example, a performance condition might be that the shares will vest as long as an employee stays with the company for three years from the grant date and the share price increases by 20% in this period.

The probability of achieving a market condition is taken into account when estimating the fair value of the equity instrument granted. Subsequent changes in this probability play no part in the recognition.

For clarity, this means that an option may not vest due to failure to meet the market condition but an expense is recognised as if the condition had been met.

3.3 Basic recognition model

A vesting period will usually cover several reporting periods.

If a grant of share options is conditional upon the completion of three years' service, recognition is based on the assumption that the services rendered by the employee in consideration for these share options will be received over that three-year vesting period.

The fraction of the total equity-settled share based payment expense that relates to a reporting period is recognised in that reporting period. This continues until the end of the vesting reporting period.

Example: Equity settled share-based payment

X Limited is a company with a 31 December year end.

On 1 January Year 1 X Limited grants 100 options to each of its 500 employees.

Each grant is conditional upon the employee working for X Limited over the next three years.

At the grant date the fair value of each option is Rs.15.

X Limited estimates that 20% of employees will leave over the vesting period (i.e. 80% of employees will receive the equity instruments).

Assuming that the estimate of the leavers does not change and is correct (i.e. 80% of employees become entitled to the equity instruments at the end of the vesting period), expense recognition over the vesting period is as follows:

Amount recognised each year:

(80% × 500) employees × 100 options × Rs.15 × 1/3	Rs. 200,000

Double entry in each year	Dr	Cr
Statement of profit or loss	200,000	
Equity		200,000

Balance accumulated in equity	Rs.
at end of year 1	200,000
at end of year 2	400,000
at end of year 3	600,000

There is no requirement to set up a separate reserve in equity for the completion of the double entry. Although an entity might do this, many companies in practice complete the double entry into retained profits.

3.4 Recognition when there are changes in estimates over the vesting period

The above example is based on the assumption that there is no change in the estimate of the number of leavers over the vesting period and that the estimate turns out to be correct. This is rarely the case. A number of variables might change the estimated total expense at each year-end including:

- the number of employees expected to meet the service condition;
- the number of options to which the employees will become entitled
- the length of the vesting period.

Changes in estimate of the outcome of the service and non-market performance conditions are taken into account in the calculation of the number of equity instruments that are expected to vest at the end of the vesting period.

The necessary expense is calculated as follows.

Step 1: At each year end an entity must estimate the total expense expected to arise in respect of a grant of equity instruments by the end of the vesting period.

- At each year end an entity must make the best available estimate of the number of equity instruments expected to vest taking account of non-market vesting conditions (including service conditions and non-market performance conditions).
- The number of shares is then valued using the fair value at the grant date.

Step 2: The entity then estimates the fraction of this total amount that relates to the vesting period to date. For example, if the total expected expense by the end of the 3 year vesting period is Rs.1,500,000 and it is the end of the second year, then only Rs. 1,000,000 (2/3 of the total) relates to the vesting period to date.

Step 3: The annual expense is the calculated by comparing the total that relates to the vesting period to date to the amount previously recognised.

The difference is recognised as an expense:

On rare occasions the process might show that the total expense relating to the vesting period to date is smaller than that previously recognised. In that case the previously recognised expense is reversed as follows:

Illustration: Equity-settled share-based payment reversal of expense

	Debit	Credit
Equity	X	
Statement of profit or loss		X

At the vesting date the actual number of equity instruments that vest (or that would have vested except for the failure of a market condition) is the basis for the overall cumulative charge (and the corresponding balance in equity).

Ultimately, the amount recognised for goods or services received as consideration for the equity instruments granted is based on the number of equity instruments that eventually vest (or that would have vested except for the failure of a market condition – see below)

No amount is recognised on a cumulative basis for goods or services received if the equity instruments granted do not vest because of failure to satisfy non-market vesting conditions.

Grant with changes in the probability of meeting the service condition

The estimated total expense is revised at the end of each reporting period to take account of the estimate of the number of employees expected to meet the service condition. (This is sometimes described as ***truing up***).

Example: Equity-settled share-based payment

X Limited is a company with a 31 December year end.

1 January Year 1

X Limited grants 100 options to each of its 500 employees.

Each grant is conditional upon the employee working for X Limited over the next three years.

At the grant date the fair value of each option is Rs.15.

31 December Year 1

X Limited estimates that 20% of employees will leave over the vesting period (including those who have actually left in year 1).

The expense recognised at the end of year 1 is as follows:

Year 1 expense	Rs.
(80% × 500) employees × 100 options × Rs.15 × 1/3	200,000
Amount previously recognised	nil
Year 1 expense	200,000

31 December Year 2

X Limited estimates that only 15% of employees will leave over the vesting period (including those who have actually left in years 1 and 2).

The expense recognised at the end of year 2 is as follows:

Year 2 expense	Rs.
(85% × 500) employees × 100 options × Rs.15 × 2/3	425,000
Amount previously recognised	(200,000)
Year 2 expense	225,000

31 December Year 3

418 employees satisfy the service condition.

The expense recognised at the end of year 3 is as follows:

Year 3 expense	Rs.
418 employees × 100 options × Rs.15 × 3/3	627,000
Amount previously recognised	(425,000)
Year 3 expense	202,000

Practice question **1**

X Limited is a company with a 31 December year end.

On 1 January Year 1 X Limited grants 100 options to each of its 500 employees.

Each grant is conditional upon the employee working for X Limited over the next three years.

At the grant date X Limited estimates that the fair value of each option is Rs.15.

Required:

Calculate the income statement charge for the year ended:

1. 31 December Year 1 if at that date, X Limited expects 85% of employees to be with the company at the end of the vesting period.
2. 31 December Year 2 if at that date, X Limited expects 88% of employees to be with the company at the end of the vesting period.
3. 31 December Year 3 if at that date 44,300 share options vest.

Grant with a non- market performance condition in which the length of the vesting period could vary

If a grant of share options is conditional on staying with an entity until a non-market performance condition is achieved the length of the vesting period could vary.

The length of the expected vesting period is estimated at grant date and revised if subsequent information indicates that the length of the vesting period differs from previous estimates (but not if the performance condition is a *market condition*).

Example: Performance condition where the length of the vesting period could vary

X Limited is a company with a 31 December year end.

1 January Year 1

X Limited grants 10,000 shares to each of its 10 directors on condition that they remain with the company in the vesting period and subject to the following performance condition.

The shares will vest at:

a. 31 December Year 1 if X Limited's earnings grow by 20% or more; or

b. 31 December Year 2 if X Limited's earnings grow by an average of 15% or more over the two years; or

c. 31 December Year 3 if X Limited's earnings grow by an average of 12% or more over the three years.

At the grant date X Limited estimates that the fair value of each share is Rs. 50.

31 December Year 1

Earnings have grown by 16% therefore the shares do not vest at this date.

X Limited makes the following estimates:

a) earnings will increase at 16% in the next year with the result that the shares are expected to vest at the next year-end (because the average growth would be over 15%).

b) 9 directors are expected to be with the company at that time.

Year 1 expense	Rs.
9 directors × 10,000 × Rs. 50 × 1/2	2,250,000
Amount previously recognised	nil
Year 1 expense	2,250,000

Example (continued): Performance condition where the length of the vesting period could vary

31 December Year 2

Earnings have grown by 10% giving an average growth of 13% (16% + 10%)/2 years). This is less than the 15% specified as a performance condition therefore the shares do not vest at this date.

X Limited makes the following estimates:

a) earnings will increase at 10% in the next year resulting in an average growth rate of 12% ((16% + 10% + 10%)/3 years) so the shares are expected to vest at the next year end.

b) 9 directors are expected to be with the company at that time.

Year 2 expense	Rs.
9 directors × 10,000 × Rs. 50 × 2/3	3,000,000
Amount previously recognised	(2,250,000)
Year 2 expense	750,000

31 December Year 3

Earnings have grown by 15% resulting in an average growth rate of 13.7% ((16% + 10% + 15%)/3 years) so the shares vest.

There are 8 directors who receive shares.

Year 3 expense	Rs.
8 directors × 10,000 × Rs. 50 × 3/3	4,000,000
Amount previously recognised	(3,000,000)
Year 3 expense	1,000,000

Grant with a non-market performance condition in which the number of equity instruments to which the employees become entitled could vary

Example: Performance condition where the number of equity instruments could vary

X Limited is a company with a 31 December year end.

1 January Year 1

X Limited grants share options to each of its 10 directors on condition that they remain with the company over a 3 year vesting period and subject to the following performance condition.

a) Each director will receive 5,000 share options if profit grows by an average of 10% to 15% per annum over the 3 year period.

b) Each director will receive 10,000 share options if profit grows by an average of at least 15% to 20% per annum over the 3 year period.

c) Each director will receive 15,000 share options if profit grows by an average of over 20% per annum over the 3 year period.

At the grant date X Limited estimates that the fair value of each share is Rs. 50.

31 December Year 1

Profit has grown by 17% in Year 1.

X Limited makes the following estimates:

a) Profit will continue to increase by at least 16% over the vesting period.

b) 9 directors are expected to be with the company at the end of the vesting period.

Year 1 expense	**Rs.**
9 directors × 10,000 × Rs. 50 × 1/3	1,500,000
Amount previously recognised	nil
Year 1 expense	1,500,000

Example (continued): Performance condition where the number of equity instruments could vary

31 December Year 2

Profit has grown by 23% in Year 2 giving an average growth of 20% (17% + 23%)/2 years).

X Limited makes the following estimates:

a) Profit will increase by at least 20% next year.

b) 9 directors are expected to be with the company at the end of the vesting period.

Year 2 expense	Rs.
9 directors × 15,000 × Rs. 50 × 2/3	4,500,000
Amount previously recognised	(1,500,000)
Year 2 expense	3,000,000

31 December Year 3

Profit grew by 18% in Year 3 giving an average growth of 18.3% (17% + 23% +18%/3 years). Therefore each director receives 10,000 share options.

There are 8 directors who receive shares.

Year 3 credit	Rs.
8 directors × 10,000 × Rs. 50 × 3/3	4,000,000
Amount previously recognised	(4,500,000)
Year 3 credit	(500,000)

In this case, a previously recognised expense is reversed in year 3 as follows:

	Dr	Cr
Equity	500,000	
Statement of profit or loss		500,000

3.5 No reversal after equity instruments have vested

Once goods or services have been recognised in accordance with IFRS 2 (with a corresponding increase in equity) an entity is not allowed to adjust total equity.

For example an entity is not allowed to reverse the transaction if options are not exercised perhaps because they are out of the money (i.e. where the exercise price is greater than the share value).

However an entity is allowed to recognise a transfer from one component of equity to another.

3.6 Market conditions

As explained earlier any condition that relates to share values is a market condition and the probability of achieving such a condition is a measurement attribute rather than a recognition attribute. This means that it is taken into account in the initial grant date valuation of the equity instrument and that subsequent changes in the probability of achieving the condition have no effect on the expense recognition.

Example: Equity settled share-based payment with market condition

X Limited is a company with a 31 December year end.

X Limited grants 10,000 share options to each of its 10 directors on condition that they remain with the company over a 3 year vesting period and that share price increases by 10% per annum over that period.

At the grant date the fair value of each share option (taking account of the probability of achieving the share price increase) is Rs. 40.

Early in Year 1 X Limited's profitability was adversely affected by a fall in world oil price making it extremely unlikely that the share price condition will be met. This has no impact on the recognition of the expense which proceeds as follows:

31 December Year 1

9 directors are expected to be with the company at the end of the vesting period.

The expense recognised at the end of year 1 is as follows:

Year 1 expense	**Rs.**
9 directors × 10,000 options × Rs. 40 × 1/3	1,200,000
Amount previously recognised	nil
Year 1 expense	1,200,000

31 December Year 2

9 directors are expected to be with the company at the end of the vesting period.

The expense recognised at the end of year 2 is as follows:

Year 2 expense	**Rs.**
9 directors × 10,000 options × Rs. 40 × 2/3	2,400,000
Amount previously recognised	(1,200,000)
Year 2 expense	1,200,000

31 December Year 3

8 directors are still employed by the company.

The share price condition is not met.

The expense recognised at the end of year 3 is as follows:

Year 3 expense	**Rs.**
8 directors × 10,000 options × Rs. 40 × 3/3	3,200,000
Amount previously recognised	(2,400,000)
Year 3 expense	800,000

Grant with a market performance condition where the date on which the target is achieved might vary

If a grant of share options is conditional on staying with an entity until a market performance condition is achieved the time taken to achieve the target could vary.

The length of the expected vesting period is estimated at grant date and is not revised subsequently.

Example: Performance condition where the length of the vesting period could vary

X Limited is a company with a 31 December year end.

1 January Year 1

X Limited grants 10,000 shares to each of its 10 directors on condition that they remain with the company in the vesting period and subject to the following performance condition.

The shares vest when the share price increases by 50% above its value at the grant date. It is estimated that this will occur in 4 years after the grant date.

At the grant date X Limited estimates that the fair value of each share is Rs. 50.

X Limited estimates that all 10 directors will remain with the firm.

The following amounts will be recognised as an expense in each of the next 4 years.

10 directors × 10,000 options × Rs. 50 × 1/4	Rs. 1,250,000

Note that the date at which the increase in share value is actually achieved is irrelevant. The original estimate of the length of the vesting period is not revised. (This is different from cases involving non-market conditions).

4 MODIFICATIONS TO EQUITY-SETTLED SHARE-BASED PAYMENT TRANSACTIONS

Section overview

- Introduction
- Modifications that increase the fair value of the equity instruments granted
- Modification that increase the number of equity instruments granted
- Modifications that decrease the total fair value of the share-based arrangement
- Modification to reduce the vesting period
- Cancellation

4.1 Introduction

The terms and conditions upon which an option was granted may be modified subsequently. For example, the entity might reduce the exercise price of options granted to employees (i.e. reprice the options), which increases the fair value of those options.

Any changes to the terms and conditions on which the options were granted must be taken into account when measuring the services received.

Background

As a minimum an entity must recognise services received measured at the grant date fair value of the equity instruments granted, unless those equity instruments do not vest because of failure to satisfy a non-market vesting condition.

In addition, the entity must recognise the effects of modifications that increase the total fair value of the share-based payment arrangement or are otherwise beneficial to the employee. In other words, modifications that are unfavourable for employees are ignored while favourable modifications are accounted for.

4.2 Modifications that increase the fair value of the equity instruments granted

The entity must calculate the incremental fair value of the equity instruments brought about by the modification.

This incremental fair value is included in the measurement of the amount recognised for services received as consideration for the equity instruments granted.

The incremental fair value granted is calculated as the difference between the following as at the date of the modification:

- the fair value of the modified equity instrument; and
- that of the original equity instrument, both estimated as at the date of the modification.

When a modification occurs during the vesting period the incremental fair value granted is included in the measurement of the amount recognised over the period from the modification date until the date when the equity instruments vest. This is in addition to the amount based on the grant date fair value of the original equity

instruments, which is recognised over the remainder of the original vesting period.

Example: Modification – reduction of exercise price

X Limited is a company with a 31 December year end.

1 January Year 1

X Limited granted 1,000 share options at an exercise price of Rs. 50 to each of its 30 key management personnel.

The options vest if the managers were still employees on 31 December Year 4.

The fair value of the share options was estimated at Rs. 20.

31 December Year 1

X Limited estimated that the options will vest with 20 managers.

Year 1 expense	**Rs.**
20 managers × 1,000 options × Rs. 20 × 1/4	100,000
Amount previously recognised	nil
Year 1 expense	100,000

1 July Year 2

X Limited's share price collapsed early in Year 2.

On 1 July Year 2 X Limited modified the share option scheme by reducing the exercise price to Rs. 15.

The fair value of an option was Rs. 2 immediately before the price reduction and Rs. 11 immediately after.

31 December Year 2

X Limited estimates that the options will vest with 20 managers.

The expense recognised at the end of year 2 is as follows:

Year 2 expense	**Rs.**
Original grant	
20 managers × 1,000 options × Rs. 20 × 2/4	200,000
Modification	
20 managers × 1,000 options × (Rs. 11 – Rs. 2) × 0.5/2.5*	36,000
	236,000
Amount previously recognised	(100,000)
Year 2 expense	136,000

** At the date of the modification there were 6 months to the year-end and 2 years and 6 months to the vesting date*

Example (continued): Modification – reduction of exercise price

31 December Year 3

X Limited estimates that the options will vest with 20 managers.

The expense recognised at the end of year 3 is as follows:

Year 3 expense	**Rs.**
Original grant	
20 managers × 1,000 options × Rs. 20 × 3/4	300,000
Modification	
20 managers × 1,000 options × (Rs. 11 – Rs. 2) × 1.5/2.5	108,000
	408,000
Amount previously recognised	(236,000)
Year 3 expense	172,000

Year 4 expense	**Rs.**
Original grant	
20 managers × 1,000 options × Rs. 20 × 4/4	400,000
Modification	
20 managers × 1,000 options × (Rs. 11 – Rs. 2) × 2.5/2.5	180,000
Amount previously recognised	580,000
Amount previously recognised	(408,000)
Year 4 expense	172,000

In summary, the original grant is accounted for as if nothing had happened and the modification results in a new expense. The annual expenses could have been calculated as follows:

Example: Modification – reduction of exercise price

All facts as above.

Original grant – expense in years 1 to 4	**Rs.**
20 managers × 1,000 options × Rs. 20 × 1/4	100,000

Modification – expense in year 2	**Rs.**
20 managers × 1,000 options × (Rs. 11 – Rs. 2) × 0.5/2.5	36,000

Modification – expense in years 3 and 4	**Rs.**
20 managers × 1,000 options × (Rs. 11 – Rs. 2) × 1/2.5	72,000

Summary	**Year 1**	**Year 2**	**Year 3**	**Year 4**
Original grant	100,000	100,000	100,000	100,000
Modification	–	36,000	72,000	72,000
Annual expense	100,000	136,000	172,000	172,000

4.3 Modification that increase the number of equity instruments granted

This is similar to the above.

The fair value of the additional equity instruments granted (measured at the date of the modification) is included in the measurement of the amount recognised for services received as consideration for the equity instruments granted.

When a modification occurs during the vesting period the fair value of the additional equity instruments granted is included in the measurement of the amount recognised for services received over the period from the modification date until the date when the additional equity instruments vest. This is in addition to the amount based on the grant date fair value of the equity instruments originally granted, which is recognised over the remainder of the original vesting period.

Example: Modification – reduction of exercise price

X Limited is a company with a 31 December year end.

1 January Year 1

X Limited grants 1,000 shares for no consideration to its CEO subject to a 3 year service condition. At grant date the fair value of the shares is Rs. 15.

During the year, the share price decreases significantly.

1 January Year 2

The share price is Rs. 5.

X Limited grants an additional 2,000 shares for no consideration worth Rs. 10,000 to compensate the CEO for the price fall of Rs. 10 per share.

Original grant – expense in years 1 to 3	**Rs.**
1 CEO × 1,000 shares × Rs. 15 × 1/3	5,000

Modification – expense in years 2 to 3	**Rs.**
1 CEO × 2,000 shares × Rs. 5 × 1/2	5,000

Summary	**Year 1**	**Year 2**	**Year 3**
Original grant	5,000	5,000	5,000
Modification	–	5,000	5,000
Annual expense	5,000	10,000	10,000

4.4 Modifications that decrease the total fair value of the share-based arrangement

In effect such modifications are ignored. The entity must continue to account for the services received as consideration for the equity instruments granted as if that modification had not occurred.

4.5 Modification to reduce the vesting period

Expense recognition is accelerated over the new vesting period.

Example: Modification – reduction of vesting period

X Limited is a company with a 31 December year end.

1 January Year 1

X Limited grants 1,000 share options to its finance director subject to a 5 year service condition.

The grant date fair value of a share option is Rs. 10.

1 July Year 2

X Limited reduces the service period to 4 years.

The finance director remains in service over the five year period.

The following amounts will be recognised as an expense in each of the next 4 years.

Expense in year 1	**Rs.**
1 × 1,000 options × Rs. 10 × 1/5	2,000

Expense in year 2	**Rs.**
1 × 1,000 options × Rs. 10 × 2/4	5,000
Amount previously recognised	(2,000)
Year 2 expense	3,000

Expense in year 3	**Rs.**
1 × 1,000 options × Rs. 10 × 3/4	7,500
Amount previously recognised	(5,000)
Year 3 expense	2,500

Expense in year 4	**Rs.**
1 × 1,000 options × Rs. 10 × 4/4	10,000
Amount previously recognised	(7,500)
Year 4 expense	2,500

4.6 Cancellation

A cancellation is accounted for as an acceleration of vesting. The amount that would otherwise have been recognised over the vesting period is recognised immediately.

Example: Cancellation

X Limited is a company with a 31 December year-end.

1 January Year 1

X Limited grants 100 options to each of its 500 employees.

Each grant is conditional upon the employee working for X Limited over the next five years.

The grant date fair value of each option is Rs. 10.

31 December Year 1

X Limited expects 20% of employees to leave over the vesting period.

The expense recognised at the end of year 1 is as follows:

Year 1 expense	Rs.
(80% × 500 employees) × 100 options × Rs. 10 × 1/5	80,000
Amount previously recognised	nil
Year 1 expense	80,000

31 December Year 2

X Limited expects 20% of employees to leave over the vesting period

The expense recognised at the end of year 2 is as follows:

Year 2 expense	Rs.
(80% × 500 employees) × 100 options × Rs. 10 × 2/5	160,000
Amount previously recognised	(80,000)
Year 2 expense	80,000

Year 3

X Limited cancelled the scheme when 460 employees were still in the scheme.

The expense recognised at the end of year 3 is as follows:

Year 3 expense	Rs.
460 × 100 options × Rs. 10 × 5/5	460,000
Amount previously recognised	(160,000)
Year 3 expense	300,000

Cancellation with cash compensation

An entity may make a payment to the employee in compensation for the cancellation. Such a payment is accounted for as the repurchase of an equity interest and deducted from equity. However if the payment exceeds the fair value of the equity instruments repurchased any excess is recognised as an expense.

Example: Cancellation with payment to the employee

X Limited is a company with a 31 December year-end.

1 January, Year 1

X Limited granted 1,000 share options to an employee subject to a 3 year service condition.

The grant date fair value of each option was Rs. 9.

31 December, Year 2

Fair value of each share option is Rs. 18.

X Limited offered to cancel the arrangement in return for a pro rata cash compensation based on the current fair value that reflects the proportion of the services provided to the services required under the plan.

The offer amounts to Rs. 12,000 (1,000 x 18 x 2/3).

The employee accepted the offer and payment was made immediately.

The expense for each of the two years is as follows:

Year 1 expense	**Rs.**
Amount to be recognised by end of year 1:	
1,000 options × Rs.9 × 1/3	**3,000**
Amount previously recognised	**nil**
Year 1 expense	**3,000**

Year 1 double entry	**Debit**	**Credit**
Statement of profit or loss	3,000	
Equity		3,000

Year 2 expense	**Rs.**
Amount to be recognised by end of year 2:	
1,000 options × Rs.9 × 2/2	**9,000**
Amount previously recognised	**(3,000)**
Year 2 expense	**6,000**

Year 2 double entry	**Debit**	**Credit**
Statement of profit or loss	6,000	
Equity		6,000

The cash payment would be accounted for as follows:

Equity	12,000	
Cash		12,000

Cancellation with new grant identified as a replacement award

An entity may grant new equity instruments to the employee and identify them as a replacement for those cancelled on the date when those new equity instruments are granted. When this happens the grant of the new instruments is accounted for in the same way as a modification.

The incremental fair value granted is calculated at the date the replacement equity instruments are granted as the difference between:

- ❑ the fair value of the replacement equity instruments; and
- ❑ the net fair value of the cancelled equity instruments which is:
  - the fair value of the cancelled instruments immediately before the cancellation, less
  - the amount of any payment made to the employee on cancellation of the equity instruments that is accounted for as a deduction from equity.

Example: Cancelation with replacement award

X Limited is a company with a 31 December year-end.

1 January Year 1

X Limited grants 1,000 share options to its CEO subject to a 4 year service condition.

The grant date fair value of each share option is Rs. 8.

1 January Year 3

The fair value of the share options has decreased to Rs. 3.

In order to restore the economic position of the CEO, X Limited cancels the original award and grants a new award as a replacement.

The new grant is for 1,000 share options with a fair value at date of replacement of Rs. 8 subject to a remaining service period until the end of the original vesting period (i.e. 31 December Year 4 being 2 years after the replacement date).

X Limited identifies the new award as a replacement award for the original award. The incremental fair value per equity instrument is Rs. 5 (Rs. 8 – Rs. 3).

The annual expenses are as follows:

Original grant – expense in years 1 to 4	**Rs.**
1 CEO × 1,000 options × Rs. 8 × 1/4	2,000

Modification – Replacement award in years 3 and 4	**Rs.**
1 CEO × 1,000 options × (Rs. 8 – Rs. 3) × 1/2	2,500

Summary	**Year 1**	**Year 2**	**Year 3**	**Year 4**
Original grant	2,000	2,000	2,000	2,000
Modification	–	–	2,500	2,500
Annual expense	2,000	2,000	4,500	4,500

Cancellation with new grant not identified as a replacement award

If the new grant is not identified as a replacement award the first grant is accounted for as a cancellation and the new grant accounted for in the usual way.

Example: Cancelation with new grant not identified as a replacement award

X Limited is a company with a 31 December year-end.

1 January Year 1

X Limited grants 1,000 share options to its CEO subject to a 4 year service condition.

The grant date fair value of each share option is Rs. 8.

1 January Year 3

The fair value of the share options has decreased to Rs. 3.

In order to restore the economic position of the CEO, X Limited cancels the original award and grants a new award not specifically identified as a replacement for the now cancelled award.

The new grant is for 1,000 share options with a fair value at date of replacement of Rs. 8 subject to a remaining service period until the end of the original vesting period (i.e. 31 December Year 4 being 2 years after the replacement date).

The annual expenses are as follows:

Original grant – expense in year 1	**Rs.**
1 CEO × 1,000 options × Rs. 8 × 1/4	2,000

Original grant – expense in year 2 (cancellation)	**Rs.**
1 CEO × 1,000 options × Rs. 8 × 4/4	8,000
Amount previously recognised	(2,000)
Year 2 expense	6,000

Modification – New grant in years 3 and 4	**Rs.**
1 CEO × 1,000 options × Rs. 8 × 1/2	4,000

Summary	**Year 1**	**Year 2**	**Year 3**	**Year 4**
Original grant	2,000	8,000	–	–
Modification	–	–	4,000	4,000
Annual expense	2,000	8,000	4,000	4,000

5 ACCOUNTING FOR CASH-SETTLED SHARE-BASED PAYMENT TRANSACTIONS

Section overview

- Introduction
- Share appreciation scheme – as an illustration

5.1 Introduction

A cash-settled share-based payment transactions is where an entity incurs a liability for goods and services and the settlement amount is based on the price (or value) of the entity's shares or other equity instruments.

The basic rules are:

- The liability incurred is measured at its fair value at each reporting date until it is settled. (There is no locking of fair value at grant date).
- Any change in the fair value of the liability is recognised in profit or loss.

5.2 Share appreciation scheme – as an illustration

An entity might grant share appreciation rights to employees as part of their pay package, whereby the employees will 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.

Immediate recognition

An entity must recognise services received, and a liability to pay for those services, as the employees render service.

Some share appreciation rights vest immediately (the employees are not required to complete a specified period of service to become entitled to the cash payment).

- In the absence of evidence to the contrary, the entity must presume that the services rendered by the employees in exchange for the share appreciation rights have been received
- The entity must recognise immediately the services received and a liability to pay for them.

Recognition over a period

Some share appreciation schemes do not vest until the employees have completed a specified period of service.

The entity must recognise the services received, and a liability to pay for them, as the employees render service during that period.

Measurement

The liability is measured, initially and at each reporting date until settled, at the fair value of the share appreciation rights.

This is done by applying an option pricing model, taking into account:

- the terms and conditions on which the share appreciation rights were granted, and
- the extent to which the employees have rendered service to date.

If the share appreciation rights granted are conditional upon the employees' remaining in the entity's employ for the next three years and the employees have completed only one year's service at the reporting date, the entity must measure the fair value of the liability at the reporting date and multiplying the resulting amount by one-third.

Example: Cash-settled share-based payment transaction

X Limited is a company with a 31 December year end.

1 January Year 1

X Limited grants 100 cash share appreciation rights (SARs) to each of its 500 employees.

Each grant is conditional upon the employee working for X Limited over the next three years.

Further information

	Actual leavers in the year	Estimate of further leavers in the future
Year 1	20	40
Year 2	30	30
Year 3	25	-

The entity estimates the fair value of the SARs at the end of each year in which a liability exists as shown below.

Year	Fair value
1	15
2	18
3	20
4	23
5	25

As at 31 December Year 5 the employees had not exercised their rights to receive cash.

The number of employees whose interest is expected to vest and whose interest does is as follows:

Number of employees whose interest is expected to vest

	Year 1	Year 2	Year 3
Number at grant date	500	500	500
Number of leavers in year 1	20	20	20
Number of leavers in year 2	–	30	30
Number of leavers in year 3	–	–	25
Expected future number of leavers	40	30	–
Total expected leavers	(60)	(80)	
Actual leavers			(75)
Expected to vest	440	420	
Actually vest			425

Example (continued): Cash settled share-based payment

The closing liability and the expense recognised at each year end are as follows:

31 December Year 1

Year 1 expense	**Rs.**
Liability b/f	nil
Year 1 expense (balancing figure)	220,000
Liability c/f:	
440 employees (W) × 100 options × Rs.15 × 1/3	220,000

31 December Year 2

Year 2 expense	**Rs.**
Liability b/f	220,000
Year 2 expense (balancing figure)	284,000
Liability c/f:	
420 employees (W) × 100 options × Rs.18 × 2/3	504,000

31 December Year 3

Year 3 expense	**Rs.**
Liability b/f	504,000
Year 3 expense (balancing figure)	346,000
Liability c/f:	
425 employees (W) × 100 options × Rs.20 × 3/3	850,000

31 December Year 4

Year 4 expense	**Rs.**
Liability b/f	850,000
Year 4 expense (balancing figure)	127,500
Liability c/f:	
425 employees (W) × 100 options × Rs.23 × 3/3	977,500

31 December Year 5

Year 5 expense	**Rs.**
Liability b/f	977,500
Year 5 expense (balancing figure)	85,000
Liability c/f:	
425 employees (W) × 100 options × Rs.25 × 3/3	1,062,500

The liability is reduced as the company pays out cash to employees who exercise their rights.

Example: Cash-settled share-based payment transaction

X Limited is a company with a 31 December year end.

1 January Year 1

X Limited grants 100 cash share appreciation rights (SARs) to each of its 500 employees.

Each grant is conditional upon the employee working for X Limited over the next three years.

Further information

	Actual leavers in the year	Estimate of further leavers in the future
Year 1	20	40
Year 2	30	30
Year 3	25	-

The fair values of the SARs at the end of each year in which a liability exists and the intrinsic values of the SARs (which equals the cash paid to the employees) are shown below.

Year	Fair value	Intrinsic value
1	15	
2	18	
3	20	16
4	23	22
5	25	24

Employees cashed in their SARs as follows:

Year	Employees
3	100
4	125
5	200

The number of employees whose interest is expected to vest and whose interest does vest is as before (shown in the previous example).

Example (continued): Cash settled share-based payment

The closing liability and the expense recognised at each year end are as follows:

31 December Year 1

Year 1 expense	**Rs.**
Liability b/f	nil
Year 1 expense (balancing figure)	220,000
Liability c/f:	
440 employees × 100 options × Rs.15 × 1/3	220,000

31 December Year 2

Year 2 expense	**Rs.**
Liability b/f	220,000
Year 2 expense (balancing figure)	284,000
Liability c/f:	
420 employees × 100 options × Rs.18 × 2/3	504,000

31 December Year 3

Year 3 expense	**Rs.**
Liability b/f	504,000
Cash paid (100 employees × 100 options × Rs.16)	(160,000)
Year 3 expense (balancing figure)	306,000
Liability c/f	
325 employees (W below) × 100 options × Rs.20 × 3/3	650,000

31 December Year 4

Year 4 expense	**Rs.**
Liability b/f	650,000
Cash paid (125 employees × 100 options × Rs.22)	(275,000)
Year 4 expense (balancing figure)	85,000
Liability c/f:	
200 employees (W below) × 100 options × Rs.23 × 3/3	460,000

31 December Year 5

Year 5 expense	**Rs.**
Liability b/f	460,000
Cash paid (200 employees × 100 options × Rs.24)	(480,000)
Year 5 expense (balancing figure)	20,000
Liability c/f:	
Nil employees × 100 options × Rs.25 × 3/3	0

Note: The total expense over the 5 year period is equal to the cash paid.

Example (continued): Cash settled share-based payment

W: Number of employees with vested interest

	Year 3	Year 4	Year 5
Number vested	425	425	425
Number cashing out in year 3	100	100	100
Number cashing out in year 4	–	125	125
Number cashing out in year 5	–	–	200
	(100)	(225)	(425)
Employees with unexercised rights	325	200	–

6 ACCOUNTING FOR SHARE-BASED PAYMENT TRANSACTIONS WITH CASH ALTERNATIVES

Section overview

- Introduction
- Transactions in which the counterparty has the choice of settlement
- Share-based payment transactions in which the entity has the choice of settlement

6.1 Introduction

Some employee share-based payment arrangements give the employees (or the employer) the right to choose to receive (or pay) cash instead of shares or options, or instead of exercising options.

The standard contains different accounting methods for cash-settled and equity-settled share-based payment transactions. Where there is a choice of settlement, it is necessary to determine which accounting method should be applied.

This depends on whether:

- ❑ the employee has the choice of settlement; or
- ❑ the entity has the choice of settlement.

6.2 Transactions in which the counterparty has the choice of settlement

Background

The counterparty has been granted rights to a compound financial instrument, (i.e. a financial instrument that includes both debt and equity components). Thus the counterparty has:

- ❑ the right to be paid in cash; with,
- ❑ an option to take shares.

The entity must measure the fair value of the compound financial instrument at grant date identifying a value to both components.

The goods or services received or acquired in respect of each component of the compound financial instrument are accounted for separately.

- ❑ For the debt component, the goods or services acquired, and a liability to pay for those goods or services are recognised as they are supplied in the same way as other cash-settled share-based payment transactions.
- ❑ For the equity component (if any) the goods or services received and an increase in equity are recognised as they are supplied in the same way as other equity-settled share-based payment transactions.

Transactions where the fair value of goods and services is measured directly

This category will not include transactions with employees.

The equity component is measured as the difference between the fair value of the goods or services received and the fair value of the debt component, at the date when the goods or services are received. In other words, the equity component is the residual amount.

The liability and equity component are measured at the date the goods and services are received for transactions where the direct method applies. Therefore, there is no subsequent remeasurement of the equity component (as no further goods and services are received). However, the liability component is remeasured as it is usually linked to a share value which will change over time.

Date of settlement

The liability is remeasured at its fair value at the date of settlement.

- If the entity issues equity instruments on settlement (instead of paying cash), the liability is transferred direct to equity, as the consideration for the equity instruments issued.
- If the entity pays cash on settlement (instead of issuing equity instruments), any equity component previously recognised remains in equity. (The entity is allowed to recognise a transfer within equity, i.e. a transfer from one component of equity to another).

Example: Counter party has choice of settlement (direct measurement)

X Limited is a company with a 31 December year end.

1 January Year 1

X Limited acquired a machine with a fair value of Rs. 500,000.

The contract for the purchase of the machine allows the supplier to choose whether to receive as payment 30,000 ordinary shares or cash equivalent to the value of 40,000 ordinary shares. In either case, the payment would be made on 31 December Year 1.

The fair values of the shares at various dates were as follows:

1 January	Rs. 12 per share
30 June	Rs. 15 per share
31 December	Rs. 13 per share

The transaction would be accounted for as follows:

1 January Year 1

	Dr	Cr
Machine	500,000	
Liability (40,000 shares × Rs. 12)		480,000
Equity (balance)		20,000

30 June Year 1

	Dr	Cr
Statement of profit or loss	120,000	
Liability: (40,000 shares × Rs. 15) – Rs. 480,000		120,000

31 December

	Dr	Cr
Liability: (40,000 shares × Rs. 13) – Rs. 600,000	80,000	
Statement of profit or loss		80,000

31 December – payment if settled in cash

	Dr	Cr
Liability	520.000	
Cash		520,000

31 December – payment if settled in equity

	Dr	Cr
Liability	520.000	
Equity		520,000

Transactions using indirect measurement

This category includes transactions with employees.

The debt component and the equity component are measured separately. The fair value of the compound financial instrument is the sum of the fair values of the two components.

Share-based payment transactions in which the counterparty has the choice of settlement are often structured so that the fair value of one settlement alternative is the same as the other. (For example, the counterparty might have the choice of receiving share options or cash-settled share appreciation rights).

In such cases, the fair value of the equity component is zero, and hence the fair value of the compound financial instrument is the same as the fair value of the debt component. (This is because the fair value of the equity component must take into account the fact that the holder forfeits the right to receive cash in order to exercise the option).

Example: Counter party has choice of settlement (indirect measurement)

X Limited is a company with a 31 December year end.

1 January Year 1

X Limited grants share based compensation to each of its 600 employees.

Each employee has an option to select either 200 shares or the cash equivalent to the value of 200 shares on condition that they remain in service for 3 years.

The fair values of the components of the compound instrument were as follows:

	Rs.
Equity	3
Liability	15
Compound instrument	18

Example (continued) : Counter party has choice of settlement (indirect measurement)

31 December Year 1

The fair value of the liability component is estimated at Rs. 20.

X Limited expects 75% of its employees will qualify to receive the compensation.

Year 1 expense re liability	**Rs.**
Liability b/f	nil
Year 1 expense (balancing figure)	600,000
Liability c/f:	
(75% × 600) employees × 200 shares × Rs. 20 × 1/3	600,000

Year 1 expense re equity	**Rs.**
Equity balance b/f	nil
Year 1 expense (balancing figure)	90,000
Equity balance c/f:	
(75% × 600) employees × 200 shares × Rs. 3 × 1/3	90,000

	Dr	**Cr**
Statement of profit or loss	690,000	
Liability		600,000
Equity		90,000

31 December Year 2

The fair value of the liability component is estimated at Rs. 25.

X Limited expects 80% of its employees will qualify to receive the compensation

Year 2 expense re liability	**Rs.**
Liability b/f	600,000
Year 2 expense (balancing figure)	1,000,000
Liability c/f:	
(80% × 600) employees × 200 shares × Rs. 25 × 2/3	1,600,000

Year 2 expense re equity	**Rs.**
Equity balance b/f	90,000
Year 2 expense (balancing figure)	102,000
Equity balance c/f:	
(80% × 600) employees × 200 shares × Rs. 3 × 2/3	192,000

	Dr	**Cr**
Statement of profit or loss	1,102,000	
Liability		1,000,000
Equity		102,000

Example (continued): Choice of settlement with counter party (indirect measurement)

31 December Year 3

The fair value of the liability component is estimated at Rs. 30.

500 employees meet the vesting condition.

Year 3 expense re liability	**Rs.**
Liability b/f	1,600,000
Year 3 expense (balancing figure)	1,400,000
Liability c/f:	
500 employees × 200 shares × Rs. 30 × 3/3	3,000,000

Year 3 expense re equity	**Rs.**
Equity balance b/f	192,000
Year 3 expense (balancing figure)	108,000
Equity balance c/f:	
500 employees × 200 shares × Rs. 3 × 3/3	300,000

	Dr	**Cr**
Statement of profit or loss	1,508,000	
Liability		1,400,000
Equity		108,000

Settlement

31 December – payment if settled in cash

	Dr	**Cr**
Liability	3,000,000	
Cash		3,000,000

31 December – payment if settled in equity

	Dr	**Cr**
Liability	3,000,000	
Equity		3,000,000

6.3 Share-based payment transactions in which the entity has the choice of settlement

Where an obligation exists

The entity must determine whether it has a present obligation to settle in cash and account for the share-based payment transaction accordingly.

The entity has a present obligation to settle in cash if the choice of settlement in equity instruments

- has no commercial substance; or,
- if the entity has a past practice or a stated policy of settling in cash.

Where an obligation exists, the entity must account for the transaction according to the rules applied to cash-settled share-based payment transactions.

Where there is no obligation

Where an obligation does not exist the entity must account for the transaction according to the rules applied to equity-settled transactions.

In this case the entity may still decide to settle in cash at the settlement date.

- If the entity elects to settle in cash, the cash payment is accounted for as the repurchase of an equity interest, i.e. as a deduction from equity.
- if the entity elects to settle by issuing equity instruments, no further accounting is required (other than a transfer from one component of equity to another, if necessary).

There is a special rule to amend the above where the entity elects the settlement alternative with the higher fair value, as at the date of settlement. If this is the case the entity must recognise an additional expense for the excess value given:

- If cash is paid and the fair value of this is greater than the fair value of the shares that could have been issued in settlement the difference must be taken to profit.
- If shares are issued in settlement and they have a fair value greater than that of the cash alternative the difference must be taken to profit.

Example: Entity has choice of settlement (indirect measurement)

X Limited is a company with a 31 December year end.

1 January Year 1

X Limited grants share based compensation to each of its 1,200 employees. X Limited will pay 200 shares or the cash equivalent to the value of 200 shares to any employee who satisfies the 3 year service condition.

The fair value of the share at the grant date is Rs. 18.

The fair values of the shares and the employees whose interest is expected to vest at each reporting date are as follows:

Date	Expected shares to be vested	Fair value of equity instrument
Year 1	80%	Rs. 17
Year 2	90%	Rs. 16
Year 3	1000 Employees	Rs. 15

Example (continued): Entity has choice of settlement (indirect measurement)

Treating the grant as cash-settled

31 December Year 1

Year 1 expense re liability	**Rs.**
Liability b/f	nil
Year 1 expense (balancing figure)	1,088,000
Liability c/f:	
(80% × 1,200) employees × 200 shares × Rs. 17 × 1/3	1,088,000

31 December Year 2

Year 2 expense re liability	**Rs.**
Liability b/f	1,088,000
Year 2 expense (balancing figure)	1,216,000
Liability c/f:	
(90% × 1,200) employees × 200 shares × Rs. 16 × 2/3	2,304,000

31 December Year 3

Year 3 expense re liability	**Rs.**
Liability b/f	2,304,000
Year 3 expense (balancing figure)	696,000
Liability c/f:	
1,000 employees × 200 shares × Rs. 15 × 3/3	3,000,000

31 December – payment if actually settled in cash

	Dr	**Cr**
Liability	3,000,000	
Cash		3,000,000

31 December – payment if settled in equity

	Dr	**Cr**
Liability	3,000,000	
Equity		3,000,000

Example (continued): Entity has choice of settlement (indirect measurement)

Treating the grant as equity-settled

31 December Year 1

Year 1 expense re liability	**Rs.**
Equity balance b/f	nil
Year 1 expense (balancing figure)	1,152,000
Equity balance c/f:	
(80% × 1,200) employees × 200 shares × Rs. 18 × 1/3	1,152,000

31 December Year 2

Year 2 expense re liability	**Rs.**
Equity balance b/f	1,152,000
Year 2 expense (balancing figure)	1,440,000
Equity balance c/f:	
(90% × 1,200) employees × 200 shares × Rs. 18 × 2/3	2,592,000

31 December Year 3

Year 3 expense re liability	**Rs.**
Equity balance b/f	2,592,000
Year 3 expense (balancing figure)	1,008,000
Equity balance c/f:	
1,000 employees × 200 shares × Rs. 18 × 3/3	3,600,000

31 December – payment if actually settled in equity

	Dr	**Cr**
Equity	3,600,000	
Equity (share capital and share premium)		3,600,000

31 December – payment if settled in cash

	Dr	**Cr**
Equity	3,600,000	
Retained earnings		600,000
Cash		3,000,000

7 DISCLOSURES

Section overview

- Disclosures about nature and extent of share based payment arrangements
- Disclosures about fair value measurement
- Disclosures about effect on profit or loss for the period and financial position

7.1 Disclosures about nature and extent of share based payment arrangements

Underlying principle

An entity must disclose information that enables users of the financial statements to understand the nature and extent of share-based payment arrangements that existed during the period.

To give effect to this principle an entity must disclose at least the following:

- a description of each type of share-based payment arrangement that existed at any time during the period, including the general terms and conditions of each arrangement, such as:
  - vesting requirements;
  - the maximum term of options granted; and,
  - the method of settlement (e.g. whether in cash or equity).
- the number and weighted average exercise prices of share options for each of the following groups of options:
  - outstanding at the beginning of the period;
  - granted during the period;
  - forfeited during the period;
  - exercised during the period;
  - expired during the period;
  - outstanding at the end of the period; and
  - exercisable at the end of the period.
- for share options exercised during the period, the weighted average share price at the date of exercise. If options were exercised on a regular basis throughout the period, the entity may instead disclose the weighted average share price during the period.
- for share options outstanding at the end of the period, the range of exercise prices and weighted average remaining contractual life. If the range of exercise prices is wide, the outstanding options shall be divided into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received upon exercise of those options.

7.2 Disclosures about fair value measurement

An entity must disclose information to enable users to understand how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined.

7.3 Disclosures about effect on profit or loss for the period and financial position

Underlying principle

An entity must disclose information that enables users of the financial statements to understand the effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position.

To give effect to this principle an entity must disclose at least the following:

- ❑ the total expense recognised for the period arising from share-based payment transactions in which the goods or services received did not qualify for recognition as assets and hence were recognised immediately as an expense, including separate disclosure of that portion of the total expense that arises from transactions accounted for as equity-settled share-based payment transactions;
- ❑ for liabilities arising from share-based payment transactions:
  - the total carrying amount at the end of the period; and
  - the total intrinsic value at the end of the period of liabilities for which the counterparty's right to cash or other assets had vested by the end of the period (e.g. vested share appreciation rights).

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

31 December Year 1

	Rs.	Equity
Expected outcome (at grant date value)		
500 × 85% × 100 × Rs.15	637,500	
	×1/3	
Year 1 charge	212,500	
Accumulated in equity		212,500

31 December Year 2

	Rs.	
Expected outcome (at grant date value)		
500 × 88% × 100 × Rs.15	660,000	
	×2/3	
	440,000	
Less expense previously recognised	(212,500)	
Year 2 charge	227,500	
Accumulated in equity		440,000

31 December Year 3

	Rs.	
Actual outcome (at grant date value)		
44,300 × Rs.15	664,500	
Less expense previously recognised	(440,000)	
Year 3 charge	224,500	
Accumulated in equity		664,500

CHAPTER 15

Financial instruments: Recognition and measurement

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 8 IFRS 9: Financial Instruments

B (a) 30 IAS 39: Financial instruments: recognition and measurement

B (a) 44 IFRIC 16: Hedges of a net investment in a foreign operation

B (a) 47 IFRIC 19: Extinguishing financial liabilities with equity instruments

1 GAAP FOR FINANCIAL INSTRUMENTS

Section overview

- Background
- Definitions
- Derivatives
- Using derivatives

1.1 Background

The rules on financial instruments are set out in four accounting standards:

- IAS 32: Financial instruments: Presentation;
- IAS 39: Financial instruments: Recognition and measurement;
- IFRS 7: Financial instruments: Disclosure;
- IFRS 9: Financial Instruments

IAS 39 and IFRS 9

The IASB inherited IAS 39 from its predecessor body. The IASB has received many complaints about IAS 39 from interested parties that the requirements in IAS 39 were difficult to understand, apply and interpret. These interested parties urged the IASB to develop a new standard for the financial reporting of financial instruments that is principle-based and less complex.

The IASB entered a project to replace IAS 39. The project progressed as a series of phases with the results of each phase being published as completed.

The full version of IFRS 9 was completed in July 2014. IFRS 9 will replace IAS 39 but IFRS 9 is not compulsory until 2018 (and then only if the regulatory authorities in various jurisdictions allow it).

IFRS 9 does allow early adoption and will be adopted before 2018 in some jurisdictions. In fact, due to the phased production of the new standard the IFRS 9 rules on classification of financial assets are already being applied in some jurisdictions.

IFRS 9 is not completely different to IAS 39. Rules in several areas have not changed.

The following table provides a summary of rules that are different.

Area	Comment
Scope	No change.
Recognition	No change.
Measurement on initial recognition	No change.
Derecognition	No change.

Area	Comment
Classification of financial assets	New rules. Also note that the classification drives subsequent measurement.
Classification of financial liabilities	No change
Measurement	No change in the methods but, as mentioned above, the classification of financial assets drives subsequent measurement. This means that some instruments will be measured differently.
Embedded derivatives	Embedded derivatives in financial assets – no need to separate as the derivative will cause the host to be measured at fair value through profit or loss (see later) Other embedded derivatives – no change
Impairment	New rules.
Hedge accounting	New rules.

1.2 Definitions

A **financial instrument** is a contract that gives rise to both:

- A financial asset in one entity, and
- A financial liability or equity instrument in another entity.

A **financial asset** is any asset that is:

- cash;
- An equity instrument of another entity;
- A contractual right:
  - to receive cash or another financial asset from another entity; or
  - to exchange financial assets or financial liabilities with another entity

A **financial liability** is any liability that is a contractual obligation:

- To deliver cash or another financial asset to another entity; or
- To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.

Financial instruments include:

- Cash
- Shares
- Loans
- Debentures
- Accounts receivable or accounts payable; and
- Financial derivatives and commodity derivatives.

1.3 Derivatives

A derivative is a financial instrument with all three of the following characteristics:

- Its value changes in response to a specified underlying (interest rate, commodity price, exchange rate etc.); and
- It requires no or little initial investment; and
- It is settled at a future date

Categories of derivatives

Derivatives can be classified into two broad categories:

- Forward arrangements (commit parties to a course of action)
  - forward contracts
  - futures
  - swaps
- Options (gives the option buyer a choice over whether or not to exercise his rights under the contract)

Forward contracts

A forward contract is a tailor-made contract to buy or sell a specified amount of a specified item (commodity or financial item) on a specified date at a specified price.

A contract like this will require no initial outlay by the company (it has zero fair value at the date it is entered into). Over the life of the contract its fair value will depend on the spot exchange rates and the time to the end of the contract.

Example: Forward contracts

A Pakistani company enters into a 6 month forward contract to buy US $100,000 at a rate of Rs. 160 = $1

This means that the Pakistani company will pay Rs. 16,000,000 to buy $100,000 in 6 months' time.

This removes uncertainty for the Pakistani company.

A simple valuation of the forward can be made at any time over the life of the contract by comparing the contracted rate to the spot rate.

	Spot rate at date of valuation	
	Rs. 150 = $1	Rs. 170 = $1
Cost of $100,000 under forward contract	Rs. 16,000,000	Rs. 16,000,000
Cost of $100,000 on open market	Rs. 15,000,000	Rs. 17,000,000
Difference	Rs. 1,000,000	Rs. 1,000,000
Pakistani company would recognise:	**a liability**	**an asset**

Note that this is a simplification. In practice the time to the end of the contract would need to be built into the value. This is beyond the scope of the syllabus.

Futures

Futures are like forwards but are standardised in terms of amounts, date, currency, commodity etc. This standardisation means that they can be traded. A company can enter into a futures contract and then may make a gain or a loss on the market just like any other traded item.

If a company holds futures they might be an asset or a liability at any particular date.

Swaps

A swap is an agreement between parties to exchange cash flows related to an underlying obligation. The most common type of swap is an interest rate swap. In an interest rate swap, two parties agree to exchange interest payments on the same notional amount of principal, at regular intervals over an agreed number of years.

One party might pay interest to the other party at a variable or floating rate, and in return the other party may pay interest on the same principal at a fixed rate (a rate that is fixed by the swap agreement).

A swap might be recorded as an asset or liability at any particular date. This depends on the interaction between the amount that an entity has contracted to pay out and the amount that it is entitled to receive.

Options

The holder of the option has entered into a contract that gives it the right but not the obligation to buy (call option) or sell (put option) a specified amount of a specified commodity at a specified price.

An option differs from a forward arrangement. An option not only offers its buyer/holder the choice to exercise his rights under the contract, but also the choice not to enforce the contract terms.

The seller of the option must fulfil the terms of the contract, but only if the option holder chooses to enforce them.

Holding an option is therefore similar to an insurance policy: it is exercised if the market price moves adversely. As the option holder has a privileged status – deciding whether or not to enforce the contract terms – he is required to pay a sum of money (a premium) to the option seller. This premium is paid when the option is arranged, and non-refundable if the holder later decides not to exercise his rights under the option.

From the point of view of the holder the option will only ever be recorded as an asset. At initial recognition this would be the amount of the premium. Subsequently the holder would only exercise the option if it was beneficial to do so. Therefore it could only ever be an asset.

1.4 Using derivatives

A company can enter into a transaction involving a derivative for one of two reasons:

- to speculate, and hope to make a profit from favourable movements in rates or prices; or
- to hedge against exposure to a particular risk

Speculation and the use of derivatives

Many derivatives are traded on exchanges, and so are easily available for buying and selling. Entities can buy or sell derivatives in order to set up speculative positions, so that a profit will be made from dealing in the derivatives provided that the market price of the 'underlying item' moves favourably.

For example, forward contracts in cocoa could be purchased by a company that has no interest in the cocoa itself, but just wants to gamble on future cocoa prices. The forward contracts would probably be exchange-traded forward contracts, known as commodity (cocoa) futures.

Speculating in derivatives may expose entities to huge risks, if expectations do not come true and the price of the underlying item moves the 'wrong way'. In extreme cases this has led to financial collapse of the company.

Hedging with derivatives

Derivatives can be used to obtain protection against exposure to the risk of an unfavourable movement in the market price of an item, such as the price of a commodity, an interest rate or a foreign exchange rate.

2 IAS 39: RECOGNITION AND MEASUREMENT

Section overview

- Recognition of financial instruments
- Initial measurement
- Categories of financial asset
- Categories of financial liability
- Subsequent measurement
- Subsequent measurement at fair value
- Subsequent measurement at amortised cost
- Regular way transactions

2.1 Recognition of financial instruments

A financial asset or a financial liability should be recognised in the statement of financial position when the reporting entity becomes a party to the contractual provisions of the instrument.

Comment

This is different from the normal recognition criteria for an asset or a liability. Usually an asset or liability is recognised when there is a probable inflow or outflow of economic benefits.

The effect of this is that all financial assets and liabilities, including derivatives, are recognised in the statement of financial position, even if they have no cost.

Classification on initial recognition

IAS 39 defines four classes of financial asset and two classes of financial liability into which financial assets and financial liabilities must be allocated to one of these classes on initial recognition.

The categories of financial assets and liabilities do not affect the initial measurement of the assets and liabilities. However, they do affect the method of accounting after initial recognition.

2.2 Initial measurement

A financial instrument should be measured initially at its fair value. This is usually the fair value of the consideration given or received.

In the case of many derivatives the fair value on initial recognition is often zero. It may seem odd to recognise a zero amount but this is done so that any gain or loss that might arise between the date of initial recognition and the reporting date is recognised in accordance with the rules in IAS 39.

Transaction costs (for example, a dealer's fee) might be incurred on initial recognition of a financial instrument. The accounting treatment of these fees depends on the subsequent accounting treatment applied to the financial asset or financial liability in question.

Transaction costs are expensed immediately in the statement of profit or loss if the financial asset or financial liability is subsequently measured at fair value with gains and losses recognised in the statement of profit or loss.

Otherwise the transaction cost is capitalised as part of the carrying amount of the financial asset or financial liability on initial recognition.

Subsequent measurement	Treatment of transaction cost
Fair value through profit or loss	Written off as an expense in profit and loss.
Other methods (Amortised cost or fair value through OCI)	The transaction cost is capitalised and included in the initial cost of the financial instrument.

2.3 Categories of financial asset

On initial recognition, financial assets are classified into one of four categories. This categorisation is very important as it determines the subsequent measurement of the financial asset.

The four categories are:

(1) **Financial assets at fair value through profit or loss**.

This includes financial assets that are held for trading.

Derivatives that are assets must be included in this category unless held in hedging relationships that qualify for hedge accounting.

An entity can choose to treat other financial instruments as 'at fair value through profit or loss', provided that they meet certain criteria.

(2) **Held to maturity investments**. These are financial assets with fixed payments and a fixed maturity that the entity intends to hold until their maturity. An example is an investment in bonds issued by another entity, where there is no intention to sell the bonds on the market before their maturity.

Loan stock, redeemable preference shares and bonds issued by other entities would fall into this category, provided that the entity plans to hold the investment to the end of its term (for example, when it is redeemable).

(3) **Loans and receivables**. These are assets with fixed payments but are not quoted in an active market. They include regular bank loans and accounts receivable (trade receivables). They are not expected to be sold in the near future.

This category could include loans made to other entities, trade receivables and investments in bonds and other forms of debt, provided that the other conditions are met.

(4) **Available-for-sale financial assets.** These are any other financial assets that do not fall into any of the three categories above. In addition, an entity can designate an asset as available-for-sale when it is first recognised.

2.4 Categories of financial liability

On initial recognition, financial liabilities are classified into one of two categories. This categorisation determines the subsequent measurement of the financial liability.

There are two categories of financial liabilities:

(1) **Financial liabilities at fair value through profit or loss**. These include derivatives that are liabilities unless held in hedging relationships that qualify for hedge accounting.

(2) **Financial liabilities measured at amortised cost**. This category is for all remaining financial liabilities.

2.5 Subsequent measurement

After initial recognition financial assets (financial liabilities) are measured either at:

- ❑ fair value; or
- ❑ amortised cost.

The measurement methods to be applied to each category of financial asset are summarised as follows:

Category of financial asset	Measurement method at subsequent reporting dates
Financial assets at fair value through profit or loss	Fair value. Gain or loss recognised in the statement of proft or loss
Held to maturity financial assets	Amortised cost
Loans and receivables	Amortised cost
Available-for-sale financial assets	Fair value. Gain or loss recognised in other comprehensive income and accumulated in a spearate equity reserve.

The measurement methods to be applied to each category of financial liabilities are summarised as follows:

Category of financial asset	Measurement method at subsequent reporting dates
Liabilities at fair value through profit or loss	Fair value. Gain or loss recognised in the statement of proft or loss
Liabilities measured at amortised cost	Amortised cost

Valuation at amortised cost is explained later.

2.6 Subsequent measurement at fair value

Financial assets at fair value through profit or loss

The accounting treatment for financial assets at fair value through profit or loss is evident in the name of the category.

All financial assets in this category are remeasured to the fair value at each reporting date with all gains and losses recognised in the statement of profit or loss. They are said to be ***marked to market***.

Available for sale financial assets

The accounting treatment of an available for sale financial asset (AFS financial asset) is more complicated. All financial assets in this category are remeasured to the fair value at each reporting date with all gains and losses recognised in other comprehensive income and taken to a separate reserve in equity.

When an AFS financial asset is sold the cumulative gain or loss previously recognised for this asset is reclassified from other comprehensive income to profit or loss.

Illustration: AFS asset

Recognition of a gain	**Dr**	**Cr**
AFS asset	X	
Other comprehensive income		X

The gain recognised in other comprehensive income is accumulated in reserves as a credit balance.

On sale of the AFS asset		
Other comprehensive income	X	
Statement of profit or loss		X

The debit recognised in other comprehensive income is set against the previously recognised credit balance in reserves thus reducing it to zero.

Companies need systems which are able to track gains and losses on individual AFS financial assets so that when an asset is sold, the appropriate amount can be reclassified.

Example: AFS asset

A company purchased a financial asset for Rs. 30,000 plus 1% transaction costs on 1 April 20X6. It classified this asset as available for sale.

At the end of the financial year (31 December 20X6) the investment was Rs. 40,000.

On 11 January 20X7 the asset was sold for Rs. 50,000.

The following double entries are necessary:

1 April 20X6: Initial recognition	Dr (Rs.)	Cr (Rs.)
AFS financial asset	30,300	
Cash		30,300

Being: Initial recognition of an AFS financial asset
(At cost plus transaction cost = Rs. 30,000 + (1% of Rs. 30,000))

31 December 20X6: Subsequent measurement	Dr (Rs.)	Cr (Rs.)
AFS financial asset (Rs.40,000 - Rs.30,300)	9,700	
Other comprehensive income		9,700

Being: Re-measurement of AFS financial asset to fair value.

1 January 20X7: Disposal	Dr (Rs.)	Cr (Rs.)
Cash	50,000	
AFS financial asset		40,000
Statement of profit or loss		10,000

Being: Recognition of profit on disposal of an AFS financial asset.

	Dr (Rs.)	Cr (Rs.)
Other comprehensive income	9,700	
Statement of profit or loss		9,700

Being: Reclassification adjustment arising on disposal of an AFS financial asset.

The statement of profit or loss would show an overall gain of Rs. 19,700 (being the gain on disposal of Rs. 10,000 plus the reclassification adjustment of Rs. 9,700).

2.7 Subsequent measurement at amortised cost

Held to maturity investments, loans and receivables and many financial liabilities are measured at amortised cost after their initial recognition.

Amortised cost is calculated as follows for a financial asset:

- amount initially recognised (initial cost of investment); plus
- interest income recognised (using the effective rate); less
- interest actually received (cash received).

Similarly, the amortised cost of a financial liability is calculated as:

- amount initially recognised as a liability (initial cost); plus
- interest expense recognised (using the effective rate); less
- interest actually paid (cash paid).

Illustration: Amortised cost

	Financial asset	Financial liability
Amount at initial recognition	X	X
Plus: Interest recognised using the effective rate:		
as income	X	
as expense		X
Less: repayments	(X)	(X)
Amortised cost	X	X

Interest expense is measured using the effective rate. This is the rate that matches the amount loaned (borrowed) with the discounted future cash flows received (paid).

The effective rate is the discount rate that, when applied to the future interest and redemption cash flows, gives an amount equal to the amount initially recognised for the financial asset or financial liability. Thus, it results in a net present value of zero. It is the IRR of all cash flows associated with lending or borrowing.

The interest recognised is calculated by applying the effective rate to the outstanding balance on the bond at the beginning of the period. The interest recognised in profit and loss each year is not necessarily the cash paid.

The outstanding balance at the end of a period is the opening balance plus the interest charge at the effective rate, minus the actual interest payments in the period.

Example: Amortised cost (liability)

A company issues a bond (borrows).

The bond has an issue value of Rs. 1 million and pays a coupon rate of 5% interest for two years, then 7% interest for two years (this is known as a stepped bond).

Interest is paid annually on the anniversary of the bond issue.

The bond will be redeemed at par after four years.

The effective rate for this bond is 5.942%

The amortised cost of the liability at the end of each year is calculated by constructing an amortisation table as follows:

Year	Amortised cost brought forward	Interest at 5.942%	Cash paid	Amortised cost carried forward
1	1,000,000	59,424	(50,000)	1,009,424
2	1,009,424	59,983	(50,000)	1,019,407
3	1,019,407	60,577	(70,000)	1,009,984
4	1,009,984	60,016	(70,000)	1,000,000
		240,000	240,000	

The bond is initially recorded at cost (Rs. 1,000,000) and by the end of year 1 it has an amortised cost of Rs. 1,009,424.

The difference is due to the difference in the interest expense recognised in the statement of profit or loss (Rs. 59,424) and the interest actually paid (Rs. 50,000).

The total interest paid over the four years is Rs. 240,000. However, it is charged to the profit or loss each year at the effective rate (5.942%) on the outstanding balance, not as the actual interest paid on the bonds in cash each year.

The investor in the above bond would recognise a financial asset at amortised cost and recognise interest income in the same amounts as above.

Practice question **1**

X purchased a loan on 1 January 20X5 and classified it as measured at amortised cost.

Terms:

Nominal value	Rs. 50 million
Coupon rate	10%
Term to maturity	3 years
Purchase price	Rs. 48 million
Effective rate	11.67%

Required

Calculate the amortised cost of the bond and show the interest income for each year to maturity.

Practice question **2**

A company issues Rs. 10 million of 6% bonds at a price of Rs. 100.50 for each Rs. 100 nominal value with issue costs of Rs. 50,000.

The bonds are redeemable after four years for Rs. 10,444,000.

The effective annual interest rate for this financial instrument is 7%.

Required

Calculate the amortised cost of the bond and show the interest expense for each year to maturity.

2.8 Regular way transactions

In some markets for financial instruments, a contract might be contract entered into on one date (trade date) is settled at a later date (settlement date) according to the rules of the market. For example, trades on the Pakistan Stock Exchange are typically settled 2 days after the date of the trade.

Such transactions are described as “regular way” transactions.

Definition: Regular way purchase or sale

A purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

Basic rules

The basic rule of initial recognition was explained in paragraph 2.1 above as a financial asset or a financial liability should be recognised in the statement of financial position when the reporting entity becomes a party to the contractual provisions of the instrument.

The date on which an entity becomes a party to the contractual provisions of a financial asset purchased under a regular way purchase is the trade date. However, IAS 39 (IFRS 9) contain an exception to this approach by which an entity can choose to account for a regular way purchase or sale of financial assets using either trade date accounting or settlement date accounting.

The same method must be applied consistently for all purchases and sales of financial assets that are classified in the same way.

Trade date accounting and settlement date accounting

The two methods differ in terms of the timing of recognition and derecognition of assets.

	Trade date	Settlement date
Meaning	The trade date is the date that an entity commits itself to purchase or sell an asset.	The settlement date is the date that an asset is delivered to or by an entity
Purchases	Asset to be received and the liability to pay for it are recognised on the trade date	Asset recognised on the date it is received by an entity.
Sales	Derecogniton of an asset with recognition of receivable and gain or loss arising occurs on the trade date	Derecognition of an asset and recognition of any gain or loss on disposal on the day that it is delivered by the entity.

Settlement date accounting issues

An entity must account for any change in the fair value of the asset between the trade date and the settlement date in the same way as it accounts for the acquired asset. In other words any change in value:

- is not recognised for assets measured at amortised cost; but
- is recognised in profit or loss for assets or other comprehensive income as appropriate for financial assets measured at fair value.

Regular way purchase of financial asset

Example: Trade and settlement accounting for the purchase of an investment

An entity bought investment worth Rs. 1,000 on 27 December 2015.

The payment was to be made on 5th January 2016. The company classifies the investment as FVTPL (held for trading).

The fair value of the asset on relevant dates was as follows:

	Date	Fair value
Trade date	27th December 2015	Rs. 1,000
Reporting date	31st December 2015	Rs. 1,005
Settlement date	5th January 2016	Rs. 1,015

The transaction is accounted for as follows using trade date accounting

27 December	Debit	Credit
Financial asset	1,000	
Payable		1,000

31 December	Debit	Credit
Financial asset	5	
Statement of profit or loss		5

5 January	Debit	Credit
Payable	1,000	
Cash		1,000

The transaction is accounted for as follows using settlement date accounting

27 December: No entry

31 December	Debit	Credit
Receivable	5	
Statement of profit or loss		5

5 January	Debit	Credit
Financial asset	1,015	
Receivable		5
Statement of profit or loss		10
Cash		1,000

Regular way sale of financial asset

Example: Trade and settlement accounting for the purchase of an investment

An entity sold an investment with a carrying amount of Rs. 1,015 for Rs. 1,100 on 27 December 2015.

The payment was to be made on 5th January 2016. The company classifies the investment as FVTPL (held for trading).

The fair value of the asset on relevant dates was as follows:

	Date	Fair value
Trade date	27th December 2015	Rs. 1,100
Reporting date	31st December 2015	Rs. 1,105
Settlement date	5th January 2016	Rs. 1,130

The transaction is accounted for as follows using trade date accounting

27 December	Debit	Credit
Receivable	1,100	
Financial asset		1,015
Statement of profit or loss		85

31 December: No entry

5 January	Debit	Credit
Cash	1,100	
Receivable		1,100

The transaction is accounted for as follows using settlement date accounting

27 December	Debit	Credit
Financial asset	85	
Statement of profit or loss		85

31 December: No entry

5 January	Debit	Credit
Cash	1,100	
Receivable		1,100

Note: Under both methods the risks and rewards are transferred on trade date. Therefore, an entity does not book any gain or loss after trade date.

3 IAS 39 (IFRS 9) DERECOGNITION OF FINANCIAL INSTRUMENTS

Section overview

- Derecognition of financial assets
- Derecognition of financial liabilities
- IFRIC 19: Extinguishing financial liabilities with equity instruments

These rules apply to both IAS 39 and IFRS 9.

3.1 Derecognition of a financial asset

Derecognition is the removal of a previously recognised financial asset or financial liability from an entity's statement of financial position.

Most transactions involving derecognition of a financial asset are straightforward. However, financial assets may be subject to complicated transactions where some of the risks and rewards that attach to an asset are retained but some are passed on. IAS 39 contains complex guidance designed to meet the challenge posed by complex transactions.

The guidance is structured so that a transaction involving a financial asset is subject to a series of tests to establish whether the asset should be derecognised.

These tests can be framed as a series of questions.

1 Have the contractual rights to cash flows of the financial asset expired?
   - If the answer is "yes" – derecognise the financial asset
   - If the answer is "no" – ask the next question

2 Has the asset been transferred to another party?
   - If the answer is "no" – the asset is retained
   - If the answer is "yes" – ask the next question

3 Have substantially all of the risks and rewards of ownership passed?
   - If the answer is "yes" – derecognise the financial asset
   - If the answer is "no" – the asset is retained
   - If the answer is "the risks and rewards are neither passed nor retained (i.e. some are passed but some kept)" – ask the next question

4 Has the asset has been transferred in a way such that risks and rewards of ownership have neither passed nor been retained but control has been lost.
   - If the answer is "yes" – derecognise the financial asset
   - If the answer is "no" – the asset is retained

This all sounds very complicated but what it means is that a financial asset is derecognised if one of three combinations of circumstances occurs:

- the contractual rights to the cash flows from the financial asset expire; or
- the financial asset is transferred and substantially all of the risks and rewards of ownership pass to the transferee; or
- the financial asset is transferred, substantially all of the risks and rewards of ownership are neither transferred nor retained but control of the asset has been lost.

Most transactions being considered involve the receipt of cash.

- Transactions where the asset is derecognised may lead to the recognition of a profit or loss on disposal.
- Transactions where the asset is not derecognised lead to the recognition of a liability for the cash received.

Example: Derecognition

ABC collects Rs. 10,000 that it is owed by a customer.

1 Have the contractual rights to cash flows of the financial asset expired?

Yes – Derecognise the asset

Dr	Cash		Rs. 10,000	
	Cr	Receivable		Rs. 10,000

Example: Derecognition

ABC sells Rs. 100,000 of its accounts receivables to a factor and receives an 80% advance immediately. The factor charges a fee of Rs. 8,000 for the service.

The debts are factored without recourse and a balancing payment of Rs. 12,000 will be paid by the factor 30 days after the receivables are factored.

Answer

1 Have the contractual rights to cash flows of the financial asset expired?

No – ask the next question

2 Has the asset been transferred to another party?

Yes (for 80% of it)

3 Have substantially all of the risks and rewards of ownership passed?

The receivables are factored without recourse so ABC has passed on the risks and rewards of ownership.

ABC must derecognise the asset transferred.

Dr	Cash		Rs. 80,000	
	Cr	Receivables		Rs. 80,000

In addition ABC has given part of the receivable to the factor as a fee:

Dr	P&L		Rs. 8,000	
	Cr	Receivables		Rs. 8,000

Example: Derecognition

ABC sells Rs. 100,000 of its accounts receivables to a factor and receives an 80% advance immediately. The factor charges a fee of Rs. 8,000 for the service.

The debts are factored with recourse and a further advance of 12% will be received by the seller if the customer pays on time.

Answer

1 Have the contractual rights to cash flows of the financial asset expired?

No – ask the next question

2 Has the asset been transferred to another party?

Yes (for 80% of it)

3 Have substantially all of the risks and rewards of ownership passed?

The debt is factored with recourse so the bad debt risk stays with ABC. In addition, ABC has access to future rewards as further sums are receivable if the customers pay on time.

As ABC has kept the future risks and rewards relating to the Rs. 80,000, this element of the receivable is not derecognised.

Dr	Cash		Rs. 80,000	
	Cr	Liability		Rs. 80,000

Being receipt of cash from factor – This liability is reduced as the factor collects the cash.

Dr	Liability		Rs. X	
	Cr	Receivable		Rs. X

In addition ABC has given part of the receivable to the factor as a fee:

Dr	P&L		Rs. 8,000	
	Cr	Receivables		Rs. 8,000

Risks and rewards are neither passed nor retained

Deals involving financial assets can be quite complex exposing the parties to different shares of risks and rewards associated with an asset. This means that it might not be possible to decide whether the risks and rewards have substantially passed or not. In such cases the entity that has "sold" will derecognise the asset only if control has been lost. This depends on whether the transferee has the practical ability to sell the asset. If so then the asset is derecognised by the transferor.

For example, an entity may not sell a financial asset but instead gives a counter party an "option" to buy it. In such a case, the passing or retaining of risks and rewards depends on whether the counter party will exercise the option or not. In other words the risks and rewards are neither passed nor retained.

Another example involves repo (sale and repurchase transactions).

Repo transactions

Under a repo transaction, a company sells an asset with a condition that the same asset will be bought at a later date on fixed price.

Such a transaction is, in substance, a loan arrangement rather than a sale. It is a method of an entity providing collateral for a loan. The rules in IAS 39 (IFRS 9) result in the transaction being treated as a financing transaction with the recognition of a liability as the conditions for derecognition of financial assets are not fulfilled.

Example: Repo

X Limited sold an investment (Rs. 100,000 15% bond carried at amortised cost of Rs. 103,000) for Rs. 110,000 and simultaneously entered into a contract to buy the same investment back in two years with a repurchase rate of 20%

The investment had an effective yield (IRR) of 18%.

This transaction should be reflected in Co. A's books as follows:

Transaction date	Debit	Credit
Cash	110,000	
Repo liability		110,000

The investment is not derecognised so X Limited recognises income on the investment at its effective yield.
However, it is the counter party not X Limited that receives the cash so X Limited shows this as a reduction in the repo liability.

Year 1	Debit	Credit
Repo liability (15% × Rs.100,000)	15,000	
Investment	3,540	
Interest income (18% × Rs.103,000)		18,540
Interest expense (20% × Rs.110,000)	22,000	
Repo liability		22,000

The movement on the investment and the repo liability is as follows (with credits being shown in brackets):

	Investment	Repo liability	Cash	Profit or loss
Balance b/f	103,000			
		(110,000)	110,000	
Year 1:				
Income	3,540	15,000		(18,540)
Interest expense		(22,000)		22,000
Balance b/f	106,540	(117,000)		

Example continued: Repo

Year 2	Debit	Credit
Repo liability	15,000	
Investment	4,177	
Interest income Cr		19,177
Interest expense (at the repo rate of 20%)	23,400	
Repo liability		23,400

Repayment of repo liability (repurchase of investment)

	Debit	Credit
Cash	125,400	
Repo liability		125,400

	Investment	Repo liability	Cash	Profit or loss
Balance b/f	106,540	(117,000)		
Year 2:				
Income	4,177	15,000		(19,177)
Interest expense		(23,400)		23,400
Repurchase of investment		125,400	(125,400)	
Balance b/f	110,717	–		

3.2 Derecognition of a financial liability

A financial liability (or a part of a financial liability) is derecognised when, and only when, it is extinguished.

This is when the obligation specified in the contract is discharged or cancelled or expires.

Modification (restructuring) of a liability

An entity facing liquidity problems might ask a lender to modify the terms of a loan. This might involve the lender changing the timing of payments (restructuring) the liability, waiving part of the loan (thus reducing the amount payable) or a combination of both.

The accounting treatment for a modification depends on whether the terms of the loan after the modification are substantially different from those of the original loan.

The terms of a modification are deemed to be substantially different when the present value of the cash flows of the modified loan discounted at the original effective rate is at least 10% different from the carrying amount of the original loan before the modification.

Modification with substantially different terms

If the new terms are identified as a substantial modification, the original loan is extinguished and a new financial liability is recognised in its place with any gain or loss recognised in the statement of profit or loss.

The new liability is recognised at its fair value in accordance with the normal rules of recognition of financial instruments. This is found by discounting the revised future payments at the market rate of interest that applies to such cash flows.

Example: Substantial modification of a liability

X Limited had a loan of Rs. 1,000 repayable in 4 years on which it paid interest at 10%.

The carrying amount of the liability was Rs. 1000.

The effective rate of the liability is 10%. (The IRR of any loan carried and redeemed at par is the same as the coupon rate).

X Limited faced liquidity problems and the lender agreed to restructure the loan. Under this new arrangement X limited was to make a single payment of Rs. 1,200 at the end of Year 4 instead of the originally scheduled payments.

The market rate at the time of restructuring was 12%.

This would be accounted for as follows:

Step 1: Identify whether the modification is substantial or not

	Rs.
Carrying amount of the original loan	1,000
PV of the revised cash flows at the original effective rate (Rs. 1,200 × 1/1.1^4)	820
Difference	180
As a percentage of the original carrying amount (180/1,000 × 100)	18%

Conclusion:
The terms of the original loan have been substantially modified

Step 2: Account for the substantial modification

	Dr	Cr
Extinguishment of original loan	1,000	
Recognition of new loan (working)		763
Gain on the modification		237

Working: Fair value of new loan on initial recognition

(Rs. 1,200 × 1/1.12^4) = Rs. 763

Modification with terms that are not substantially different

A liability is not derecognised when the terms of a modification are not substantially different from those of the original loan.

Instead, a new effective rate is calculated based on the carrying amount at the date of the modification (adjusted for any associated modification fee) and the revised cash flows.

Example: Modification with terms that are not substantially different

X Limited had a liability of Rs. 2,000,000 repayable in 5 years on which it paid interest at 15%.

The carrying amount of the liability was Rs. 2,000,000.

The effective rate of the liability is 15%.

X Limited faced liquidity problems and the lender agreed to restructure the loan. Under this new arrangement X limited was to make a single payment of Rs. 3,500,000 at the end of Year 5 instead of the originally scheduled payments.

A fee of Rs. 100,000 was paid for the revision.

This would be accounted for as follows:

Step 1: Identify whether the modification is substantial or not

	Rs.
Carrying amount of the original loan	2,000,000
PV of the revised cash flows at the original effective rate (Rs. 100,000 + (Rs. 3,500,000 × 1/1.15^5))	1,840,119
Difference	159,881
As a percentage of the original carrying amount (159,881/2,000,000 × 100)	8%

Conclusion:
The terms of the original loan have not been substantially modified

Step 2: Calculate the new effective yield

Year	Cash flow	Discount factor at 10%	Present value at 10%	Discount factor at 15%	Present value at 15%
0	(2,000)	1.000	(2,000)	1,000	(2,000)
0	100	1.000	100	1,000	100
5	3,500	0.621	2,173	0.497	1,740
NPV			273		(160)

Using

$$\text{IRR} = \text{A}\% + \left(\frac{\text{NPV}_\text{A}}{\text{NPV}_\text{A} - \text{NPV}_\text{B}}\right) \times (\text{B} - \text{A})\%$$

$$\text{IRR} = 10\% + \left(\frac{273}{433}\right) \times 5\% = 13\%$$

Interest is recognised at 13% instead of 15% from the date of the modification.

3.3 IFRIC 19: Extinguishing financial liabilities with equity instruments

Background

The terms of a liability might be renegotiated such that the lender (creditor) accepts equity instruments as payment instead of cash. (The lender accepts a debt to equity swap).

IFRIC 19 sets out how an entity that issues equity instruments to extinguish all or part of a financial liability should account for the transaction.

IFRIC 19 does not address accounting by the creditor.

The following transactions are scoped out of IFRIC 19:

- Transactions involving the creditor in its capacity as an existing shareholder (e.g. a rights issue);
- Transactions between businesses under common control both before and after the transaction. This allows companies within a group to account for exchange of debt for equity instruments in a corporate reconstruction without regard to the rules in this interpretation.
- Extinguishing a financial liability by issuing equity instruments in accordance with the original terms of the liability (e.g. convertible instruments).

Issues addressed

Are an entity's equity instruments issued to extinguish all or part of a financial liability "consideration paid" in the context of IAS 39 liability derecognition rules?

How should an entity initially measure the equity instruments issued?

How should the entity account for any difference between the carrying amount of the liability and the initially measured equity instruments?

Consensus: Are the equity instruments "consideration paid"

The issue of equity instruments is "consideration paid" to extinguish all or part of a financial liability. This leads to the derecognition of the liability.

Consensus: Initial measurement of equity instruments issued

Equity instruments issued must be initially measured at the fair value of those instruments. If the fair value cannot be reliably measured then the fair value of the liability extinguished is used instead.

Consensus: Accounting for the difference

The difference between the carrying amount of the liability extinguished and the consideration paid (fair value of equity instruments issued) must be recognised in profit or loss. A separate line item or disclosure in the notes is required.

If only a part of the financial liability is extinguished the part of the consideration allocated to the remaining liability must form part of the assessment as to whether the remaining liability has been substantially modified.

Example: Accounting for the difference

Entity X has in issue Rs. 50m 6% loan stock.

It negotiates with the lenders an extinguishment of the debt by the issue of equity instruments with a fair value of Rs. 48m.

The double entry is as follows:

	Debit	Credit
Financial liability	Rs. 50m	
Equity		Rs. 48m
Profit on extinguishment		Rs. 2m

Example: IFRIC 19

1 January Year 1

X Limited borrowed Rs. 25,000,000 on the following terms:

Face value	Rs. 25,000,000
Term of loan	10 years
Redemption value	Rs. 30,000,000
Coupon rate	12%
Effective rate (IRR)	13.08150%

31 December Year 5

X Limited has fallen into financial difficulties and renegotiated the terms of the loan.

The lender has agreed to extinguish 55% of the loan in exchange for an equity stake in X Limited.

The terms of the agreement were as follows:

Shares to be issued by X Limited to lender	Rs. 17,000,000
Of which:	
Consideration for extinguishment of 55% of the loan	Rs. 16,500,000
Shares issued for modification (restructuring fee)	Rs. 500,000
Market rate at the date of arrangement	14.5%

Under the terms of the modification no interest will be paid on the remaining amount and a sum of Rs. 30,000,000 will be paid at the end of the term. (5 Years from now)

Required

Show how X Limited must account for the modification to the terms of the loan.

Example (continued): IFRIC 19

Step 1: Estimate the carrying amount of the liability at the date of the arrangement

Year	Opening	Interest	Payment	Closing
1	25,000,000	3,270,375	(3,000,000)	25,270,375
2	25,270,375	3,305,744	(3,000,000)	25,576,119
3	25,576,119	3,345,740	(3,000,000)	25,921,860
4	25,921,860	3,390,968	(3,000,000)	26,312,828
5	26,312,828	3,442,113	(3,000,000)	26,754,940
Extinguished (55%)				14,715,217
Retained (45%)				12,039,723

Step 2: Accounting for extinguishment of the 55%

	Debit	Credit
Statement of profit or loss	1,784,783	
Financial liability Dr	14,715,214	
Equity		16,500,000

Step 3 Accounting for portion retained (45%)

Step 3a: Identify whether the modification is substantial or not

	Rs.
Carrying amount of the original loan	12,039,723
PV of the revised cash flows at the original effective rate Rs. 500,000 + (30,000,000 × 1/(1.1308150)^5)	16,724,206
Difference	4,684,483
As a percentage of the original carrying amount (4,684,483/12,039,723 × 100)	39%

Conclusion:

The terms of the original loan have been substantially modified

Step 3b: Account for the substantial modification

	Debit	Credit
Original liability	12,039,723	
Statement of profit or loss	3,704,097	
Equity		500,000
New liability (working)		15,243,820

Working: Fair value of new loan on initial recognition

(Rs. 30,000,000 × 1/1.145^5) = Rs. 15,243,820

4 IAS 39: OTHER MATTERS

Section overview

- Embedded derivatives
- Impairment of financial instruments

4.1 Embedded derivatives

Certain contracts may not meet the definition of a derivative in their entirety but may have implicit or explicit terms that act in a manner similar to a derivative. They are said to have a derivative embedded in them.

If a contract contains an embedded derivative it is known as a hybrid contract, being made up of a host contract and an embedded derivative.

The effect of an embedded derivative is that it causes some of the cash flows associated with the contract to vary in a similar way to a stand-alone derivative.

The problem is that in the absence of rules requiring separation of embedded derivatives:

- an entity could bury a derivative position in another contract to avoid the IAS 39 fair value rules; or
- two different entities could hold similar derivative positions and therefore face exactly the same economic exposure, but if the derivative of one company was embedded in another contract these same economic exposures would be accounted for differently.

Derivatives might be embedded in financial assets and financial liabilities but might also be associated with transactions like leases and supply contracts.

Examples: Embedded derivatives

A loan might have interest or principal repayments linked to oil price. There is an oil derivative embedded in the loan.

Rules

The decision about whether an embedded derivative must be separated, or not, requires an analysis of the terms and conditions of the hybrid contract.

Separation is required subject to three conditions, all of which must be met.

An embedded derivative must be separated when:

- the hybrid is not measured at fair value with changes to P&L; and
- a separate instrument with similar terms would be a derivative; and
- its economic characteristics and risks are ***not*** closely related to those of the host.

Commentary on the separation rules

There would be no point in splitting something that is already fair valued into two components that would be fair valued. Therefore, there is no need to separate an embedded derivative from an instrument that is measured at fair value through profit or loss.

However, many contracts cannot be fair valued (e.g. leases, supply contracts, insurance contracts etc.). These contracts will always satisfy this condition and therefore, might contain embedded derivatives that would require separation

Secondly "a separate instrument with similar terms would be a derivative". There must be a derivative that can be separated. The contract must include terms (implied or explicit) that satisfy the definition of a derivative

Lastly separation is only required when the underlying economics of the derivative are different to those of the host or as IAS 39 puts it, when "the economic characteristics and risks of the embedded derivative are not closely related to those of the host".

Example: Embedded derivative

A company invests in a convertible debt instrument costing Rs. 250,000.

The fixed interest rate is 7%. At the end of ten years, the instrument can be converted into ordinary shares, at the option of the company. Otherwise, the capital of Rs. 250,000 will be repaid.

The investment is classed as available-for-sale.

The fair value of the equity option has been estimated as Rs. 35,000.

Analysis:

The embedded derivative is the option to convert the debt instrument into equity at the end of ten years. The host contract is the debt instrument. The embedded derivative must be separated from the host contract because the conditions listed above are met:

a. The debt instrument is not measured at fair value, with changes in fair value recognised as profit or loss.

b. A separate instrument with similar terms would be a derivative

c. The debt and equity do not have closely-related characteristics.

There is an embedded derivative.

Since the fair value of the embedded derivative (the equity option) is Rs. 35,000 the transaction is recognised as follows:

	Rs.
Available for sale asset	215,000
Derivative (share option)	35,000

Subsequently, the available-for-sale investment and the derivative will be accounted for in different ways.

4.2 Impairment of financial instruments

Impairment of most non-current assets is covered by IAS 36, but impairment of financial instruments is dealt with by IAS 39. The rules for financial assets are similar to those for non-financial assets.

This is only an issue for financial assets measured at amortised cost and fair value through OCI. Any impairment losses on those measured at fair value through profit and loss are automatically recognised through the basic fair value model.

A financial asset is impaired if its carrying amount exceeds its estimated recoverable amount. This comparison is made only if there are indications of impairment at the reporting date. An entity must assess whether this is the case.

Indicators of impairment might include:

- financial difficulties of the issuer – indicating that interest may not be received by a holder of bonds of the issuer;
- default by the borrower on interest payments;
- disappearance of an active market for the investment;
- a significant continued decline in value.

If there are indications of impairment of an asset measured at amortised cost an entity must estimate its recoverable amount. This is the present value of estimated future cash flows from the asset discounted at the original effective rate.

Example: Impairment of financial asset

Company X invests in a bond.

The bond has an issue value of Rs. 1 million and pays a coupon rate of 5% interest for two years, then 7% interest for two years (this known as a stepped bond).

Interest is paid annually on the anniversary of the bond issue.

The bond will be redeemed at par after four years.

The effective rate for this bond is 5.942%

At the end of the second year it becomes apparent that the issuer has financial difficulties and it is estimated that Company X will only receive Rs. 60 for every Rs. 100 of the future cash flows

At the end of year 2 the amortised cost is:

Year	Amortised cost brought forward	Interest at 5.942%	Cash paid	Amortised cost carried forward
1	1,000,000	59,424	(50,000)	1,009,424
2	1,009,424	59,983	(50,000)	1,019,407

The recoverable amount is calculated as follows:

Year	Future cash flows	Discount factor (@5.942%)	
3	70,000 @ 60% = 42,000	0.9439	39,644
4	1,070,000 @ 60% = 642,000	0.891	572,022
Recoverable amount			611,666
Carrying amount			1,019,407
Impairment			407,741

Note that the recoverable amount could have been calculated easily as 60% of the carrying amount:

60% of 1,019,407 = 611,644 (22 difference due to rounding)

Any impairment loss is charged to profit or loss.

5 IAS 39: HEDGE ACCOUNTING

Section overview

- What is hedging?
- Definitions
- The principles of hedge accounting
- Fair value hedge
- Cash flow hedge
- Cash flow hedge – basis adjustment
- Hedges of a net investment in a foreign operation

5.1 What is hedging?

Hedging is the process of entering into a transaction in order to reduce risk. Companies may use derivatives to establish 'positions', so that gains or losses from holding the position in derivatives will offset losses or gains on the related item that is being hedged.

Example:

A UK company has a liability to pay a US supplier $200,000 in three months' time.

The company is exposed to the risk that the US dollar will increase in value against the British pound in the next three months, so that the payment in dollars will become more expensive (in pounds).

A hedge can be created for this exposure to foreign exchange risk by making a forward contract to buy $200,000 in three months' time, at a rate of exchange that is fixed now by the contract.

This is an example of hedging: the exposure to risk has been removed by the forward contract.

The logic of accounting for hedging should be that if a position is hedged, then any gains on the underlying instrument that are reported in profit and loss should be offset by matching losses on the hedging position in derivatives, which should also be reported in profit or loss.

Similarly, any losses on the underlying instrument that are reported in profit or loss should be offset by matching gains on the hedging position in derivatives, which should also be reported in profit or loss.

However, without special rules to account for hedging, the financial statements may not reflect the offsetting of the risk and the economic reality of hedging.

5.2 Definitions

A company can hedge whatever it wants to but, IAS 39 only allows hedge accounting when certain conditions are satisfied. IAS 39 uses the following definitions in describing the hedge accounting rules.

Hedged item

Definition

A hedged item is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that exposes the entity to risk of changes in fair value or future cash flows and is designated as being hedged.

Hedges of net items cannot qualify for hedge accounting. Suppose a company whose functional currency was rupees had a €100 asset and an €80 liability. This company would have a foreign exchange risk exposure on €20. In practice a company might hedge this €20 position. This cannot qualify for hedge accounting.

Further guidance in IAS 39 limits the risks that can be hedged. A company might hedge risk components. For example, a company might invest in a foreign currency, interest bearing bond. The company might hedge the foreign currency risk and/or the interest rate risk and/or the credit risk of this bond. In each case it would be allowed to use hedge accounting.

However, this is not the case for non-financial items which must be hedged for foreign exchange risk or their total risk. For example, a jet fuel manufacturer might hedge the crude oil cost component of its production costs. This cannot be hedge accounted under IAS 39.

Hedging instrument

Definition

A hedging instrument is a designated derivative or (for a hedge of the risk of changes in foreign currency exchange rates only) a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item.

Hedge accounting is not allowed for hedges where non derivative financial assets and liabilities are used as hedging instruments except for hedges of foreign exchange risk.

Hedge accounting is only allowed for hedges involving derivatives external to the entity. Therefore, if a member of a group takes a derivative position with another member of the group in order to hedge a risk it may use hedge accounting in its own financial statements. This hedge accounting must be removed on consolidation as then the derivative is not external.

Hedge effectiveness

Definition

Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

IAS 39 does not specify methods of measuring effectiveness but does require that it be measured on every reporting date (at least). Whatever method is used must be documented and in place before hedge accounting is allowed.

5.3 The principles of hedge accounting

Hedge accounting provides special rules that allow the matching of the gain or loss on the derivatives position with the loss or gain on the hedged item. This reduces volatility in the statement of financial position and the statement of profit or loss, and so is very attractive to the preparers of accounts.

The special rules for accounting for hedging can only be used where very stringent conditions are met:

- ❑ The derivative must be designated as a hedging instrument.
- ❑ The hedge must be expected to be highly effective (almost fully offset).
- ❑ The hedge must be regularly assessed and found to be highly effective. (*Highly effective is where the change in the value of the hedging instrument (derivative) relative to the change in the item that is being hedged is in the range 80% - 125%).*
- ❑ Formal documentation must be prepared to describe
  - the hedging instrument;
  - the hedged item;
  - the hedged risk;
  - the method of testing effectiveness; and
  - the type of hedge.

Hedge accounting models

Where the conditions for using hedge accounting are met, the method of hedge accounting to be used depends on the type of hedge.

IAS 39 identifies three types of hedging relationship:

- ❑ fair value hedges
- ❑ cash flow hedges; and
- ❑ hedges of a net investment in a foreign entity (accounted for as a cash flow hedge).

5.4 Fair value hedge

A fair value hedge is a hedge against the risk of a **change in the fair value of an asset or liability**. For example, oil held in inventory could be hedged with an oil forward contract to hedge the exposure to a risk of a fall in oil sales prices. Or the risk of a change in the fair value of a fixed rate debt owed by a company could be hedged using an interest rate swap.

Accounting treatment of fair value hedges

Accounting for a fair value hedge is as follows:

- The **gain or loss** on the hedging instrument (the derivative) is taken to profit or loss, as normal.
- The carrying amount of the hedged item is adjusted by the **loss or gain** on the hedged item attributable to the hedged risk with the other side of the entry recognised in profit or loss.

Example: Fair value hedge

Entity X holds an inventory of 100 barrels of oil at a cost of $70 a barrel.

30th September 20X1: Oil is trading at $100 a barrel. Entity X decides to hedge the fair value of its oil inventory by entering into a 12 m forward contract to sell the oil at $100 per barrel.

31st December 20X1: Oil is trading at $90 per barrel.

Required

Assuming that the hedge has been properly documented explain the accounting treatment for this hedge (ignore time value).

Answer

Hedging instrument (gain)

The forward contract gives Entity X the right to sell oil at $100 per barrel but it is only worth $90 per barrel. This represents a gain of $10 per barrel

Dr	Derivative asset (100 barrels @ $10)	$1,000	
Cr	P&L		$1,000

Hedged item (loss)

The fair value of oil has fallen by $10 per barrel. The carrying amount of the inventory is adjusted by this amount.

Dr	P&L	$1,000	
Cr	Inventory		$1,000

Note that the hedged item is not fair valued. Its carrying amount is adjusted by the change in its fair value.

Summary

	Debit/(credit)		
	Inventory	Derivative (asset)	P&L
30th September 20X1	10,000		
31st December 20X1:			
Fair value change			
Derivative		1,000	(1,000)
Inventory	(1,000)		1,000
	9,000	1,000	Nil

5.5 Cash flow hedge

A cash flow hedge is a hedge against the risk of changes in cash flows relating to a recognised asset or liability or an anticipated purchase or sale. For example, floating rate debt issued by a company might be hedged using an interest rate swap to manage increases in interest rates. Or future US dollar sales of airline seats by a Pakistani company might be hedged by a US$/Rs. forward contracts to manage changes in exchange rates. These are hedges relating to future cash flows from interest payments or foreign exchange receipts.

Accounting treatment of cash flow hedges

Accounting for a cash flow hedge is as follows:

- The change in the fair value of the hedging instrument is analysed into 'effective' and 'ineffective' elements.
- The 'effective' portion is recognised in other comprehensive income (directly in equity).
- The 'ineffective' portion is recognised in profit or loss.

- The amount recognised in other comprehensive income is subsequently released to the profit or loss as a reclassification adjustment in the same period as the hedged forecast cash flows affect profit or loss.

Example: Cash flow hedge

X SA is a French company

It expects to sell $1,000 of airline seats for cash in six months' time.

The current spot rate is €1 = $1.

It sells the future dollar receipts forward to fix the amount to be received in euros and to provide a hedge against the risk of a fall in the value of the dollar against the euro.

At inception (30 September 20X1)

At inception, the anticipated future sale is not recorded in the accounts, and the derivative (the forward contract) has an initial value of zero.

Reporting date (31 December 20X1)

The dollar has weakened with the following results:

a. The derivative is an asset with a fair value of €80.

b. The change in expected cash flows in euros from the forecast seat sales has fallen by €75 (€1,000 to €925).

Effectiveness:

The hedge is highly effective, because the change in the value of the forward contract (+ €80) closely matches the change in the value of the forecast sales receipts (– €75).

The hedge is 93.75% effective (75/80). Alternatively, this could be expressed as 106.67% (80/75). It is within the range 80% to 125%.

Accounting:

The gain on the derivative of €80 must be split into 'effective' and 'ineffective' elements.

The 'effective' gain is the amount of the gain that matches the fall in value in the hedged item. In this example, this is €75.

The 'ineffective' gain is the difference (€80 - €75 = €5).

The effective gain is recognised in other comprehensive income and accumulated in an equity reserve.

The ineffective element of €5 is reported as a gain in profit or loss for the period.

	Dr	Cr
Derivative	80	
Equity reserve		75
Profit or loss		5

Example (continued): Cash flow hedge.

31 March 20X2 (At settlement)

The forward contract is settled with a gain of €103. This is €23 more than expected at the last reporting date. The amount must be recognised with the effective element being taken to OCI and the ineffective element recognised in P&L.

The airline seats are sold, but the proceeds in euros are €905. This is €20 less than the €925 estimated at the last reporting date.

The further gain on the derivative must be split into effective and ineffective elements:

a. Effective = €20 (€ 925 – € 905, which is the loss on the euro receipts)

b. Ineffective = €3 (the balance, €23 – €20).

	Dr	Cr
Derivative	23	
Equity reserve		20
Profit or loss		3

Accounting on settlement

The income from the sales is €905.

The 'effective' gains on the derivative held in the equity reserve are released to profit or loss as a reclassification adjustment in other comprehensive income.

The release of the €95 to profit or loss means that the total income from the seat sales and the effective hedged gains is €1,000. This was the amount of income that was 'hedged' by the original forward contract.

Summary:

	Debit /(credit)			
	Cash	Derivative (asset)	OCI	Profit or loss
Previous period		80	(75)	(5)
Current period:				
Fair value change		23	(20)	(3)
Sale of seats	905			(905)
Reclassification adjustment			95	(95)
Settle forward contract	103	(103)		
	1,008	0	0	(1,008)

The statement of profit or loss includes €1,000 revenue that the company 'locked into' with the hedging position, plus the gain of €8 (€5 + €3) on the ineffective part of the hedge (= the speculative element of the derivative).

5.6 Cash flow hedge – Basis adjustment

A cash flow hedged transaction might be the future purchase of a non-financial asset.

Example: Cash flow hedge – Basis adjustment

Entity X is based in the UK and has a December year end. Its functional currency is sterling (GBP)

Entity X forecasts the purchase of a machine from a US supplier and will be paid for in dollars (USD). The purchase is expected to occur on 1st January 20X3.

It is now 30th September 20X2. The cost of the machine is $15,000. The exchange rate is $1.5=£1 giving a cost to Entity X of £10,000.

Entity X hedges the exchange risk be entering into a forward contract for $15,000 @ $1.5=£1. This is designated as a cash flow hedge and accounted for accordingly.

1st January 20X3

Entity X buys the machine for $15,000. The exchange rate is $1.47=£1 giving a cost to Entity X of £10,200.

A gain on the forward contract of £200 has been recognised through OCI by this date. This means that there is a credit balance of £200 in the cash flow hedge reserve in equity.

This must be released to profit as the hedged transaction impacts the profit and loss account. The hedged transaction impacts the profit and loss account as the asset is depreciated.

There are two ways of doing this.

Approach one

	Debit /(credit)		
	Machine	**OCI (equity reserve)**	**Profit or loss)**
1 January 20X3	10,200	(200)	
31 December 20X3: Depreciation (say 10 years)	(1,020)		1,020
Transfer from equity: reclassification adjustment		20	(20)
Charge for the year			1,000
Balance carried forward	9,180	(180)	

The amounts recognised on the statement of financial position net at £10,000 on initial recognition (10,200 – 200). This is because Entity X was able to lock in the rate of $1.5=£1 for the purchase of the machine. The accounting treatment results in a net expense in the P&L of £1,000 (£10,000/10 years).

Example: Cash flow hedge – Basis adjustment

IAS 39 allows a simpler approach.

When a hedged forecast transaction results in the recognition of a non-financial asset (or liability) an entity is allowed to net off the amount deferred in equity against the initial amount recognised for the asset.

This is known as a "basis adjustment".

Approach two

	Debit /(credit)		
	Machine	Equity reserve (via OCI)	Profit or loss (P&L)
1 January 20X3	10,200	(200)	
Basis adjustment	(200)	200	
Carrying amount on initial recognition	10,000	nil	
31 December 20X3: Depreciation (say 10 years)	(1,000)		1,000
Charge for the year			1,000
Balance carried forward	9,000	nil	

This is only allowed for non-financial assets and liabilities. Approach one must be used for financial assets and liabilities.

5.7 Hedges of a net investment in a foreign operation

A later chapter explains the accounting treatment, for consolidation purposes, of an investment in a foreign subsidiary or other foreign operation.

The net assets of the foreign subsidiary are translated at the end of each financial year, and any foreign exchange differences are recognised in other comprehensive income (until the foreign subsidiary is disposed of, when the cumulative profit or loss is then reclassified from 'equity' to profit or loss).

IAS 39 allows hedge accounting for an investment in a foreign subsidiary. An entity may designate an eligible hedging instrument for a net investment in a foreign subsidiary, provided that the hedging instrument is equal to or less than the value of the net assets in the foreign subsidiary.

This is accounted for as a cash flow hedge.

6 IFRIC 16: HEDGES OF A NET INVESTMENT IN A FOREIGN OPERATION

Section overview

- Introduction
- Consensus – Location of hedging instrument
- Consensus – Nature of hedged risk
- Consensus – Amounts to be reclassified from equity

6.1 Introduction

Scope

IFRIC 16 applies to hedges of foreign currency risk in a net investment in a foreign operation where an entity wishes to qualify for hedge accounting under IAS 39

Background

IAS 39 (IFRS 9) allows hedge accounting of hedges of a net investment in a foreign operation (subject to satisfying the hedge accounting criteria).

Definitions

Foreign operation: an entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.

Net investment in a foreign operation: the amount of the reporting entity's interest in the net assets of that operation.

Therefore (by definition) hedge accounting of the foreign exchange risk of the net investment in a foreign operation only applies in financial statements where the interest in the foreign operation is included as the investing company's share of its net assets. This means for example that hedge accounting in respect of the exchange risk associated with an investment in a foreign subsidiary is only allowed in the consolidated financial statements.

Where there is such a designated hedging relationship the effective part of the gain or loss on the hedging instrument is recognised in other comprehensive income and accumulated with the foreign exchange differences arising on translation of the results and financial position of the foreign operation.

Investments in a foreign operation may be held directly or indirectly

IFRIC 16 addresses the following three issues:

- Where the hedging instrument should be held within a group.
- The nature of the hedged risk and the amount of a hedged item for which a hedging relationship may be designated?
- The amounts that should be reclassified from equity to profit or loss as on disposal of the foreign operation?

6.2 Consensus – Location of hedging instrument

The hedging instrument may be held by any entity within the group.

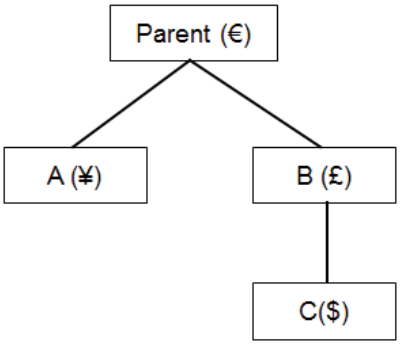
6.3 Consensus – Nature of hedged risk

Hedge accounting may be applied only to foreign exchange differences arising between the functional currency of the foreign operation and that of **any** parent entity but not to hedges of forex differences between functional currency of a subsidiary to presentation currency of a parent.

Example:

The following group comprises a parent and 3 100% owned subsidiaries.

The functional currency of each member of the group is shown in brackets.



Further information:

Subsidiary A has external borrowings of $300,000.

Subsidiary C has net assets of $300,000.

Designation of hedged risk

In its consolidated financial statements, the parent designates Subsidiary A's borrowing as a hedge of the €/$ exchange risk of its net investment in C.

Accounting

The exchange difference on the retranslation of the net assets of C is recognised in OCI and accumulated in the currency translation reserve. (IAS 21).

(In effect this is a translation of dollars to pounds and then the pounds into euro).

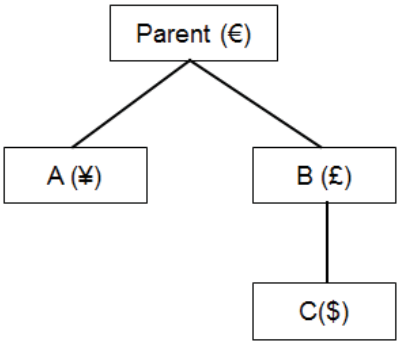
The exchange gain or loss on the external borrowing is recognised in OCI and accumulated in the currency translation reserve. (IAS 39/IFRS 9).

(In effect this is a translation of dollars to yen and then the yen into euro).

Example:

The following group comprises a parent and 3 100% owned subsidiaries.

The functional currency of each member of the group is shown in brackets.



Further information:

Subsidiary A has external borrowings of $300,000.
Subsidiary C has net assets of $300,000.

Designation of hedged risk

In its consolidated financial statements, the parent designates Subsidiary A's borrowing as a hedge of the £/$ exchange risk between subsidiary B and C.

Accounting

The exchange difference on the retranslation of the net assets of C is recognised in OCI and accumulated in the currency translation reserve. (IAS 21).
(In effect this is a translation of dollars to pounds and then the pounds into euro).

The recognition of the exchange gain or loss arising on the external borrowing is quite complicated.
Dollars to pounds: Any gain or loss recognised in OCI (applying IAS39/IFRS 9 – this is the offset of the hedged risk above).
Pounds to yen: Any gain or loss recognised in P&L (applying IAS 21 for individual company transactions).
Yen to dollars: Any gain or loss recognised in OCI (IAS 21 for translation differences arising on consolidation).

The hedged item may be an amount of net assets equal to or less than the carrying amount of the net assets of the foreign operation.

A forex exposure arising from a net investment in a foreign operation may qualify for hedge accounting only once in consolidated financial statements.

6.4 Consensus – Amounts to be reclassified from equity

The following two amounts must be reclassified from the forex translation reserve to P&L (via OCI) on disposal of a hedged net investment in a foreign operation:

- the cumulative translation reserve that has arisen on the consolidation of the net investment (IAS 21); and
- the cumulative effective gain or loss on the hedging instrument (IAS 39)

7 IFRS 9: RECOGNITION AND MEASUREMENT

Section overview

- Recognition of financial instruments
- Classification of financial assets
- Other measurement rules
- Classification of financial liabilities

7.1 Recognition of financial instruments

The initial recognition rule and the measurement on initial recognition are the same as those in IAS 39.

A financial asset might be an investment in debt or in equity.

7.2 Classification of financial assets

Classification determines how financial assets are accounted for and in particular, how they are measured on an ongoing basis.

A company must classify financial assets as subsequently measured at:

- amortised cost;
- fair value through other comprehensive income; or
- fair value through profit or loss

This classification is made on the basis of both:

- the business model for managing the financial assets and
- the contractual cash flow characteristics of the financial asset.

Financial assets at amortised cost

A financial asset must be measured at amortised cost if both of the following conditions are met:

- the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows; and
- 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.

Financial assets at fair value through other comprehensive income

A financial asset must be measured at fair value through other comprehensive income if both of the following conditions are met:

- the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows **and** selling financial assets and
- 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.

Financial assets at fair value through profit or loss

A financial asset must be measured at fair value through profit or loss unless it is measured at amortised cost or at fair value through other comprehensive income.

Reclassification of financial assets after initial recognition is required when an entity changes its model for managing financial assets. It is not allowed in any other circumstance.

Example: Classification of financial assets

A company makes a large bond issue to the market.

Three companies (A Limited, B Limited and C Limited) each buy identical Rs. 10,000,000 bonds.

Company	Business model	Classification of bond
A Limited	A Limited holds bonds for the purpose of collecting contractual cash flows to maturity	A Limited must measure the bond at amortised cost
B Limited	B Limited holds bonds for the purpose of collecting contractual cash flows but sells them on the market when prices are favourable	B Limited must measure the bond at fair value through OCI
C Limited	C Limited buys bonds to trade in them	C Limited must measure the bond at fair value through P&L

7.3 Other measurement rules

Option to designate a financial asset at fair value through profit or loss

Despite the above, a company may, at initial recognition, irrevocably designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.

Equity instruments

Investments in equity are measured at fair value through profit or loss.

However a company can make an irrevocable election at initial recognition to measure an equity investment at fair value through other comprehensive income as long as it is not held for trading.

Amortised cost criteria - commentary

The rules try to limit the use of amortised cost to those situations where it best reflects the substance of the transactions. Therefore it can only be used by a company whose business model is to make loans and collect future repayments.

A company might sell a loan before its maturity. This does not preclude classification of loans at amortised cost as long as the company's overall business model is to hold assets in order to receive contractual cash flows.

On the other hand a company might hold a portfolio of loans in order to profit from the sale of these assets when market conditions are favourable. In this case the company's business model is not to hold assets in order to receive contractual cash flows. The loans in this portfolio must be measured at fair value.

The cash flows received by a company must be solely repayments of the principal and interest on this principal. An investment in a convertible bond would not satisfy this criteria as a company might convert it into equity. In that case the amounts received by the company would not solely be by repayments of principal or interest.

Overview of classification of financial assets

Method	Which instruments?
Amortised cost	Loans and receivables that satisfy the amortised cost criteria
Fair value to OCI	Loans and receivables that satisfy the fair value through OCI criteria Equity that has been subject to a declaration
Fair value through profit or loss (FVTPL)	Equity Derivatives Loans and receivables that fail the amortised cost criteria Loans and receivables that satisfy the amortised cost criteria but are designated into this category on initial recognition

7.4 Classification of financial liabilities

The rules on accounting for financial liabilities are the same as in IAS 39.

At initial recognition, financial liabilities are classified as subsequently measured at amortised cost with specific exceptions including:

- derivatives that are liabilities at the reporting date; and
- financial liabilities that might arise when a financial asset is transferred but this transfer does not satisfy the derecognition criteria.

Reclassification of a financial liability after initial recognition is not allowed.

Irrevocable designation

A company is allowed to designate a financial liability as measured at fair value through profit or loss. This designation can only be made if:

- it eliminates or significantly reduces a measurement or recognition inconsistency; or
- this would allow the company to reflect a documented risk management strategy.

Any such designation is irrevocable.

If a financial liability is measured at fair value any change due to the company's own credit risk is recognised in OCI (not P&L)

Reclassification of a financial liability after initial recognition is not allowed.

Summary of accounting of items measured at fair value

Category	Examples
Financial asset at fair value through profit or loss	Whole fair value movement to profit or loss
Financial asset at fair value through OCI	Whole fair value movement to OCI **Subsequent sale of the asset** Gain or loss on disposal calculated based on the carrying amount of the asset at the date of disposal. No reclassification of the amounts previously recognised in OCI in respect of equity for which an irrevocable election has been made. (This is different to the IAS 39 requirement on disposal of an AFS equity investment). Reclassification is still required for debt instruments measured at fair value through OCI.
Financial liability at fair value through profit or loss	Change in fair value attributed to change in credit risk to OCI. Remaining change in fair value to profit or loss

Example: Equity investment

An equity investment is purchased for Rs. 30,000 plus 1% transaction costs on 1 January 20X6. It is classified as at fair value through OCI.

At the end of the financial year (31 December) the investment is revalued to its fair value of Rs. 40,000.

On 11 December 20X7 it is sold for Rs. 50,000.

Required

Explain the accounting treatment for this investment.

Answer

1 January 20X6 The investment is recorded at Rs. 30,300. This is the cost plus the capitalised transaction costs.

31 December 20X6 The investment is revalued to its fair value of Rs. 40,000.

The gain of Rs. 9,700 is included in other comprehensive income for the year.

11 December 20X7 The journal entry to record the disposal is as follows:

	Dr	Cr
Cash	50,000	
Investment		40,000
Statement of profit or loss		10,000

8 IFRS 9: IMPAIRMENT OF FINANCIAL ASSETS

Section overview

- Introduction
- Definitions
- Simplified approach
- General approach
- Credit impairment

8.1 Introduction

Impairment of most non-current assets is covered by IAS 36. IAS 36 operates an incurred loss model. This means that impairment is recognised only when an event has occurred which has caused a fall in the recoverable amount of an asset.

Impairment of financial instruments is dealt with by IFRS 9. IFRS 9 contains an expected loss model. The expected loss model applies to all debt instruments (loans, receivables etc.) recorded at amortised cost or at fair value through OCI. It also applies to lease receivables (IAS 17), contract assets (IFRS 15).

The aim of the expected loss model is that financial statements should reflect the deterioration or improvement in the credit quality of financial instruments held by an entity. This is achieved by recognising amounts for the expected credit loss associated with financial assets.

The rules look complex because they have been drafted to provide guidance to banks and similar financial institutions on the recognition of credit losses on loans made. However, there is a simplified regime that applies to other financial assets as specified in the standard (such as trade receivables and lease receivables).

This section explains the simplified regime in the first instance (which in our view is more likely to be examined). The section then provides an overview of the more complicated general regime. This is of great importance to lenders, for example, banks and similar financial institutions.

8.2 Definitions

Credit loss The difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e. all cash shortfalls), discounted at the original effective interest rate

Lifetime expected credit losses: The expected credit losses that result from all possible default events over the expected life of a financial instrument.

12-month expected credit losses: The portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date

8.3 Simplified approach

This applies to trade receivables, contract assets and lease receivables. The approach involves the recognition of lifetime expected losses for the relevant assets.

The following table summarises when the approach must or may be used.

Financial asset	Simplified approach
Trade receivables or contract assets (IFRS 15) that do not do not contain a significant financing component	Must be used
Trade receivables or contract assets that contain a significant financing component	May be used if chosen as an accounting policy to be applied consistently to all trade receivables or contract assets. It may be applied separately to trade receivables and contract receivables.
Lease receivables	May be used if chosen as an accounting policy to be applied consistently. It may be applied separately to finance and operating lease receivables.

Example:

X Limited has total trade receivables of Rs. 30,000,000.

The trade receivables do not have a significant financing component.

The loss allowance recognised at the end of the previous year was Rs. 500,000.

X Limited has constructed the following provision matrix to calculate expected lifetime losses of trade receivables.

	Number of days past due (overdue)				
	Current	1 to 30	31 to 60	61 to 90	More than 90
Default rate	0.3%	1.6%	3.6%	6.6%	10.6%

Required: Calculate the lifetime expected credit loss, show the necessary double entry to record the loss and state the amounts to be recognised in the statement of financial position.

Answer

The expected lifetime credit loss is measured as follows:

	Gross carrying amount of trade receivables	Default rate	Lifetime expected credit loss
	Rs.	%	Rs.
Current	15,000,000	0.3	45,000
1 to 30 days	7,500,000	1.6	120,000
31 to 60 days	4,000,000	3.6	144,000
61 to 90 days	2,500,000	6.6	165,000
More than 90	1,000,000	10.6	106,000
	30,000,000		580,000

X Limited must recognise a loss provision of Rs. 580,000.

The following double entry would be necessary to increase the opening loss provision to this amount:

	Debit	Credit
Statement of profit or loss	80,000	
Loss allowance		80,000

The trade receivables would be presented at an amount net of this allowance in the statement of financial position (Rs. 30,000,000 - Rs. 580,000 = Rs. 29,420,000).

8.4 General approach

This approach must be applied to financial assets measured at amortised cost and financial assets measured at fair value through OCI. The approach also applies to lease receivables and contract assets unless the entity adopts the simplified approach described above. (Any impairment losses on financial assets measured at fair value through profit and loss are automatically recognised in profit or loss).

The objective of the requirements is to recognise lifetime expected credit losses for all financial instruments for which there have been significant increases in credit risk since initial recognition (whether assessed on an individual or collective basis) considering all reasonable and supportable information.

Overview

For those financial assets to which the general approach applies, a loss allowance measured as the **12-month expected credit losses** is recognised at initial recognition.

The expected credit loss associated with the financial asset is then reviewed at each subsequent reporting date. The amount of expected credit loss recognised as a loss allowance depends on the extent of credit deterioration since initial recognition.

- If there is no significant increase in credit risk the loss allowance for that asset is remeasured to the 12 month expected credit loss as at that date.
- If there is a significant increase in credit risk the loss allowance for that asset is remeasured to the **lifetime expected credit losses** as at that date. This does not mean that the financial asset is impaired. The entity still hopes to collect amounts due but the possibility of a loss event has increased.
- If there is credit impairment, the financial asset is written down to its estimated recoverable amount. The entity accepts that not all contractual cash flows will be collected and the asset is impaired.

Credit impairment (the third bullet above) will be dealt with in a separate section.

The first two bullets simply differ in terms of how the expected loss is measured. There is no difference between the necessary double entry in each case.

Loss allowance for financial assets carried at amortised cost.

Movement on the loss allowance is recognised in profit or loss.

The loss allowance balance is netted against the financial asset to which it relates on the face of the statement of financial position.

NB: this is just for presentation only; the loss allowance does not reduce the carrying amount of the financial asset in the double entry system.

Example:

1 January 20X1

X Limited has purchased a bond for Rs. 1,000,000.

The bond pays interest at 5% and is to be redeemed at par in 5 years' time.

12 month expected credit loss = Rs. 25,000.

31 December 20X1

Interest is collected at its due date.

There is no significant change in credit risk.

12 month expected credit loss = Rs. 30,000.

Required

Show the double entries on initial recognition and at 31 December necessary to account for the bond and the loss allowance.

Answer

1 January 20X1	**Debit**	**Credit**
Financial asset at amortised cost	1,000,000	
Cash		1,000,000
Being: Purchase of financial asset at amortised cost		
Statement of profit or loss	25,000	
Loss allowance		25,000
Being: Recognition of loss allowance on financial asset at amortised cost		
31 December 20X1		
Financial asset at amortised cost	50,000	
Statement of profit or loss		50,000
Being: Accrual of interest income at the effective rate from financial asset at amortised cost		
Cash	50,000	
Financial asset at amortised cost		50,000
Being: Receipt of interest income from financial asset at amortised cost		
Statement of profit or loss	5,000	
Loss allowance		5,000
Being: Recognition of movement on loss allowance.		

Loss allowance for financial assets at fair value through OCI

Movement on the loss allowance is recognised in profit or loss but the loss allowance balance is not netted against the financial asset to which it relates as this is carried at fair value. The loss allowance is recognised in other comprehensive income.

Example:

1 January 20X1

X Limited has purchased a bond for Rs. 1,000,000.

The bond pays interest at 5% and is to be redeemed at par in 5 years' time.

12 month expected credit loss = Rs. 25,000.

31 December 20X1

Interest is collected at its due date.

There is no significant change in credit risk.

The fair value of the bond is Rs. 940,000.

12 month expected credit loss = Rs. 30,000.

Required

Show the double entries on initial recognition and at 31 December necessary to account for the bond and the loss allowance.

Answer

1 January 20X1	Debit	Credit
Financial asset at amortised cost	1,000,000	
Cash		1,000,000
Being: Purchase of financial asset at FVOCI		
Statement of profit or loss	25,000	
Other comprehensive income		25,000
Being: Recognition of loss allowance on financial asset at FVOCI.		
31 December 20X1		
Financial asset at amortised cost	50,000	
Statement of profit or loss		50,000
Being: Accrual of interest income at the effective rate from financial asset at FVOCI.		
Cash	50,000	
Financial asset at FVOCI.		50,000
Being: Receipt of interest income from financial asset FVOCI.		
Other comprehensive income	60,000	
Financial asset at FVOCI.		60,000
Being: Fair value adjustment (loss) on financial asset at FVOCI.		
Statement of profit or loss	5,000	
Other comprehensive income		5,000
Being: Recognition of movement on loss allowance.		

Answer (continued)

The following table summarises the above double entries. Credit entries are shown as figures in brackets

	Cash	Financial asset	OCI	P&L
	Rs. 000	Rs. 000	Rs. 000	Rs. 000
1 January 20X1				
Purchase of financial asset	(1,000)	1,000		
Recognition of loss allowance			(25)	25
31 December 20X1				
Interest accrual		50		(50)
Interest payment	50	(50)		
		1,000		
Fair value adjustment		(60)	60	
Movement on loss allowance			(5)	5
		940	30	

The balance in OCI for this asset is the fair value adjustment net of the loss allowance.

8.5 Credit impairment

A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is credit-impaired include (but is not limited to) observable data about the following events:

- significant financial difficulty of the issuer or the borrower;
- a breach of contract, such as a default or past due event;
- the lender has granted to the borrower a concession for economic or contractual reasons relating to the borrower's financial difficulty that the lender would not otherwise have considered:
- it is becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
- the disappearance of an active market for that financial asset because of financial difficulties; or
- the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses.

If an entity revises its estimates of receipts it must adjust the gross carrying amount of the financial asset to reflect actual and revised estimated contractual cash flows. The financial asset must be remeasured to the present value of estimated future cash flows from the asset discounted at the original effective rate.

Example:

Company X invests in a bond.

The bond has an issue value of Rs. 1 million and pays a coupon rate of 5% interest for two years, then 7% interest for two years (this known as a stepped bond).

Interest is paid annually on the anniversary of the bond issue.

The bond will be redeemed at par after four years.

The effective rate for this bond is 5.942%

At the end of the second year it becomes apparent that the issuer has financial difficulties and it is estimated that Company X will only receive 60 paisa in the rupee of the future cash flows.

At the end of year 2 the amortised cost is:

Year	Amortised cost brought forward	Interest at 5.942%	Cash paid	Amortised cost carried forward
1	1,000,000	59,424	(50,000)	1,009,424
2	1,009,424	59,983	(50,000)	1,019,407

The recoverable amount is calculated as follows:

Year	Future cash flows	Discount factor (@5.942%)	
3	70,000 @ 60% = 42,000	0.9439	39,644
4	1,070,000 @ 60% = 642,000	0.891	572,022
Recoverable amount			611,666
Carrying amount			1,019,407
Impairment			407,741

Note that the recoverable amount could have been calculated easily as 60% of the carrying amount:

60% of 1,019,407 = 611,644 (22 difference due to rounding)

The impairment loss is charged to profit or loss taking into account the balance on the loss allowance account already recognised for the asset.

Example:

Suppose in the above example there was a loss allowance of Rs. 100,000 recognised on the asset before the impairment event.

The necessary double entries would be as follows:

	Debit	Credit
Statement of profit or loss	307,741	
Loss allowance	100,000	
Financial asset		407,741

Future revenue recognition

Interest is recognised in the future by applying the effective rate to the new amortised cost (after the recognition of the impairment loss).

9 IFRS 9: OTHER MATTERS

Section overview

- Embedded derivatives
- Derecognition of financial instruments

9.1 Embedded derivatives

The treatment of embedded derivatives depends on whether the hybrid contract contains a host that is an asset within the scope of IFRS 9.

Hybrid contains a host contract within the scope of IFRS 9

If the host contract is an asset within the scope of IFRS 9 the normal rules of classification and accounting apply.

The contractual cash flows of the financial asset are assessed in their entirety, and the asset as a whole is measured at FVTPL if any of its cash flows do not represent payments of principal and interest.

It may well be the case that the presence of the derivative causes this to happen.

Hybrid contains a host contract outside the scope of IFRS 9

If a hybrid contract contains a host that is not an asset within the scope of IFRS 9, an embedded derivative must be separated from the host and accounted for as a derivative subject to the same rules as in IAS 39

9.2 Derecognition of financial instruments

Derecognition is the removal of a previously recognised financial asset or financial liability from an entity's statement of financial position.

The IAS 39 rules have been incorporated into IFRS 9 with no change.

10 IFRS 9: HEDGE ACCOUNTING

Section overview

- Reasons for change
- Summary of changes

10.1 Reasons for change

The hedge accounting rules in IAS 39 have been criticised. Commentators have pointed out that the accounting treatment is based on rules rather than principles.

This results in the rules being too restrictive resulting in accounting information that does not adequately reflect risk management practices.

For example, there are instances where hedge accounting cannot be applied to groups of items, whereas for risk management purposes items are often hedged on a group basis.

What is the objective of hedge accounting?

An entity uses hedging to manage risks, for example, foreign exchange risk, interest rate risk or the price of a commodity. It may choose to apply hedge accounting to show the effect of managing those risks in the financial statements.

IFRS 9 states that the objective of hedge accounting is to represent the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss (or OCI).

This statement links the accounting rules to the risk management objective resulting in a principles based approach.

10.2 Summary of changes

IAS 39	IFRS 9
Hedge accounting criteria	
IAS 39 sets a high hurdle before hedge accounting is available and for it to continue. There is a strict quantitative effectiveness test (80%-125%) which is widely criticised as being arbitrary and for causing unavailability of hedge accounting for hedges that are good in economic terms.	The quantitative hurdle removed.
Hedging instruments	
Non derivative financial instrument can only be used as hedge of foreign exchange risk.	Non derivative financial instrument can be designated as hedging instruments as long as they are at FVTPL
Hedged items	
IAS 39 allows components (parts) of financial items to be hedged, but not components of non-financial items. For example hedge accounting can be achieved for a hedge of credit risk in bond but not for a hedge of oil price in jet fuel. Risk managers often hedge a risk component for non-financial items.	This distinction has been eliminated. Hedges of components of non-financial items will qualify for hedge accounting.
Companies often hedge net positions but IAS 39 does not allow hedge accounting for these hedges creating an inconsistency between hedge accounting and risk management activity. For example, a company might hedge a net foreign exchange position of 20 that is made up of an asset of 100 and a liability of 80.	Hedges of net positions can qualify for hedge accounting as long as certain criteria are met.
Hedge accounting models	
Fair value hedge accounting: Fair value differences to P&L	No change
Basis adjustment allowed when a cash flow hedge results in the recognition of a non-financial asset or liability	Basis adjustment required when a cash flow hedge or a fair value hedge results in the recognition of a non-financial asset or liability

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

The amount recognised as income in profit or loss each year is based on the effective rate of return, but the cash actually received is based on the coupon rate of 10%.

The difference is treated as an adjustment to the carrying value of the investment in the statement of financial position, which is the amortised cost of the asset.

This is calculated as follows:

Year	Asset value brought forward	Interest at 11.67%	Cash paid	Asset value carried forward
20X5	48.00m	5.60m	(5m)	48.06m
20X6	48.60m	5.65m	(5m)	49.25m
20X7	49.25m	5.75m	(5m)	50.00m
		17m	15m	

Solution **2**

The initial liability is (Rs. 10 million × 100.50/100) – Rs. 50,000 = Rs. 10,000,000.

	Liability at start of year	Finance charge at 7%	Interest paid	Liability at end of year
	Rs.	Rs.	Rs.	Rs.
Year 1	10,000,000	700,000	(600,000)	10,100,000
Year 2	10,100,000	707,000	(600,000)	10,207,000
Year 3	10,207,000	714,490	(600,000)	10,321,490
Year 4	10,321,490	722,510	(600,000)	10,444,000
		2,844,000	2,400,000	

The final interest payment of Rs. 722,510 contains a rounding adjustment of Rs. 6.

Note that the difference between the interest charged and the interest paid is because the final payment of the redemption proceeds has not been shown. This contains a redemption premium of Rs. 444,000 which has already been recognised as an expense by the year end.

CHAPTER 16

Financial instruments: Presentation and disclosure

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 7 IFRS 7: Financial instruments: Disclosures

B (a) 25 IAS 32: Financial instruments: Presentation

B (a) 34 IFRIC 2: Members› shares in co-operative entities and similar instruments

B (a) 45 IFRIC 17: Distributions of non-cash assets to owners

1 IAS 32: PRESENTATION

Section overview

- Liability or equity?
- Preference shares: debt or equity?
- Compound instruments
- Transactions in own equity
- Offsetting
- Distributable profit

1.1 Liability or equity?

Financial instruments issued by a company must be classified as either liabilities or equity. This classification should be based on the substance of the contract, rather than the legal form.

A financial liability is any liability where the issuer has a contractual obligation:

- To deliver cash or another financial asset to another entity, or
- To exchange financial instruments with another entity on potentially unfavourable terms.

The owner of an equity instrument is entitled to receive a dividend, but the company does not have a contractual obligation to make the payment. So equity does not meet the above definition of a financial liability.

An equity instrument is defined as any contract that offers the residual interest in the assets of the company after deducting all of the liabilities.

Returns on financial instruments

Returns on financial instruments are reported differently, depending on whether the instrument is a liability or equity. The classification of the financial instrument determines the treatment of the interest, dividends, gains and losses.

- Interest expense, dividend payments, gains and losses relating to a financial liability are recognised in the statement of profit or loss.
- Distributions to equity holders are debited to equity and shown in the statement of changes in equity.

1.2 Preference shares: debt or equity?

Preference shares are shares that are entitled to a payment of their dividend, usually a fixed amount each year, before the ordinary shareholders can be paid any dividend or that rank ahead of ordinary shares for any distribution of net assets in the event of a winding up of the company.

Preference shares include the following types:

- Redeemable preference shares are those that the entity has an obligation to buy back (or the right to buy back) at a future date.
- Irredeemable (perpetual) preference shares are those that will not be bought back at any time in the future.
- convertible preference shares are those that are convertible at a future date into another financial instrument, usually into ordinary equity shares of the entity.

Classification of preference shares

Depending on their characteristics, preference shares issued by a company might be classified as:

- equity; or
- a financial liability of the company; or
- a compound financial instrument containing elements of both financial liability and equity.

IAS 32 states (in a guidance note) that the key factor for classifying preference shares is the extent to which the entity is obliged to make future payments to the preference shareholders.

- Redeemable preference shares.
  - Redemption is mandatory: Since the issuing entity will be required to redeem the shares, there is an obligation. The shares are a financial liability.
  - Redemption at the choice of the holder: Since the issuing entity does not have an unconditional right to avoid delivering cash or another financial asset there is an obligation. The shares are a financial liability.
  - Redemption at the choice of the issuer: The issuing entity has an unconditional right to avoid delivering cash or another financial asset there is no obligation. The shares are equity.
- Irredeemable non-cumulative preference shares should be treated as equity, because the entity has no obligation to the shareholders that the shareholders have any right to enforce.

1.3 Compound instruments

A compound instrument is a financial instrument, issued by a company that cannot be classified as simply a liability or as equity, because it contains elements of both debt and equity. An example of a compound instrument is a convertible bond. The company issues a bond that can be converted into equity in the future or redeemed for cash. Initially, it is a liability, but it has a call option on the company's equity embedded within it.

Typically, a convertible bond pays a rate of interest that is lower than the market rate for a non-convertible bond (a 'straight bond') with the same risk profile. This

is because the terms of the conversion normally allow the bondholder to convert the bond into shares at a rate that is lower than the market price.

Split accounting for compound instruments

On initial recognition of compound instrument, the credit entry for the financial instrument must be split into the two component parts, equity and liability.

When convertible bonds are issued they are shown in the statement of financial position partly as debt finance and partly as equity finance. The question is how to determine the amount of the issue price that is debt and the amount that is equity.

The method to use is to calculate the equity element as the residual after determining the present value of the debt element:

- The present value of the interest payments and the redemption value of the convertible is found using a market interest rate for similar debt finance which is not convertible (normally a higher interest rate as there is no conversion element).
- Compare this present value to the proceeds of the bond issue to find the residual equity element.
- Any transaction costs incurred by issuing the instrument should be allocated to each component, the liability and equity, according to the split in value above.

Comment on the measurement of the debt element

The process starts by deriving a fair value for the liability, on the assumption that the bond has no conversion rights, and is a 'straight' fixed rate bond that will be redeemed at par at maturity.

If the company had sold a bond with identical features but with no conversion rights, how much could it have been sold for? To answer this question, it is necessary to recognise that the fair value of a bond is simply the present value of the future cash flows that the bond will generate, discounted at the market rate of interest, which in the following example is 8%.

Example: Convertible bond

A company issues Rs. 10 million of 6% convertible bonds at par on 1 January 20X1.

The bonds are redeemable at par after four years or can be converted at any time up to that date into shares with a nominal value of Rs. 2,000,000.

The market rate of interest for similar debt which is not convertible is 8%.

The bonds should be recorded in the statement of financial position at the date of issue as follows:

Step 1: Measure the liability component first by discounting the interest payments and the amount that would be paid on redemption (if not converted) at the prevailing market interest rate of 8%.

31 December	Cash flow	DF (8%)	Rs.
20X1 to 20X4			
Interest: 10,000,000 × 6%	600,000	3.312	1,987,200
20X4:			
Repayment of principle	10,000,000	0.735	7,350,000
Value of debt element			9,337,200

Step 2: Compare the value of the debt element to the cash raised. The difference is the equity element.

Total proceeds	10,000,000
Value of equity element (residual)	662,800

The initial double entry to recognise the bond would be as follows:

	Dr	Cr
Cash	10,000,000	
Liability		9,337,200
Equity		662,800

The liability component is measured at amortised cost in the usual way at each subsequent reporting date.

Example (continued): Subsequent measurement of the debt element of the convertible bond

	Amortised cost at start of the year	Interest at effective rate (8%)	Cash flow (interest actually paid at 6%)	Amortised cost at year end
20X1	9,337,200	746,976	(600,000)	9,484,176
20X2	9,484,176	758,734	(600,000)	9,642,910
20X3	9,642,910	771,433	(600,000)	9,814,343
20X4	9,814,343	785,557	(600,000)	10,000,000

Note that the final interest expense of Rs. 785,557 includes a rounding adjustment of Rs. 510).

There is no guidance on the subsequent accounting treatment of the equity element. One approach would be to retain it as a separate component of equity and then release it to retained earnings when the bond is paid or converted.

Example (continued): Double entry on repayment or conversion of the bond.

At 31 December 20X4 the bond will either be paid or converted. Possible double entries in each case are as follows:

If the bond is repaid

	Dr	Cr
Liability	10,000,000	
Cash		10,000,000
and:		
Equity component	662,800	
Retained earnings		662,800

If the bond is converted:

	Dr	Cr
Liability	10,000,000	
Share capital		2,000,000
Share premium		8,000,000
and:		
Equity component	662,800	
Retained earnings		662,800

Practice question **1**

A company issued a convertible bond for Rs. 2,000,000 on 1 January 20X5.

The bond is to be redeemed on 31 December 20X7 (3 years after issue). The bond holders can take cash or shares with a nominal value of Rs. 1,200,000 on this date.

The bond pays interest at 5% but the market rate of interest for similar risk bonds without the conversion feature was 9% at the date of issue.

Required

a) Calculate the liability and equity components of the bond on initial recognition.

b) Construct the necessary journal on initial recognition.

c) Construct an amortisation table to show how the liability component would be measured over the life of the bond.

d) Construct the journal to reflect the possible conversion of the bonds to shares on 31 December 20X7.

1.4 Transactions in own equity

A company may reacquire its own shares. Such shares are called ***treasury shares***. '. The company might then hold on to the shares until it uses them for a particular purpose, such as awarding shares to employees in a share grant scheme. The accounting treatment of treasury shares is that they should be deducted from equity.

Any gain or loss on transactions involving treasury shares is recognised directly in equity, and should not be reported in the statement of profit or loss and other comprehensive income.

IAS 32 requires that the amount of treasury shares held should be disclosed separately, either:

- on the face of the statement of financial position as a deduction from share capital, or
- offset against share capital and disclosed in the notes to the accounts.

1.5 Offsetting

Offsetting an asset and a liability and presenting a net amount on the face of the statement of financial position can result in a loss of information to the users. IAS 1 prohibits offset unless required or permitted by an IFRS.

The idea is that offset should only be allowed if it reflects the substance of the transactions or balances.

IAS 32 adds more detail to this guidance in respect of offsetting financial assets and liabilities.

IAS 32 requires the presentation of financial assets and financial liabilities in a way that reflects the company's future cash flows from collecting the cash from the asset and paying the cash on the liability. It limits a company's ability to offset a financial asset and a financial liability to those instances when the cash flows will occur at the same time.

The IAS 32 rule is that a financial asset and a financial liability must be offset and shown net in the statement of financial position when and only when an entity:

- Currently has a legal right to set off the amounts; and
- Intends either to settle the amounts net, or to realise (sell) the asset and settle the liability simultaneously.

In order for a legal right of set off to be current it must not be contingent on a future event. Furthermore it must be legally enforceable in all of the following circumstances:

- The normal course of business;
- The event of default;
- The event of insolvency or bankruptcy of the entity and all of the counterparties

Note: The existence of a legal right to set off a cash balance in one account with an overdraft in another is insufficient for offsetting to be allowed. The company must additionally show **intent** to settle the balances net, and this is likely to be rare in practice. Consequently, cash balances in the bank and bank overdrafts are usually reported separately in the statement of financial position, and not 'netted off' against each other.

Many companies adopting IFRS for the first time find that they have net amounts in the statement of financial position under their old GAAP that have to be shown as a separate financial asset and financial liability under IFRS. The net position is described as being "grossed up".

1.6 Distributable profit

Rules are set out in The Companies Ordinance 1984 (Sections 248 to 251).

Dividends are declared, in respect of a period, in a general meeting on the recommendation of the directors.

A dividend cannot exceed the amount recommended by the directors.

Dividends are payable only out of the distributable profits of the company (but not profit on the sale of capital assets).

Dividends are paid by individual entities. When a group announces that it is paying a dividend it is actually the parent company that is making the payment.

Example: Group distributions

P acquired 80% of S on 1 January 20X1 for Rs. 230,000.

The retained profits of S were Rs. 100,000 at that date and are Rs. 300,000 at the current year end.

P has retained profits of Rs. 400,000 at the current year end.

The consolidated retained profits are as follows:

Consolidated retained profits:	Rs.
All of P's retained profits	400,000
P's share of the post-acquisition retained profits of S (80% of (300,000 – 100,000))	160,000
	560,000

The maximum distribution that can be made by the group (i.e. as a dividend paid to P's shareholders) is Rs. 400,000.

The share of post-acquisition retained profits of S are contained in a separate legal entity and are not available for distribution by the parent.

If S were to pay a dividend, 80% would pass to P and hence become available for P to pay out to its owners. (The remaining 20% would be owned by the NCI).

2 INTERPRETATIONS

Section overview

- IFRIC 2: Members shares in cooperative entities and similar instruments
- IFRIC 17: Distributions of non-cash assets to owners

2.1 IFRIC 2: Members shares in cooperative entities and similar instruments

Background

IFRIC 2 applies to financial instruments within the scope of IAS 32, including financial instruments issued to members of co-operative entities that evidence the members' ownership interest in the entity.

Co-operatives (and similar entities) are formed by groups of persons to meet common economic or social needs. Members' interests in a co-operative are often described as "members' shares".

Members' shares have characteristics of equity. For example they give the member the rights to vote and to participate in dividend distributions.

Members' shares may also give the holder the right to request redemption for cash or another financial asset but include limits on whether the financial instruments will be redeemed.

The issue

IAS 32 gives guidance on classification of financial instruments as financial liabilities or equity. The guidance covers instruments that allow the holder to put those instruments to the issuer for cash or another financial instrument ("puttable instruments").

IFRIC 2 explains how redemption terms should be evaluated in determining whether the financial instruments should be classified as liabilities or equity

Consensus

A contractual right of a holder to request redemption does not in itself mean that the financial instrument must be classified as a financial liability.

An entity must consider all of the terms and conditions of the financial instrument to determine its classification, including relevant local laws, regulations and the entity's governing charter in effect at the date of classification.

Members' shares that give holders the right to request redemption are classified as equity when:

- the instrument would be classified as equity if there were no such terms attached; and
- the entity has an unconditional right to refuse redemption of the members' shares; or
- redemption is unconditionally prohibited by local law, regulation or the entity's governing charter.

Example: Equity or liability

X co-operative has a charter which allows redemption of members' shares at sole discretion of the co-operative but redemption has never been refused.

Analysis

X co-operative has the unconditional right to refuse redemption so the members' shares are equity.

The fact that redemption has never been refused is not relevant in deciding the status of the instruments.

Provisions that prohibit redemption only if conditions (such as liquidity constraints) are met/not met do not result in members' shares being equity.

Example: Equity or liability

X co-operative has a charter which allows redemption of members' shares at sole discretion of the co-operative but also states that redemption is automatic unless X cannot make payments without violating local regulations regarding liquidity.

Analysis

X co-operative does not have the unconditional right to refuse redemption so the members' shares are liabilities.

Unconditional prohibition may be:

- absolute
  - all redemptions are prohibited
  - members shares are equity
- partial
  - redemption prohibited where it causes the number of members' shares or amount of paid-in capital from members' shares to fall below a specified level
    - Members' shares above this level – liability
    - Members' shares below this level – equity

The limit may change from time to time – leading to a transfer between financial liabilities and equity.

2.2 IFRIC 17: Distributions of non-cash assets to owners

Introduction

IFRIC 17 sets out guidance on how an entity should measure distributions of assets other than cash when it pays dividends to owners in their capacity as owners.

Issues addressed:

- When should an entity recognise a dividend payable?
- How should an entity measure the dividend payable?

- When an entity settles the dividend payable, how should it account for any difference between the carrying amount of the assets distributed and the carrying amount of the dividend payable?

A dividend payable should be recognised when it is appropriately authorised and is no longer at the discretion of the entity

Dividend payable should be measured at the fair value of the net assets to be distributed

Any difference between the dividend paid and the carrying amount of the net assets distributed is recognised in profit and loss

Scope

Within scope:

- Distributions of non-cash assets (e.g. items of property, plant and equipment, businesses as defined in IFRS 3, ownership interests in another entity or disposal groups under IFRS 5).
- Distributions that give owners choice of settlement in cash or non-cash assets.

The IFRIC applies only to distributions in which all owners of the same class of equity instruments are treated equally.

Outside of the scope

- Distributions of non-cash assets that are ultimately controlled by the same party/parties before and after the distribution, in separate, individual and consolidated financial statements.
- Distributions of part ownership interests in a subsidiary with retention of control.

IFRIC 17 does not address the accounting for the non-cash distribution by the shareholders who receive the distribution

Recognition of dividend payable

Dividend payable should be recognised when it is appropriately authorised and is no longer at the discretion of the entity

This is:

- when the declaration is approved by the relevant authority where such approval is required in the jurisdiction; or
- when the dividend is declared if no such approval is required

Measurement of a dividend payable

A liability to distribute non-cash assets to the owners as a dividend must be measured at the fair value of the assets to be distributed

If the owners have a choice of receiving a non-cash asset or a cash alternative, the fair value of each and the associated probability of owners selecting each alternative must be estimated.

Subsequent measurement:

The carrying amount of the dividend payable must be reviewed at the end of each reporting period and at settlement with any changes in the amount of the dividend payable must be recognised in equity.

Accounting for any difference

Any difference between the carrying amount of the assets distributed and the carrying amount of the dividend payable at settlement must be recognised in profit and loss

Presentation and disclosure

Any difference between the carrying amounts of the dividend payable and the assets distributed must be presented as a separate line item in the statement of profit or loss.

An entity must disclose:

- The brought forward and carried forward carrying amount of the dividend payable.
- Any decrease/increase in the carrying amount as a result of the change in the fair value of the assets to be distributed

When a dividend of non-cash assets is declared after the end of the period but before the financial statements are authorised for issue the entity must disclose the:

- nature of asset;
- carrying amount at period end;
- estimated fair value; and
- estimation methodology as required by IFRS 7

3 IFRS 7: DISCLOSURE

Section overview

- Objectives of IFRS 7
- Statement of financial position disclosures
- Statement of profit or loss disclosures
- Risk disclosures

3.1 Objectives of IFRS 7

All companies are exposed to various types of financial risk. Some risks are obvious from looking at the statement of financial position. For example, a loan requiring repayment in the next year is reported as a current liability, and users of the financial statements can assess the risk that the company will be unable to repay the loan.

However, there are often many other risks that a company faces that are not apparent from the financial statements. For example if a significant volume of a company's sales are made overseas, there is exposure to the risk of exchange rate movements.

Example:

A UK company has an investment of units purchased in a German company's floating rate silver-linked bond. The bond pays interest on the capital, and part of the interest payment represents bonus interest linked to movements in the price of silver.

There are several financial risks that this company faces with respect to this investment.

It is a floating rate bond. So if market interest rates for bonds decrease, the interest income from the bonds will fall.

Interest is paid in euros. For a UK company there is a foreign exchange risk associated with changes in the value of the euro. If the euro falls in value against the British pound, the value of the income to a UK investor will fall.

A bonus is linked to movements in the price of silver. So there is exposure to changes in the price of silver.

There is default risk. The German company may default on payments of interest or on repayment of the principal when the bond reaches its redemption date.

IFRS 7 requires that an entity should disclose information that enables users of the financial statements to 'evaluate the significance of financial instruments' for the entity's financial position and financial performance.

There are two main parts to IFRS 7:

A section on the disclosure of 'the significance of financial instruments' for the entity's financial position and financial performance

A section on disclosures of the nature and extent of risks arising from financial instruments.

3.2 Statement of financial position disclosures

The carrying amounts of financial instruments must be shown, either in the statement of financial position or in a note to the financial statements, for each class of financial instrument:

- Financial assets at fair value through profit or loss
- Held-to-maturity investments
- Loans and receivables
- Available-for-sale financial assets
- Financial liabilities at fair value through profit or loss
- Financial liabilities measured at amortised cost.

The above categories are replaced by the following if IFRS 9 is being followed:

- Financial assets at fair value through profit or loss
- Financial assets at amortised cost
- Financial liabilities at fair value through profit or loss
- Financial liabilities measured at amortised cost.

Other disclosures relating to the statement of financial position are also required. These include the following:

- **Collateral**. A note should disclose the amount of financial assets that the entity has pledged as collateral for liabilities or contingent liabilities.
- **Allowance account for credit losses**. When financial assets (such as trade receivables) are impaired by credit losses and the impairment is recorded in a separate account (such as an allowance account for irrecoverable trade receivables), the entity should provide a reconciliation of changes in the account during the period, for each class of financial assets.
- **Defaults and breaches**. For loans **payable**, the entity should disclose details of any defaults during the period in the loan payments, or any other breaches in the loan conditions.

With some exceptions, for each class of financial asset and financial liability, an entity must disclose the fair value of the assets or liabilities in a way that permits the fair value to be compared with the carrying amount for that class. An important exception is where the carrying amount is a reasonable approximation of fair value, which should normally be the case for short-term receivables and payables.

3.3 Statement of profit or loss disclosures

An entity must disclose the following items either in the statement of profit or loss or in notes to the financial statements:

- Net gains or losses on financial assets or financial liabilities at fair value through profit or loss.

- Net gains or losses on available-for-sale financial assets, showing separately:
  - the gain or loss recognised in other comprehensive income (and so directly in equity) during the period, and
  - the amount removed from equity and reclassified from equity to profit and loss through other comprehensive income in the period.
- Net gains or losses on held-to-maturity investments.
- Net gains or losses on loans and receivables.
- Net gains or losses on financial liabilities measured at amortised cost.
- Total interest income and total interest expense, calculated using the effective interest method, for financial assets or liabilities that are not at fair value through profit or loss.
- Fee income and expenses arising from financial assets or liabilities that are not at fair value through profit or loss.
- The amount of any impairment loss for each class of financial asset.

Other disclosures

IFRS 7 also requires other disclosures. These include the following:

- Information relating to **hedge accounting**, for cash flow hedges, fair value hedges and hedges of net investments in foreign operations. The disclosures should include a description of each type of hedge, a description of the financial instruments designated as hedging instruments and their fair values at the reporting date, and the nature of the risks being hedged.
- With some exceptions, for each class of financial asset and financial liability, an entity must disclose the fair value of the assets or liabilities in a way that permits the fair value to be compared with the carrying amount for that class. An important exception is where the carrying amount is a reasonable approximation of fair value, which should normally be the case for short-term receivables and payables.

3.4 Risk disclosures

IFRS 7 also requires that an entity should disclose information that enables users of its financial statements to evaluate the nature and extent of the risks arising from its financial instruments.

These risks typically include, but are not restricted to:

- Credit risk
- Liquidity risk, and
- Market risk.

For each category of risk, the entity should provide both quantitative and qualitative information about the risks.

- **Qualitative disclosures**. For each type of risk, there should be disclosures of the exposures to risk and how they arise; and the objectives policies and processes for managing the risk and the methods used to measure the risk.
- **Quantitative disclosures**. For each type of risk, the entity should also disclose summary quantitative data about its exposures at the end of the reporting period. This disclosure should be based on information presented to the entity's senior management, such as the board of directors or chief executive officer.

Credit risk

Credit risk is the risk that someone who owes money (a trade receivable, a borrower, a bond issuer, and so on) will not pay. An entity is required to disclose the following information about credit risk exposures:

- A best estimate of the entity's maximum exposure to credit risk at the end of the reporting period and a description of any collateral held.
- For each class of financial assets, a disclosure of assets where payment is 'past due' or the asset has been impaired.

Liquidity risk

Liquidity risk is the risk that the entity will not have access to sufficient cash to meet its payment obligations when these are due. IFRS 7 requires disclosure of:

- A maturity analysis for financial liabilities, showing when the contractual liabilities fall due for payment
- A description of how the entity manages the liquidity risk that arises from this maturity profile of payments.

Market risk

Market risk is the risk of losses that might occur from changes in the value of financial instruments due to changes in:

- Exchange rates,
- Interest rates, or
- Market prices.

An entity should provide a sensitivity analysis for each type of market risk to which it is exposed at the end of the reporting period. The sensitivity analysis should show how profit or loss would have been affected by a change in the market risk variable (interest rate, exchange rate, market price of an item) that might have been reasonably possible at that date.

Alternatively, an entity can provide sensitivity analysis in a different form, where it uses a different model for analysis of sensitivity, such as a value at risk (VaR) model. These models are commonly used by banks.

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

a) Split of liability and equity on initial recognition

31st December	Cash (Rs.)	Discount factor 9%	Present value (Rs.)
20X5 - interest	100,000	0.9174	91,743
20X6 - interest	100,000	0.8417	84,168
20X7 - interest	100,000	0.7722	77,218
20X7 - principal	2,000,000	0.7722	1,544,367
Fair value of bond			1,797,496
Value of equity (balance)			202,504
Proceeds from issue of bond			2,000,000

b) Journal on initial recognition

	Dr (Rs.)	Cr (Rs.)
Cash	2,000,000	
Liability		1,797,496
Equity		202,504

c) Amortisation table

	Liability at start of year	Finance charge at 9%	Interest paid	Liability at end of year
	Rs.	Rs.	Rs.	Rs.
20X5	1,797,496	161,775	(100,000)	1,859,271
20X6	1,859,271	167,334	(100,000)	1,926,605
20X7	1,926,605	173,395	(100,000)	2,000,000

d) Journal on conversion to shares

	Rs.	Rs.
Bond	2,000,000	
Equity - option proceeds	202,504	
Share capital		1,200,000
Share premium		1,002,504

CHAPTER 17

IFRS 13: Fair Value Measurement

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 9 IFRS 13: Fair value measurement

1 INTRODUCTION TO IFRS 13

Section overview

- Background
- Definition of fair value
- The asset or liability
- Market participants

1.1 Background

There are many instances where IFRS requires or allows entities to measure or disclose the fair value of assets, liabilities or their own equity instruments.

Examples include (but are not limited to):

Standard	
IASs 16/38	Allows the use of a revaluation model for the measurement of assets after recognition. Under this model, the carrying amount of the asset is based on its fair value at the date of the revaluation.
IAS 40	Allows the use of a fair value model for the measurement of investment property. Under this model, the asset is fair valued at each reporting date.
IAS 19	Defined benefit plans are measured as the fair value of the plan assets net of the present value of the plan obligations.
IAS 39	All financial instruments are measured at their fair value at initial recognition. Subsequent measurement of financial assets depends on their classification but is often at fair value. Subsequent measurement of financial liabilities is sometimes at fair value.
IFRS 9	All financial instruments are measured at their fair value at initial recognition. Financial assets that meet certain conditions are measured at amortised cost subsequently. Any financial asset that does not meet the conditions is measured at fair value. Subsequent measurement of financial liabilities is sometimes at fair value.
IFRS 7	If a financial instrument is not measured at fair value that amount must be disclosed.
IFRS 3	Measuring goodwill requires the measurement of the acquisition date fair value of consideration paid and the measurement of the fair value (with some exceptions) of the assets acquired and liabilities assumed in a transaction in which control is achieved.
IFRS 2	Requires an accounting treatment based on the grant date fair value of equity settled share based payment transactions.

Other standards required the use of measures which incorporate fair value.

Standard	
IAS 36	Recoverable amount is the higher of value in use and fair value less costs of disposal.
IFRS 5	An asset held for sale is measured at the lower of its carrying amount and fair value less costs of disposal.

Some of these standards contained little guidance on the meaning of fair value. Others did contain guidance but this was developed over many years and in a piecemeal manner.

Purpose of IFRS 13

The purpose of IFRS 13 is to:

- define fair value;
- set out a single framework for measuring fair value; and
- specify disclosures about fair value measurement.

IFRS 13 does not change what should be fair valued nor when this should occur.

The fair value measurement framework described in this IFRS applies to both initial and subsequent measurement if fair value is required or permitted by other IFRSs.

Scope of IFRS 13

IFRS 13 applies to any situation where IFRS requires or permits fair value measurements or disclosures about fair value measurements (and other measurements based on fair value such as fair value less costs to sell) with the following exceptions.

IFRS 13 does not apply to:

- share based payment transactions within the scope of IFRS 2; or
- measurements such as net realisable value (IAS 2 *Inventories*) or value in use (IAS 36 *Impairment of Assets*) which have some similarities to fair value but are not fair value.

The IFRS 13 **disclosure requirements** do not apply to the following:

- plan assets measured at fair value (*IAS 19: Employee benefits*);
- retirement benefit plan investments measured at fair value (*IAS 26: Accounting and reporting by retirement benefit plans*); and
- assets for which recoverable amount is fair value less costs of disposal in accordance with IAS 36.

1.2 Definition of fair value

Definition: Fair value

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 (i.e. it is an exit price).

This definition emphasises that fair value is a market-based measurement, not an entity-specific measurement. In other words, if two entities hold identical assets these assets (all other things being equal) should have the same fair value and this is not affected by how each entity uses the asset or how each entity intends to use the asset in the future.

The definition is phrased in terms of assets and liabilities because they are the primary focus of accounting measurement. However, the guidance in IFRS 13 also applies to an entity's own equity instruments measured at fair value (e.g. when an interest in another company is acquired in a share for share exchange).

Note that the fair value is an exit price, i.e. the price at which an asset would be sold.

Definition: Exit and entry prices

Exit price: The price that would be received to sell an asset or paid to transfer a liability.

Entry price: The price paid to acquire an asset or received to assume a liability in an exchange transaction.

1.3 The asset or liability

A fair value measurement is for a particular asset or liability.

Whether the fair value guidance in IFRS 13 applies to a stand-alone asset or liability or to a group of assets, a group of liabilities or to a group of assets and liabilities depends on the unit of account for the item being fair valued.

Definition: Unit of account

Unit of account: The level at which an asset or a liability is aggregated or disaggregated in an IFRS for recognition purposes.

The unit of account for the asset or liability must be determined in accordance with the IFRS that requires or permits the fair value measurement.

An entity must use the assumptions that market participants would use when pricing the asset or liability under current market conditions when measuring fair value. The fair value must take into account all characteristics that a market participant would consider relevant to the value. These characteristics might include:

- the condition and location of the asset; and
- restrictions, if any, on the sale or use of the asset.

1.4 Market participants

Definition: Market participants

Market participants: Buyers and sellers in the principal (or most advantageous) market for the asset or liability.

Market participants have all of the following characteristics:

- They are independent of each other;
- They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary.
- They are able to enter into a transaction for the asset or liability.
- They are willing to enter into a transaction for the asset or liability, i.e. they are motivated but not forced or otherwise compelled to do so.

2 MEASUREMENT

Section overview

- Measuring fair value
- Principal or most advantageous market
- Fair value of non-financial assets – highest and best use

2.1 Measuring fair value

Fair value measurement assumes that the asset (liability) is exchanged in an orderly transaction between market participants to sell the asset (transfer the liability) at the measurement date under current market conditions.

Sometimes it might be possible to use observable market transactions to fair value an asset or a liability (e.g. a share might be quoted on the Karachi Stock Exchange). For other assets and liabilities this may not be possible. However, in each case the objective is the same, being to estimate the price at which an orderly transaction to sell the asset (or transfer a liability) would take place between market participants at the measurement date under current market conditions.

Active market

If an active market exists then it will provide information that can be used for fair value measurement.

- ❑ A quoted price in an active market provides the most reliable evidence of fair value and must be used to measure fair value whenever available.
- ❑ It would be unusual to find an active market for the sale of non- financial assets so some other sort of valuation technique would usually be used to determine their fair value.

Definition: Active market

A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

If there is no such active market (e.g. for the sale of an unquoted business or surplus machinery) then a valuation technique would be necessary.

2.2 Principal or most advantageous market

Fair value measurement is based on a possible transaction to sell the asset or transfer the liability in the principal market for the asset or liability.

If there is no principal market fair vale measurement is based on the price available in the most advantageous market for the asset or liability.

Definitions: Most advantageous market and principal market

Most advantageous market: The market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs.

Principal market: The market with the greatest volume and level of activity for the asset or liability.

Identifying principle market (or most advantageous market)

It is not necessary to for an entity to make an exhaustive search to identify the principal market (or failing that, the most advantageous market). However, it should take into account all information that is reasonably available.

Unless there is evidence to the contrary, principal market (or failing that, the most advantageous market) is the one in which an entity normally enters into transactions sell the asset or to transfer the liability being fair valued.

If there is a principal market for the asset or liability, the fair value measurement must use the price in that market even if a price in a different market is potentially more advantageous at the measurement date.

The price in a principle market might either be directly observable or estimated using a valuation technique.

Transaction costs

The price in the principal (or most advantageous) market used to measure the fair value of the asset (liability) is not adjusted for transaction costs. Note that:

- fair value is not “net realisable value” or “fair value less costs of disposal”; and
- using the price at which an asset can be sold for as the basis for fair valuation does not mean that the entity intends to sell it

Transport costs

If location is a characteristic of the asset the price in the principal (or most advantageous) market is adjusted for the costs that would be incurred to transport the asset from its current location to that market.

Example: Fair valuation

An entity holds an asset which could be sold in one of two markets.

Information about these markets and the costs that would be incurred if a sale were to be made is as follows:

	Market A	Market B
	Rs.	Rs.
Sale price	260	250
Transport cost	(20)	(20)
	240	230
Transaction cost	(30)	(10)
Net amount received	210	220

(a) What fair value would be used to measure the asset if Market A were the principal market?

(b) What fair value would be used to measure the asset if no principal market could be identified?

Answer

(a) If Market A is the principal market for the asset the fair value of the asset would be measured using the price that would be received in that market, after taking into account transport costs (Rs. 240).

(b) If neither market is the principal market for the asset, the fair value of the asset would be measured 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 transaction costs and transport costs (i.e. the net amount that would be received in the respective markets). This is Market B where the net amount that would be received for the asset would be Rs. 220.

The fair value of the asset is measured using the price in that market (Rs. 250), less transport costs (Rs. 20), resulting in a fair value measurement of Rs. 230.

Transaction costs are taken into account when determining which market is the most advantageous market but the price used to measure the fair value of the asset is not adjusted for those costs (although it is adjusted for transport costs).

Example: Fair valuation

An entity owns an item of industrial equipment (asset x) for which it wishes to ascertain a fair value in accordance with IFRS 13.

Information about the markets in which the asset could be sold and the costs that would be incurred if a sale were to be made is as follows:

	Market A	Market B
	Rs.	Rs.
Sale price	500	505
Transport cost	(20)	(30)
	480	475
Volume of sales of asset x (units)	1,000	29,000

(a) Which is the most advantageous market?

(b) What is the fair value of the asset in accordance with IFRS 13?

Answer

a) Market A is the most advantageous market as it provides the highest return after transaction costs.

b) The fair value of the asset in accordance with IFRS 13 is $505. This is the price available in the principal market before transaction costs. (The principal market is the one with the highest level of activity).

Different entities might have access to different markets. This might result in different entities reporting similar assets at different fair values.

2.3 Fair value of non-financial assets – highest and best use

Fair value measurement of a non-financial asset must value the asset at its highest and best use.

Highest and best use is a valuation concept based on the idea that market participants would seek to maximise the value of an asset.

Definition: Highest and best use

Highest and best use: The use of a non-financial asset by market participants that would maximise the value of the asset or the group of assets and liabilities (e.g. a business) within which the asset would be used.

This must take into account use of the asset that is:

- physically possible;
- legally permissible; and
- financially feasible.

The current use of land is presumed to be its highest and best use unless market or other factors suggest a different use.

Example: Highest and best use

X Limited acquired a plot of land developed for industrial use as a factory. A factory with similar facilities in Karachi and access has recently been sold for Rs. 50 million.

The plot is located on the outskirts of Clifton in Karachi.

Similar sites nearby have recently been developed for residential use as sites for high-rise apartment buildings.

X Limited determines that the land could be developed as a site for residential use at a cost of Rs. 10 million (to cover demolition of the factory and legal costs associated with the change of use). The plot of land would then be worth Rs. 62 million.

The highest and best use of the land would be determined by comparing the following:

	Rs. million
Value of the land as currently developed	50
Value of the land as a vacant site for residential use (Rs. 62 million – Rs. 10 million)	52

Conclusion:
The fair value of the land is Rs. 52 million.

3 VALUATION TECHNIQUES

Section overview

- Valuation techniques
- Inputs to valuation techniques
- Fair value hierarchy
- Bid/offer prices

3.1 Valuation techniques

The objective of using a valuation technique is to estimate the price at which an orderly transaction to sell the asset (or to transfer the liability) would take place between market participants at the measurement date under current market conditions.

IFRS 13 requires that one of three valuation techniques must be used:

- market approach – uses prices and other relevant information from market transactions involving identical or similar assets and liabilities;
- cost approach – the amount required to replace the service capacity of an asset (also known as the current replacement cost);
- income approach – converts future amounts (cash flows, profits) to a single current (discounted) amount.

An entity must use a valuation technique that is appropriate in the circumstances and for which sufficient data is available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs.

3.2 Inputs to valuation techniques

An entity must use valuation techniques that are appropriate in the circumstances and for which sufficient information is available to measure fair value.

A valuation technique should be used to maximise the use of relevant observable inputs and minimise the use of unobservable inputs.

Definition: Inputs

Inputs: The assumptions that market participants would use when pricing the asset or liability, including assumptions about risk, such as the following:

(a) **the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model); and**

(b) **the risk inherent in the inputs to the valuation technique.**

Quoted price in an active market provides the most reliable evidence of fair value and must be used to measure fair value whenever available.

3.3 Fair value hierarchy

IFRS 13 establishes a fair value hierarchy to categorise inputs to valuation techniques into three levels.

	Definition	Examples
Level 1	Quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date	Share price quoted on the London Stock Exchange
Level 2	Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.	Quoted price of a similar asset to the one being valued. Quoted interest rate.
Level 3	Unobservable inputs for the asset or liability.	Cash flow projections.

3.4 Bid /Offer prices

For some assets (liabilities) markets quote prices that differ depending on whether the asset is being sold to or bought from the market.

- The price at which an asset can be sold to the market is called the bid price (it is the amount the market bids for the asset).
- The price at which an asset can be bought from the market is called the ask or offer price (it is the amount the market asks for the asset or offers to sell it for).

The price within the bid-ask spread that is most representative of fair value in the circumstances must be used to measure fair value.

Previously, bid price had to be used for financial assets and ask price for financial liabilities but this is no longer the case.

4 LIABILITIES AND AN ENTITY'S OWN EQUITY INSTRUMENTS

Section overview

- General principles
- Liabilities and equity instruments held by other parties as assets
- Liabilities and equity instruments not held by other parties as assets
- Financial assets and financial liabilities managed on a net basis

4.1 General principles

Fair value measurement assumes the transfer of an item to a market participant at the measurement date.

The fair valuation of a liability assumes that it not be settled with the counterparty at the measurement date but would remain outstanding. In other words, the market participant to whom the liability could be transferred would be required to fulfil the obligation.

The fair valuation of an entity's own equity instrument assumes that market participant to whom the instrument could be transferred would take on the rights and responsibilities associated with the instrument.

The same guidance that applies to the fair value of assets also applies to the fair value of liabilities and an entity's own equity instruments including that:

- an entity must maximise the use of relevant observable inputs and minimise the use of unobservable inputs; and
- quoted price in an active market must be used to measure fair value whenever available.

In the absence of an active market there might be an observable market for items held by other parties as assets.

4.2 Liabilities and equity instruments held by other parties as assets

If a quoted price for the transfer of an identical or a similar liability or entity's own equity instrument is not available it may be possible to measure fair value from the point of view of a party that holds the identical item as an asset at the measurement date.

If this is the case fair value is measured as follows:

- using the quoted price in an active market (if available) for the identical item held by another party as an asset; or failing that
- using other observable inputs (e.g. quoted price in a market that is not active for the identical item held by another party as an asset); or failing that
- another valuation technique (e.g. using quoted prices for similar liabilities or equity instruments held by other parties as assets (market approach).

Adjustments to quoted price

There might be factors that are specific to the asset held by the third party that are not applicable to the fair value of the liability or entity's own equity.

The quoted price of such items is adjusted for such factors. For example, a quoted price might relate to a similar (but not identical) liability or equity instrument held by another party as an asset.

However, the price of the asset must not reflect the effect of a restriction preventing the sale of that asset.

4.3 Liabilities and equity instruments not held by other parties as assets

In this case fair value is measured from the perspective of a market participant that owes the liability or has issued the claim on equity.

For example, when applying a present value technique an entity might take into account the future cash outflows that a market participant would expect to incur in fulfilling the obligation (including the compensation that a market participant would require for taking on the obligation).

4.4 Financial assets and financial liabilities managed on a net basis

An entity might manage a group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk.

In this case the entity is allowed to measure the fair value net position (i.e. a net asset or a net liability as appropriate).

This is an exception to the general rules in IFRS 13 which would otherwise apply separately to the asset and the liability. It applies only to financial assets and financial liabilities within the scope of *IAS 39: Financial instruments: Recognition and Measurement* or *IFRS 9: Financial instruments*.

The exception is only allowed if the entity does all the following:

- It manages the group of financial assets and financial liabilities on the basis of the entity's net exposure to a particular risk (market risk or credit risk of a particular counterparty) in accordance with its documented risk management or investment strategy;
- It provides information on that basis about the group of financial assets and financial liabilities to the entity's key management personnel; and
- It measures those financial assets and financial liabilities at fair value in the statement of financial position at the end of each reporting period.

5 DISCLOSURE

Section overview

- Recurring and non-recurring fair value measurement
- Overall disclosure objective
- Disclosures

5.1 Recurring and non-recurring fair value measurement

The fair value measurement of assets and liabilities might be recurring or non-recurring.

- Recurring fair value measurements are those that are required or permitted in the statement of financial position at the end of each reporting period (e.g. the fair value of investment property when the IAS 40 fair value model is used);
- Non-recurring fair value measurements are those that are required or permitted in the statement of financial position in particular circumstances (e.g. when an entity measures an asset held for sale at fair value less costs to sell in accordance with IFRS 5).

Disclosures are necessary in respect of each of the above.

5.2 Overall disclosure objective

Information must be disclosed to help users assess both of the following:

- the valuation techniques and inputs used to measure the fair value assets and liabilities on a recurring or non-recurring basis;
- the effect on profit or loss or other comprehensive income for the period of recurring fair value measurements using significant unobservable inputs (Level 3).

All of the following must be considered to meet the above objectives:

- the level of detail necessary to satisfy the disclosure requirements;
- how much emphasis to place on each of the various requirements;
- how much aggregation or disaggregation to undertake; and
- the need for additional information.

Classes of assets and liabilities

Classes of assets and liabilities must be identified for the purpose of fulfilling the minimum disclosure requirements of IFRS 15.

Appropriate classes are identified on the basis of the following:

- the nature, characteristics and risks of the asset or liability; and
- the level of the fair value hierarchy within which the fair value measurement is categorised.

5.3 Disclosures

The following information must be disclosed as a minimum for each class of assets and liabilities measured at fair value in the statement of financial position after initial recognition.

For recurring and non-recurring fair value measurements

The fair value measurement at the end of the reporting period and the reasons for the measurement for non-recurring fair value measurements

The level of the fair value hierarchy within which the fair value measurements are categorised in their entirety (Level 1, 2 or 3).

For fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy:

- a description of the valuation technique(s) and the inputs used in the fair value measurement for;
- the reason for any change in valuation technique;

Quantitative information about the significant unobservable inputs used in the fair value measurement for fair value measurements categorised within Level 3 of the fair value hierarchy.

A description of the valuation processes used for fair value measurements categorised within Level 3 of the fair value hierarchy.

The reason why a non-financial asset is being used in a manner that differs from its highest and best use when this is the case.

For recurring fair value measurements

The amounts of any transfers between Level 1 and Level 2 of the fair value hierarchy, the reasons for those transfers and the entity's policy for determining when transfers between levels are deemed to have occurred.

For fair value measurements categorised within Level 3 of the fair value hierarchy:

- a reconciliation of opening balances to closing balances, disclosing separately changes during the period attributable to the following:
  - total gains or losses recognised in profit or loss (and the line items in which they are recognised);
  - unrealised amounts included in the above;
  - total gains or losses recognised in other comprehensive income(and the line item in which they are recognised);
  - purchases, sales, issues and settlements;
  - details of transfers into or out of Level 3 of the fair value hierarchy;
- for recurring fair value measurements categorised within Level 3 of the fair value hierarchy:

- a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs;
- the fact that a change to one or more of the unobservable inputs would change fair value significantly (if that is the case) and the effect of those changes.

Other

If financial assets and financial liabilities are managed on a net basis and the fair value of the net position is measured that fact must be disclosed.

CHAPTER 18

IAS 12: Income taxes

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 16 IAS 12: Income Taxes

B (a) 53 SIC 25: Income taxes – changes in the tax status of an enterprise or its shareholders

1 ACCOUNTING FOR TAXATION

Section overview

- Taxation of profits
- Over-estimate or under-estimate of tax from the previous year
- Taxation in the statement of financial position

1.1 Taxation of profits

Companies pay tax on their profits. The tax charge is based on their accounting profit as adjusted according to the tax law of Pakistan.

Definitions

Accounting profit is profit or loss for a period before deducting tax expense.

Taxable profit (tax loss) is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).

Current tax is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

Tax computation

A series of adjustments is made against a company's accounting profit to arrive at its taxable profit. These adjustments involve:

- ❑ Adding back inadmissible deductions (accounting expenses which are not allowed as a deduction against taxable profit).
- ❑ Deducting admissible deductions which include:
  - expenses that are allowable as a deduction against taxable profit but which have not been recognised in the financial statements; and
  - income recognised in the financial statements but which is exempted from company income tax.

The tax rate is applied to the taxable profit to calculate how much a company owes in tax for the period. IFRS describes this as ***current tax***.

An exam question might require you to perform a basic taxation computation from information given in the question.

Illustration: Tax computation format

	Rs.
Accounting profit before tax	X
Add back: Inadmissible deductions	X
Less: Admissible deductions	(X)
Taxable profit	X
Tax rate	x%
Tax payable (current tax)	X

Example: Taxation computation

X Limited had an accounting profit of Rs. 789,000 for the year ended 31 December 2016.

The accounting profit was after depreciation of Rs. 70,000 and included a profit on disposal (capital gain) of Rs. 97,000.

The company had incurred borrowing costs of Rs. 70,000 in the year of which Rs. 10,000 had been capitalised in accordance with IAS 23.

The company holds some assets under finance leases. During the year finance charge in respect of the leases was Rs. 15,000 and rentals paid were Rs. 80,000.

At 1 January 2016 the tax written down value of machinery was Rs. 120,000 and for buildings was Rs. 600,000.

Tax regime

All borrowing costs are deductible for tax purposes.

Capital gains are not taxable.

Fines are not tax deductible.

Finance lease rentals are deductible in full for tax purposes.

Accounting depreciation is not allowable for tax purposes.

Tax depreciation is claimable at 10% per annum for buildings and 15% per annum for machinery applied to tax written down value at the start of the year.

Tax is paid at 30%

The tax computation is as follows:

	Rs.
Accounting profit	789,000
Add back inadmissible deductions:	
Accounting depreciation	70,000
Fine paid	125,000
Finance charge on finance lease	15,000
	210,000
Less: Admissible deductions	
Lease payments	80,000
Capital gain	97,000
Borrowing cost capitalised	10,000
	(187,000)
Assessable profit	812,000
Less: Capital allowances	
(15% × 120,000 + 10% × 600,000)	(78,000)
Taxable profit	734,000
Income tax (30% of taxable profit)	220,200

Tax base

The above example referred to the tax written down value of the machinery and buildings. This is the tax authority's view of the carrying amount of the asset measured at cost less capital allowances calculated according to the tax legislation.

IFRS uses the term tax base to refer to an asset or liability measured according to the tax rules.

Definition

The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.

The tax base of an asset is the amount that the tax authorities will allow as a deduction in the future.

Measurement

Current tax liabilities (assets) for the current and prior periods must be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

1.2 Over-estimate or under-estimate of tax from the previous year

Current tax for current and prior periods must be recognised as a liability until paid. If the amount already paid exceeds the amount due the excess must be recognised as an asset.

When the financial statements are prepared, the tax charge on the profits for the year is likely to be an estimate. The figure for tax on profits in the statement of comprehensive income is therefore not the amount of tax that will eventually be payable, because it is only an estimate. The actual tax charge, agreed with the tax authorities some time later, is likely to be different.

In these circumstances, the tax charge for the year is adjusted for any under-estimate or over-estimate of tax in the previous year.

- an under-estimate of tax on the previous year's profits is added to the tax charge for the current year.
- an over-estimate of tax on the previous year's profits is deducted from the tax charge for the current year.

Example: Over-estimate or under-estimate of tax

	Rs.	Rs.
Profit from operations		460,000
Interest		(60,000)
Profit before tax		400,000
Tax:		
Adjustment for under-estimate of tax in the previous year	3,000	
Tax on current year profits	100,000	
Tax charge for the year		(103,000)
Profit after tax		297,000

1.3 Taxation in the statement of financial position

The taxation charge for the year is the liability that the company expects to pay. The timing of tax payments on profits varies from one country to another, depending on the tax rules in each country. The actual amount of tax payable, and reported in the statement of financial position as a current liability (taxation payable), is calculated as follows:

Illustration: Taxation in the statement of financial position

	Rs.
Tax payable at the beginning of the year	X
Tax charge for the year	X
	X
Tax payments made during the year	(X)
Tax payable at the end of the year	X

Example: Taxation in the financial statements

Fresh Company has a financial year ending on 31 December.

At 31 December 2015 it had a liability for income tax of Rs. 77,000.

The tax on profits for the year to 31 December 2016 was Rs. 114,000.

The tax charge for the year to 31 December 2015 was over-estimated by Rs. 6,000.

During the year to 31 December 2016, the company made payments of Rs. 123,000 in income tax.

This would result in the following accounting treatment:

Tax charge in the statement of comprehensive income	**Rs.**
Tax on current year profits	114,000
Adjustment for over-estimate of tax in the previous year	(6,000)
Taxation charge for the year	108,000

Tax liability in the statement of financial position	**Rs.**
Tax payable at the beginning of the year	77,000
Tax charge for the year	108,000
	185,000
Tax payments made during the year	(123,000)
Tax payable at the end of the year	62,000

2 DEFERRED TAX: INTRODUCTION

Section overview

- Deferred taxation – Underlying problem
- Identifying deferred tax balances
- IAS 12 approach to the problem

2.1 Deferred taxation - Underlying problem

As explained in the last section, in most jurisdictions the rules for the recognition and measurement of certain assets, liabilities, income and expenses for tax purposes differ from the equivalent rules under IFRSs. This results in different figures in the financial statements and in the tax computations/tax working papers.

It is convenient to envisage two separate sets of accounts:

- one set constructed following IFRS rules; and,
- a second set following the tax rules (tax computations).

This results in a breakdown in the tax rate percentage relationship between the profit before tax figure and the taxation figure. In other words the tax charge is not the tax rate applied to the profit before tax.

Example: Deferred taxation - Underlying problem

X Limited made accounting profit before tax of Rs. 50,000 in each of the years, 20X1, 20X2 and 20X3 and pays tax at 30%.

X Limited bought an item of plant on 1 January 20X1 for Rs. 9,000. This asset is to be depreciated on a straight line basis over 3 years.

Accounting depreciation is not allowed as a taxable deduction in the jurisdiction in which the company operates. Instead tax allowable depreciation is available as shown in the following tax computations.

	20X1	20X2	20X3
	Rs.	Rs.	Rs.
Accounting profit (after depreciation)	50,000	50,000	50,000
Add back depreciation	3,000	3,000	3,000
Deduct capital allowances	(4,500)	(2,500)	(2,000)
	(1,500)	500	1,000
Taxable profit	48,500	50,500	51,000
Tax @ 30%	14,550	15,150	15,300

Example continued: Deferred taxation - Underlying problem

In the absence of the recognition of deferred tax this would be reported as follows:

X Limited: Statement of comprehensive income for the years ending:

	20X1	20X2	20X3	Total
	Rs.	Rs.	Rs.	Rs.
Profit before tax	50,000	50,000	50,000	150,000
Income tax @ 30% (as above)	(14,550)	(15,150)	(15,300)	(45,000)
Profit after tax	35,450	34,850	34,700	105,000

Looking at the total column, the profit before tax is linked to the taxation figure through the tax rate (150,000 × 30% = 45,000).

This is not the case in each separate year.

This is because the current tax charge is not found by multiplying the accounting profit before tax by the tax rate. Rather, it is found by multiplying an adjusted version of this figure by the tax rate

The item of plant is written off in the calculation of both accounting profit and taxable profit but by different amounts in different periods. The differences are temporary in nature as over the three year period, the same expense is recognised for the item of plant under both the accounting rules and the tax rules.

Transactions recognised in the financial statements in one period may have their tax effect deferred to (or more rarely, accelerated from) another. Thus the tax is not matched with the underlying transaction that has given rise to it.

In the above example the tax consequences of an expense (depreciation in this case) are recognised in different periods to when the expense is recognised.

Accounting for deferred tax is based on the principle that the tax consequence of an item should be recognised in the same period as the item is recognised. It tries to match tax expenses and credits to the period in which the underlying transactions to which they relate are recognised.

In order to do this, the taxation effect that arises due to the differences between the figures recognised under IFRS and the tax rules is recognised in the financial statements.

The double entry to achieve this is between a deferred tax balance in the statement of financial position (which might be an asset or a liability) and the tax charge in the statement of comprehensive income.

The result of this is that the overall tax expense recognised in the statement of comprehensive income is made up of the current tax and deferred tax numbers.

Definition: Tax expense

Tax expense (tax income) is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.

2.2 Identifying deferred tax balances

The differences between the two sets of rules will result in different numbers in the financial statements and in the tax computations.

Two perspectives

These differences can be viewed from:

- a statement of comprehensive income (income and expenses) perspective:
  - the differences arising in the period are identified by comparing income and expenses recognised under IFRS to the equivalent figures that are taxable or allowable under tax legislation;
  - the approach identifies the deferred tax expense or credit recognised in the statement of comprehensive income for the period (with the other side of the entry recognised as a liability or asset);or
- a statement of financial position (assets and liabilities) perspective:
  - the differences are identified on a cumulative basis by comparing the carrying amount of assets and liabilities under IFRS to the carrying amount of the same assets and liabilities according to the tax rules;
  - the approach identifies the deferred tax liability (or asset) that should be recognised (with the movement on this amount recognised as a credit or expense in the statement of comprehensive income).

IAS 12 uses the statement of financial position perspective but both will be explained here for greater understanding.

Example continued: Two perspectives

The following table identifies the differences between the accounting treatment and the taxation treatment of the item of plant from both perspectives.

	Carrying amount	Tax base	Assets and liabilities	Income and expenses
Cost at 01/01/X1	9,000	9,000		
Charge for the year	(3,000)	(4,500)		(1,500)
Cost at 31/12/X1	6,000	4,500	1,500	
Charge for the year	(3,000)	(2,500)		500
Cost at 31/12/X2	3,000	2,000	1,000	
Charge for the year	(3,000)	(2,000)		1,000
Cost at 31/12/X3	–	–	–	–

Statement of comprehensive income perspective

Example continued: Statement of comprehensive income perspective

20X1:

Rs. 3,000 is disallowed but Rs. 4,500 is allowed instead.

⇒ taxable expense is Rs. 1,500 greater than the accounting expense.

⇒taxable profit is Rs. 1,500 less than accounting profit.

⇒ current tax is reduced by 30% of Rs. 1,500 (Rs. 450).

⇒ deferred tax expense of Rs. 450 must be recognised to restore the balance (Dr: Tax expense / Cr: Deferred taxation liability).

20X2:

Rs. 3,000 is disallowed but Rs. 2,500 is allowed instead.

⇒ taxable expense is Rs. 500 less than the accounting expense.

⇒taxable profit is Rs. 500 more than accounting profit.

⇒ current tax is increased by 30% of Rs. 500 (Rs. 150).

⇒ deferred tax credit of Rs. 150 must be recognised to restore the balance (Dr: Deferred taxation liability / Cr: Tax expense).

20X3:

Rs. 3,000 is disallowed but Rs. 2,000 is allowed instead.

⇒ taxable expense is Rs. 1,000 less than the accounting expense.

⇒taxable profit is Rs. 1,000 more than accounting profit.

⇒ current tax is increased by 30% of Rs. 1,000 (Rs. 300).

⇒ deferred tax credit of Rs. 300 must be recognised to restore the balance (Dr: Deferred taxation liability / Cr: Tax expense).

The statement of comprehensive income would now be as follows:

	20X1	20X2	20X3
	Rs.	Rs.	Rs.
Profit before tax	50,000	50,000	50,000
Income tax @ 30% W1	14,550	15,150	15,300
Deferred tax	450	(150)	(300)
	(15,000)	(15,000)	(15,000)
Profit after tax	35,000	35,000	35,000

Statement of financial position	20X1	20X2	20X3
Deferred tax liability:	Rs.	Rs.	Rs.
Balance b/f	nil	450	300
Movement in the year	450	(150)	(300)
Balance b/f	450	300	nil

Statement of financial position perspective

Example continued: Statement of financial position perspective

This approach compares the carrying amount of assets and liabilities in the financial statements to their tax base to identify the cumulative differences to that point in time.

These differences are called temporary differences.

An asset in the financial statements compared to the taxman's view requires the recognition of a deferred tax liability which is measured by applying the tax rate to the temporary difference.

	Carrying amount	Tax base	Temporary difference	Tax @ 30%
At 31/12/X1	6,000	4,500	1,500	450
At 31/12/X2	3,000	2,000	1,000	300
At 31/12/X3	nil	nil	nil	nil

By the end of 20X1

The asset in the financial statements is Rs. 1,500 more than the tax base.

A deferred tax liability of Rs. 450 must be recognised.

	Debit	Credit
Tax expense	450	
Deferred tax liability		450

By the end of 20X2

The asset in the financial statements is Rs. 1,000 more than the tax base.

A deferred tax liability of Rs. 300 must be recognised but there was Rs. 450 at the start of the year so the liability must be reduced.

	Debit	Credit
Deferred tax liability	150	
Tax expense		150

By the end of 20X3

The asset in the financial statements is the same as the tax base (nil).

A deferred tax liability of nil must be recognised but there was Rs. 300 at the start of the year so the liability must be reduced.

	Debit	Credit
Deferred tax liability	300	
Tax expense		300

These amounts are the same as on the previous page and would have the same impact on the financial statements.

The recognition of deferred taxation has restored the relationship between profit before tax and the tax charge through the tax rate in each year (30% of Rs. 50,000 = Rs. 15,000).

Terminology

When a difference comes into existence or grows it is said to originate. When the difference reduces in size it is said to reverse.

Thus, in the above example a difference of Rs. 1,500 originated in 20X1. This difference then reversed in 20X2 and 20X3.

2.3 IAS 12 approach to the problem

IAS 12: Income taxes, advocates a statement of financial position approach.

Business must identify a deferred tax liability (or perhaps asset) at each reporting date.

It must do this by identifying the differences between the carrying amount of assets and liabilities in the financial statements to the tax base (tax authority's view of those same items). These differences are known as temporary differences (this will be explained in more detail in the next section).

Once the temporary differences have been identified the deferred tax balance is calculated by applying the appropriate tax rate to the difference.

3 RECOGNITION OF DEFERRED TAX: BASIC APPROACH

Section overview

- Identifying the temporary difference
- Taxable and deductible temporary differences
- Sources of temporary differences
- Accounting for deferred tax
- Deferred tax relating to revaluations and other items recognised outside profit or loss
- SIC 25: Changes in tax status of an entity or its shareholders

3.1 Identifying the temporary difference

Accounting for deferred tax is based on the identification of the temporary differences.

Definition: Temporary difference

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:

(a) **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; or**

(b) **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 is the amount that will be deductible for tax purposes against any taxable economic benefit that will flow to an entity when it recovers the carrying amount of the asset.

Definition: Tax base

The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.

3.2 Taxable and deductible temporary differences

Temporary differences may be either taxable temporary differences or deductible temporary differences.

Taxable temporary differences

A taxable temporary difference is caused by a debit in the carrying amount of an asset or liability in the financial statements compared to the tax base of that item.

Taxable temporary differences lead to the recognition of deferred tax liabilities.

Example: Taxable temporary differences

Each of the following is a taxable temporary difference leading to the recognition of a deferred tax liability.

	Carrying amount	Tax base	Temporary difference	Deferred tax liability (30%)
Non-current asset	1,000	800	200	60
Inventory	650	600	50	15
Receivable	800	500	300	90
Receivable (note 1)	500	nil	500	150
Payable (note 2)	(1,000)	(1,200)	200	60

Note 1:

This implies that an item accounted for using the accruals basis in the financial statements is being taxed on a cash bases.

If an item is taxed on cash basis the tax base would be zero as no receivable would be recognised under the tax rules.

Note 2:

The credit balance in the financial statements is Rs. 1,000 and the tax base is a credit of Rs. 1,200. Therefore, the financial statements show a debit balance of 200 compared to the tax base. This leads to a deferred tax liability.

IAS 12 rationalises the approach as follows (using the non-current assets figures to illustrate)

Inherent in the recognition of an asset is that the carrying amount (Rs. 1,000) will be recovered in the form of economic benefits that will flow to the entity in future periods.

When the carrying amount exceeds the tax base (as it does in this case at Rs. 800) the amount of taxable economic benefit will exceed the amount that will be allowed as a deduction for tax purposes.

This difference is a taxable temporary difference and the obligation to pay the resulting income tax in the future periods is a liability that exists at the reporting date.

The company will only be able to deduct Rs. 800 in the tax computations against the recovery of Rs. 1,000.

The Rs. 200 that is not covered will be taxed and that tax should be recognised for now.

Definition: Deferred tax liability

Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

Deductible temporary differences

A deductible temporary difference is caused by a credit in the carrying amount of an asset or liability in the financial statements compared to the tax base of that item.

Deductible temporary differences lead to the recognition of deferred tax assets.

Example: Deductible temporary differences

Each of the following is a deductible temporary difference leading to the recognition of a deferred tax asset.

	Carrying amount	Tax base	Temporary difference	Deferred tax asset (30%)
Non-current asset (note 1)	1,000	1,200	(200)	60
Receivable	800	900	(100)	30
Payable	(1,200)	(1,000)	(200)	60

Note 1:
There is a debit balance for the non-current asset of Rs. 1,000 and its tax base is a debit of Rs. 1,200. Therefore, the financial statements show a credit balance of 200 compared to the tax base. This leads to a deferred tax asset.

Definition: Deferred tax asset

Deferred tax assets are the amounts of income taxes recoverable in future periods in respect of:

(a) deductible temporary differences;

(b) the carry forward of unused tax losses; and

(c) the carry forward of unused tax credits.

3.3 Sources of temporary differences

Circumstances under which temporary differences arise include;

- Situations when income or expense is included in accounting profit in one period but included in the taxable profit in a different period. Examples include:
  - items which are taxed on a cash basis but which will be accounted for on an accruals basis.
  - situations where the accounting depreciation does not equal capital allowances.
- Revaluation of assets where the tax authorities do not amend the tax base when the asset is revalued.

Examples leading to the recognition of deferred tax liabilities

Interest may be received in arrears, leading to a receivable in the statement of financial position. However, this interest may not be taxable until the cash is received.

Example: Recognition of deferred tax liabilities

A Limited recognises interest receivable of Rs. 600,000 in its financial statements.

No cash has yet been received and interest is taxed on a cash basis. The interest receivable has a tax base of nil.

	Carrying amount	Tax base	Temporary difference
	Rs.	Rs.	Rs.
Interest receivable	600,000	–	600,000
Deferred tax liability @ 30%			180,000

Development costs may be capitalised and amortised (in accordance with IAS 38) but tax relief may be given for the development costs as they are paid.

Example: Recognition of deferred tax liabilities

In the year ended 30 June 2016, B Limited incurred development costs of Rs. 320,000.

These were capitalised in accordance with IAS 38, with an amortisation charge of Rs. 15,000 in 2016.

Development costs are an allowable expense for tax purposes in the period in which they are paid. The relevant tax rate is 30%.

	Carrying amount	Tax base	Temporary difference
	Rs.	Rs.	Rs.
Development costs	305,000	–	305,000
Deferred tax liability @ 30%			91,500

Accounting depreciation is not deductible for tax purposes in most tax regimes. Instead the governments allow a deduction on statutory grounds.

Example: Recognition of deferred tax liabilities

C Limited has non-current assets at 31 December 2016 with a cost of Rs. 5,000,000.

Accumulated depreciation for accounting purposes is Rs. 2,250,000 to give a carrying amount of Rs. 2,750,000

Tax deductible depreciation of Rs. 3,000,000 has been deducted to date.

The fixed assets have a tax base of Rs. 2,000,000.

	Carrying amount	Tax base	Temporary difference
	Rs.	Rs.	Rs.
Non-current asset	2,750,000	2,000,000	750,000
Deferred tax liability @ 30%			225,000

Examples leading to the recognition of deferred tax assets

Warranty costs may be recognised as a liability (in accordance with IAS 37) but tax relief may be given only when the cash is spent in the future.

Example: Recognition of deferred tax assets

D Limited recognises a liability of Rs. 100,000 for accrued product warranty costs.

For tax purposes, the product warranty costs will not be deductible until the entity pays any warranty claims. (Therefore the tax base is nil).

The company is very profitable and does not expect this to change. (This means that they expect to pay tax in the future so should be able to recover the deferred tax asset).

	Carrying amount	Tax base	Temporary difference
	Rs.	Rs.	Rs.
Warranty provision	100,000	–	100,000
Deferred tax asset @ 30%			30,000

This time the financial statements contain a liability when compared to the tax authority's view of the situation. Therefore deferred tax is an asset.

It is possible to have a temporary difference even if there is no asset or liability. In such cases there is a zero value for the asset (or liability). For example, research costs may be expensed as incurred (in accordance with IAS 38) but tax relief may be given for the costs at a later date.

Example: Recognition of deferred tax assets

In the year ended 31 December 2016, E Limited incurred research costs of Rs. 500,000.

These were expensed accordance with IAS 38.

Research costs are not permitted as a taxable deduction until a later period.

The relevant tax rate is 30%.

	Carrying amount	Tax base	Temporary difference
	Rs.	Rs.	Rs.
Research costs	nil	500,000	500,000
Deferred tax asset @ 30%			150,000

As a general rule when

- Income approach
  - Accounting income > Taxable income = Deferred tax liability
  - Taxable income > Accounting income = Deferred tax asset
- Balance sheet approach
  - In case of assets: Carrying amount > Tax base = Deferred tax liability (and vice versa)
  - In case of liabilities: Carrying amount > Tax base = Deferred tax asset (and vice versa)

3.4 Accounting for deferred tax

Accounting for deferred taxation involves the recognition of a liability (or an asset) in the statement of financial position at each year end. The business must then account for the movement on the liability (or asset).

The other side of the entry that changes the balance on the deferred taxation liability (asset) is recognised in the statement of profit or loss except to the extent that it arises in other comprehensive income or directly in equity.

Approach

The calculation of the balance to be recognised in the statement of financial position is quite straightforward.

- **Step 1:** Identify the temporary differences (this should always involve a columnar working as in the example below);
- **Step 2:** Multiply the temporary differences by the appropriate tax rate.
- **Step 3:** Compare this figure to the opening figure and complete the double entry.

Example: Accounting for deferred tax

X Limited has non-current assets with a carrying value of Rs. 200,000 and a tax base of Rs. 140,000.

It has recognised a receivable of Rs. 10,000. This relates to income which is taxed on a cash basis.

It has also accrued for an expense in the amount of Rs. 20,000. Tax relief is only given on this expense when it is paid.

At the start of the year X Limited had a deferred tax liability of Rs. 12,000.

Required

Show the movement on the deferred tax account and construct the journal to record this movement.

In order to answer a question like this you need to complete the following proforma:

	Rs.
Deferred taxation balance at the start of the year	12,000
Transfer to the income statement (as a balancing figure)	?
Deferred taxation balance at the end of the year (**working**)	?

In order to complete this you need a working to identify the temporary differences.

Example continued: Accounting for deferred tax

The temporary differences are identified and the required deferred tax balance calculated as follows:

Working:

	Carrying amount	Tax base	Temporary differences	DT balance at 30%
	Rs.	Rs.	Rs.	Rs.
Non-current assets	200,000	140,000	60,000	18,000 (liability)
Accrued income	10,000	–	10,000	3,000 (liability)
Accrued expense	(20,000)	–	(20,000)	(6,000) asset
			50,000	15,000

The answer can then be completed by filling in the missing figures and constructing the journal as follows:

	Rs.
Deferred taxation balance at the start of the year	12,000
Statement of profit or loss (as a balancing figure)	3,000
Deferred taxation balance at the end of the year **(working above)**	15,000

Journal:	**Debit**	**Credit**
Income statement (tax expense)	3,000	
Deferred tax liability		3,000

3.5 Deferred tax relating to revaluations and other items recognised outside profit or loss

A change in the carrying amount of an asset or liability might be due to a transaction recognised outside the statement of profit or loss.

For example, IAS 16: Property, plant and equipment, allows for the revaluation of assets. The revaluation of an asset without a corresponding change to its tax base (which is usually the case) will change the temporary difference in respect of that asset. An increase in the carrying amount of an asset due to an upward revaluation is recognised outside profit or loss. In Pakistan it is credited directly to an account "outside equity" called revalution surplus in accordance with the **Companies Ordinance 1984**. (Elsewhere is credited to other comprehensive income in accordance with IAS 16).

In these cases, the other side of the entry that changes the balance on the deferred taxation liability (asset) is also recognised outside the statement of profit or loss and in the same location as the transaction that gave rise to the change in the temporary difference.

Example continued: Accounting for deferred tax

The following information relates to the movement on the carrying amount of an item of plant together with temporary differences in a reporting period.

	Carrying amount	Tax base	Temporary differences	DT balance at 30%
	Rs.	Rs.	Rs.	Rs.
At 1 January	100,000	80,000	20,000	6,000
Depreciation	(10,000)	(15,000)	5,000	1,500
	90,000	65,000		
Revaluation	35,000	–	35,000	10,500
	125,000	65,000	60,000	18,000

The movement on the deferred tax liability is as follows:

	Rs.
Deferred taxation balance at the start of the year	6,000
Statement of profit or loss (usually as a balancing figure)	1,500
Revaluation surplus	10,500
Deferred taxation balance at the end of the year **(working above)**	18,000

Journal:	**Debit**	**Credit**
Statement of profit or loss (tax expense)	1,500	
Revaluation surplus	10,500	
Deferred tax liability		12,000

Note: The balance on the revaluation surplus account is a credit balance stated net of taxation at Rs. 24,500 (Rs. 35,000 – Rs. 10,500).

Items recognised outside profit or loss

IFRS requires or permits various items to be recognised in other comprehensive income. Examples of such items include:

- a change in carrying amount arising from the revaluation of property, plant and equipment (IAS 16) though this is not the case in Pakistan;
- a change in carrying amount arising from the revaluation of intangible assets (*IAS 38: Intangible assets*) though this is not the case in Pakistan;
- remeasurements of defined benefit plans (*IAS 19: Employee benefits*);
- exchange differences arising on the translation of the financial statements of a foreign operation (*IAS 21: The effects of changes in foreign exchange rates*);

IFRS requires or permits various items to be recognised directly in equity. Examples of such items include:

- adjustment to the opening balance of retained earnings resulting from either a change in accounting policy that is applied retrospectively or the correction of an error (see *IAS 8: Accounting policies, changes in accounting estimates and errors*); and
- amounts arising on initial recognition of the equity component of a compound financial instrument (*IAS 32: Financial Instruments: Presentation*).

Deferred tax and convertible bonds

IAS 32: Financial instruments: Presentation requires that on initial recognition of a compound instrument, for example a convertible bond, the credit entry must be split into the two component parts, equity and liability.

In many jurisdictions the tax base of the convertible bond would be the amount borrowed. Therefore, split accounting results in the origination of a taxable temporary difference (being the difference between the carrying amount of the liability and its tax base).

An entity must recognise the resultant deferred tax liability. The temporary difference arises on initial recognition because the equity portion of the bond is recognised in equity. Therefore, the other side of the double entry to establish the deferred tax liability is also recognised in equity (where it is netted off against the equity component.

Over the life of the bond its carrying value is adjusted to the amount borrowed. Therefore, the taxable temporary difference and the resultant deferred tax liability falls over the bond's life. These changes in the deferred taxation liability are due differences in the annual effective rate used to value the initial liability and the cash interest. Therefore, the movement in deferred tax is recognised in the statement of profit or loss.

The following example is a continuation of the example seen in paragraph 1.3 in *Chapter 16: Financial Instruments: Presentation and disclosure*.

Example: Deferred taxation and convertible bonds

A company issues Rs. 10 million of 6% convertible bonds at par on 1 January 20X1.

The bonds are redeemable at par after four years.

The market rate of interest for similar debt which is not convertible is 8%.

The bonds was recorded in the statement of financial position at the date of issue as follows:

	Dr	Cr
Cash	10,000,000	
Liability		9,337,200
Equity (see working)		662,800

Subsequent measurement of the liability would be as follows:

End of:	Amortised cost at start of the year	Interest at effective rate (8%)	Cash flow (interest actually paid at 6%)	Amortised cost at year end
20X1	9,337,200	746,976	(600,000)	9,484,176
20X2	9,484,176	758,734	(600,000)	9,642,910
20X3	9,642,910	771,433	(600,000)	9,814,343
20X4	9,814,343	785,557	(600,000)	10,000,000

The deferred tax liability at initial recognition and at each subsequent year end is as calculated as follows:

	Carrying amount Rs.	Tax base Rs.	Temporary difference Rs.	Deferred tax liability (30%)
Initial recognition	9,337,200	10,000,000	(662,800)	(198,840)
End of:				
20X1	9,484,176	10,000,000	(515,824)	(154,747)
20X2	9,642,910	10,000,000	(357,090)	(107,127)
20X3	9,814,343	10,000,000	(185,657)	(55,697)
20X4	10,000,000	10,000,000		0

Working

End of:	Interest paid and actual cash outflow	Discount factor at market interest rate (8%)	Discounted cash flow
20X1	600,000	0.9259	555,540
20X2	600,000	0.8573	514,380
20X3	600,000	0.7938	476,280
20X4	10,600,000	0.7350	7,791,000
		Liability	9,337,200
		Cash received	10,000,000
		Equity	662,800

Example (continued): Deferred taxation and convertible bonds

The double entries to record the deferred taxation at initial recognition and at each year end are as follows:

Initial recognition

	Dr	Cr
Equity	198,840	
Deferred tax liability		198,840

Note: The complete double entry to record the convertible bond and deferred tax on initial recognition is as follows

	Dr	Cr
Cash	10,000,000	
Liability		9,337,200
Deferred tax liability		198,840
Equity (662,800 – 198,840)		463,960

Year 1

	Dr	Cr
Deferred tax liability (198,840 – 154,747)	44,093	
Statement of profit and loss		44,093

Year 2

	Dr	Cr
Deferred tax liability (154,747 – 107,127)	47,620	
Statement of profit and loss		47,620

Year 3

	Dr	Cr
Deferred tax liability (107,127 – 55,697)	51,429	
Statement of profit and loss		51,429

Year 4

	Dr	Cr
Deferred tax liability (55,697 – 0)	55,697	
Statement of profit and loss		55,697

3.6 SIC 25: Changes in tax status of an entity or its shareholders

Issue

A change in the tax status of an entity or its shareholders may increase or decrease tax assets and liabilities.

How should the tax consequences of such change be accounted for?

Consensus

The current and deferred tax consequences of a change in tax status must be included in the statement of profit or loss for the period unless they relate to transactions recognised in other comprehensive income or directly in equity.

In those cases the tax consequences should be recognised in other comprehensive income or directly in equity.

4 RECOGNITION AND MEASUREMENT RULES

Section overview

- Recognition of deferred tax liabilities
- Recognition of deferred tax assets
- A recognition issue – non-taxable items
- Measurement of deferred tax balances

4.1 Recognition of deferred tax liabilities

A deferred tax liability must be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:

- ❑ the initial recognition of goodwill; or
- ❑ the initial recognition of an asset or liability in a transaction which:
  - is not a business combination; and
  - at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

There is further guidance on the recognition of deferred tax liabilities in respect of taxable temporary differences arising in a business combination.

Comment on the exceptions: Goodwill

Goodwill usually exists only in group accounts. Groups are not taxed as such: it is the members of a group that are the taxable entities, i.e. the parent and each subsidiary are taxed separately. Goodwill in group accounts is not an asset recognised by the tax authorities so has a tax base of nil. This means that goodwill is a temporary difference but does not lead to the recognition of a deferred tax liability because of the exception.

Example: Goodwill

In the year ended 31 December 2016, A Limited acquired 80% of another company and recognised goodwill of Rs. 100,000 in respect of this acquisition.

The relevant tax rate is 30%.

	Carrying amount	Tax base	Temporary difference
	Rs.	Rs.	Rs.
Goodwill	100,000	nil	100,000
Deferred tax (due to the exception)			nil

The exception refers to the initial recognition of goodwill. However, there is no deferred tax in respect of this difference at any time in the future even if the carrying amount (and hence the temporary difference) changes..

In some jurisdictions goodwill can arise in individual company financial statements. Furthermore, the goodwill might be tax deductible in those jurisdictions. In such cases goodwill is just the same as any other asset and its tax consequences would be recognised in the same way.

Example: Goodwill

In the year ended 31 December 2016, B Limited acquired a partnership and recognised good will of Rs. 100,000 in respect of this acquisition.

The relevant tax rate is 30%.

	Carrying amount	Tax base	Temporary difference
	Rs.	Rs.	Rs.
Goodwill	100,000	100,000	nil
Deferred tax on initial recognition			nil

In the future, both the carrying amount and the tax base of the goodwill might change leading to deferred tax consequences.

Comment on the exceptions: Initial recognition of other items

A temporary difference may arise on initial recognition of an asset or liability, for example if part or all of the cost of an asset will not be deductible for tax purposes. This exception relates to the initial recognition of an asset or liability in a transaction that is not a business combination. In other words, the exception does not apply if the initial recognition is due to a business combination. There is guidance on deferred tax arising in business combinations

If the transaction is not a business combination and affects either accounting profit or taxable profit the exception does not apply and deferred tax is recognised on initial recognition.

Example: Loan

In the year ended 31 December 2016, C Limited lent Rs. 100,000 to another company and incurred costs of Rs. 5,000 in arranging the loan. The loan is recognised at Rs. 105,000 in the accounts.

Under the tax rules in C Limited's jurisdiction the cost of arranging the loan is deductible in the period in which the loan is made.

The relevant tax rate is 30%.

	Carrying amount	Tax base	Temporary difference
	Rs.	Rs.	Rs.
Loan	105,000	100,000	5,000
Deferred tax on initial recognition			1,500

The exception does not apply as the transaction affects the taxable profits on initial recognition. Hence a deferred taxation liability is booked.

If the transaction is not a business combination, and affects neither accounting profit nor taxable profit, deferred tax would normally be recognised but the exception prohibits it.

Example: Initial recognition

In the year ended 31 December 2016, D Limited acquired a non-current asset at a cost of Rs. 100,000. The asset is to be depreciated on a straight line basis over its useful life of 5 years.

The asset falls outside the tax system. Depreciation is not allowable for tax purposes and there is no tax deductible equivalent. Any gain on disposal is not taxable and any loss on disposal not taxable.

The relevant tax rate is 30%.

Initial recognition:

	Carrying amount	Tax base	Temporary difference
	Rs.	Rs.	Rs.
Non-current asset	100,000	Nil	100,000
Deferred tax on initial recognition (due to the exception)			nil

Subsequent measurement (1 year later)

	Carrying amount	Tax base	Temporary difference
	Rs.	Rs.	Rs.
Non-current asset	80,000	Nil	80,000
Deferred tax on initial recognition (due to the exception – this still results from the initial recognition)			nil

4.2 Recognition of deferred tax assets

IAS 12 brings a different standard to the recognition of deferred tax assets than it does to deferred tax liabilities:

- liabilities are always be recognised in full (subject to certain exemptions); but
- assets may not be recognised in full (or in some cases at all).

IAS 12 rule

A deferred tax asset must be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:

- is not a business combination; and
- at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

There is further guidance on the recognition of deferred tax asset in respect of deductible temporary differences arising in a business combination

A deferred tax asset must only be recognised to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be used.

Implication

In order to meet this requirement an entity must make an assessment of the probability that profits will be available in the future against which the deferred tax asset might be utilised.

IAS 12 says that this will be the case when there are sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity which are expected to reverse:

- in the same period as the expected reversal of the deductible temporary difference; or
- in periods into which a tax loss arising from the deferred tax asset can be carried back or forward.

If this is not the case (i.e. there are insufficient taxable temporary differences relating to the same taxation authority and the same taxable entity) a deferred tax asset is recognised only to the extent that such profits exist or tax planning opportunities are available that will create taxable profit in appropriate periods.

Tax planning opportunities are actions that could be taken in order to create or increase taxable income in a particular period.

Deferred tax assets for unused tax losses

The availability of unused tax losses and unused tax credits that can be carried forward to reduce future taxable profits will result in the recognition of a deferred tax asset according to the same criteria as above. In other words, a deferred tax asset will be recognised to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.

Example: Unused tax losses

X Limited pays tax at 30%

In the year ended 31 December 2016, X Limited had incurred a taxable loss of Rs 200,000.

This was the first such loss suffered by the company. It fully expects to return to profit next year. In fact its forecasts show an expected profit of Rs. 300,000 next year.

The company had a single taxable temporary difference as follows:.

Analysis

The loss is fully recoverable against future taxable profits.

Conclusion

X Limited should recognise a deferred tax asset of Rs. 60,000 (30%× Rs. 200,000).

However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. An entity with a history of recent losses may only recognise a deferred tax asset in respect of unused tax losses or tax credits to the extent that:

- there are sufficient taxable temporary differences; or
- there is convincing other evidence that sufficient taxable profit will be available against which they can be used.

In such circumstances, IAS 12 requires disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition.

Example: Unused tax losses

X Limited pays tax at 30%

By the 31 December 2016 year-end, X Limited had unused taxable loss of Rs 200,000.

These losses had been building up over several recent years.

The company forecasts a profit of Rs. 300,000 next year. There is no convincing evidence that this will be the case.

The company had a single taxable temporary difference as follows:.

	Carrying amount	Tax base	Temporary difference
	Rs.	Rs.	Rs.
Non-current asset	1,500,000	1,380,000	120,000

Analysis

The loss is not fully recoverable against future taxable profits.

Conclusion

X Limited should recognise a deferred tax asset to the extent of the taxable temporary differences. This is an amount of Rs. 36,000 (30%× Rs. 120,000).

Review at the end of each period

IAS 12 requires that the carrying amount of a deferred tax asset must be reviewed at the end of each reporting period to check if it is still probable that sufficient taxable profit is expected to be available to allow the benefit of its use.

If this is not the case the carrying amount of the deferred tax asset must be reduced to the amount that it is expected will be used in the future. Any such reduction might be reversed in the future if circumstances change again.

IAS 12 also requires that unrecognised deferred tax assets should be reassessed at the end of each reporting period. A previously unrecognised deferred tax asset will be recognised to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered.

4.3 A recognition issue – non-taxable items

The definition of temporary difference is repeated here for convenience:

Definition: Temporary difference

Temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base.

Deferred tax should be recognised only in respect of those items where expense or income is recognised in both accounting profit and taxable profit but in different periods.

Unfortunately, applying the definition of temporary difference given above would result in the inclusion of items where the difference might not be temporary but permanent in nature.

Example: Permanent difference.

E Limited has recognised Rs. 100,000 income as a receivable in its accounting profit for the year.

This income is not taxable.

Applying the definition of temporary difference would lead to the following:

	Carrying amount	Tax base	Temporary difference
	Rs.	Rs.	Rs.
Receivable	100,000	nil	100,000

However, this is not a temporary difference. It is not a transaction recognised in accounting profits in one period and taxable profits in another.

It is never recognised in taxable profits.

Items not taxable or tax allowable should not result in the recognition of deferred tax balances. In order to achieve this effect, IAS 12 includes the following rules:

- the tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount.
- the tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods. In the case of revenue which is 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.

Returning to the above example:

Example: Permanent difference.

E Limited has recognised Rs. 100,000 income as a receivable in its accounting profit for the year.

This income is not taxable.

Applying the definition of temporary difference would lead to the following:

	Carrying amount	Tax base	Temporary difference
	Rs.	Rs.	Rs.
Receivable	100,000	100,000	nil

The item is not taxable so its tax base is set to be the same as its carrying amount.

This results in a nil temporary difference and prevents the recognition of deferred tax on this asset.

This sounds rather complicated but just remember that it is a mechanism to exclude non-taxable items from the consideration of deferred tax (even though the definition might have included them).

Remember this: there is no deferred tax to recognise on items that are not taxed or for which no tax relief is given.

Closing comment

Accounting for deferred taxation restores the relationship that should exist between the profit before tax in the financial statements, the tax rate and the tax charge. In earlier examples we saw that after accounting for deferred tax the tax expense (current and deferred tax) was equal to the tax rate × the accounting profit before tax.

This will not be the case if there are permanent differences.

4.4 Measurement of deferred tax balances

Discounting

Deferred tax assets and liabilities must not be discounted.

Tax rates

Deferred tax assets and liabilities must be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

Manner of settlement

Deferred tax balances must be measured in a way that reflects the tax consequences that would follow from the manner in which the entity expects to recover or settle the carrying amount of its assets and liabilities.

For example, the tax rate that applies might depend on whether an asset is used to generate profits or is sold. The tax rate used would depend on how the asset is expected to be recovered in the future.

In addition to this general guidance, IAS 12 also provides specific guidance as follows:

- Deferred tax balances arising from the revaluation of a non-depreciable asset (IAS 16) must be measured to reflect the tax consequences of recovering its carrying amount through sale.
- There is a rebuttable presumption that the carrying amount of an investment property will be recovered through sale when it is measured using the IAS 40 fair value model.

5 DEFERRED TAX: BUSINESS COMBINATIONS

Section overview

- Introduction
- Revaluation of assets/liabilities in the fair value exercise
- Unremitted earnings of group companies
- Unrealised profit adjustments
- Change in recoverability of parent's deferred tax asset due to an acquisition

5.1 Introduction

Additional deferred tax items need to be considered in preparing group accounts, because new sources of temporary differences arise:

- revaluation of assets/liabilities in the fair value exercise;
- unremitted earnings of group companies;
- unrealised profit adjustments.

5.2 Revaluation of assets/liabilities in the fair value exercise

When a parent company makes an acquisition, it must perform a fair value exercise on the assets and liabilities of the entity it has acquired. This will result in a change in the carrying value of some of the assets and liabilities. However, the tax base will not be affected, as this is based on the original cost.

Temporary differences arise for all the revalued assets and liabilities

Double entry

The deferred tax is recognised automatically during the consolidation process. There is no need to make a specific double entry.

Example: Fair value exercise and deferred tax

P Ltd acquires a 100% subsidiary on 31 December 20X6.for Rs. 600,000.

The subsidiary's deferred taxation position at the date of acquisition was as follows:

	Book value	Tax base	Temporary differences
	Rs. 000	Rs. 000	Rs. 000
Property, plant and equipment	180	150	30
Accounts receivable	210	210	-
Inventory	124	124	-
Pension liability	-	-	-
Accounts payable	(120)	(120)	-
Temporary differences			30
Deferred tax at 30%			9

P Ltd carries out a fair value exercise.

The deferred tax balance must be recomputed to take account of the fair value differences as follows:

	Fair value	Tax base	Temporary differences
	Rs. 000	Rs. 000	Rs. 000
Property, plant and equipment	270	150	120
Accounts receivable	210	210	-
Inventory	174	124	50
Pension liability	(30)	-	(30)
Accounts payable	(120)	(120)	-
Fair value of net assets	504		
Temporary differences			140
Deferred tax at 30%			42

The deferred tax balance of Rs. 9,000 must be increased to Rs. 42,000 in the consolidation workings.

Goodwill is calculated as follows:

	Rs. 000
Cost of investment	600
Fair value of net assets acquired (as in the statement of financial position)	504
Deferred tax arising on fair value exercise	(42)
	(462)
Goodwill on acquisition	138

5.3 Unremitted earnings of group companies

When a company acquires a subsidiary or associate, it acquires a right to receive dividends out of its accumulated profits. A temporary difference arises on the profits of the subsidiary or associate that have not been distributed to the parent as at the date of consolidation. For clarity, this is the parent's share of the subsidiary's post acquisition retained profit.

IAS 12 requires that a deferred tax liability be recognised for these undistributed earnings, because they will attract tax when the dividends are paid to the parent in the future.

However, deferred taxation is not recognised on such amounts when:

- the parent is able to control the timing of the reversal of the temporary difference (i.e. the timing of when the dividend is paid); and
- it is probable that the temporary difference will not reverse in the future (i.e. there is no intention to instigate the payment of a dividend).

In practice, it is unusual to see companies recognising deferred tax liability for undistributed profits of a subsidiary because of the above rule.

The situation for investments in associates is different because the parent is unlikely to control the timing of the reversal of the temporary difference. Recognition of deferred tax liability for undistributed profits of associates is quite common.

5.4 Unrealised profit adjustments

Where inter-company trading takes place between group companies and the inventory is still held by the group at the year end, an adjustment is made in the group accounts because the profit has not been realised outside of the group.

However, tax is charged on the profits of the individual companies, not on the group as a whole. The profit on intra-group sales will therefore be subjected to tax, and this will create a temporary difference.

The issue to resolve is whose tax rate should be used when providing for the deferred tax on this temporary difference – the seller's or the buyer's? IAS 12 requires that deferred tax be provided at the buyer's rate of tax.

5.5 Change in recoverability of parent's deferred tax asset due to an acquisition

A parent company may have a deferred tax asset that it has not recognised as it does not believe it probable that taxable profits will be available against which the asset can be used.

The probability of realising a pre-acquisition deferred tax asset of the acquirer could change as a result of a business combination.

For example, the acquirer may be able to utilise the benefit of its unused tax losses against the future taxable profit of the acquiree.

In such cases, the parent company should recognise the change in the deferred tax asset in the period of the business combination. This does not affect the goodwill calculation.

6 PRESENTATION AND DISCLOSURE

Section overview

- Presentation
- Disclosure

6.1 Presentation

IAS 12: Income taxes contains rules on when current tax liabilities may be offset against current tax assets

Offset of current tax liabilities and assets

A company must offset current tax assets and current tax liabilities if, and only if, it:

- ❑ has a legally enforceable right to set off the recognised amounts; and
- ❑ intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

These are the same rules as apply to assets and liabilities in general as described in IAS 1.

In the context of taxation balances whether a current tax liability and asset may be offset is usually specified in tax law, thus satisfying the first criterion.

In most cases, where offset is legally available the asset would then be settled on a net basis (i.e. the company would pay the net amount).

Offset of deferred tax liabilities and assets

A company must offset deferred tax assets and deferred tax liabilities if, and only if:

- ❑ the entity has a legally enforceable right to set off current tax assets against current tax liabilities; and
- ❑ the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation authority on either:
  - the same taxable entity; or
  - different taxable entities which intend either to settle current tax liabilities and assets on a net basis, or to realise the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered.

The existence of deferred tax liability is strong evidence that a deferred tax asset from the same tax authority will be recoverable.

Example: Offset of deferred tax liabilities and assets

The following deferred tax positions relate to the same entity:

	Situation 1	Situation 2
Deferred tax liability	12,000	5,000
Deferred tax asset	(8,000)	(8,000)
	4,000	(3,000)

In situation 1, the financial statements will report the net position as a liability of 4,000. The existence of the liability indicates that the company will be able to recover the asset, so the asset can be set off against the liability.

In situation 2, setting off the asset against the liability leaves a deferred tax asset of 3,000. This asset may only be recognised if the entity believes it is probable that it will be recovered in the foreseeable future.

6.2 Disclosure

Components of tax expense (income)

The major components of tax expense (income) must be disclosed separately.

Components of tax expense (income) may include:

- current tax expense (income);
- any adjustments recognised in the period for current tax of prior periods;
- the amount of deferred tax expense (income) relating to the origination and reversal of temporary differences;
- the amount of deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes;
- the amount of the benefit arising from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce current tax expense;
- deferred tax expense arising from the write-down, or reversal of a previous write-down, of a deferred tax asset;
- the amount of tax expense (income) relating to those changes in accounting policies and errors that are included in profit or loss in accordance with IAS 8, because they cannot be accounted for retrospectively.

Illustration: Note to the statement of comprehensive income

Taxation expense	**Rs.**
Current tax	129,000
Adjustment for over estimate of tax in prior year	(5,000)
Deferred taxation	
Arising during the period	20,000
Due to change in tax rate	(5,000)
	15,000
	139,000

Example: Change in rate

31 December 2015

Profits were taxed at 30%.

A Limited recognised a deferred tax liability of Rs. 30,000 (it had temporary differences of Rs. 100,000).

31 December 2016

The tax rate changed to 25% during the year.

At the year- end A Limited carried out the following deferred tax calculation:

	Carrying amount	Tax base	Temporary difference
	Rs.	Rs.	Rs.
Non-current assets	1,000,000	820,000	180,000
Deferred tax at 25%			45,000

The movement on the deferred tax liability would be shown as follows:

	Rs.
Deferred taxation b/f	30,000
Statement of comprehensive income: Rate change (5/30 × 30,000)	(5,000)
Deferred taxation b/f restated	25,000
Statement of comprehensive income (balancing figure – due to the origination of temporary differences in the period)	20,000
Deferred taxation balance at the end of the year **(working)**	45,000

Journal:	Debit	Credit
Income statement (tax expense)		5,000
Income statement (tax expense)	20,000	
Deferred tax liability		15,000

Tax reconciliation

The following must also be disclosed:

- an explanation of the relationship between tax expense (income) and accounting profit in either or both of the following forms:
  - a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed; or
  - a numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed;
- an explanation of changes in the applicable tax rate(s) compared to the previous accounting period;

A major theme in this chapter is that the different rules followed to calculate accounting profit and taxable profit lead to distortion of the relationship that exists

between profit before tax in the financial statements, the tax rate and the current tax expense for the period. Accounting for deferred tax corrects this distortion so that after accounting for deferred tax the tax expense (current and deferred tax) was equal to the tax rate × the accounting profit before tax.

This is not the case if there are permanent differences. The above reconciliations show the effect of permanent differences.

Instances of when permanent differences may arise:

- Exempt Income e.g. capital gains
- Non-Allowable expense e.g. penalties
- Income taxable at lower or higher rates e.g. dividend income

Include example of Dividend

Example: Tax reconciliations

B Limited had an accounting profit before tax of Rs. 500,000.

This contained income of Rs. 20,000 which is not taxable.

Accounting depreciation in the year was Rs. 100,000 and tax allowable depreciation was Rs. 150,000. This means that a temporary difference of Rs. 50,000 originated in the year.

B Limited's taxation computation is as follows:	**Rs.**
Accounting profit	500,000
Add back inadmissible deductions	
Depreciation	100,000
Deduct admissible deduction	
Income not taxed	(20,000)
Assessable profit	580,000
Tax allowable depreciation	(150,000)
Taxable profit	430,000
Tax at 30%	129,000
Tax expense	
Current tax	129,000
Deferred taxation (30% × Rs. 50,000)	15,000
Tax expense	144,000
Tax reconciliation (in absolute numbers)	
Accounting profit	500,000
Applicable tax rate	30%
Accounting profit × the applicable tax rate	150,000
Tax effect of untaxed income (30% of Rs. 20,000)	(6,000)
Tax expense	144,000
Tax reconciliation (in percentages)	
Applicable tax rate	30.0%
Tax effect of untaxed income ($^{6,000}/_{500,000}$)	(1.2%)
Effective tax rate ($^{144,000}/_{500,000}$)	28.8%

Note: this difference arises only when there are permanent differences

Other disclosures

The following must also be disclosed separately:

- the aggregate current and deferred tax relating to items recognised directly in equity;
- the amount of income tax relating to each component of other comprehensive income;
- details (amount and expiry date, if any) of deductible temporary differences, unused tax losses, and unused tax credits for which no deferred tax asset is recognised;
- the aggregate amount of temporary differences associated with investments in subsidiaries, branches and associates and interests in joint arrangements, for which deferred tax liabilities have not been recognised;
- in respect of each type of temporary difference, and in respect of each type of unused tax losses and unused tax credits:
  - the amount of the deferred tax assets and liabilities recognised in the statement of financial position for each period presented;
  - the amount of the deferred tax income or expense recognised in profit or loss if not apparent from the changes in the amounts recognised in the statement of financial position;
- in respect of discontinued operations, the tax expense relating to:
  - the gain or loss on discontinuance; and IAS 12
  - the profit or loss from the ordinary activities of the discontinued operation for the period, together with the corresponding amounts for each prior period presented;
- the amount of income tax consequences of dividends to shareholders proposed or declared before the financial statements were authorised for issue, but are not recognised as a liability in the financial statements;
- the amount of any change recognised for an acquirer's pre-acquisition deferred tax asset caused by a business combination; and
- the reason for the recognition of a deferred tax benefits acquired in a business combination recognised at the acquisition date but not recognised at the acquisition date.
- the amount of a deferred tax asset and the nature of the evidence supporting its recognition, when:
  - the utilisation of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences; and
  - the entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.

Practice questions **1**

XYZ Limited had an accounting profit before tax of Rs. 90,000 for the year ended 31st December 2016. The tax rate is 30%.

The following balances and information are relevant as at 31st December 2016.

	Rs.	Rs.	
Non-current assets			
Property	63,000		1
Plant and machinery	100,000	90,000	2
Assets held under finance lease	80,000		3
Receivables:			
Trade receivables	73,000		4
Interest receivable	1,000		5
Payables			
Fine	10,000		
Finance lease obligation	85,867		3
Interest payable	3,300		5

Note 1: The property cost the company Rs. 70,000 at the start of the year. It is being depreciated on a 10% straight line basis for accounting purposes.

The company's tax advisers have said that the company can claim Rs. 42,000 accelerated depreciation as a taxable expense in this year's tax computation.

Note 2: The balances in respect of plant and machinery are after providing for accounting depreciation of Rs. 12,000 and tax allowable depreciation of Rs. 10,000 respectively.

Note 3: The asset held under the finance lease was acquired during the period.

The tax code does not distinguish between finance leases and operating leases. Rental expense for leases is tax deductible. The annual rental for the asset is Rs. 28,800 and was paid on 31st December 2017.

Note 4: The receivables figure is shown net of an allowance for doubtful balances of Rs. 7,000. This is the first year that such an allowance has been recognised. A deduction for debts is only allowed for tax purposes when the debtor enters liquidation.

Note 5: Interest income is taxed and interest expense is allowable on a cash basis. There were no opening balances on interest receivable and interest payable.

a. **Prepare a tax computation and calculate the current tax expense.**
b. **Calculate the deferred tax liability required as at 31 December 2016.**
c. **Show the movement on the deferred tax account for the year ended 31 December 2016 given that the opening balance was Rs. 3,600 Cr.**
d. **Prepare a note showing the components of the tax expense for the period.**
e. **Prepare a reconciliation between the tax expense and the product of the accounting profit multiplied by the applicable rate.**

SOLUTIONS TO PRACTICE QUESTIONS

Solution: Tax computation for the year ended 31 December 2016 **1a**

	Rs.	Rs.
Accounting profit		90,000
Add back inadmissible expenses		
Depreciation on property	7,000	
Depreciation of plant and machinery	12,000	
Depreciation of asset held under finance lease	20,000	
Finance charge re finance lease	14,667	
Increase in provision for doubtful debts	7,000	
Interest payable accrual	3,300	
Fine	10,000	73,967
Less admissible deductions		
Interest income	1,000	
Tax allowable depreciation on property	42,000	
Tax allowable depreciation on plant and machinery	10,000	
Lease rentals	28,800	(81,800)
		82,167
Tax 30%		24,650

Solution: Deferred tax liability as 31 December 2016 **1b**

	Carrying value	Tax base	Temporary difference
	Rs.	Rs.	Rs.
Property	63,000	28,000	35,000
Plant and machinery	100,000	90,000	10,000
Assets held under finance lease	80,000	nil	80,000
Finance lease obligation	(85,867)	nil	(85,867)
	(5,867)	nil	(5,867)
Trade receivables	73,000	80,000	(7,000)
Interest receivable	1,000	nil	1,000
Fine	(10,000)	(10,000)	–
Interest payable	(3,300)	nil	(3,300)
			29,833
Deferred tax @ 30%			8,950

	Temporary differences	Deferred tax @ 30%
Deferred tax liabilities	46,000	13,800
Deferred tax assets	(16,167)	(4,850)
		8,950

Solution: Movement on the deferred tax account for the year ended 31 December 2016. **1c**

	Rs.
Deferred tax as at 1st January 2016	3,600
Statement of comprehensive income (balancing figure)	5,350
Deferred tax as at 31st December 2016	8,950

Solution: Components of tax expense for the year ended 31 December 2016. **1d**

	Rs.
Current tax expense (see part a)	24,650
Deferred tax (see part c)	5,350
Tax expense	30,000

Solutions: Tax reconciliation for the year ended 31 December 2016. **1e**

	Rs.
Accounting profit	90,000
Tax at the applicable rate (30%)	27,000
Tax effects of expenses that are not deductible in determining taxable profit	
Fines	3,000
Tax expense	30,000

CHAPTER 19

Business combinations and consolidation

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

PRESENTATION OF FINANCIAL STATEMENTS INCLUDING PUBLIC SECTOR ACCOUNTING

A 1 Presentation of financial statements (IAS 1)

A 3 IFRS 10: Consolidated financial statements

FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 4 IFRS 3: Business combinations

1 THE NATURE OF A GROUP AND CONSOLIDATED ACCOUNTS

Section overview

- International accounting standards and group accounts
- Location of accounting rules
- The nature and purpose of consolidated financial statements

1.1 International accounting standards and group accounts

The following standards relate to accounting for investments:

- IFRS 10 *Consolidated financial statements*
- IAS 27 *Separate financial statements*
- IAS 28 *Investments in associates and joint ventures*
- IFRS 11 *Joint Arrangements*
- IFRS 3 *Business combina*tions

IAS 1 and group accounts

IAS 1 requires that financial statements distinguish between:

- profit or loss for the period;
- other comprehensive income, which consists of gains or losses that are not reported in profit or loss – such as gains on asset revaluations;
- transactions between the entity and its owners in their capacity as owners, which are called 'equity transactions' and reported in the statement of changes in equity.

This applies to consolidated accounts (group accounts).

1.2 Location of accounting rules

IFRS 3 defines a business combination as a transaction or other event in which an acquirer obtains control of one or more businesses.

IFRS 10 explains that a business under the control of another is a subsidiary and the controlling entity is the parent.

IFRS 10 defines consolidated financial statements as 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. This means that groups must present their financial statements in the form of consolidated accounts.

Guidance on the process of consolidation is set out in two standards, IFRS 3 *Business Combinations* and IFRS 10 *Consolidated Financial Statements*.

IFRS 3 is largely about the initial accounting for a new investment, setting out the rules on the calculation of goodwill.

IFRS 10 covers the on-going rules related to consolidation. It is IFRS 10 that requires:

- that the financial statements of P and S be prepared using uniform accounting policies;
- the consolidated assets, liabilities, income and expenses are those of the parent and its subsidiaries added on a line by line basis;
- the elimination of unrealised profit on intra group transactions; and
- the cancellation of intra group balances.

Changes of ownership

IFRS 3 explains how to account for further investments in a subsidiary after control has been achieved. These are called step acquisitions.

IFRS 10 explains how to account for disposals.

1.3 The nature and purpose of consolidated financial statements

A subsidiary is usually acquired through the purchase of a controlling interest in its equity. The parent makes a long-term investment in the subsidiary. In the statement of financial position of the parent, there is a non-current asset: 'Investment in subsidiary, at cost'

Sometimes, a parent company has no assets at all except shares in the subsidiaries in the group. A parent whose main assets (or only assets) are shares in subsidiaries is sometimes called a **holding company**.

When a large part of the assets of a parent company consists of investments in subsidiaries, it is difficult for the users of the financial statements of the parent to understand anything about its financial position or financial performance. To find out meaningful information about their investment, users of the parent's financial statements need to know about the financial position and performance of the operating subsidiaries.

The purpose of consolidated accounts is to provide financial statements that have meaning and relevance to users.

When a parent acquires a subsidiary, both the parent and the subsidiary remain legally separate entities. However, in practice they operate as if they were one organisation. Consolidated financial statements reflect the reality (or substance) of the situation: the group is a single economic unit.

Consolidated financial statements are 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.

2 IFRS 10: CONSOLIDATED FINANCIAL STATEMENTS

Section overview

- Introduction to IFRS 10
- Situations where control exists
- The requirement to prepare consolidated accounts

2.1 Introduction to IFRS 10

IFRS 10 establishes principles for the presentation of consolidated financial statements when an entity controls one or more other entities

Definitions: Group, parent and subsidiary

Group: A parent and its subsidiaries

Parent: An entity that controls one or more entities.

Subsidiary: An entity that is controlled by another entity.

A group consists of a parent entity and one or more entities that it has control over. These are called subsidiaries.

The entity that ultimately controls all the entities in the group is called the parent.

Some parent companies have no assets at all except shares in the subsidiaries of the group. A parent whose main assets (or only assets) are shares in subsidiaries is sometimes called a **holding company**.

Control

An entity is a subsidiary of another entity if it is controlled by that other entity.

IFRS 10 contains a principles based definition of control.

Definition: Control

An investor controls an investee when:

a. **it is exposed, or has rights, to variable returns from its involvement with the investee; and**

b. **it has the ability to affect those returns through its power over the investee.**

In other words an investor controls an investee, if and only if, it has all the following:

- ❑ power over the investee;
- ❑ exposure, or rights, to variable returns from its involvement with the investee; and
- ❑ ability to use its power over the investee to affect the amount of its returns

2.2 Situations where control exists

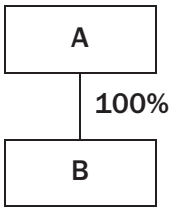
The above definition of control is quite complicated.

In practice, the vast majority of cases involve a company achieving control of another through buying a controlling interest in its shares.

Furthermore, in the vast majority of cases obtaining a controlling interest means buying shares which give the holder more than 50% of the voting rights in the other company.

Illustration: Wholly owned subsidiary

A owns 100% of B's voting share capital.



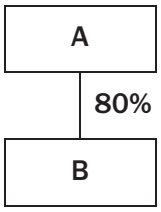
This 100% holding is described as a controlling interest and gives A complete control of B.

B would be described as a wholly owned subsidiary.

A company does not have to own all of the shares in another company in order to control it.

Illustration: Partly owned subsidiary

A owns 80% of B's voting share capital.



This 80% holding is described as a controlling interest and gives A complete control of B.

B would be described as a partly owned subsidiary.

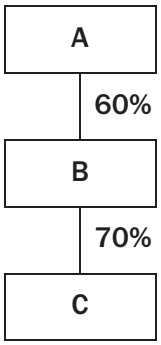
Other parties own the remaining 20% of the shares. They have an ownership interest in B but do not have control.

This is described as a non-controlling interest.

Non-controlling interest (NCI) is defined by IFRS 10 as: "the equity in a subsidiary not attributable ... to a parent."

Control is assumed to exist when the parent owns directly, or indirectly through other subsidiaries, more than half of the voting power of the entity, unless in exceptional circumstances it can be clearly demonstrated that such control does not exist.

Illustration:



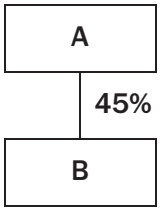
A owns a controlling interest in B.
B owns a controlling interest in C.
Therefore, A controls C indirectly through its ownership of B.
C is described as being a sub-subsidiary of A.

In certain circumstances, a company might control another company even if it owns shares which give it less than half of the voting rights. Such a company is said to have ***de facto*** control over the other company. (***De facto*** is a Latin phrase which translates as ***of fact***. It is used to mean **in reality** or to refer to a position held in fact if not by legal right).

Illustration: Wholly owned subsidiary

A owns 45% of B's voting share capital.

The other shares are held by a large number of unrelated investors none of whom individually own more than 1% of B.



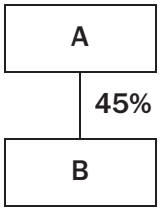
This 45% holding probably gives A complete control of B.
It would be unlikely that a sufficient number of the other shareholders would vote together to stop A directing the company as it wishes.

A company might control another company even if it owns shares which give it less than half of the voting rights because it has an agreement with other shareholders which allow it to exercise control.

Illustration: Wholly owned subsidiary

A owns 45% of B's voting share capital.

A further 10% is held by A's bank who have agreed to use their vote as directed by A.



This 45% holding together with its power to use the votes attached to the banks shares gives A complete control of B.

It was stated above but is worth emphasising that in the vast majority of cases control is achieved through the purchase of shares that give the holder more than 50% of the voting rights in a company.

Two or more investors collectively control an investee when they must act together to direct the relevant activities. If this is the case, no investor can direct the activities without the co-operation of the others so no investor individually controls the investee and it is not a subsidiary. Each investor must account for its interest in accordance with the relevant IFRSs, such as IFRS 11 Joint Arrangements, IAS 28 Investments in Associates and Joint Ventures or IFRS 9 Financial Instruments.

Power

An investor has power over an investee when it has existing rights that give it the current ability to direct the relevant activities (the activities that significantly affect the investee's returns). This power does not necessarily have to be exercised. As long as the rights exist, all other things being equal, the investee is a subsidiary.

Power arises from rights.

- Assessing power is often straightforward – for example when power arises through holding more than 50% of voting rights; or
- Assessing power might be more complex, for example:
  - when power results from one or more contractual arrangements; or
  - when power is due to a dominant but not majority shareholding.

Only substantive rights are taken into account. Substantive rights are rights that an investor has the *practical ability* to exercise. Usually such rights must be currently exercisable so that the entity is in a position to direct the relevant activities of the other entity. However sometimes rights might be substantive, even though they are not currently exercisable.

Example: Substantive rights

S Ltd. is an investee company.

Policies over the relevant activities can be changed only at special or scheduled shareholders' meetings. This includes the approval of material sales of assets as well as the making or disposing of significant investments.

S Ltd. holds annual shareholder meetings at which decisions to direct the relevant activities are made. The next scheduled shareholders' meeting is in eight months.

Shareholders that individually or collectively hold at least 5% of the voting rights can call a special meeting to change the existing policies over the relevant activities with 30 days' notice.

X Ltd holds a majority of the voting rights in S Ltd. Are these rights substantive?

Answer

The rights are substantive and S Ltd is a subsidiary of X Ltd.

X Ltd is able to make decisions about the direction of the relevant activities when they need to be made. The fact that it takes 30 days before it can exercise its voting rights does not stop it from having the current ability to direct the relevant activities.

Example: Substantive rights

B Ltd is an investee company (with the same fact pattern as for S Ltd above).

A Ltd holds an option, which if exercised, would give it ownership of shares with more than 50% of the voting rights of B Ltd. This option is exercisable in 25 days and is deeply in the money.

Is B Ltd a subsidiary of A Ltd?

Answer

The option contract is a substantive right that gives A Ltd the current ability to direct the relevant activities of B Ltd.

A Ltd has rights that are essentially equivalent to those of a majority shareholder in that it can make decisions about the direction of the relevant activities when they need to be made.

The fact that it takes 30 days before it can exercise its votes does not stop it from having the current ability to direct the relevant activities.

B Ltd is a subsidiary of A Ltd.

2.3 The requirement to prepare consolidated accounts

Definition

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

All parents?

An entity that is a parent must present consolidated financial statements.

There is an exception to this rule. A parent need not present consolidated financial statements if (and only if) it meets all of the following conditions:

- The parent itself (X) is a wholly-owned subsidiary, with its own parent (Y).
- Alternatively, the parent (X) is a partially-owned subsidiary, with its own parent (Y), and the other owners of X are prepared to allow it to avoid preparing consolidated financial statements.
- The parent's debt or equity instruments are not traded in a public market.

- The parent does not file its financial statements with a securities commission for the purpose of issuing financial instruments in a public market.
- The parent's own parent, or the ultimate parent company (for example, the parent of the parent's parent), **does** produce consolidated financial statements for public use that comply with International Financial Reporting Standards.

All subsidiaries?

Consolidated financial statements should include all the subsidiaries of the parent from the date at which control is achieved to the date upon which control is lost.

A question might explain that a parent does not wish to consolidate a subsidiary but it would usually have to do so. The following might be given as spurious justification for failing to consolidate a particular subsidiary:

- The subsidiary's activities are dissimilar from those of the parent, so that the consolidated financial statements might not present the group's financial performance and position fairly.
- Obtaining the information needed would be expensive and time-consuming and might delay the preparation of the consolidated financial statements.
- The subsidiary operates under severe long term restrictions, so that the parent is unable to manage it properly. For example, a subsidiary might be located in a country badly disrupted by a war or a revolution. However, note that if the parent loses control then the investee is no longer a subsidiary and should not be consolidated.

Sometimes a group is acquired and the new parent intends to sell one of the new subsidiaries. In this case the subsidiary is accounted for as discontinued operation according to the rules in IFRS 5. This means that all of its assets and all of its liabilities are included as separate lines on the face of the statement of financial position and the group share of its profit (or loss) is shown as a separate line on the face of the statement of profit or loss.

Investment entities exemption

Under normal rules a parent must consolidate all controlled entities.

However, an investment entity might take shares in another entity in order to make gains through dividends or capital appreciation, not to become involved in business of that entity. Furthermore, an investment entity might hold shares in a diverse range of businesses in very different sectors.

These rules apply to an entity whose business activity is primarily investing activity for example, venture capitalists, unit trusts and mutual funds. Some investments of such entities may result in control.

An investment entity must not consolidate the entities that it controls but it must measure them at fair value through profit or loss in accordance with IFRS 9 Financial Instruments.

An entity is an investment entity only if it meets **all** of the following criteria:

- Its only substantive activities are investing in multiple investments for capital appreciation, investment income (dividends or interest), or both.
- It has made an explicit commitment to its investors that its purpose of investment is to earn capital appreciation, investment income (dividends or interest), or both.
- Ownership in the entity is represented by units of investments, such as shares or partnership interests, to which proportionate shares of net assets are attributed.
- The funds of its investors are pooled so that they can benefit from professional investment management.
- It has investors that are unrelated to the parent (if any), and in aggregate hold a significant ownership interest in the entity.
- Substantially all of the investments of the entity are managed, and their performance is evaluated, on a fair value basis.
- It provides financial information about its investment activities to its investors.

3 PROPOSED AMENDMENTS

Section overview

- ED/2014/2: Investment entities: Applying the consolidation exemption
- ED/2014/4: Measuring quoted investments in subsidiaries, joint ventures and associates at fair value

3.1 ED/2014/2: Investment entities: Applying the consolidation exemption

Exemption from presenting consolidated financial statements

IFRS 10 provides an exemption from presenting consolidated financial statements for a parent entity that meets specified criteria. One criterion is that its ultimate or any intermediate parent produces consolidated financial statements that are available for public use and comply with IFRS.

The ED proposes to amend IFRS 10 to confirm that the exemption from preparing consolidated financial statements is also available to a parent entity that is a subsidiary of an investment entity, even when the investment entity measures its subsidiaries at fair value in accordance with paragraph 31 of IFRS 10.

Example: Proposed clarification on exemption from presenting consolidated financial statements

A owns 100% of B

B owns 100% of C

B is exempt from preparing group accounts (in which it consolidates C) if its ultimate parent produces consolidated financial statements that are available for public use and comply with IFRS (subject to meeting other criteria).

If A were an investment entity it cannot consolidate B but must measure it at fair value through profit or loss.

The ED proposes that in this case B would still not need to consolidate C.

Investment entities

IFRS 10 requires an investment entity to measure its investments in subsidiaries at fair value. However, IFRS 10 requires an investment entity to consolidate a subsidiary that provides services that relate to the investment entity's investment activities.

When a subsidiary of an investment entity itself meets the definition of an investment entity and, additionally, provides services that relate to the parent's investment activities, it is unclear as to whether the investment entity parent should measure that investment entity subsidiary at fair value or consolidate it.

The ED proposes to amend IFRS 10 to say that the requirement for an investment entity to consolidate a subsidiary, instead of measuring it at fair value, applies only to those subsidiaries that act as an extension of the operations of the investment entity parent, and do not themselves qualify as investment entities.

The ED proposes to limit the need for an investment entity to consolidate subsidiaries that provide services to those who are not themselves investment entities and whose main purpose is to provide services to the parent.

Example: Investment entities

Situation 1

A owns 100% of B

A is an investment entity

A is not allowed to consolidate B but must measure its interest at fair value through profit or loss.

Situation 2

A owns 100% of B

A is an investment entity

B provides services to A that relate to A's investment activities.

A must consolidate B.

Situation 3

A owns 100% of B

Both A and B are investment entities

B provides services to A that relate to A's investment activities.

The proposal is that A must not consolidate B but must measure its interest at fair value through profit or loss.

Consolidation of investment entities

IFRS 10 states that a non-investment entity parent of an investment entity cannot retain the fair value measurement applied by the investment entity to its interests in subsidiaries. That non-investment entity parent must instead consolidate all subsidiaries in the group.

Example: Consolidation of investment entities

A owns 100% of B

B owns 100% of C

B is an investment entity

B must not consolidate C but must measure it at fair value through profit or loss.

A is not allowed to retain this treatment in its consolidated financial statements. It must consolidate B and C in the usual way.

IAS 28 does not contain an equivalent explicit statement related to the application of the equity method by a non-investment entity investor for its investments in joint ventures or associates that are investment entities. The ED proposes to include such a statement.

Example: Consolidation of investment entities

A owns 40% of B

B owns 100% of C

B is an investment entity

B must not consolidate C but must measure it at fair value through profit or loss.

Proposal: A is not allowed to retain this treatment in its consolidated financial statements. It must equity account for B and C in the usual way.

3.2 ED/2014/4: Measuring quoted investments in subsidiaries, joint ventures and associates at fair value

The proposals in the ED clarify that the fair value measurement of quoted investments in subsidiaries, joint ventures and associates should be the product of the quoted price (P) multiplied by the quantity of financial instruments held (Q), or P × Q, without adjustments. For example, an entity might argue that the product should be adjusted to take account of the size of the holding but this would not be allowed.

4 IFRS 3: BUSINESS COMBINATIONS

Section overview

- Introduction to IFRS 3
- Acquisition method
- Goodwill
- Cost (consideration transferred)
- Acquisition date amounts of assets acquired and liabilities assumed

4.1 Introduction to IFRS 3

Definitions

A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses.

A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

Objective of IFRS 3

The objective of IFRS 3 is to improve the relevance, reliability and comparability of information reported about business combinations and their effects.

It establishes principles and requirements for:

- ❑ the recognition and measurement of identifiable assets acquired, liabilities assumed and non-controlling interest in the acquiree;
- ❑ the recognition and measurement of goodwill (or a gain from a bargain purchase); and
- ❑ disclosures that enable users to evaluate the nature and financial effects of a business combination.

Transactions under common control are not within the scope of IFRS 3.This means that transfers of ownership of a subsidiary within a group (for example in group reconstructions) are not subject to the rules in this standard. Companies engaging in such transactions must develop accounting policies in accordance with the guidance given in IAS 8.

4.2 Acquisition method

All business combinations are accounted for by the acquisition method which involves:

- ❑ identifying the acquirer;
- ❑ determining the acquisition date;
- ❑ recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree; and

- recognising and measuring goodwill or a gain from a bargain purchase

Identifying the acquirer

It might be difficult to identify an acquirer:

- The acquirer is usually the combining entity whose relative size is significantly greater than that of the other(s).
- In a business combination affected by transferring cash (other assets) or by incurring liabilities the acquirer is usually the entity that makes the transfer or incurs the liabilities.
- In a business combinations affected by exchange of equity interests the acquirer is usually the entity that issues equity (however, in a "reverse acquisition" the issuing entity is the acquiree).

Also note that the acquirer is usually the entity:

- whose owners have the largest portion of the voting rights in the combined entity;
- whose owners have the ability to determine the composition of the governing body of the combined entity;
- whose (former) management dominates the management of the combined entity;
- that pays a premium over the pre-combination fair value of the equity interests of the others

Determining the acquisition date

Acquisition date is the date on which the acquirer effectively obtains control of the acquiree.

This generally the closing date (date of transfer of consideration and when net assets are acquired) but might be before or after this date depending on circumstances.

4.3 Goodwill

IFRS 3 is largely about the calculation of goodwill.

Definition: Goodwill

Goodwill: An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised.

IFRS 3 sets out the calculation of goodwill as follows:

Illustration: Goodwill

N.B. All balances are as at the date of acquisition.

	Rs.
Consideration transferred (cost of the business combination)	X
Non-controlling interest	X
	X
The net of the acquisition date amounts of identifiable assets acquired and liabilities assumed (measured in accordance with IFRS 3)	X
Goodwill recognised	X

The non-controlling interest may be stated as either:

- a proportionate share of the identifiable assets acquired and liabilities assumed; or
- at fair value as at the date of acquisition

Issues to address:

IFRS 3 gives guidance on:

- cost of a business combination;
- recognition and measurement of identifiable assets and liabilities assumed; and
- accounting for goodwill.

4.4 Cost (consideration transferred)

IFRS 3 states that the purchase consideration for an acquisition (business combination) is the sum of:

- the fair values, at the acquisition date, of the assets transferred by the acquirer, such as cash
- the liabilities incurred by the acquirer to the former owners of the acquiree
- equity instruments issued by the acquirer in exchange for control of the acquiree.

The purchase consideration may include some deferred consideration.

When the acquirer issues shares as part of the purchase consideration and the shares are quoted equity instruments, they are normally valued at their market price at the acquisition date for the purpose of measuring the consideration/acquisition cost.

If the consideration includes assets or liabilities of the acquirer carried at amounts that differ from their fair values at the acquisition date, these are revalued with gains and losses taken to P&L.

Consideration includes any asset or liability resulting from a contingent consideration arrangement:

- recognised at acquisition-date fair value; and
- classified as a liability or equity on the basis of guidance in IAS 32 or other applicable IFRSs.

A right to the return of previously transferred consideration is classified as an asset if specified conditions are met.

Costs of acquisition: transaction costs

Transaction costs incurred in making an acquisition, such as the cost of the fees of advisers and lawyers, must not be included in the cost of the acquisition. These costs must be treated as an expense as incurred and written off to profit or loss.

The amount of transaction costs associated with an acquisition and written off during the period to profit or loss must be disclosed in a note to the financial statements.

However, if an entity borrows money to finance an acquisition, the costs associated with arranging the borrowing are treated in accordance with the rules of IAS 39. These costs are deducted from the value of the debt and amortised over the term of the debt using the effective rate of interest (i.e. the amortised cost method).

Example: Cost of acquisition

Company P acquired 80% of the shares of Company S when the fair value of the net assets of S was Rs. 800,000.

The purchase price was Rs. 300,000 in cash plus 10,000 new shares in Company P.

The new shares were to be issued 1 month after the date of acquisition.

The market value of P's shares at the date of acquisition was Rs.40 each. One month later the market value had increased to Rs.45.

The costs of making the acquisition were Rs. 80,000.

The cost of the investment in the shares of S = Rs. 300,000 + (10,000 × Rs.40 = Rs. 700,000. The share price at the date of acquisition is used not that at the date of issue.

The costs of making the acquisition should be written off to profit or loss.

The parent company's share of the net assets of S at the acquisition date was Rs. 640,000 (80% × Rs. 800,000). Purchased goodwill attributable to owners of the parent company is therefore Rs. 60,000 (Rs. 700,000 - Rs. 640,000).

Deferred consideration

Sometimes all or part of the cost of an acquisition is deferred and does not become payable until a later date.

The amount of any deferred consideration (the amount not payable immediately) is discounted to its present value at the acquisition date.

Contingent consideration

Sometimes the final cost of the combination is contingent on (depends on) a future event. For example, an acquirer could agree to pay an additional amount if the acquired subsidiary's profits exceed a certain level within three years of the acquisition.

In a situation such as this, the contingent payment should be included in the cost of the combination (discounted to present value if the payment will occur more than 12 months in the future).

Under the rules of IFRS 3, contingent consideration must be recognised at fair value at acquisition, even if it is not probable that the consideration will actually have to be paid.

Example: Contingent consideration

Company X purchased 100% of the issued capital of Company S on 1 January Year 4.

The purchase agreement required Company X to pay Rs. 300,000 in cash immediately and an additional sum of Rs. 100,000 on 31 December Year 6 if the earnings of Company S increase at an annual rate of 25% per year in each of the three years following the acquisition.

How should the contingent payment be recognised in calculating the goodwill arising at the date of acquisition?

Answer

The contingent consideration should be included in the cost of investment (the purchase consideration) whether or not it is probable that it will have to be paid. The contingent consideration of Rs. 100,000 should be measured at fair value.

If it is fairly certain that the contingent consideration will have to be paid, an appropriate measure of fair value might be the present value of the future payment, discounted at an appropriate cost of capital. The purchase consideration is therefore Rs. 300,000 plus the present value of the contingent (deferred) consideration.

If there is still contingent consideration at the end of an accounting period, it might be necessary to re-measure it.

If the contingent consideration will be payable in cash, it should be re-measured to fair value at the end of the reporting period. Any gain or loss on re-measurement should be taken to profit or loss.

If the contingent consideration will take the form of debt, the amount of the debt is re-measured at fair value at the end of the reporting period and the change in value is recognised in profit or loss in the period.

If the contingent consideration will take the form of equity, it is not re-measured at the end of the reporting period. The eventual settlement of the payment will be accounted for as an equity transaction (i.e. a transaction between the entity and owners of the group in their capacity as owners).

A reason for re-measuring the contingent consideration is that the amount payable might depend on the performance of the subsidiary after its acquisition.

If the profits are higher than expected, the contingent consideration might be re-measured to a higher value, increasing the liability (the contingent payment) and reducing the reported profit for the period.

Similarly if the profits are lower than expected, the contingent consideration might be re-measured to a lower value, reducing the liability (the contingent payment) and increasing the reported profit for the period.

(Note: Under the previous accounting rules, before the introduction of IFRS 3, any increase in the value of contingent consideration was charged to goodwill.)

Share options given to the previous owners

When an entity acquires a subsidiary that was previously managed by its owners, the previous owners might be given share options in the entity as an incentive to stay on and work for the subsidiary after it has been acquired. IFRS 3 states that the award of share options in these circumstances is not a part of the purchase consideration. The options are post-acquisition employment expenses and should be accounted for as share-based payments in accordance with IFRS 2.

4.5 Acquisition date amounts of assets acquired and liabilities assumed

Core principle

An acquirer of a business must recognise assets acquired and liabilities assumed at their acquisition date fair values and disclose information that enables users to evaluate the nature and financial effects of the acquisition.

To support this IFRS 3 sets out:

- a recognition principle;
- classification guidance; with
- a measurement principle.

There are specified exceptions to each of these.

Any asset acquired or liability assumed is subsequently measured in accordance with applicable IFRS. There are also exceptions to this rule.

Recognition principle

An acquirer must recognise (separately from goodwill), identifiable assets acquired, liabilities assumed and any non-controlling interest in the acquiree as of the acquisition date.

To qualify for recognition identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities set out in *The Conceptual Framework* as at the acquisition date.

This might result in recognition of assets and liabilities not previously recognised by the acquiree.

When a company acquires a subsidiary, it may identify intangible assets of the acquired subsidiary, which are not included in the subsidiary's statement of

financial position. If these assets are separately identifiable and can be measured reliably, they should be included in the consolidated statement of financial position as intangible assets, and accounted for as such.

This can result in the recognition of assets and liabilities not previously recognised by the acquiree.

Illustration: Identifiable asset on acquisition

If a company bought 100% of the Coca-Cola Corporation they would be buying a lot of assets but part (perhaps the largest part) of the purchase consideration would be to buy the Coca Cola brand.

Coca Cola does not recognise its own brand in its own financial statements because companies are not allowed to recognised internally generated brands.

However, as far as the company buying the Coca-Cola Corporation is concerned the brand is a purchased asset. It would be recognised in the consolidated financial statements and would be taken into account in the goodwill calculation.

Contingent liabilities

Many acquired businesses will contain contingent liabilities such as contingent liabilities for the settlement of legal disputes or for warranty liabilities. IFRS 3 states that contingent liabilities should be recognised at acquisition 'even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.'

The contingent liabilities should be measured at fair value at the acquisition date. (Contingent assets are not recognised).

Restructuring costs

An acquirer should not recognise a liability for the cost of restructuring a subsidiary or for any other costs expected to be incurred as a result of the acquisition (including future losses).

This is because a plan to restructure a subsidiary after an acquisition cannot be a liability at the acquisition date. For there to be a liability (and for a provision to be recognised) there must have been a past obligating event. This can only be the case if the subsidiary was already committed to the restructuring before the acquisition.

This means that the acquirer cannot recognise a provision for restructuring or reorganisation at acquisition and then release it to profit and loss in order to 'smooth profits' or reduce losses after the acquisition.

Measurement principle

Identifiable assets acquired and the liabilities assumed are measured at their acquisition date fair values.

Definition: Fair value

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.

The net assets of a newly acquired business are subject to a fair valuation exercise.

The table below shows how different types of asset and liability should be valued.

Item	Fair value
Marketable investments	Current market value
Non-marketable investments	Estimated values that take into consideration features such as: (a) price earnings ratios (b) dividend yield (c) expected growth rates of comparable investments
Trade and other receivables	Present values of the amounts to be received. This is normally the same as the book value. Discounting is not usually required because amounts are expected to be received within a few months.
Inventories: finished goods	Selling price less the sum of: (a) the costs of disposal, and (b) a reasonable profit allowance for the selling effort of the acquirer based on profit for similar finished goods.
Inventories: work in progress	Selling price of finished goods less the sum of: (a) costs to complete, (b) costs of disposal, and (c) a reasonable profit for the completing and selling effort based on profit for similar finished goods.
Inventories: raw materials	Current replacement costs
Land and buildings	Market value
Plant and equipment	Normally market value. Use depreciated replacement cost if market value cannot be used (e.g., because of the specialised nature of the plant and equipment or because the items are rarely sold, except as part of a continuing business).
Intangible assets	As discussed above
Trade and other payables; long-term debt and other liabilities.	Present values of amounts to be disbursed in meeting the liability determined at appropriate current interest rates. For current liabilities this is normally the same as book value.

Exceptions

Note that this table only shows the exceptions to the above principles and guidance.

Topic	Recognition principle	Measurement at acquisition	Measurement at later dates
Contingent liability	Defined by IAS 37 and not recognised. Contingent liability due to a present obligation is recognised	Fair value	At the higher of the original amount and the amount that would be reported under IAS 37.
Income taxes	IAS 12 applies	IAS 12 applies	IAS 12 applies
Employee benefits	IAS 19 applies	IAS 19 applies	IAS 19 applies
Indemnification assets	This is a right to be compensated by the seller if a defined contingency occurs Recognition of the asset mirrors the recognition of the liability	Measurement of the asset mirrors the recognition of the liability	Measurement of the asset mirrors the recognition of the liability
Reacquired rights	n/a	Recognised as an intangible asset and measured on the basis of the remaining contractual term of the related contract regardless of whether market participants would consider potential contractual renewals in determining its fair value	The asset recognised is amortised over the remaining contractual period of the contract in which the right was granted.
Share based payments		IFRS 2 applies	
Assets held for sale		IFRS 5 applies	

Deferred tax

Deferred income tax assets and liabilities are recognised and measured in accordance with IAS 12 *Income Taxes*, rather than at their acquisition-date fair values.

Measurement period

Initial accounting for goodwill may be determined on a provisional basis and must be finalised by the end of a measurement period.

This ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed at the acquisition date but must not exceed one year from the acquisition date.

During the measurement period new information obtained about facts and circumstances that existed at the acquisition date might lead to the adjustment of provisional amounts or recognition of additional assets or liabilities with a corresponding change to goodwill.

Any adjustment restates the figures as if the accounting for the business combination had been completed at the acquisition date.

Classification guidance

Identifiable assets acquired and liabilities assumed must be classified (designated) as necessary at the acquisition date so as to allow subsequent application of appropriate IFRS.

The classification is based on relevant circumstances as at the acquisition date with two exceptions:

- classification of a lease contract in accordance with IAS 17 *Leases*; and
- classification of a contract as an insurance contract in accordance with IFRS 4 *Insurance Contracts*.

Classification in these cases is based on circumstances at the inception of the contract or date of a later modification that would change the classification.

5 CONSOLIDATION TECHNIQUE

Section overview

- The basic approach
- Practice questions

5.1 The basic approach

Suggested step by step approach to the preparation of consolidated statements of financial position

To prepare a consolidated statement of financial position as at the acquisition date, the following steps should be taken.

Step 1: Establish the group share (parent company share) in the subsidiary and the percentage owned by non-controlling interests.

Step 2: Perform double entry to record any individual company adjustments that might be necessary. Mark these in the face of the question. The information can be lifted into workings later so that the marker can understand what you have done.

Step 3: Set out a pro-forma (skeleton) statement of financial position and fill in the easy numbers (for example those assets and liabilities that are a straight cross cast and the share capital)

Step 4: Calculate the net assets of the subsidiary at the acquisition date and at the end of the reporting period taking into account information about the fair value of assets at the acquisition date and the existence of any assets not recognised by the subsidiary that might need to be capitalised for consolidation purposes.

Step 5: Calculate the goodwill

Illustration: Goodwill

	Rs.
Consideration transferred (cost of the business combination)	X
Non-controlling interest	X
	X
The net of the acquisition date amounts of identifiable assets acquired and liabilities assumed (measured in accordance with IFRS 3)	X
Goodwill recognised	X

Step 6: Calculate the non-controlling interest.

Illustration: Consolidated retained earnings

	Rs.
NCI at the date of acquisition	X
NCI's share of the post-acquisition retained earnings of S	X
NCI's share of each other post-acquisition reserves of S (if any)	X
NCI at the date of consolidation	X

Step 7: Calculate consolidated retained earnings.

Possible complications

You should be familiar with the following of possible complications that you may need to take into account when answering questions:

- ❑ Before consolidation
  - Measuring the cost of acquisition
  - Identifying assets not recognised by the subsidiary which need to be included for consolidation purposes
  - Performing the fair value exercise

Construct a net assets summary of each subsidiary showing net assets at the date of acquisition and at the reporting date.

- ❑ During consolidation
  - Mid-year acquisition – consolidation must be from the date of acquisition so you may need to construct a net assets total for a subsidiary at a point during the previous year.
  - Elimination of inter-company balances
  - Elimination of unrealised profit.
- ❑ After consolidation
  - Impairment testing goodwill
  - Accounting for a gain on a bargain purchase.

5.2 Practice questions

Practice question **1**

P acquired 70% of S on 1 January 20X1 for Rs.450,000

The retained earnings of S were Rs. 50,000 at that date.

It is P's policy to recognise non-controlling interest at the date of acquisition as a proportionate share of net assets.

The statements of financial position P and S as at 31 December 20X1 were as follows:

Assets:	P (Rs.)	S(Rs.)
Investment in S, at cost	450,000	-
Other assets	500,000	350,000
	950,000	350,000
Equity		
Share capital	100,000	100,000
Retained earnings	650,000	100,000
	750,000	200,000
Current liabilities	200,000	150,000
	950,000	350,000

Required

Prepare a consolidated statement of financial position as at 31 December 20X1.

Practice question **2**

P acquired 70% of S on 1 January 20X1 for Rs.450,000

The retained earnings of S were Rs. 50,000 at that date.

It is P's policy to recognise non-controlling interest at the date of acquisition at fair value.

The fair value of the non-controlling interest at the date of acquisition was Rs. 75,000.

The statements of financial position P and S as at 31 December 20X1 were as follows:

Assets:	P (Rs.)	S(Rs.)
Investment in S, at cost	450,000	-
Other assets	500,000	350,000
	950,000	350,000
Equity		
Share capital	100,000	100,000
Retained earnings	650,000	100,000
	750,000	200,000
Current liabilities	200,000	150,000
	950,000	350,000

Required

Prepare a consolidated statement of financial position as at 31 December 20X1.

Practice question **3**

P bought 80% of S 2 years ago.

At the date of acquisition S's retained earnings stood at Rs. 600,000. The fair value of its net assets was not materially different from the book value except for the fact that it had a brand which was not recognised in S's accounts. This had a fair value of 100,000 at this date and an estimated useful life of 20 years.

The statements of financial position P and S as at 31 December 20X1 were as follows:

	P (Rs.)	S(Rs.)
PP and E	1,800,000	1,000,000
Investment in S	1,000,000	
Other assets	400,000	300,000
	3,200,000	1,300,000
Share capital	100,000	100,000
Retained earnings	2,900,000	1,000,000
Liabilities	200,000	200,000
	3,200,000	1,300,000

Required

Prepare a consolidated statement of financial position as at 31 December 20X1.

Practice question **4**

P bought 80% of S 2 years ago.

At the date of acquisition S's retained earnings stood at Rs. 600,000 and the fair value of its net assets were Rs. 1,000,000. This was Rs. 300,000 above the book value of the net assets at this date.

The revaluation was due to an asset that had a remaining useful economic life of 10 years as at the date of acquisition.

The statements of financial position P and S as at 31 December 20X1 were as follows:

	P	S
	Rs.	Rs.
PP and E	1,800,000	1,000,000
Investment in S	1,000,000	
Other assets	400,000	300,000
	3,200,000	1,300,000
Share capital	100,000	100,000
Retained earnings	2,900,000	1,000,000
Liabilities	200,000	200,000
	3,200,000	1,300,000

Required

Prepare a consolidated statement of financial position as at 31 December 20X1.

Practice question **5**

P acquired 70% of S on 1 January 20X1 for Rs.1,000,000

The retained earnings of S were Rs. 50,000 at that date.

Also, at the date of acquisition S held an item of plant with a carrying amount of 250,000 less than its fair value. This asset had a remaining useful life of 10 years as from that date.

It is P's policy to recognise non-controlling interest at the date of acquisition as a proportionate share of net assets.

The statements of financial position of P and S as at 31 December 20X1 were as follows:

	P (Rs.)	S(Rs.)
Assets:		
Investment in S, at cost	1,000,000	-
Other non-current assets	400,000	200,000
Current assets	500,000	350,000
	1,900,000	550,000
Equity		
Share capital	100,000	100,000
Retained earnings	1,600,000	300,000
	1,700,000	400,000
Current liabilities	200,000	150,000
	1,900,000	550,000

Required

Prepare a consolidated statement of financial position as at 31 December 20X1.

6 ACCOUNTING FOR GOODWILL

Section overview

- Accounting for goodwill
- Impairment testing of goodwill

6.1 Accounting for goodwill

Positive goodwill - Excess of cost of combination over share of net assets

After initial recognition goodwill is measured at cost less any accumulated impairment losses.

- Goodwill acquired in a business combination is not amortised.
- It is tested for impairment annually or more frequently if events or changes in circumstances indicate that it might be impaired, in accordance with *IAS 36, Impairment of Assets*.

Gain from a bargain purchase ("Negative goodwill")

A bargain purchase is a business combination in which the calculation of goodwill leads to a negative figure.

When this happens the acquirer must reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and must recognise any additional assets or liabilities that are identified in that review.

The acquirer must then review the procedures used to measure the amounts this IFRS requires to be recognised at the acquisition date for all of the following:

- the identifiable assets acquired and liabilities assumed;
- the non-controlling interest in the acquiree (if any); and
- the consideration transferred.

Any amount remaining after applying the above requirements is recognised as a gain in profit or loss on the acquisition date.

This means that in most cases when a bargain purchase occurs, the 'negative goodwill' should be added to the consolidated profit for the group for the year.

6.2 Impairment testing of goodwill

Purchased goodwill is not amortised, but must be tested for impairment on an annual basis. It cannot be tested for impairment directly. It is allocated to one or more cash generating unit (IAS 36) and then the carrying amount of the cash generating unit is compared to its recoverable amount.

The following discussion and examples assume that the subsidiary in question is a cash generating unit (CGU).

Partial goodwill method (NCI at acquisition measured as a proportionate share of subsidiary's net assets

Recoverable amount of the CGU is based on the cash flows that its assets are expected to generate (either through use or sale of the unit). These cash flows will be a function of all of the assets of the unit including the NCI's share of the goodwill but this latter figure has not been recognised.

The carrying amount of the CGU is made up of:

- the total net assets of the unit (parent's interest and NCI's); and
- the parent's interest in goodwill.

Any comparison of carrying amount to recoverable amount should compare like to like but the cash flows from the NCI's goodwill contribute to the recoverable amount but this goodwill is not in the carrying amount. IAS 36 requires a working that grosses up the carrying amount of the CGU's assets by the NCI share of goodwill. Note that this is only in a working; it is not part of the double entry.

This notionally adjusted carrying amount is then compared with the recoverable amount of the unit to determine whether the cash-generating unit is impaired.

Any impairment is charged against the goodwill in the first instance with any balance writing down other assets in the unit.

Only that part of any impairment loss attributable to the parent is recognised by the entity as a goodwill impairment loss.

Example: Impairment of goodwill

X Ltd paid Rs. 1,600 for an 80% interest in Y Ltd on 01/01/X1.

On this date Y had identifiable net assets with a fair value of Rs. 1,500.

Goodwill on acquisition:	**Rs.**
Cost of acquisition	**1,600**
Share of net assets (80% × Rs.1,500)	**(1,200)**
Goodwill	**400**

The following amounts are recognised in the consolidated financial statements at the date of acquisition:

	Rs.
Goodwill	**400**
Asset	**1,500**
NCI (20% × 1,500)	**300**

This cash-generating unit includes goodwill within its carrying amount, so it must be tested for impairment annually (or more frequently if there is an indication that it may be impaired).

31/12/X1 – Impairment test

X Ltd estimates that the recoverable amount of Y Ltd is Rs. 1,400.

The net assets of Y Ltd (after fair value adjustments) were still Rs. 1,520.

Carrying amount of Y Ltd:	Goodwill	Asset	Total
As at 01/01/X1	400	1,500	1,900
Notional grossing up of goodwill			
$400 \times {}^{20}/_{80}$	100	-	100
	500	1,500	2,000
Recoverable amount			(1,520)
Impairment loss			480

The whole loss (480) is covered by the goodwill of 500 but only 80% of this is in the financial statements. Therefore only 80% of the loss is recognised

Allocation of impairment loss	**Notional write off**	**X Ltd share**	**X Ltd write off**
Goodwill (notional)	480	80%	384

Allocation of impairment loss	**Goodwill**	**Asset**	**Total**
As at 31/12/X1	400	1,500	1,900
Impairment loss	(384)		(384)
	16	1,500	1,516

Full goodwill method (NCI at acquisition measured at fair value

This is more straightforward.

If there is a NCI in a cash-generating unit to which goodwill has been allocated, the carrying amount of that unit is made up of:

- both the parent's interest and the NCI in the net assets of the unit; and
- both the parent's interest in goodwill and the NCI's interest in goodwill.

When non-controlling interests are valued by the fair value method, any impairment in the total goodwill after acquisition should be shared between the parent company shareholders and the NCI.

It is tempting to allocate the write off of goodwill between the parent and NCI in proportion to the goodwill attributable to each. However, para C6, Appendix C to

IAS 36 says that the impairment should be "allocated between the parent and the NCI on the same basis as that on which profit or loss is allocated".

Example: Impairment of goodwill

S has 10 million shares of Rs.1 each in issue. H acquired 80% of these shares at a price of Rs.11.6 million when the net assets of S were Rs.10 million. Prior to the acquisition, the shares of S had been trading in the stock market at Rs.1.20 per share.

Suppose that subsequently goodwill is impaired in value by Rs.1.5 million, so that it is now valued at just Rs. 2,500,000.

The impairment in the goodwill must be attributed to the parent company and the NCI in the according to the proportions used to allocate profit or loss (80:20).

Goodwill

	Total	Parent	NCI
	Rs.000	Rs.000	Rs.000
Purchase consideration	11,600	11,600	
Non-controlling interest (2m shares @ Rs.1.2)	2,400		2,400
	14,000		
Fair value of net assets of subsidiary at acquisition	(10,000)	(8,000)	(2,000)
Goodwill	4,000	3,600	400
Impairment of goodwill:	(1,500)	(1,200)	(300)
	2,500	2,400	100

Note that the impairment is allocated 80:20 not 3,600:400 which might have been expected.

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

P Group: Consolidated statement of financial position at 31 December 20X1

Assets	Rs.
Goodwill (W3)	345,000
Other assets (500 + 350)	850,000
Total assets	1,195,000
Equity	
Share capital (P only)	100,000
Consolidated retained earnings (W4)	685,000
	785,000
Non-controlling interest (W2)	60,000
	845,000
Current liabilities (200 + 150)	350,000
Total equity and liabilities	1,195,000

Workings:

W1 Net assets summary

	At date of consolidation	At date of acquisition	Post-acquisition
Share capital	100,000	100,000	
Retained earnings	100,000	50,000	50,000
Net assets	200,000*	150,000	

W2 Non-controlling interest

	Rs.
NCI's share of net assets at the date of acquisition (30% × 150,000 (W1))	45,000
NCI's share of the post-acquisition retained earnings of S (30% of 50,000 (W1))	15,000
NCI's share of net assets at the date of consolidation	60,000
Alternative working	
NCI's share of net assets at the date of consolidation (30% × 200,000*)	60,000

W3 Goodwill

	Rs.
Cost of investment	450,000
Non-controlling interest at acquisition (see W2)	45,000
	495,000
Net assets at acquisition (W1)	(150,000)
	345,000

W4 Consolidated retained profits:

	Rs.
All of P's retained earnings	650,000
P's share of the post-acquisition retained earnings of S (70% of 50,000 (W1))	35,000
	685,000

Solution **2**

P Group: Consolidated statement of financial position at 31 December 20X1

Assets	Rs.
Goodwill (W3)	375,000
Other assets (500 + 350)	850,000
Total assets	1,225,000
Equity	
Share capital (P only)	100,000
Consolidated retained earnings (W4)	685,000
	785,000
Non-controlling interest (W2)	90,000
	875,000
Current liabilities (200 + 150)	350,000
Total equity and liabilities	1,225,000

Workings:

W1 Net assets summary

	At date of consolidation	At date of acquisition	Post-acquisition
Share capital	100,000	100,000	
Retained earnings	100,000	50,000	50,000
Net assets	200,000*	150,000	

W2 Non-controlling interest

	Rs.
Fair value of NCI at the date of acquisition	75,000
NCI's share of the post-acquisition retained earnings of S (30% of 50,000 (W1))	15,000
NCI's share of net assets at the date of consolidation	90,000

W3 Goodwill

	Rs.
Cost of investment	450,000
Non-controlling interest at acquisition (given)	75,000
	525,000
Net assets at acquisition (W1)	(150,000)
	375,000

W4 Consolidated retained profits:

	Rs.
All of P's retained earnings	650,000
P's share of the post-acquisition retained earnings of S (70% of 50,000 (W1))	35,000
	685,000

Solution **3**

A consolidated statement of financial position as at 31 December 20X1 can be prepared as follows:

P Group: Consolidated statement of financial position at 31 December 20X1

	Rs.
Assets	
Brand (see working)	90,000
Goodwill (see working)	360,000
Property, plant and equipment (1,800 + 1000)	2,800,000
Other assets (400 + 300)	700,000
Total assets	3,950,000
Equity	
Share capital (P only)	100,000
Consolidated retained earnings (see working)	3,212,000
	3,312,000
Non-controlling interest	238,000
	3,550,000
Current liabilities (200 + 200)	400,000
Total equity and liabilities	3,950,000

Workings:

Net assets summary of S

	At date of consolidation	At date of acquisition	Post-acquisition
Share capital	100,000	100,000	
Retained earnings			
Given in the question	1,000,000	600,000	
Extra depreciation on brand (100,000 × 2 years/20 years)	(10,000)	–	
	990,000	600,000	390,000
Consolidation reserve on recognition of the brand	100,000	100,000	
Net assets	1,190,000	800,000	

Non-controlling interest	Rs.
NCI's share of net assets at the date of acquisition (20% × 800,000)	160,000
NCI's share of the post-acquisition retained earnings of S (20% of 390,000 (see above))	78,000
NCI's share of net assets at the date of consolidation	238,000

Solution (continued) **3**

Goodwill	**Rs.**
Cost of investment	1,000,000
Non-controlling interest at acquisition (20% × 800,000)	160,000
	1,160,000
Net assets at acquisition (see above)	(800,000)
	360,000

Consolidated retained profits:	**Rs.**
All of P's retained earnings	2,900,000
P's share of the post-acquisition retained earnings of S (80% of 390,000 (see above))	312,000
	3,212,000

Brand	Rs.
On initial recognition	100,000
Depreciation since acquisition (100,000 × $^{2\text{ years}}/_{20\text{ years}}$)	(10,000)
	90,000

Solution **4**

P Group: Consolidated statement of financial position at 31 December 20X1

	Rs.
Assets	
Goodwill (see working)	200,000
PP and E (see working)	3,040,000
Other assets (400,000 + 300,000)	700,000
Total assets	3,940,000
Equity	
Share capital (P only)	100,000
Consolidated retained earnings (see working)	3,172,000
	3,272,000
Non-controlling interest	268,000
	3,540,000
Current liabilities (200 + 200)	400,000
Total equity and liabilities	3,940,000

Solution (continued) **4**

	At date of consolidation	At date of acquisition	Post-acquisition
Share capital	100,000	100,000	
Retained earnings			
Given in the question	1,000,000	600,000	
Extra depreciation on fair value adjustment (300 × 2 years/10 years) – *see explanation on next page*	(60,000)	–	
	940,000	600,000	340,000
Fair value reserve	300,000	300,000	
Net assets	1,340,000	1,000,000	

Non-controlling interest	**Rs.**
NCI's share of net assets at the date of acquisition (20% × 1,000)	200,000
NCI's share of the post-acquisition retained earnings of S (20% of 340 (see above))	68,000
NCI's share of net assets at the date of consolidation	268,000

Goodwill	**Rs.**
Cost of investment	1,000,000
Non-controlling interest at acquisition (20% × 1,000)	200,000
	1,200,000
Net assets at acquisition (see above)	(1,000,000)
	200,000

Consolidated retained profits:	**Rs.**
All of P's retained earnings	2,900,000
P's share of the post-acquisition retained earnings of S (80% of 340 (see above))	272,000
	3,172,000

Solution (continued) **4**

Property plant and equipment	Rs.
Parent's	1,800
Subsidiary's	
Given in question	1,000
Fair value adjustment	300
Extra depreciation on fair value adjustment (300 × 2 years/10 years)	(60)
	1,240
To statement of financial position	3,040

Solution **5**

P Group: Consolidated statement of financial position at 31 December 20X1

Assets	Rs.
Goodwill (W3)	720,000
Other non-current assets (400 + (200 + 250 – 25))	825,000
Other assets (500 + 350)	850,000
Total assets	2,395,000
Equity	
Share capital (P only)	100,000
Consolidated retained earnings (W4)	1,757,500
	1,857,500
Non-controlling interest (W2)	187,500
	2,045,000
Current liabilities (200 + 150)	350,000
Total equity and liabilities	2,395,000

Solution **5**

Workings:

W1 Net assets summary

	At date of consolidation	At date of acquisition	Post-acquisition
Share capital	100,000	100,000	
Retained earnings			
Given in the question	300,000	50,000	
Extra depreciation on fair value adjustment (250 × 1 years/10 years)	(25,000)	–	
	275,000	50,000	225,000
Fair value reserve	250,000	250,000	
Net assets	625,000	400,000	

W2 Non-controlling interest

	Rs.
NCI's share of net assets at the date of acquisition (30% × 400)	120,000
NCI's share of the post-acquisition retained earnings of S (30% of 225 (W1))	67,500
NCI's share of net assets at the date of consolidation	187,500

W3 Goodwill

	Rs.
Cost of investment	1,000,000
Non-controlling interest at acquisition (W2)	120,000
	1,120,000
Net assets at acquisition (see above)	(400,000)
	720,000

W4 Consolidated retained profits:

	Rs.
All of P's retained earnings	1,600,000
P's share of the post-acquisition retained earnings of S (70% of 225 (W1))	157,500
	1,757,500

CHAPTER 20

Consolidated statements of profit or loss and other comprehensive income

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

PRESENTATION OF FINANCIAL STATEMENTS INCLUDING PUBLIC SECTOR ACCOUNTING

A 3 IFRS 10: Consolidated financial statements

1 CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

Section overview

- Consolidated statement of profit or loss: the basic rules
- Inter-company items
- Other adjustments
- Pre- and post-acquisition profits

1.1 Consolidated statement of profit or loss: the basic rules

A consolidated statement of profit or loss brings together the sales revenue, income and expenses of the parent and the sales revenue, income and expenses of its subsidiaries.

Similarly a consolidated statement of other comprehensive income brings together the gains and losses of the parent and the gains and losses of its subsidiaries.

In the consolidated statements, all items of income, expenses, gains and losses are a straight cross cast of equivalent items in the individual financial statements of the members of the group.

Non-controlling interest

Consolidated financial statements must also disclose the profit or loss for the period and the total comprehensive income for the period attributable to:

- owners of the parent company; and
- non-controlling interests.

The figure for NCI is simply their share of the subsidiary's profit for the year that has been included in the consolidated statement of comprehensive income.

The amounts attributable to the owners of the parent and the non-controlling interest are shown as a metric (small table) immediately below the statement of comprehensive income.

Illustration: Amounts attributable to the owners of the parent and the non-controlling interest

Profit attributable to:	Rs.
Owners of the parent (balancing figure)	X
Non-controlling interests (x% of y)	X
	X

Where: x% is the NCI ownership interest

y is the subsidiary's profit for the year that has been included in the consolidated statement of comprehensive income

1.2 Inter-company items

Consolidated statements of profit or loss are prepared by combining the information given in the statements of profit or loss of the individual companies.

It is usually necessary to make adjustments to eliminate the results of inter-company trading. This includes adjustments to cancel out inter-company trading balances and unrealised profit.

Inter-company trading

Inter-company trading will be included in revenue of one group company and purchases of another. These are cancelled on consolidation.

Illustration:

	Debit	Credit
Revenue	X	
Cost of sales (actually purchases within cost of sales)		X

Unrealised profits on trading

If any items sold by one group company to another are included in inventory (i.e. have not been sold on outside the group by the year end), their value must be adjusted to lower of cost and net realisable value from the group viewpoint (as for the consolidated statement of financial position).

This is an inventory valuation adjustment made in the consolidated financial statements.

Illustration:

	Debit	Credit
Closing inventory – Statement of comprehensive income	X	
Closing inventory – Statement of financial position		X

The adjustment in the statement of comprehensive income reduces gross profit and hence profit for the year. The NCI share in this reduced figure and the balance is added to retained earnings. Thus, the adjustment is shared between both ownership interests.

If the sale is from S to P the unrealised profit adjustment must be shared with the NCI.

Inter-company management fees and interest

All other inter-company amounts must also be cancelled.

Where a group company charges another group company, management fees/interest, there is no external group income or external group expense and they are cancelled one against the other like inter-company sales and cost of sales.

Illustration:

	Debit	Credit
Income (management fees)	X	
Expense (management charges)		X

Inter-company dividends

The parent may have accounted for dividend income from a subsidiary. This is cancelled on consolidation.

Dividends received from a subsidiary are ignored in the consolidation of the statement of comprehensive income because the profit out of which they are paid has already been consolidated.

1.3 Other adjustments

Fair value adjustments

Depreciation is charged on the carrying amount of assets.

If a depreciable asset is revalued on consolidation the depreciation stream that relates to that asset will also need to be revalued.

This adjustment is carried out in the financial statements of the subsidiary. It will affect the subsidiary's profit after tax figure and therefore will affect the NCI.

Accounting for Impairment of goodwill

When purchased goodwill is impaired, the impairment does not affect the individual financial statements of the parent company or the subsidiary. The effect of the impairment applies exclusively to the consolidated statement of financial position and the consolidated income statement.

If goodwill is impaired:

- It is written down in value in the consolidated statement of financial position, and
- The amount of the write-down is charged as an expense in the consolidated income statement (normally in administrative expenses).

Practice question **1**

P acquired 80% of S 3 years ago. Goodwill on acquisition was Rs. 80,000. The recoverable amount of goodwill at the year-end was estimated to be Rs. 65,000. This was the first time that the recoverable amount of goodwill had fallen below the amount at initial recognition.

S sells goods to P. The total sales in the year were Rs. 100,000. At the year-end P retains inventory from S which had cost S Rs. 30,000 but was in P's books at Rs. 35,000.

The distribution costs of S include depreciation of an asset which had been subject to a fair value increase of Rs. 100,000 on acquisition. This asset is being written off on a straight line basis over 10 years.

The statements of profit or loss for the year to 31 December 20X1 are as follows:

	P	S
	Rs.(000)	Rs.(000)
Revenue	1,000	800
Cost of sales	(400)	(250)
Gross profit	600	550
Distribution costs	(120)	(75)
Administrative expenses	(80)	(20)
	400	455
Dividend from S	80	-
Finance cost	(25)	(15)
Profit before tax	455	440
Tax	(45)	(40)
Profit for the period	410	400

Prepare the consolidated income statement for the year ended 31 December.

1.4 Pre- and post-acquisition profits

A change in ownership in the period will have an impact on the consolidated statement of profit or loss and other comprehensive income.

The financial statements of a subsidiary must be consolidated from the date control is achieved until the date that control is lost. In other words, the pattern of ownership must be reflected in the statement of profit or loss and other comprehensive income.

- All of an entity's results are consolidated if it is controlled for the whole year
- If an entity is controlled for only part of the year, only those results that relate to that part of the year are consolidated.

For example, if a parent acquires a subsidiary **during** a financial year, the profits of the subsidiary have to be divided into pre-acquisition and post-acquisition and only post acquisition profits are consolidated.

The following straightforward example is of a type that you have seen in previous papers. Later chapters on step acquisitions and disposals will show more complex applications of the principle.

Example: Consolidated statement of profit or loss (mid-year acquisition)

Entity P acquired 80% of S on 1 October 20X1.

The statements of profit or loss for the year to 31 December 20X1 are as follows:

	P	S
	Rs.	Rs.
Revenue	400,000	260,000
Cost of sales	(200,000)	(60,000)
Gross profit	200,000	200,000
Other income	20,000	-
Distribution costs	(50,000)	(30,000)
Administrative expenses	(90,000)	(95,000)
Profit before tax	80,000	75,000
Income tax expense	(30,000)	(15,000)
Profit for the period	50,000	60,000

A consolidated statement of comprehensive income can be prepared as follows:

	Working		
	P	S (3/12)	Consolidated
	Rs.	Rs.	Rs.
Revenue	400,000	65,000	465,000
Cost of sales	(200,000)	(15,000)	(215,000)
Gross profit	200,000	50,000	250,000
Other income	20,000	–	20,000
Distribution costs	(50,000)	(7,500)	(57,500)
Administrative expenses	(90,000)	(23,750)	(113,750)
Profit before tax	80,000	18,750	98,750
Income tax expense	(30,000)	(3,750)	(33,750)
Profit for the period	50,000	15,000	65,000

Total comprehensive income attributable to:	
Owners of the parent (balancing figure)	62,000
Non-controlling interests (20% of 15,000)	3,000
	65,000

2 CONSOLIDATED STATEMENT OF OTHER COMPREHENSIVE INCOME

Section overview

- A single statement or two statements
- Consolidation of other comprehensive income

2.1 A single statement or two statements

The statement of profit or loss and other comprehensive income provides information about the performance of an entity in a period. It consists of two parts:

- a statement of profit or loss – a list of income and expenses which result in a profit or loss for the period; and
- a statement of other comprehensive income – a list of other gains and losses that have arisen in the period.

IAS 1 allows an entity to present the two sections in a single statement or in two separate statements.

Information to be presented in the other comprehensive income section

The other comprehensive income section must present line items for amounts of other comprehensive income in the period, classified by nature (including share of the other comprehensive income of associates and joint ventures accounted for using the equity method) and grouped into those that, in accordance with other IFRSs:

- will not be reclassified subsequently to profit or loss:
  - revaluation surpluses on property, plant and equipment (IAS 16) (but remember in Pakistan such changes are not recognised in OCI as per Companies Ordinance 1984);
  - revaluation surpluses on intangible assets (IAS 38) (but remember in Pakistan such changes are not recognised in OCI as per Companies Ordinance 1984);
  - remeasurements of defined benefit pension schemes (IAS 19); and
- will be reclassified subsequently to profit or loss when specific conditions are met, including:
  - gains and losses on retranslation of foreign operations (IAS 21);
  - gains and losses recognised on remeasurement of available for sale financial assets (IAS 39); and
  - gains and losses recognised on the effective element of cash flow hedges (IAS 39)

2.2 Consolidation of other comprehensive income

Consolidation of the statement of other comprehensive income is carried out in a similar way to the consolidation of the statement of profit or loss.

In the consolidated statements, all items of income, expenses, gains and losses are a straight cross cast of equivalent items in the individual financial statements of the members of the group.

Items in the statement of comprehensive income are unlikely to be affected by inter-company trading or similar issues.

Non-controlling interest

Profit or loss and other comprehensive income in the period together are described as total comprehensive income for the period.

Consolidated financial statements must disclose total comprehensive income for the period attributable to the

- owners of the parent company; and
- non-controlling interests.

This is in addition to the disclosure for profit or loss described earlier.

The figure for NCI is simply their share of the subsidiary's other comprehensive income for the year that has been included in the consolidated statement of other comprehensive income.

The amounts attributable to the owners of the parent and the non-controlling interest are shown as a metric (small table) immediately below the statement of comprehensive income.

Illustration: Amounts attributable to the owners of the parent and the non-controlling interest

Total comprehensive income attributable to:	Rs.
Owners of the parent (balancing figure)	X
Non-controlling interests	X
	X

Example: Consolidated statement of profit or loss and other comprehensive income

Entity P acquired 80% of S several years ago.

Entity P presents the statement of profit or loss and other comprehensive income as a single statement. Items in other comprehensive income are shown net of tax.

The summarised statements of profit or loss and other comprehensive income for the year to 31 December 20X1 are as follows:

	P	S
Profit or loss	Rs.	Rs.
Revenue	400,000	260,000
Cost of sales	(200,000)	(60,000)
Gross profit	200,000	200,000
Expenses	(90,000)	(95,000)
Profit before tax	110,000	105,000
Income tax expense	(30,000)	(15,000)
Profit for the year	80,000	90,000
Other comprehensive income		
Items that will not be reclassified to profit or loss		
Remeasurement of defined benefit plan	2,000	1,000
Items that may be reclassified to profit or loss		
Cash flow hedge	(1,200)	400
Other comprehensive income for the year	800	1,400
Total comprehensive income for the year	80,800	91,400

A consolidated statement of profit or loss and other comprehensive income can be prepared as follows:

Example (continued): Consolidated statement of profit or loss and other comprehensive income

A consolidated statement of profit or loss and other comprehensive income can be prepared as follows:

	Working		
	P	S	Consolidated
	Rs.	Rs.	Rs.
Revenue	400,000	260,000	660,000
Cost of sales	(200,000)	(60,000)	(260,000)
Gross profit	200,000	200,000	400,000
Expenses	(90,000)	(95,000)	(185,000)
Profit before tax			215,000
Income tax expense	(30,000)	(15,000)	(45,000)
Profit for the period	80,000	90,000	170,000
Other comprehensive income			
Items that will not be reclassified...			
Remeasurement of defined benefit plan	2,000	1,000	3,000
Items that may be reclassified			
Cash flow hedge	(1,200)	400	(800)
Other comprehensive income for the year	800	1,400	2,200
Total comprehensive income for the year		91,400	172,200

Profit attributable to:	
Owners of the parent (balancing figure)	152,000
Non-controlling interests (20% of 90,000)	18,000
	170,000
Total comprehensive income attributable to:	
Owners of the parent (balancing figure)	62,000
Non-controlling interests (20% of 91,400)	18,820
	153,380

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

Consolidated statement of comprehensive income for the year ended 31 December.

	Workings				
	P	**S**	**Dr**	**Cr**	**Consol.**
	Rs.(000)	Rs.(000)	Rs.(000)	Rs.(000)	Rs.(000)
Revenue	1,000	800	(100)		1,700
Cost of sales	(400)	(250)	[3](5)	100	(555)
Gross profit	600	550	(105)	100	1,145
Distribution costs	(120)	(75)			
Fair value adjustment		[1](10)			
	(120)	(85)			(205)
Administrative expenses	(80)	(20)	[2](15)		(115)
	400	445			
Dividend from S	80	-	(80)		
Finance cost	(25)	(15)			(40)
Profit before tax	455	430			785
Tax	(45)	(40)			(85)
Profit for the period	410	390	(200)	100	700

Total comprehensive income attributable to:	Rs.(000)
Owners of the parent (balancing figure)	633
Non-controlling interests (20% of 390,000) – (20% of [3]5,000)	77
	700

Notes:

1: Extra depreciation on fair value adjustment ($^{100}/_{10\ years}$)

2: Goodwill impairment

3: Unrealised profit

CHAPTER 21

Associates and joint ventures

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1	**Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**
LO 2	**Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

PRESENTATION OF FINANCIAL STATEMENTS INCLUDING PUBLIC SECTOR ACCOUNTING

A 4	IAS 28: Accounting for associates and joint ventures
A 5	IFRS 11: Joint arrangements

1 IFRS 11: JOINT ARRANGEMENTS

Section overview

- Introduction
- Joint arrangements
- Types of joint arrangements
- Accounting for joint operations and joint ventures

1.1 Introduction

A controlling interest in an investee results in an investment (a subsidiary) which is consolidated.

An interest in the equity shares of another company that gives no influence is accounted for as follows:

- The shares are shown in the statement of financial position as long-term assets (an investment) and valued in accordance with IAS 39 (IFRS 9); and
- Any dividends received for the shares are included in profit or loss for the year as other income.

Other investments might result in joint control or significant influence. The rules for accounting for these are given in:

- ***IFRS 11 Joint Arrangements***: and
- ***IAS 28 Investments in Associates and Joint ventures***.

This session introduces the rules on accounting for joint arrangements.

1.2 Joint arrangements

Definition

A joint arrangement is an arrangement of which two or more parties have joint control.

Joint control is 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.

A joint arrangement has the following characteristics:

- The parties are bound by a contractual arrangement; and
- The contractual arrangement gives two or more of those parties joint control of the arrangement.

Definition

A party to a joint arrangement is an entity that participates in a joint arrangement, regardless of whether that entity has joint control of the arrangement.

Contractual arrangement

Any contractual arrangement will usually be evidenced in writing, usually in the form of a contract or documented discussions between the parties.

A joint arrangement might be structured through a separate vehicle in which case some aspects of the contractual arrangement might be incorporated in its articles, charter or by-laws.

Any contractual arrangement sets out the terms upon which the parties participate in the activity that is the subject of the arrangement and would generally deal with such matters as:

- the purpose, activity and duration of the joint arrangement;
- how the members of the board of directors, or equivalent governing body, of the joint arrangement, are appointed;
- the decision-making process (the matters requiring decisions from the parties, the voting rights of the parties and the required level of support for those matters).
- the capital or other contributions required of the parties.
- how the parties share assets, liabilities, revenues, expenses or profit or loss relating to the joint arrangement.

Joint control

IFRS 11 states that decisions about the relevant activities require unanimous consent of all parties that collectively control the arrangement. It is not necessary for every party to the arrangement to agree in order for unanimous consent to exist. This requires agreement by only those parties that collectively control the arrangement.

Day to day decision making might be delegated to a manager or to one of the parties to the arrangement. In such cases, the situation would need to be analysed to decide whether, in fact, decisions require the unanimous agreement of the interested parties. Such an arrangement is still a joint arrangement when the manager executes the policy decisions that have been agreed unanimously by the investors.

Example: Joint control

In each of the following scenarios three entities A, B and C establish an arrangement.

	Scenario 1	Scenario 2	Scenario 3
Decisions about relevant activities	**Require the unanimous consent of A, B and C**	**Require at least 75% of voting rights**	**Require at least 75% of voting rights**
Ownership interest			
A	50%	50%	50%
B	30%	30%	25%
C	20%	20%	25%

Required
For each scenario analyse whether a joint arrangement exists and which parties have joint control.

Answer

Scenario 1

A, B and C have joint control of the arrangement and each must account for its investment according to IFRS 11.

Scenario 2

Although A can block any decision, it does not control the arrangement because it needs the agreement of B.

A and B have joint control of the arrangement. The terms of their contractual arrangement requiring at least 75% of the voting rights to make decisions about the relevant activities imply that A and B have joint control of the arrangement because decisions about the relevant activities of the arrangement cannot be made without both A and B agreeing.

A and B must each account for its investment according to IFRS 11.

C is a party to a joint arrangement but has no control.

Scenario 3

The arrangement can be controlled by A with B or by A with C. This means that no party can be said to have joint control.

In order for this to be a joint arrangement the contractual terms would have to specify which combination of parties is required to agree about the relevant activities.

IFRS 11 does not apply to this investment.

1.3 Types of joint arrangements

There are two types of joint arrangement. A joint arrangement is either a joint operation or a joint venture.

Definition

A **joint operation** is 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. Those parties are called joint operators.

A joint venture is a joint arrangement where the parties that have joint control of the arrangement have rights to the net assets of the arrangement. Those parties are called joint venturers.

This classification depends on the rights and obligations of the parties to the arrangement.

Investors may or may not establish a joint arrangement as a separate vehicle.

Definition

A separate vehicle is a separately identifiable financial structure, including separate legal entities or entities recognised by statute, regardless of whether those entities have a legal personality.

The application guidance to IFRS 11 says that if a joint arrangement **is not** structured through a separate vehicle it must be a joint operation.

If a joint arrangement **is** structured through a separate vehicle it could be a joint operation or a joint venture.

For a joint arrangement to be a joint venture it is the separate vehicle that must have the rights to the assets and the obligations to the liabilities with the investor only having an interest in the net assets of the entity. If an investor has a direct interest in specific assets and direct obligation for specific liabilities of the separate vehicle then the joint arrangement is a joint operation.

1.4 Accounting for joint operations and joint ventures

The method of accounting for an interest in a joint arrangement depends on what type of joint arrangement it is.

Joint operations

A joint operator must recognise the following in its own financial statements:

- its assets, including its share of any assets held jointly;
- its liabilities, including its share of any liabilities incurred jointly;
- its revenue from the sale of its share of the output arising from the joint operation;
- its share of the revenue from the sale of the output by the joint operation; and
- its expenses, including its share of any expenses incurred jointly.

If an entity participates in, but does not have joint control of a joint operation but has rights to the assets, and obligations for the liabilities, relating to the joint operation it must also apply the above accounting treatment.

If an entity participates in, but does not have joint control of a joint operation and also does not have rights to the assets, and obligations for the liabilities, relating to the joint operation it must account for its interest in the joint operation in accordance with the IFRSs applicable to that interest.

Amendment to IFRS 11

The amendment must be applied for annual periods beginning on or after 1 January 2016. Earlier application is permitted but must be disclosed.

When an entity acquires an interest in a joint operation in which the activity of the joint operation constitutes a business (as defined in IFRS 3), it must apply the principles on business combinations accounting in IFRS 3.

This applies to the acquisition of both the initial interest and additional interests in a joint operation.

The principles on business combinations include:

- The measurement of identifiable assets and liabilities at fair value;
- Expensing acquisition-related costs;
- recognising goodwill; and
- impairment testing goodwill.

Joint ventures

A joint venturer must recognise its interest in a joint venture as an investment and account for it using the equity method in accordance with IAS 28 *Investments in Associates and Joint Ventures* unless the entity is exempted from applying the equity method as specified in that standard.

If an entity participates in, but does not have joint control of a joint operation it must account for its interest in the arrangement in accordance with IFRS 9 Financial Instruments, unless it has significant influence over the joint venture, in which case it must account for it in accordance with IAS 28.

Example – Accounting for a joint operation

On 1 January 20X7, X and Y entered into a joint operation to purchase and operate an oil pipeline.

Both entities contributed equally to the purchase cost of Rs.20 million and this was financed by a joint loan of Rs.20,000,000.

Contract terms

Y carries out all maintenance work on the pipeline but maintenance expenses are shared between X and Y in the ratio 40%: 60%.

Both entities use the pipeline for their own operations and share any income from third parties 50%: 50%. Sales to third parties are invoiced by Y.

The full interest on the loan is initially paid by X but the expense is to be shared equally.

During the year ended 31 December 20X7

Y carried out maintenance at a cost of Rs. 1,200,000.

Income from third parties was Rs. 900,000, all paid to Y.

Interest of Rs. 1,500,000 was paid for the year on 31 December by X.

Required

Show the relevant figures that would be recognised in the financial statements of X and Y for the year to 31 December 20X7.

Answer

	Total amount	In X financial statements	In Y financial statements
Statement of financial position	Rs.	Rs.	Rs.
Jointly-controlled assets			
Property, plant and equipment			
Cost	20,000,000	10,000,000	10,000,000
Share of liabilities incurred			
Bank loan	20,000,000	10,000,000	10,000,000
Current: account with Y (owed by Y) – see workings		720,000	
Current: account with X (owed to X) – see workings			720,000
Share of revenue			
Income from third parties (50:50)	900,000	450,000	450,000
Share of expenses			
Maintenance costs (40:60)	1,200,000	480,000	720,000
Interest on loan (50:50)	1,500,000	750,000	750,000
	2,700,000	1,230,000	1,470,000
Workings			
Statement of profit or loss			
Income from third parties (50:50)	900,000	450,000	450,000
Maintenance costs (40:60)	1,200,000	480,000	720,000
Interest on loan (50:50)	1,500,000	750,000	750,000
	(2,700,000)	(1,230,000)	(1,470.000)
	(1,800,000)	(780,000)	(1,020.000)
Cash expense		(1,500,000)	(1,200,000)
Cash collected			900,000
Net cash expense		(1,500,000)	(300,000)
Cash due to X from Y		720,000	(720,000)

2 IAS 28: INVESTMENTS IN ASSOCIATES AND JOINT VENTURES

Section overview

- Associates and joint ventures
- Accounting for associates and joint ventures
- Trading with an associate or joint venture

2.1 Associates and joint ventures

Definition

An associate is an entity over which the investor has significant influence.

Significant influence

Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.

- IAS 28 states that if an entity holds 20% or more of the voting power (equity) of another entity, it is presumed that significant influence exists, and the investment should be treated as an associate.
- If an entity owns less than 20% of the equity of another entity, the normal presumption is that significant influence does not exist.

Holding 20% to 50% of the equity of another entity therefore means as a general rule that significant influence exists, but not control; therefore the investment is treated as an associate, provided that it is not a joint venture.

The '20% or more' rule is a general guideline, however, and IAS 28 states more specifically how significant influence arises. The existence of significant influence is usually evidenced in one or more of the following ways:

- Representation on the board of directors;
- Participation in policy-making processes, including participation in decisions about distributions (dividends);
- Material transactions between the two entities;
- An interchange of management personnel between the two entities; or
- The provision of essential technical information by one entity to the other.

2.2 Accounting for associates and joint ventures

IAS 28 states that associates and joint ventures must be accounted for using the equity method.

The **equity method** is defined as a method of accounting whereby the investment is initially recognised 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 and the investor's other comprehensive income includes its share of the investee's other comprehensive income.

Statement of financial position: investment in the associate

In the statement of financial position of the reporting entity (the investor), an investment in an associate is measured at:

Illustration: Equity method

	Rs.
Cost of investment	X
Plus/(Minus): Parent's share of profits (losses) of the associate (or JV) since acquisition	X
Plus/(Minus): Parent's share of OCI of the associate (or JV) since acquisition	X
Minus any impairment of the investment recognised	(X)
	X

There is no goodwill-recognised for an investment in an associate.

The accumulated profits of the reporting entity (or the consolidated accumulated reserves when consolidated accounts are prepared) should include the investor's share of the post-acquisition retained profits of the associate (or JV), (**minus** any impairment in the value of the investment since acquisition). This completes the other side of the entry when the investment is remeasured.

Similarly any other reserve of the reporting entity (or any other consolidated reserves when consolidated accounts are prepared) should include the investor's share of the post-acquisition movement in the reserve of the associate (or JV).

Statement of profit or loss and other comprehensive income

In the statement of profit or loss and other comprehensive income, there should be separate lines for:

- 'Share of profits of associate (or JV)' in the profit and loss section of the statement
- 'Share of other comprehensive income of associate (or JV)' in the 'other comprehensive income' section of the statement.

Example: Equity method

Entity P acquired 30% of the equity shares in Entity A during Year 1 at a cost of Rs. 147,000 when the fair value of the net assets of Entity A was Rs. 350,000.

Entity P is able to exercise significant influence over Entity A.

At 31 December Year 5, the net assets of Entity A were Rs. 600,000.

In the year to 31 December Year 5, the profits of Entity A after tax were Rs. 80,000.

The figures that must be included to account for the associate in the financial statements of Entity P for the year to 31 December Year 5 are as follows:

Statement of financial position:

The investment in the associate is as follows:

	Rs.
Investment at cost	147,000
Investor's share of post-acquisition profits of A (**W1**)	75,000
Investment in the associate	222,000

W1 Retained post-acquisition profits of Entity A	Rs.
Net assets of the associate at 31 December Year 5	600,000
Net assets of Entity A at date of acquisition of shares	(350,000)
Retained post-acquisition profits of Entity A	250,000
Entity P's share of A	30%
Entity P's share of A's profits since the date of acquisition	Rs.75,000

Note: Rs.75,000 will be included in the accumulated profits of Entity P

The journal to achieve the re-measurement is

Dr Cost Rs.75,000 and Cr Accumulated profits Rs.75,000

Statement of profit or loss

The share of the associate's after-tax profit for the year is shown on a separate line as:

Share of profits of associate (30% × Rs. 80,000): Rs. 24,000.

Practice question **1**

Entity P acquired 40% of the equity shares in Entity A during Year 1 at a cost of Rs. 128,000 when the fair value of the net assets of Entity A was Rs. 250,000.

Since that time, the investment in the associate has been impaired by Rs. 8,000.

Since acquisition of the investment, there has been no change in the issued share capital of Entity A, nor in its share premium reserve or revaluation reserve.

On 31 December Year 5, the net assets of Entity A were Rs. 400,000.

In the year to 31 December Year 5, the profits of Entity A after tax were Rs. 50,000.

What figures would be included for the associate in the financial statements of Entity P for the year to 31 December Year 5?

2.3 Trading with an associate or joint venture

There might be trading between a parent and an associate (or JV). If in addition to the associate (or JV) the parent holds investments in subsidiaries there might also be trading between other members of the group and the associate (or JV).

In such cases there might be:

- Inter-company balances (amounts owed between the parent (or group) and the associate (or JV) in either direction); and
- Unrealised profit on inter-company transactions.

The accounting rules for dealing with these items for associate (or JVs) are different from the rules for subsidiaries.

Inter-company balances

Inter-company balances between the members of a group (parent and subsidiaries) are cancelled out on consolidation.

Inter-company balances between the members of a group (parent and subsidiaries) and associates (or JVs) ***are not cancelled out*** on consolidation. An associate (or JV) is not a member of the group but is rather an investment made by the group. This means that it is entirely appropriate that consolidated financial statements show amounts owed by the external party as an asset and amount owed to the external party as a liability.

This is also the case if a parent has an associate (or JV) and no subsidiaries. The parent must equity account for the investment. Once again, it is entirely appropriate that consolidated financial statements show amounts owed by the external party as an asset and amount owed to the external party as a liability.

Unrealised inter-group profit

Unrealised inter-company (intra-group) profit between a parent and a member of a group must be eliminated in full on consolidation.

For unrealised profit arising on trade between a parent and associate (or JV***)*** ***only the parent's share*** of the unrealised profit is eliminated.

IAS 28 does not specify the double entry to achieve this.

The following are often used in practice

Parent sells to associate (or JV):

- The unrealised profit is held in inventory of the associate (or JV). The investment in the associate (or JV) should be reduced by the parent's share of the unrealised profit.
- The other side of the entry increases cost of sales

Illustration: Unrealised profit double entry when parent sells to associate

	Debit	Credit
Cost of sales	X	
Investment in associate		X

Associate (or JV) sells to parent:

- The unrealised profit is held in inventory of the parent and this should be reduced in value by the parent's share of the unrealised profit.
- The other side of the entry reduces the parent's share of the profit of the associate (or JV).

Illustration: Unrealised profit double entry when associate sells to parent

	Debit	Credit
Share of profit of associate	X	
Inventory		X

In both cases, there will also be a reduction in the post-acquisition profits of the associate (or JV), and the investor entity's share of those profits (as reported in profit or loss). This will reduce the accumulated profits in the statement of financial position.

Example: Unrealised profit

Entity P acquired 40% of the equity shares of Entity A several years ago. The cost of the investment was Rs. 205,000.

As at 31 December Year 6 Entity A had made profits of Rs. 275,000 since the date of acquisition.

In the year to 31 December Year 6, Entity P sold goods to Entity A at a sales price of Rs. 200,000 at a mark-up of 100% on cost.

Goods which had cost Entity A Rs. 30,000 were still held as inventory by Entity A at the year-end.

The necessary adjustments for unrealised profit, and the double entries are as follows:

Unrealised profit adjustment	Rs.
Inventory sold by P to A	200,000
Profit on the sale (200,000 × 100%/200%)	100,000
Unrealised profit (100,000 × Rs.30,000/Rs.200,000)	15,000
Entity P's share (40%)	6,000

Double entries:	Dr(Rs.)	Cr(Rs.)
Investment in associate	110,000	
Accumulated profits		110,000
Being: Share of post-acquisition profits (40% of Rs.275,000)		

	Dr(Rs.)	Cr(Rs.)
Cost of sales (hence accumulated profit)	6,000	
Investment in associate		6,000
Being: Elimination of share of unrealised profit (see above)		

Investment in associate (see above for adjustments)	Rs.
Cost of the investment	205,000
Entity P's share of post-acquisition profits of Entity A	110,000
Minus: Entity P's share of unrealised profit in inventory	(6,000)
	309,000

Practice question **2**

Entity P acquired 30% of the equity shares of Entity A several years ago at a cost of Rs. 275,000.

As at 31 December Year 6 Entity A had made profits of Rs. 380,000 since the date of acquisition.

In the year to 31 December Year 6, the reported profits after tax of Entity A were Rs. 100,000.

In the year to 31 December Year 6, Entity P sold goods to Entity A for Rs. 180,000 at a mark-up of 20% on cost.

Goods which had cost Entity A Rs. 60,000 were still held as inventory by Entity A at the year-end.

a) Calculate the unrealised profit adjustment and state the double entry.

b) Calculate the investment in associate balance that would be included in Entity P's statement of fiancial position as at 31 December Year 6.

c) Calculate the amount that would appear as a share of profit of associate in Entity P's statement of profit or loss for the year ending 31 December Year 6.

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

The figures that must be included to account for the associate in the financial statements of Entity P for the year to 31 December Year 5 are as follows:

Statement of financial position:

The investment in the associate is as follows:

	Rs.
Investment at cost	128,000
Investor's share of post-acquisition profits of A (**W1**)	60,000
Minus: Accumulated impairment in the investment	(8,000)
Investment in the associate	180,000

W1 Retained post-acquisition profits of Entity A	Rs.
Net assets of the associate at 31 December Year 5	400,000
Net assets of Entity A at date of acquisition of shares	(250,000)
Retained post-acquisition profits of Entity A	150,000
Entity P's share of A	40%
Entity P's share of A's profits since the date of acquisition	Rs.60,000

Statement of profit or loss

The share of the associate's after-tax profit for the year is shown on a separate line as:

Share of profits of associate (40% × Rs. 50,000): Rs. 20,000.

Solution **2**

a) **Unrealised profit adjustment**

	Rs.
Inventory sold by P to A	180,000
Profit on the sale (180,000 × 20%/120%)	30,000
Unrealised profit (30,000 × Rs.60,000/Rs.180,000)	10,000
Entity P's share (30%)	3,000

Double entry	Dr(Rs.)	Cr(Rs.)
Cost of sales (hence accumulated profit)	3,000	
Investment in associate		3,000

Being: Elimination of share of unrealised profit (see above)

b) **Investment in associate (see above for adjustments)**

	Rs.
Cost of the investment	275,000
Entity P's share of post-acquisition profits of Entity A (30% of Rs.380,000)	114,000
Minus: Entity P's share of unrealised profit in inventory	(3,000)
	386,000

c) **Statement of profit or loss**

The share of the associate's after-tax profit for the year is shown on a separate line as:

Share of profits of associate (30% × Rs. 100,000): Rs.30,000.

CHAPTER 22

Business combinations achieved in stages

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

PRESENTATION OF FINANCIAL STATEMENTS INCLUDING PUBLIC SECTOR ACCOUNTING

A 3 IFRS 10: Consolidated financial statements

FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 4 IFRS 3: Business combinations

1 ACQUISITIONS ACHIEVED IN STAGES

Section overview

- Acquisitions achieved in stages
- Purchase of additional equity interest after control is achieved

1.1 Acquisitions achieved in stages

As well as being achieved in a single transaction control might be achieved through a series of transactions. (These are known as step acquisitions, successive share purchases or piecemeal acquisitions).

Example: Step acquisition

A company may purchase a 35% stake, and then a year later, purchase a further 40%.

When the second purchase is made the company's interest in the subsidiary increases from 35% to 75%.

This is a controlling interest.

In other words control is achieved at the date of the second acquisition.

This is the date of acquisition.

Consolidation is from the acquisition date which is the date that control is achieved. Goodwill is calculated at the acquisition date with reference to the fair value of the consideration:

IFRS 3 requires that, for a business combination achieved in stages, the parent must remeasure any previously held equity interest in the new subsidiary to its fair value at the date that control is achieved. This is added to the cost of the investment that resulted in control. This figure is used to calculate goodwill.

Goodwill is measured as follows.

Illustration: Goodwill

	Rs.
Consideration transferred (cost of the business combination)	X
The acquisition-date fair value of the acquirer's previously held equity interest in the entity	X
Non-controlling interest	X
	X
The net of the acquisition date amounts of identifiable assets acquired and liabilities assumed	(X)
Goodwill recognised	X

The resulting gain or loss on the remeasurement of the previously held equity interest is recognised in profit or loss or other comprehensive income, as appropriate.

Example: Step acquisition

H bought 10% of S 2 years ago for Rs. 45m. The balance on S's retained earnings was Rs. 150m at this date.

H bought 60% of S 1 year ago for Rs. 540m. The balance on S's retained earnings was Rs. 300m at this date and S held a non-current asset with a fair value of Rs. 150m more than its carrying amount.

The fair value of the original investment (10%) in S was Rs. 60m at this date.

Statements of financial position for H and S as at 31 December 20X1:

	H	S
Assets:	Rs. m	Rs. m
Investment in S:		-
First holding (10%)	45	-
Second holding (60%)	540	-
	585	-
Other assets	2,500	650
	3,085	650
Equity		
Share capital	100	100
Retained earnings	2,485	500
	2,585	600
Current liabilities	500	50
	3,085	650

A consolidated statement of financial position as at 31 December 20X1 can be prepared as follows:

H Group: Consolidated statement of financial position at 31 December 20X1

	Rs. m
Assets	
Goodwill (see working)	215
Other assets (2,500 + (650 + 150))	3,300
Total assets	3,515
Equity	
Share capital (P only)	100
Consolidated retained earnings (see working)	2,640
	2,740
Non-controlling interest (see working)	225
	2,965
Current liabilities (500 + 50)	550
Total equity and liabilities	3,515

Example (continued): Net assets summary of S

	At date of consolidation	At date of acquisition	Post-acquisition
Share capital	100	100	
Retained earnings	500	300	200
Fair value reserve	150	150	
Net assets	750	550	

Non-controlling interest	**Rs. m**
NCI's share of net assets at the date of acquisition (30% × 550)	165
NCI's share of the post-acquisition retained earnings of S (30% of 200 (see above))	60
NCI's share of net assets at the date of consolidation (30% × 550)	225

Goodwill	**Rs. m**
Cost of investment	
Cost of second purchase (60%)	540
Fair value of first purchase (10%) – (45 + 15)	60
	600
Non-controlling interest at acquisition	165
	765
Less: Net assets at acquisition (see above)	(550)
	215

Consolidated retained earnings:	**Rs. m**
H's retained earnings	
Per the question	2,485
Gain on remeasurement of previously held equity interest in S (60 – 45)	15
	2,500
H's share of the post-acquisition retained earnings of S (70% of 200 (see above))	140
	2,640

Practice question **1**

Company P bought shares in Company T as follows:

		Cost	Retained profits
		Rs.	Rs.
1 January Year 1	40,000 shares	180,000	500,000
30 June Year 4	120,000 shares	780,000	800,000

No fair value adjustments arose on the acquisitions.

Company T had issued share capital of 200,000 Rs. 1 ordinary shares and retained profits at 31 December Year 4 were Rs. 900,000. The fair value of its initial investment in 40,000 shares of T was Rs. 250,000 at 30 June Year 4.

What is the value goodwill on acquisition.

Practice question **2**

Company P bought shares in Company T as follows:

		Cost	Retained profits
		Rs.	Rs.
1 January Year 1	40,000 shares	180,000	500,000
30 June Year 4	120,000 shares	780,000	800,000

No fair value adjustments arose on the acquisition. Between 1 January Year 1 and 30 June Year 4, Company T was treated as an associate and the investment in T was accounted for by the equity method. There was no impairment in the investment.

Company T had issued share capital of 200,000 Rs. 1 ordinary shares. The fair value of its initial investment in 40,000 shares of T was Rs. 250,000 at 30 June Year 4.

What gain or loss should be recognised on 30 June Year 4 on the initial investment in 40,000 shares of Company T?

1.2 Purchase of additional equity interest after control is achieved

A company may make a further purchase of shares after control has been achieved.

This is a transaction between the owners of the subsidiary (the controlling interest and the non-controlling interest) which will cause the non-controlling interest to change.

Any difference between the purchase consideration and the change in the non-controlling interest is recognised directly in equity.

The equity adjustment

Illustration: Equity adjustment

	Rs.
Consideration paid	X
Reduction in non-controlling interest at the date of the purchase	(X)
Equity adjustment	X

The reduction in non-controlling interest at the date of the purchase is the share of net assets given up by the non-controlling interest at that date. This requires a working to show the net assets of the subsidiary at that date.

This is very similar to the goodwill working but this figure is not goodwill. Goodwill arises at the acquisition date (the date at which control is achieved).

Non-controlling interest (NCI)

The NCI in the statement of financial position at the reporting date is based on the percentage holdings at that date.

Group policy might be to measure NCI as a proportionate share of net assets at the acquisition date. In this case the NCI at the reporting date can be easily measured as the NCI share of assets at that date.

If group policy is to measure NCI at fair value at the acquisition date the calculation can be quite tricky. In this case, you have to start with the NCI at the acquisition date and adjust it by the appropriate NCI share of profits since that date. This must be adjusted by NCI share of profits sold at the date of the second purchase by the parent.

Illustration: Non-controlling interest (NCI)

	Rs.
NCI at the date of acquisition (Original NCI % × Net assets at that date)	X
NCI's share of retained earnings of S from the acquisition date to the date of the second purchase (based on original NCI %)	X
NCI's share of retained earnings of S from the date of the second purchase to the reporting date (based on the new NCI %)	X
Share of profits disposed of at date of second purchase	
NCI at the date of consolidation	X

This is best demonstrated using figures and is shown in the following example.

Consolidated retained earnings

This must be calculated in the usual way by adding the parent's share of the subsidiary's post acquisition retained profits to those of the parent but remembering to make the equity adjustment.

The parent's share of the subsidiary's post acquisition retained profits must be measured as two figures.

Illustration: parent's share of the subsidiary's post acquisition retained profits

	Rs.
Parent's share of retained earnings of S from the acquisition date to the date of consolidation (Original % held)	X
Parent's share of retained earnings of S from date of second purchase to the date of consolidation (Incremental NCI% held)	X
Equity adjustment	X/(X)
	X

Again this is best demonstrated using figures and is shown in the following example. Work through it carefully.

Example: Purchase of additional equity interest after control is achieved

H bought 60% of S 2 years ago for Rs. 540m. The balance on S's retained earnings was Rs. 150m.

H bought 10% of S 1 year ago for Rs. 45m. The balance on S's retained earnings was Rs. 300m at this date.

Statements of financial position H and S as at 31 December 20X1:

	H	S
Assets:	Rs. m	Rs. m
Investment in S:	585	-
Other assets	2,500	650
	3,085	650
Equity		
Share capital	100	100
Retained earnings	2,485	500
	2,585	600
Current liabilities	500	50
	3,085	650

The NCI was 40% at the date of the first acquisition and remained the same until the date of the second purchase at which time it changed to 30%;

Example (continued) : Purchase of additional equity interest after control is achieved

A consolidated statement of financial position as at 31 December 20X1 can be prepared as follows:

H Group: Consolidated statement of financial position at 31 December 20X1

	Rs. m
Assets	
Goodwill (**W3**)	390
Other assets (2,500 + 650)	3,150
Total assets	3,540
Equity	
Share capital (P only)	100
Consolidated retained earnings (see working)	2,710
	2,810
Non-controlling interest (see working)	180
	2,990
Current liabilities (500 + 50)	550
Total equity and liabilities	3,540

W1: Net assets summary of S

	At date of consolidation	1 year ago	2 years ago
Share capital	100	100	100
Retained earnings	500	300	150
Net assets	600	400	250

W2: Non-controlling interest	**Rs. m**
NCI's share of net assets at the date of consolidation (30% of 600 **W1**)	180

A proof of this figure is shown at the end of the example

Example (continued): Purchase of additional equity interest after control is achieved

W3: Goodwill	**Rs. m**
Cost of investment	540
Non-controlling interest at acquisition (40% of 250)	100
	640
Net assets at acquisition (see above)	(250)
	390

W4: Equity adjustment	**Rs. m**
Cost of investment	45
Non-controlling interest sold (10% of 400)	(40)
	5

Consolidated retained profits:	**Rs. m**
H's retained earnings	2,485
Equity adjustment **W4**	(5)
H's share of the post-acquisition retained earnings of S	
(60% of (500 – 150) **W1**	210
(10% of (500 – 300) **W1**	20
	2,710

Non-controlling interest (Proof)	**Rs. m**
NCI's share of net assets at the date of acquisition (40% × 250)	100
NCI's share of the post-acquisition retained earnings of S from date of acquisition to the date of the later purchase ((40% of 300 – 150) **W1**))	60
	160
Less movement in NCI at date of second purchase(10% of 400)	(40)
NCI's share of the post-acquisition retained earnings of S from date of second purchase to the date of consolidation ((30% of 500 – 300) **W1**))	60
NCI's share of net assets at the date of consolidation (30% of 600) **W1**	180

Practice question **3**

Company H bought shares in Company S as follows:

		Cost	Retained profits
		Rs.	Rs.
1 January Year 1	120,000 shares	600,000	500,000
30 June Year 4	40,000 shares	270,000	800,000

No fair value adjustments arose on the acquisition.

Company S has issued share capital of 200,000 Rs. 1 ordinary shares.

What was the goodwill arising on the acquisition?

Practice question **4**

Company H bought shares in Company S as follows:

		Cost	Retained profits
		Rs.	Rs.
1 January Year 1	120,000 shares	600,000	500,000
30 June Year 4	40,000 shares	270,000	800,000

No fair value adjustments arose on the acquisition. There has been no impairment of goodwill since the acquisition. No goodwill is attributed to non-controlling interests.

Company S has issued share capital of 200,000 Rs. 1 ordinary shares.

What journal is required on the acquisition of the 40,000 shares in Company S on 30 June Year 4?

2 PATTERN OF OWNERSHIP IN THE CONSOLIDATED STATEMENT OF PROFIT OR LOSS

Section overview

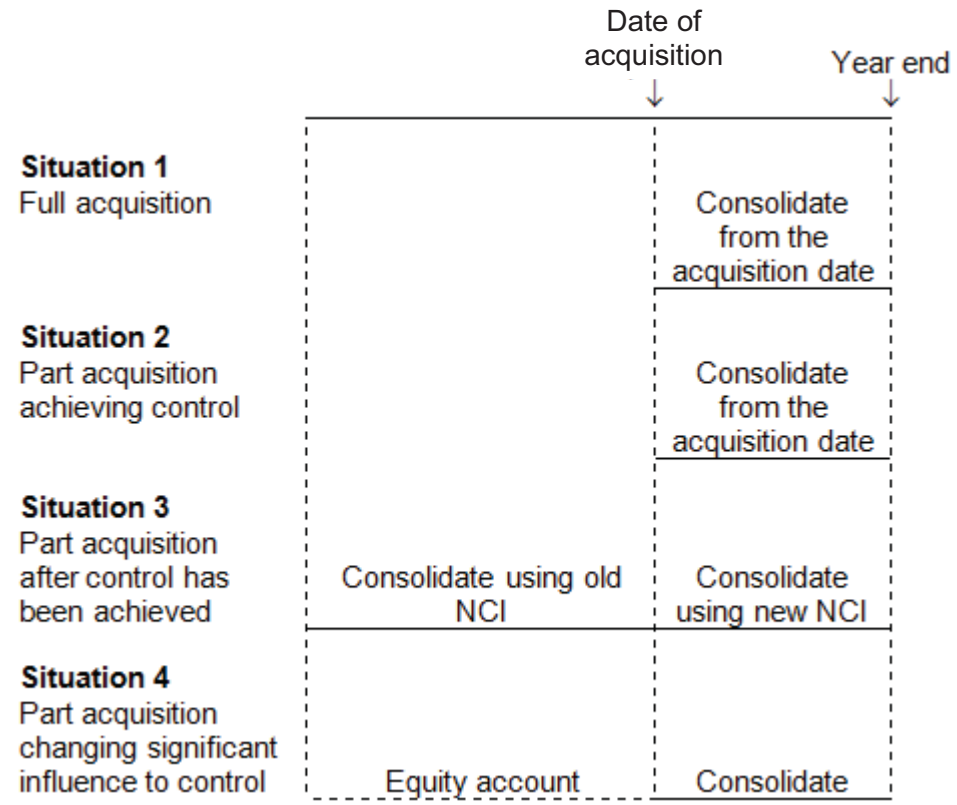
- Introduction
- Step acquisition
- Purchase of additional equity interest after control is achieved
- Purchase turning significant influence into control

2.1 Introduction

The pattern of ownership must be reflected in the statement of profit or loss and other comprehensive income.

A change in ownership in the period will have an impact on the consolidated statement of profit or loss and other comprehensive income.

Illustration: Pattern of ownership



Situation 1 is the basic situation which you will have seen before. The results must be consolidated from the date that control is achieved.

Situations 2 to 4 are explained in more detail in the following sections

2.2 Step acquisition

Situation 2: In this case the parent had a previously held equity interest. This gave the parent no influence. Control was achieved by the second acquisition and consolidation commences from that point.

Example: Step acquisition

H has owned 10% of S for several years

H bought a further 60% of S on 30th September 20X1.

Statements of profit or loss for the year ended 31 December 20X1:

	H	S
	Rs. m	Rs. m
Revenue	10,000	6,000
Cost of sales	(7,000)	(4,800)
Gross profit	3,000	1,200
Expenses	(1,000)	(300)
Profit before tax	2,000	900
Income tax	(500)	(160)
Profit after tax	1,500	740

A consolidated statement of comprehensive income can be prepared as follows:

	Working		
	H	S (3/12)	Consolidated
	Rs.	Rs.	Rs.
Revenue	10,000	1,500	11,500
Cost of sales	(7,000)	(1,200)	(8,200)
Gross profit	3,000	300	3,300
Expenses	(1,000)	(75)	(1,075)
Profit before tax			2,225
Income tax expense	(500)	(40)	(540)
Profit for the period	1,500	185	1,685

Total comprehensive income attributable to:	
Owners of the parent (balancing figure)	1,629
Non-controlling interests (30% of 185)	56
	1,685

2.3 Purchase of additional equity interest after control is achieved

Situation 3: In this case the parent has a subsidiary for the whole year. Therefore the results of that subsidiary must be consolidated for the whole year. However, the pattern of ownership changes during the year. The pattern of ownership is reflected in the statement of profit or loss by applying the appropriate NCI to the results for that part of the year in which that NCI was valid.

Example:

H has owned 60% of S for several years

H bought a further 10% of S on 30th September 20X1.

Statements of profit or loss for the year ended 31 December 20X1:

	H	S
	Rs. m	Rs. m
Revenue	10,000	6,000
Cost of sales	(7,000)	(4,800)
Gross profit	3,000	1,200
Expenses	(1,000)	(300)
Profit before tax	2,000	900
Income tax	(500)	(160)
Profit after tax	1,500	740

A consolidated statement of comprehensive income can be prepared as follows:

	Working		
	H	S	Consolidated
	Rs.	Rs.	Rs.
Revenue	10,000	6,000	16,000
Cost of sales	(7,000)	(4,800)	(11,800)
Gross profit	3,000	1,200	4,200
Expenses	(1,000)	(300)	(1,300)
Profit before tax	2,000	900	2,900
Income tax expense	(500)	(160)	(660)
Profit for the period	1,500	740	2,240

Total comprehensive income attributable to:	
Owners of the parent (balancing figure)	1,962
Non-controlling interests	
40% × 9/12 × 740	222
30% × 3/12 × 740	56
	278
	2,240

2.4 Purchase turning significant influence into control

Situation 4: In this case the parent had significant influence in the first part of the years and then made an acquisition which achieved control. The results for the year must be split into two parts. The results for the period in which the parent had significant influence must be equity accounted. The results for the period in which the parent had control must be consolidated.

Example: Step acquisition (associate to subsidiary)

H has owned 40% of S for several years. This holding gave H significant influence over S.

H bought a further 30% of S on 30th September 20X1.

Statements of profit or loss for the year ended 31 December 20X1:

	H	S
	Rs. m	Rs. m
Revenue	10,000	6,000
Cost of sales	(7,000)	(4,800)
Gross profit	3,000	1,200
Expenses	(1,000)	(300)
Profit before tax	2,000	900
Income tax	(500)	(160)
Profit for the period	1,500	740

A consolidated statement of comprehensive income can be prepared as follows:

	Working		
	H	S (3/12)	Consolidated
	Rs.	Rs.	Rs.
Revenue	10,000	1,500	11,500
Cost of sales	(7,000)	(1,200)	(8,200)
Gross profit	3,000	300	3,300
Expenses	(1,000)	(75)	(1,075)
Share of profit of associate (40% × 9/12 × 740)			222
Profit before tax			2,447
Income tax expense	(500)	(40)	(540)
Profit for the period	1,500	185	1,907

Total comprehensive income attributable to:	
Owners of the parent (balancing figure)	1,851
Non-controlling interests (30% of 185)	56
	1,907

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

Goodwill is calculated when control is acquired (IFRS 3).

	Rs.
Fair value of original investment	250,000
Cost of additional shares	780,000
Cost of investment to acquire T	1,030,000
Less: Net assets acquired (160/200 × (800 + 200))	(800,000)
Goodwill	230,000

Goodwill is calculated when control is acquired (IFRS 3)

Solution **2**

A step acquisition occurs in June Year 4. The original investment is revalued at fair value.

	Rs.
Cost of original investment	180,000
Share of retained profits of associate (20% × (800 – 500)	60,000
	240,000
Less: Fair value of original investment	(250,000)
Gain recognised in profit or loss	(10,000)

Goodwill is calculated when control is acquired (IFRS 3)

Solution **3**

Goodwill is calculated when control is acquired (IFRS 3). This is on purchase of the first investment.

	Rs.
Fair value of original investment	600,000
Less: Net assets acquired (120/200 × (500 + 200))	(420,000)
Goodwill	180,000

Solution **4**

	Dr	Cr
Equity attributable to parent	Rs. 70,000	
Non-controlling interest	Rs. 200,000	
Bank		Rs. 270,000

The acquisition of the extra 40,000 shares does not affect control of Company S, and it is therefore accounted for as an equity transaction between equity owners of the company in their capacity as owners. IAS 27 states that any difference between cash paid and the adjustment made to NCI is attributed to parent equity

CHAPTER 23

Complex groups

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

PRESENTATION OF FINANCIAL STATEMENTS INCLUDING PUBLIC SECTOR ACCOUNTING

A 1 Presentation of financial statements (IAS 1)

A 3 IFRS 10: Consolidated financial statements

FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 4 IFRS 3: Business combinations

1 INTRODUCTION

Section overview

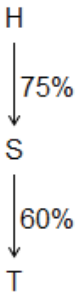
- Vertical and mixed groups
- Date of acquisition of the sub-subsidiary

1.1 Vertical and mixed groups

A subsidiary is an entity controlled by another entity (its parent). It follows that a parent will also control its subsidiary's subsidiary. A group structure in which a parent has a subsidiary which in turn is itself a parent of another subsidiary is known as a vertical group.

In the following explanation we shall refer to the parent as H, its subsidiary as S and the subsidiary's subsidiary as T.

Illustration: Vertical group



H Ltd owns 75% of S Ltd. S Ltd is thus a subsidiary of H Ltd.
S Ltd owns 60% of T Ltd. T Ltd is a subsidiary of S Ltd.
T Ltd is also a subsidiary of H Ltd.

Explanation

H Ltd has a direct interest in S Ltd and an indirect interest in T Ltd (exercised via S Ltd's holding in T Ltd).

T Ltd is a subsidiary of H Ltd because H Ltd has a controlling interest in S Ltd and S Ltd has a controlling interest in T Ltd.

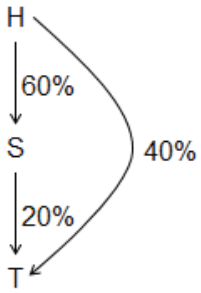
This is a 'vertical group' consisting of H Ltd, S Ltd and T Ltd.

T Ltd is said to be a sub-subsidiary of H Ltd.

In practice, structures can be much more complex than this with groups comprised of many layers of companies. However, they will be consolidated by applying the same principles as explained in this chapter for the relatively straightforward vertical group structure shown above.

Another group structure that could be examined is a mixed group (also known as a D-shaped group).

Illustration: Mixed group



H Ltd owns 60% of S Ltd and 40% of T Ltd
S Ltd owns 20% of W Ltd.
S Ltd is a subsidiary of H Ltd.
T Ltd is also a subsidiary of H Ltd.

Explanation

H Ltd and S Ltd between them own more than 50% of T Ltd (the fact that S Ltd is not a wholly-owned subsidiary of H Ltd is irrelevant).

H Ltd controls T Ltd because it owns 40% directly and because it controls another 20% through its control of S Ltd.

You may also come across examples where there is a sub-associate. This will be covered in a later section of this chapter.

Status of the investment

The starting point in any question involving a complex structure is to draw a diagram of the group and then decide on the status of the bottom company in relation to the ultimate parent.

The bottom company will either be a sub-subsidiary as shown above or a sub-associate. The status of the bottom investment is always decided in terms of whether H can exercise control or significant influence either directly or indirectly.

1.2 Date of acquisition of the sub-subsidiary

A subsidiary must be consolidated from the date of acquisition. The issue is the date of acquisition of the sub-subsidiary. It is not always obvious as to what that date should be.

The acquisition date for a sub-subsidiary in a vertical group depends on whether:

- the holding company H acquired its shares in subsidiary S before S acquired its shares in the sub-subsidiary T; or
- the holding company H acquired its shares in subsidiary S after S acquired its shares in the sub-subsidiary T.

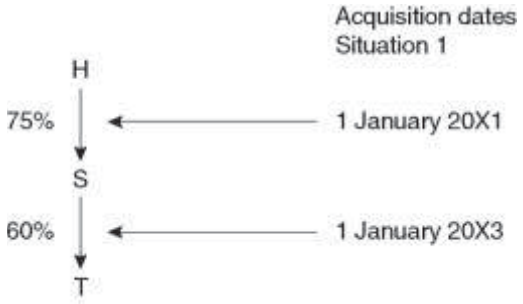
The date of acquisition of the sub-subsidiary is the later of the date on which the main subsidiary (S) was purchased by the parent and the date on which the sub-subsidiary (T) was purchased by the main subsidiary (S).

In other words:

- **Situation 1:** If the holding company H acquired its shares in subsidiary S before S acquired its shares in the sub-subsidiary T, the date that T becomes a member of the H Group is the date that S acquired the shares in T.

- **Situation 2:** If the holding company H acquired its shares in subsidiary S after S acquired its shares in the sub-subsidiary T, the date that T becomes a member of the H Group is the date that H acquired its shares in S.

Illustration: Date of acquisition – Situation 1



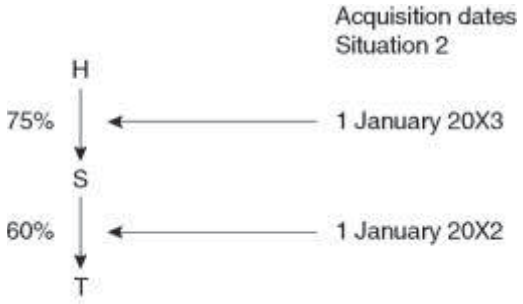
Explanation

H acquired 75% of S on 1 January 20X1.

S acquired 60% of T two years later on 1 January 20X3.

H acquired control of T when S bought its interest on 1 January 20X3. Therefore, the date of acquisition of T Ltd from H Ltd's viewpoint is 1 January 20X3.

Illustration: Date of acquisition – Situation 2



Explanation

H acquired 75% of S on 1 January 20X3.

S already held 60% of T.

H therefore acquired control of S and T at the same date.

Therefore, the date of acquisition of T Ltd from H Ltd's viewpoint is 1 January 20X3.

2 CONSOLIDATION OF SUB-SUBSIDIARIES (TWO STAGE METHOD)

Section overview

- Consolidation of sub-subsidiaries: Two methods
- Indirect method (2 stages)
- Direct method (1 stage)
- Rationale for splitting the cost of investment when using the direct method

2.1 Consolidation of sub-subsidiaries: Two methods

There are two methods (direct and indirect) which can be used for dealing with sub-subsidiaries. The different methods may result in different balances for certain items.

2.2 Indirect method (2 stages)

The consolidation takes place in two stages. Firstly, the S group accounts are prepared by consolidating T into S. Then, the S group accounts are consolidated into H.

Example: Consolidation of sub-subsidiary using the indirect method

H Ltd acquired 75% of S Ltd on 1 January 20X4 when the retained profits of S were Rs. 40,000.

S Ltd acquired 60% of T Ltd on 30 June 20X4 when the retained profits of T Ltd were Rs. 25,000. They had been Rs. 20,000 on the date of H Ltd's acquisition of S Ltd.

Draft statements of financial position of H Ltd, S Ltd and T Ltd, as at 31 December 20X4, are as follows:

	H Ltd	S Ltd	T Ltd
	Rs. '000	Rs. '000	Rs. '000
Other assets	280	110	100
Investment in S	120		
Investment in T		80	
	400	190	100
Share capital	200	100	50
Retained profits	100	60	30
Liabilities	100	30	20
	400	190	100

A consolidated statement of financial position as at 31 December 20X4 can be prepared as follows:

Example: Consolidation of sub-subsidiary using the indirect method

Step 1: Consolidate S Ltd and T Ltd

S Sub-Group: Consolidated statement of financial position at 31 December 20X4

	Rs. 000
Assets	
Goodwill (W2)	35.00
Other assets (110 + 100)	210.00
Total assets	245.00
Equity	
Share capital	100.00
Consolidated retained profits (W4)	63.00
	163.00
Non-controlling interest (W3)	32.00
	195.00
Current liabilities (30 + 20)	50.00
Total equity and liabilities	245.00

W1: Net assets summary of T

	At date of consolidation	At date of acquisition	Post-acquisition
Share capital	50	50	
Retained profits	30	25	5
Net assets	80	75	

W2: Goodwill (on acquisition of T)	**Rs. 000**
Cost of investment	80.00
Non-controlling interest at acquisition (40% × 75)	30.00
	110.00
Net assets at acquisition (W1)	(75.00)
	35.00

W3: NCI in T	
NCI's share of net assets at the date of acquisition (40% × 75)	30.00
NCI's share of the post-acquisition retained profits of S (40% of 5 (W1))	2.00
	32.00

W4: Consolidated retained profits:	
All of S's retained profits	60.00
S's share of the post-acquisition retained profits of T (60% of 5 (W1))	3.00
	63.00

Example: Consolidation of sub-subsidiary using the indirect method

Step 2: Consolidate H Ltd and S Group

H-Group: Consolidated statement of financial position at 31 December 20X4

	Rs. 000
Assets	
Goodwill (15 (W2) + 35 (step 1))	50.00
Other assets (280 + 210 (step1))	490.00
Total assets	540.00
Equity	
Share capital	200.00
Consolidated retained profits (W4)	117.25
	317.25
Non-controlling interest (40.75 (W3) + 32 (step 1))	72.75
	390.00
Current liabilities (100 + 50 (step1))	150.00
Total equity and liabilities	540.00

W1: Net assets summary of S

	At date of consolidation	At date of acquisition	Post-acquisition
Share capital	100	100	
Retained profits (step 1)	63	40	23
Net assets	163	140	

W2: Goodwill (on acquisition of S)	**Rs. 000**
Cost of investment	120.00
Non-controlling interest at acquisition (25% × 140)	35.00
	155.00
Net assets at acquisition (W1)	(140.00)
	15.00

W3: NCI in S	
NCI's share of net assets of at the date of acquisition (25% × 140)	35.00
NCI's share of the post-acquisition retained profits of S (25% of 23 (W1))	5.75
	40.75

W4: Consolidated retained profits:	
All of H's retained profits	100.00
H's share of the post-acquisition retained profits of S Group (75% × 23)	17.25
	117.25

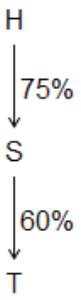
In the above example H bought S before S had bought its interest in T. If H bought S after S had bought its interest in T it would be necessary to calculate the consolidated net assets of the S group at the date of its acquisition by H.

The indirect method is the way that most groups would perform consolidation in practice. However, examiners usually expect the use of the direct approach when answering exam questions.

2.3 Direct method (1 stage)

This approach involves identifying H's effective holding in the sub-subsidiary and then using this to consolidate the sub-subsidiary directly along with the main subsidiary.

Illustration: Effective holding



H Ltd owns 75% of S Ltd.
S Ltd owns 60% of T Ltd.
H Ltd effectively owns 45% (75% of 60%) of T Ltd

Comment

H Ltd will consolidate a 75% of interest in S Ltd. The non-controlling interest in S Ltd is 25%.

H Ltd will consolidate a 45% of interest in S Ltd. The non-controlling interest in S Ltd is 55% (taken as a balancing figure).

Do not be confused by the existence of a non-controlling interest of 55%. Remember that we have already established that T is a subsidiary of H. The effective interests are mathematical conveniences which allow us to produce the consolidation. (Ownership and control are two separate issues).

The main subsidiary is consolidated by the parent in the usual way.

The sub-subsidiary is also consolidated by the parent in the usual way using the effective holding with one further adjustment. The cost of investment in T is split. H's share is used in the goodwill working and the balance is charged to the non-controlling interest.

To illustrate, in the next example the cost of investment in T is Rs. 80,000. This number is split so that H's share of Rs. 60,000 (75% × Rs. 80,000) is the cost used in the goodwill calculation and the balance Rs. 20,000 (25% × Rs. 80,000) is a deduction from the non-controlling interest.

Example: Consolidation of sub-subsidiary using the direct method

H Ltd acquired 75% of S Ltd on 1 January 20X4 when the retained profits of S were Rs. 40,000.

S Ltd acquired 60% of T Ltd on 30 June 20X4 when the retained profits of T Ltd were Rs. 25,000. They had been Rs. 20,000 on the date of H Ltd's acquisition of S Ltd.

Draft statements of financial position of H Ltd, S Ltd and T Ltd, as at 31 December 20X4, are as follows:

	H Ltd	S Ltd	T Ltd
	Rs. '000	Rs. '000	Rs. '000
Other assets	280	110	100
Investment in S	120		
Investment in T		80	
	400	190	100
Share capital	200	100	50
Retained profits	100	60	30
Liabilities	100	30	20
	400	190	100

A consolidated statement of financial position as at 31 December 20X4 can be prepared as follows:

H Group: Consolidated statement of financial position at 31 December 20X4

	Rs. 000
Assets	
Goodwill (W2)	41.25
Other assets (280 + 110 + 100)	490.00
Total assets	531.25
Equity	
Share capital	200.00
Consolidated retained profits (W4)	117.25
	317.25
Non-controlling interest (W3)	64.00
	381.25
Current liabilities	150.00
Total equity and liabilities	531.25

Example (continued): Consolidation of sub-subsidiary using the direct method

W1a: Net assets summary of S

	At date of consolidation	At date of acquisition	Post-acquisition
Share capital	100	100	
Retained profits	60	40	20
Net assets	160	140	

W1b: Net assets summary of T

	At date of consolidation	At date of acquisition	Post-acquisition
Share capital	50	50	
Retained profits	30	25	5
Net assets	80	75	

W2: Goodwill	**Rs. 000**
On acquisition of S	
Cost of investment	120.00
Non-controlling interest at acquisition (25% × 140 (W1a))	35.00
	155.00
Net assets at acquisition (see above)	(140.00)
	15.00
On acquisition of T	
Cost of investment (75% × 80)	60.00
Non-controlling interest at acquisition (55% × 75 (W1b))	41.25
	101.25
Net assets at acquisition (see above)	(75.00)
	26.25
Total goodwill	41.25

Example (continued): Consolidation of sub-subsidiary using the direct method

W3: Non-controlling interest	**Rs. 000**
NCI in S	
NCI's share of net assets of at the date of acquisition (25% × 140 (W1a))	35.00
NCI's share of the post-acquisition retained profits of S (25% of 20 (W1a))	5.00
NCI's share of net assets at the date of consolidation	40.00
NCI in T	
NCI's share of net assets of at the date of acquisition (55% × 75(W1b))	41.25
NCI's share of the post-acquisition retained profits of S (55% of 5 (W1b))	2.75
NCI's share of net assets at the date of consolidation	44.00
Less NCI in S share of cost of investment in T (25% × 80)	(20.00)
	24.00
Total NCI	64.00

W4: Consolidated retained profits:	**Rs.**
All of H's retained profits	100.00
H's share of the post-acquisition retained profits of S (75% of 20 (W1a))	15.00
H's share of the post-acquisition retained profits of T (45% of 5 (W1b))	2.25
	117.25

2.4 Rationale for splitting the cost of investment when using the direct method

Goodwill

Goodwill is the difference between the cost of investment and the share of net assets acquired. This is not obvious from the format of the calculation but it can be rearranged to demonstrate this as follows:

Example: Goodwill on acquisition

Returning to the facts of the previous example:

Goodwill on acquisition of S	**Rs. 000**
Cost of investment	120.00
Non-controlling interest at acquisition (25% × 140)	35.00
	155.00
Net assets at acquisition (see above)	(140.00)
	15.00
This could be rearranged to:	
Cost of investment	120.00
Less: Share of net assets at acquisition	
Net assets at acquisition (see above)	140.00
Non-controlling interest at acquisition	(35.00)
(75% × 140)	105.00
	15.00

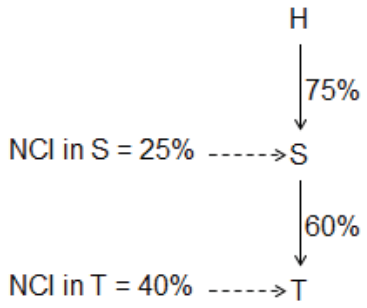
The effective interest is the **parent's share** of the main subsidiaries share of the sub-subsidiary.

- Goodwill calculated for the main subsidiary is cost less share of net assets.
- Goodwill calculated for the sub-subsidiary must be the **share** of cost less **share** of share of net assets.

Non-controlling interest

In previous examples, the NCI in the sub-subsidiary was calculated as a balancing figure. It is possible to prove this figure in terms of the shareholdings of the main subsidiary and the sub-subsidiary.

Illustration: Non-controlling interest



Comment

H Ltd has an effective interest of 45% of T (75% × 60%).
The NCI is 55% (taken as a balancing figure).
The NCI in the sub-subsidiary is made up of the following:

NCI in T	**40%**
NCI in S's share of investment in T (25% × 60%)	**15%**
	55%

Consolidation involves replacing cost of investment with a share of net assets. Using the effective interest to calculate the NCI in the sub-subsidiary gives the NCI in the main subsidiary a share of the net assets of the sub-subsidiary (see the 15% above). However, the NCI in the main subsidiary has already been given a share of the net assets of the main subsidiary and this includes the cost of investment in T. Therefore, the NCI in the main subsidiary's share of cost must be eliminated to avoid double counting.

This sounds more complicated than it is. Always split the cost of investment in the sub-subsidiary as shown in the worked example.

Practice question **1**

The statements of financial position H, S and T as at 31 December 20X7 were as follows:

Assets:	H (Rs.)	S(Rs.)	T(Rs.)
Investment in S	5,000		
Investment in T		750	
Other assets	11,900	6,000	1,500
	16,900	6,750	1,500
Equity			
Share capital	10,000	3,000	300
Retained profits	4,900	2,750	700
Liabilities	2,000	1,000	500
	16,900	6,750	1,500

H acquired its 80% investment in S on 1 January 20X7.

S acquired its 60% investment in T on 1 January 20X4.

At the dates of the share purchases, the following information is available:

Date	Retained profits of S	Retained profits of T
1 January 20X4	2,000	500
1 January 20X7	2,300	650

Required

Prepare the consolidated statement of financial position for the H Group as at 31 December 20X7.

Practice question **2**

The statements of financial position H, S and T as at 31 December 20X8 were as follows:

Assets:	H (Rs. 000)	S(Rs. 000)	T(Rs. 000)
Investment in S	3,300		
Investment in T		2,200	
Other assets	3,700	2,400	3,500
	7,000	4,600	3,500
Equity			
Share capital	4,000	2,500	2,000
Retained profits	2,000	1,100	1,000
Liabilities	1,000	1,000	500
	7,000	4,600	1,500

H acquired its 80% investment in S on 1 January 20X7.
S acquired its 60% investment in T on 31 December 20X7.
H measures NCI on acquistion at its fair value.
At the dates of the share purchases, the following information is available:

Date	Retained profits of S (Rs. 000)	Retained profits of T (Rs. 000)
1 January 20X7	400	200
31 December 20X7	700	320

Date	Fair value of NCI of S (Rs. 000)	Fair value of NCI of T (Rs. 000)
1 January 20X7	800	1,600
31 December 20X7	960	2,000

Required

Prepare the consolidated statement of financial position for the H Group as at 31 December 20X8.

3 CONSOLIDATION OF MIXED GROUPS

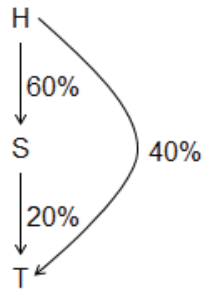
Section overview

- Mixed groups
- Effective interest in mixed groups
- Date of acquisition of the sub-subsidiary in a mixed group
- Direct method consolidation of mixed group

3.1 Mixed groups

In a mixed group, the parent has both direct and indirect interests in the sub-subsidiary. The following illustration was shown earlier in section 1 of this chapter. It is repeated here for your convenience.

Illustration: Mixed group



H Ltd owns 60% of S Ltd and 40% of T Ltd
S Ltd owns 20% of W Ltd.
S Ltd is a subsidiary of H Ltd.
T Ltd is also a subsidiary of H Ltd.

3.2 Effective interest in mixed groups

In the above example of a mixed group, H has two interests in T:

- It has a direct interest in T, with the shares that it owns in T.
- It also has an indirect interest in T, through its control of S, which also owns shares in T.

The group interest in the sub-subsidiary T is the sum of the direct interest and the indirect interest in T as follows:

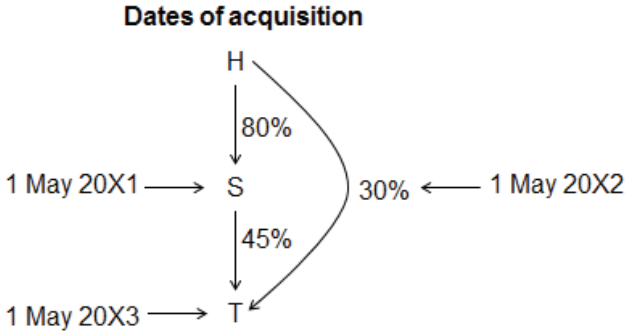
Illustration: Mixed group – Effective interest in sub-subsidiary

H's direct holding in T	40%
H's indirect holding in T (60% × 20%)	12%
H's effective holding in T	52%
Non-controlling interest in T (balance)	48%
	100%

3.3 Date of acquisition of the sub-subsidiary in a mixed group

The same rules apply to mixed groups as they do to vertical groups.

Illustration: Date of acquisition – Situation 1



Commentary

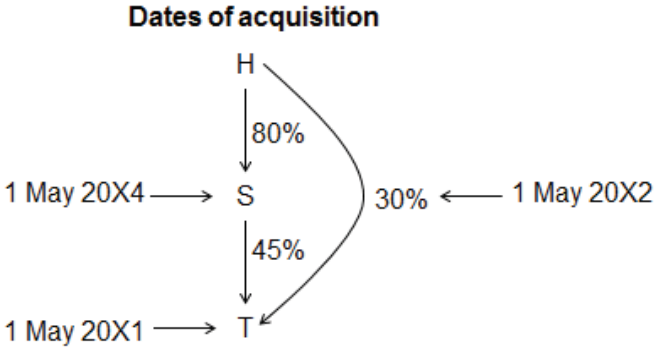
H obtains control of S on 1 May 20X1.

H obtains control of T on 1 May 20X3 when S acquires its stake in T.

From 1 May 20X2 to 1 May 20X3, T is an associate of H.

From 1 May 20X3 onwards T is a subsidiary of H and H has an effective holding of 66% (30% + (80% × 45%)) in T.

Illustration: Date of acquisition – Situation 2



Commentary

H achieves significant influence over T on 1 May 20X2.

H obtains control of S on 1 May 20X4. Thus H also obtains control of T. due to gaining indirect control over S's holding in T.

From 1 May 20X2 to 1 May 20X4, T is an associate of H.

From 1 May 20X4 onwards T is a subsidiary of H.

The above illustrations show that there is a further complication that must be taken into account when consolidating mixed groups. If H's direct and indirect interests in the sub-subsidiary arise on different dates the step acquisition rules apply.

3.4 Direct method consolidation of mixed group

Example: Consolidation of a mixed group

The statements of financial position H, S and T as at 31 December 20X7 were as follows:

Assets:	H (Rs. 000)	S(Rs.000)	T(Rs.000)
Investment in S	5,000		
Investment in T	1,000	1,750	
Other assets	11,900	9,000	2,400
	17,900	10,750	2,400
Equity			
Share capital	10,000	3,000	300
Retained profits	5,900	4,750	1,600
Liabilities	2,000	3,000	500
	17,900	10,750	2,400

H acquired its 80% investment in S on 1 June 20X1.
H acquired its 10% investment in S on 15 October 20X2.
S acquired its 45% investment in T on 1 May 20X3.

The following information is available:

Date	Retained profits of S	Retained profits of T
	Rs. 000	Rs. 000
1 June 20X1	2,000	500
15 October 20X2	2,300	650
1 May 20X3	3,000	800

The fair value of H's 10% holding in T was Rs. 1,500,000 on 1 May 20X3.

Required

Prepare the consolidated statement of financial position for the H Group as at 31 December 20X7.

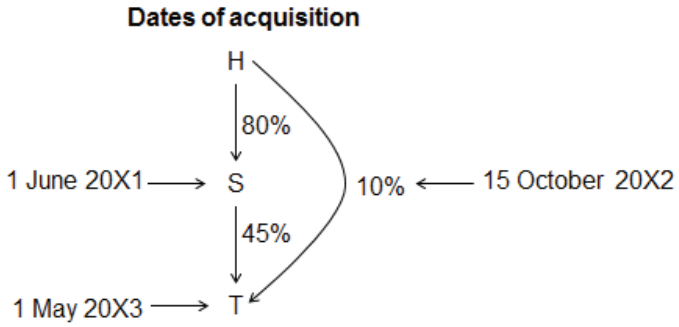
Example: Consolidation of a mixed group

H Group: Consolidated statement of financial position at 31 December 20X7:

	Rs. 000
Assets	
Goodwill (W3)	3,394
Other assets (11,900 + 9,000 + 2,400)	23,300
Total assets	26,694
Equity	
Share capital	10,000
Consolidated retained profits (W5)	8,968
	18,968
Non-controlling interest (W2)	2,226
	21,194
Liabilities (2,000 + 3,000 + 500)	5,500
Total equity and liabilities	26,694

Workings

W1: Group structure



T became a subsidiary of H on 1 May 20X3 when S bought its interest in T.

H's effective holding in T	
Direct holding	10%
Indirect holding (80% × 45%)	36%
Effective holding	46%
Non-controlling interest (balance)	54%
	100%

Example (continued): Consolidation of a mixed group

W2a: Net assets summary of S

	At date of consolidation	At date of acquisition	Post-acquisition
Share capital	3,000	3,000	
Retained profits	4,750	2,000	2,750
Net assets	7,750	5,000	

W2b: Net assets summary of T

	At date of consolidation	At date of acquisition	Post-acquisition
Share capital	300	300	
Retained profits	1,600	800	800
Net assets	1,900	1,100	

W3: Goodwill	**Rs. 000**
On acquisition of S	
Cost of investment	5,000
Non-controlling interest at acquisition (20% × 5,000 (W2a))	1,000
	6,000
Net assets at acquisition (see above)	(5,000)
	1,000
On acquisition of T	
Direct holding	
Cost of direct holding	1,000
Fair value adjustment	500
Fair value of first purchase (given)	1,500
Indirect holding	
Cost of investment (80% × 1,750)	1,400
Total cost of control	2,900
Non-controlling interest at acquisition (54% × 1,100 (W2b))	594
	3,494
Net assets at acquisition (see above)	(1,100)
	2,394
Total goodwill	3,394

Example (continued): Consolidation of a mixed group

W4: Non-controlling interest	Rs. 000
NCI in S	
NCI's share of net assets of at the date of acquisition (20% × 5,000 (W2a))	1,000
NCI's share of the post-acquisition retained profits of S (20% of 2,750 (W2a))	550
NCI's share of net assets at the date of consolidation	1,550
NCI in T	
NCI's share of net assets of at the date of acquisition (54% × 1,100(W2b))	594
NCI's share of the post-acquisition retained profits of S (54% of 800 (W2b))	432
NCI's share of net assets at the date of consolidation	1,026
Less NCI in S share of cost of investment in T (20% × 1,750)	(350)
	676
Total NCI	2,226

W5: Consolidated retained profits:	Rs. 000
All of H's retained profits	5,900
Revaluation of first investment in T	500
	6,400
H's share of the post-acquisition retained profits of S (80% of 2,750 (W2a))	2,200
H's share of the post-acquisition retained profits of T (46% of 800 (W2b))	368
	8,968

4 OTHER ISSUES

Section overview

- Accounting for sub-associates
- Consolidated statements of profit or loss when there are sub-subsidiaries

4.1 Accounting for sub-associates

An associate is an entity over which an investor has significant influence.

Sub-subsidiaries may be consolidated either using the indirect (2 stage) method or the direct (1 stage) method.

There is no such choice in accounting for interests in sub-associates. They **must** be accounted for using a two stage approach.

- **Step 1:** The investment is equity accounted into the financial statements of the main subsidiary.
- **Step 2:** The revised statements of the main subsidiary are then consolidated with those of the parent. The main subsidiary's non-controlling interest will share in the equity accounted associate in the usual way.

There is no concept of effective holding when accounting for investments in sub-associates.

This is because when a member of a group has a holding that gives it significant influence over another entity, that entity is not a member but an associate of the group. As such it must be equity accounted into the group accounts based on the group's share of the movement in its net assets since the date of acquisition.

Example: Consolidation where there is a sub-associate

H Ltd acquired 75% of S Ltd on 1 January 20X4 when the retained profits of S were Rs. 40,000.

S Ltd acquired 20% of T Ltd on 30 June 20X4 when the retained profits of T Ltd were Rs. 25,000. They had been Rs. 20,000 on the date of H Ltd's acquisition of S Ltd.

Draft statements of financial position of H Ltd, S Ltd and T Ltd, as at 31 December 20X4, are as follows:

	H Ltd	S Ltd	T Ltd
	Rs. '000	Rs. '000	Rs. '000
Other assets	280	110	100
Investment in S	120		
Investment in T		80	
	400	190	100
Share capital	200	100	50
Retained profits	100	60	30
Liabilities	100	30	20
	400	190	100

A consolidated statement of financial position as at 31 December 20X1 can be prepared as follows:

H Group: Consolidated statement of financial position at 31 December 20X1

	Rs.
Assets	
Goodwill (see working)	15
Investment in associate	81
Other assets	390
Total assets	486
Equity	
Share capital	200.00
Consolidated retained profits (see working)	115.75
	315.75
Non-controlling interest (see working)	40.25
	356.00
Current liabilities	130.00
Total equity and liabilities	486.00

Example (continued): Consolidation where there is a sub-associate

Step 1:Equity account T into S

Net assets summary of T

	At date of consolidation	At date of acquisition	Post-acquisition
Share capital	50	50	
Retained profits	30	25	5
Net assets	80	75	

In S's books	Dr	Cr
Cost of investment	1	
Statement of profit or loss (retained profits) (20% × 5)		1

S's balances change as follows:	Investment in S	Retained profits
Per question	80	60
Share of post-acquisition profits	1	1
	81	61

Step 2: Consolidate S into H

Net assets summary of S

	At date of consolidation	At date of acquisition	Post-acquisition
Share capital	100	100	
Retained profits	61	40	21
Net assets	161	140	

Goodwill on acquisition of S	**Rs.**
Cost of investment	120
Non-controlling interest at acquisition (25% × 140)	35
	155
Net assets at acquisition (see above)	(140)
	15

Example (continued): Consolidation where there is a sub-associate

Non-controlling interest	**Rs.**
NCI in S	
NCI's share of net assets of at the date of acquisition (25% × 140)	35.00
NCI's share of the post-acquisition retained profits of S (25% of 21 (see above))	5.25
NCI's share of net assets at the date of consolidation	40.25

Consolidated retained profits:	**Rs.**
All of H's retained profits	100.00
H's share of the post-acquisition retained profits of S (75% of 21 (see above))	15.75
	115.75

5.2 Consolidated statements of profit or loss when there are sub-subsidiaries

Consolidation of statements of profit or loss involving sub-subsidiaries and sub-associates is carried out as normal. The effective rate may be used to consolidated sub-subsidiaries and sub-associates are equity accounted using a two stage process.

There is one possible complication when consolidating sub-subsidiaries..

- If the sub-subsidiary has paid a dividend and the main subsidiary has accounted for its share through the profit and loss account this will be part of the subsidiary's profit before tax.
- It must be eliminated (as a consolidation adjustment) during the non-controlling interest calculation.

Example: Consolidated statement of profit or loss with a sub-subsidiary

H owns 80% of S which owns 60% of T.

H's effective holding in T is 48% (80% × 60%) and the NCI in T is 52%.

T has paid a dividend of Rs. 200 and S has duly accounted for its share (Rs. 120 = 60% of Rs. 200) as follows

	H	S	T	CP&L
Operating profit	1,200	600	500	2,300
Dividend receivable from T	–	120*	–	–
	1,200	720	500	2,300
Taxation	(400)	(250)	(100)	(750)
PAT	800	470	400	1,550

Total comprehensive income attributable to:	
Owners of the parent (balancing figure)	1,272
Non-controlling interests (working)	278
	1,550

Working: Non-controlling interest	
In S (20% × (470 – 120)	70
In T (52% × 400)	208
	278

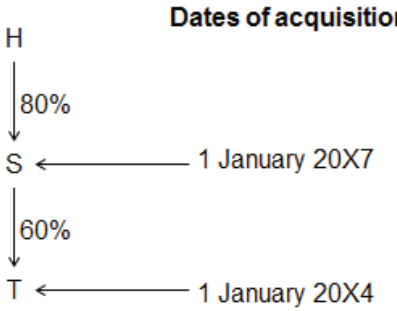
SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

H Group: Consolidated statement of financial position at 31 December 20X4

	Rs.
Assets	
Goodwill (W2)	904
Other assets (11,900 + 6,000 + 1,500)	19,400
Total assets	20,304
Equity	
Share capital	10,000
Consolidated retained profits (W4)	5,284
	15,284
Non-controlling interest (W3)	1,520
	16,804
Current liabilities (2,000 + 1,000 + 500)	3,500
Total equity and liabilities	20,304

W1: Group structure



S acquired its interest in T before H purchased its interest in S.
Therefore, both S and T entered the H group on 1 January 20X7.

H's effective holding in T (80% × 60%)	48%
Non-controlling interest (balance)	52%
	100%

Solution (continued) **1**

W1a: Net assets summary of S

	At date of consolidation	At date of acquisition	Post-acquisition
Share capital	3,000	3,000	
Retained profits	2,750	2,300	450
Net assets	5,750	5,300	

W1b: Net assets summary of T

	At date of consolidation	At date of acquisition	Post-acquisition
Share capital	300	300	
Retained profits	700	650	50
Net assets	1,000	950	

W2: Goodwill	**Rs.**
On acquisition of S	
Cost of investment	5,000
Non-controlling interest at acquisition (20% × 5,300 (W1a))	1,060
	6,060
Net assets at acquisition (see above)	(5,300)
	760
On acquisition of T	
Cost of investment (80% × 750)	600
Non-controlling interest at acquisition (52% × 950 (W1b))	494
	1,094
Net assets at acquisition (see above)	(950)
	144
Total goodwill	904

Solution (continued) **1**

W3: Non-controlling interest	**Rs.**
NCI in S	
NCI's share of net assets at the date of acquisition (20% × 5,300 (W1a))	1,060
NCI's share of the post-acquisition retained profits of S (20% of 450 (W1a))	90
NCI's share of net assets at the date of consolidation	1,150
NCI in T	
NCI's share of net assets at the date of acquisition (52% × 950 (W1b))	494
NCI's share of the post-acquisition retained profits of S (52% of 50 (W1b))	26
NCI's share of net assets at the date of consolidation	520
Less NCI in S share of cost of investment in T (20% × 750)	(150)
	370
Total NCI	1,520

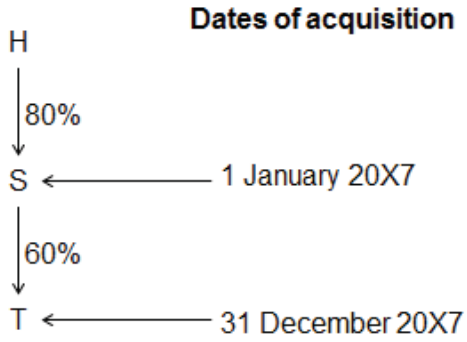
W4: Consolidated retained profits:	**Rs.**
All of H's retained profits	4,900
H's share of the post-acquisition retained profits of S (80% of 450 (W1a))	360
H's share of the post-acquisition retained profits of T (48% of 50 (W1b))	24
	5,284

Solution **2**

H Group: Consolidated statement of financial position at 31 December 20X4

	Rs. 000
Assets	
Goodwill (W2)	2,640
Other assets (3,700 + 2,400 + 3,500)	9,600
Total assets	12,240
Equity	
Share capital	4,000
Consolidated retained profits (W4)	2,886
	6,886
Non-controlling interest (W3)	2,854
	9,740
Current liabilities (1,000 + 1,000 + 500)	2,500
Total equity and liabilities	12,240

W1: Group structure



S acquired its interest in T after H purchased its interest in S.
Therefore, the date of acquisition of S is 1 January 20X7 and the date of acquisition of T is 31 December 20X7

H's effective holding in T (80% × 60%)	48%
Non-controlling interest (balance)	52%
	100%

Solution (continued) **2**

W1a: Net assets summary of S

	At date of consolidation	At date of acquisition	Post-acquisition
Share capital	2,500	2,500	
Retained profits	1,100	400	700
Net assets	3,600	2,900	

W1b: Net assets summary of T

	At date of consolidation	At date of acquisition	Post-acquisition
Share capital	2,000	2,000	
Retained profits	1,000	320	680
Net assets	3,000	2,320	

W2: Goodwill	**Rs. 000**
On acquisition of S	
Cost of investment	3,300
Non-controlling interest at acquisition(fair value)	800
	4,100
Net assets at acquisition (see above)	(2,900)
	1,200
On acquisition of T	
Cost of investment (80% × 2,200)	1,760
Non-controlling interest at acquisition (fair value)	2,000
	3,760
Net assets at acquisition (see above)	(2,320)
	1,440
Total goodwill	2,640

Solution (continued) **2**

W3: Non-controlling interest	**Rs. 000**
NCI in S	
Fair value of NCI at the date of acquisition	800
NCI's share of the post-acquisition retained profits of S (20% of 700 (W1a))	140
NCI at the date of consolidation	940
NCI in T	
Fair value of NCI at the date of acquisition	2,000
NCI's share of the post-acquisition retained profits of S (52% of 680 (W1b))	354
NCI at the date of consolidation	2,354
Less NCI in S share of cost of investment in T (20% × 2,200)	(440)
	1,914
	2,854

W4: Consolidated retained profits:	**Rs. 000**
All of H's retained profits	2,000
H's share of the post-acquisition retained profits of S (80% of 700 (W1a))	560
H's share of the post-acquisition retained profits of T (48% of 680 (W1b))	326
	2,886

CHAPTER 24

Disposal of subsidiaries

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

PRESENTATION OF FINANCIAL STATEMENTS INCLUDING PUBLIC SECTOR ACCOUNTING

A 3 IFRS 10: Consolidated financial statements

A 9 IFRS 5: Non-current assets held for sale and discontinued operations

1 FULL DISPOSALS

Section overview

- Introduction
- Pattern of ownership
- Profit or loss on disposal
- Step by step approach

1.1 Introduction

A parent company might dispose of a holding in a subsidiary.

IFRS 10 Consolidated Financial Statements contains rules on accounting for disposals of a subsidiary.

Accounting for a disposal is an issue that impacts the statement of profit or loss.

There are two major tasks in constructing a statement of profit or loss for a period during which there has been a disposal of a subsidiary:

- The statement of profit or loss must reflect the pattern of ownership of subsidiaries in the period.
- When control is lost, the statement of profit or loss must show the profit or loss on disposal of the subsidiary.

The rules in IFRS 10 cover full disposals and part disposals.

When a parent makes a part disposal of an interest in a subsidiary it will be left with a residual investment. The accounting treatment for a part disposal depends on the nature of the residual investment.

If a part disposal results in loss of control the parent must recognise a profit or loss on disposal in the consolidated statement of profit or loss.

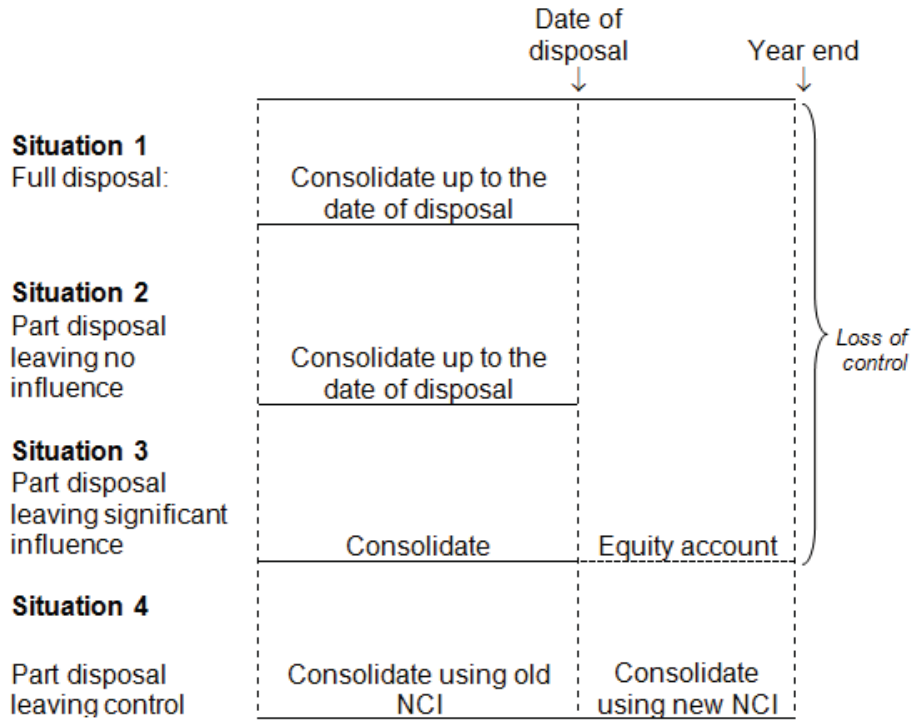
A part disposal which does not result in loss of control is a transaction between the owners of the subsidiary. In this case the parent does not recognise a profit or loss on disposal in the consolidated statement of profit or loss. Instead the parent recognises an equity adjustment.

1.2 Pattern of ownership

The pattern of ownership in a period is always reflected in the consolidated statement of profit or loss.

IFRS 11 requires that an interest in a subsidiary is consolidated from the date of acquisition to the date of disposal.

Illustration: Disposal during the year



An interest in an associate must also be equity accounted from the date that significant influence is achieved to the date that it is lost.

Thus, the figures from the statement of profit or loss and other comprehensive income that relate to the period up to the date of disposal must be identified. In practice, this would normally be achieved by constructing a set of accounts up to the date of disposal. In exam questions we tend to use time apportionment.

There is another reason for consolidating up to the date of disposal. The calculation of the profit on disposal involves comparing the sale proceeds to what leaves the statement of financial positon as at the date of disposal. Therefore, the results of the subsidiary must be consolidated up to the date of disposal in order to establish the correct net assets figure.

1.3 Profit or loss on disposal

IFRS 10 specifies an approach to calculating the profit or loss on disposal.

This approach involves comparing the asset that is recognised as a result of the disposal (i.e. the proceeds of the sale) to the amounts that are derecognised as a result of the disposal.

The calculation is as follows:

Illustration: Profit (loss) on disposal

Recognise:	Rs.
Proceeds	X
Fair value of residual interest (only for part disposals)	X
	X
Derecognise:	
Net assets of subsidiary	X
Non-controlling interest	(X)
Share of net assets	(X)
Unimpaired goodwill	(X)
Profit(loss) on disposal recognised in profit or loss	X

Example: Profit on disposal of a subsidiary

On 1 January Year 9, H Ltd acquired 90% of the equity shares of S Ltd for Rs.120 million.

The fair value of the identifiable net assets in S Ltd at that date was Rs.111 million. The fair value of the NCI at 1 January Year 9 was Rs.9 million.

H Ltd uses the full goodwill method for consolidation leading to the recognition of goodwill of Rs.18m ((Rs.120m + Rs.9m – Rs.111m).

H Ltd subsequently sold the shares on 31 December Year 9 for Rs.197 million. The carrying value of the net assets of S Ltd at 31 December Year 9 was Rs.124 million.

The gain on disposal recognised in profit or loss should be calculated as follows:

	Rs. m
Consideration received for shares in S Ltd on 31 December	197.0
Net assets de-recognised in consolidated accounts	
Net assets de-recognised	124.0
Value of NCI at 31 December (Rs. 9m + 10% × (124 million – 111 million))	(10.3)
	113.7
Goodwill derecognised: (120 + 9 – 111)	18.0
Net assets sold	(131.7)
Gain on disposal, reported in profit or loss	65.3

The calculation of profit or loss on disposal must be supported by several other calculations. These are:

- the goodwill arising on acquisition, which in turn needs the net assets of the subsidiary at the date of acquisition; and
- the net assets of the subsidiary at the date of disposal, which in turn needs a calculation of the equity reserves at the date of disposal.

Example:

At 1 January Year 9, H Ltd held 80% of the equity of S Ltd. The carrying value of the net assets of S Ltd at this date was Rs.570 million.

There was also goodwill of Rs.20 million net of accumulated impairments relating to the investment in S Ltd: all this goodwill is attributable to the equity owners of H Ltd.

On 1 April Year 9, H Ltd sold its entire shareholding in S Ltd for Rs.575 million in cash.

H Ltd has a financial year ending 31 December. It was subsequently established that the profit after tax of S Ltd for the year to 31 December Year 9 was Rs.120 million.

S Ltd did not make any dividend payment during the year before the disposal of the shares.

How should the disposal of the shares be accounted for? (Ignore deferred taxation).

Answer

In the three months of the year to the date of disposal of the shares in S Ltd, the after-tax profit of S Ltd was Rs.30 million (Rs.120 million × 3/12).

The carrying value of the net assets of S Ltd at the date that control was lost is therefore Rs.600 million (Rs.570 million + Rs.30 million).

The gain on disposal of the shares is as follows:

	Rs. million
Consideration received from sale of shares	575
Net assets derecognised (including goodwill)	620
NCI removed/derecognised	(120)
H Ltd's share of assets derecognised	(500)
Total gain	75

Practice question **1**

P bought 80% of the issued ordinary shares of S twenty five years ago at a cost of Rs. 330,000 when the net assets of S amounted to Rs. 280,000.

No goodwill is attributed to the non-controlling interests. Goodwill arising on the acquisition has suffered an impairment of 80% of its original value.

On the final day of the current accounting period P sold its entire shareholding in S for proceeds of Rs.460,000. At this date the net assets of S amounted to Rs. 400,000.

Required

What is the profit or loss on disposal reported in consolidated profit or loss for the current period?

1.4 Step by step approach

The following approach can be used to prepare answers to questions requiring a consolidated statement of profit or loss when there is a disposal of a subsidiary during the year.

Step 1: Reflect the pattern of ownership

Construct a pro-forma answer with columns for the parent, the subsidiary and the consolidated figures.

Enter the figures to be consolidated remembering to prorate the subsidiary's figures up to the date of disposal and add across to give the consolidated figures.

The non-controlling interest can be calculated from the subsidiary's column.

Step 2: Construct the following workings:

- Net assets summary as at the date of disposal and the date of acquisition
- Retained earnings as at the date of disposal (for the above);
- Goodwill arising on acquisition (using the net assets at the date of acquisition from the net assets summary)

Step 3: Calculate the profit or loss on disposal

Step 4: Include the profit or loss on disposal into the consolidated statement of profit or loss and finish it off.

Work through the following example carefully.

Example: Facts

Example: Disposal of subsidiary

The following financial statements are to the year-end 31 December 20X4

	H	S
Statements of profit or loss	Rs.000	Rs.000
Revenue	22,950	8,800
Expenses	(10,000)	(5,000)
Operating profit	12,950	3,800
Tax	(5,400	(2,150)
Profit after tax	7,550	1,650
Statement of changes in equity	Rs.000	Rs.000
Retained earnings b/f	3,760	1,850
Profit after tax	7,550	1,650
Retained earnings c/f	11,310	3,500

a. H Ltd bought 90% of S Ltd 4 years ago for Rs. 3,750,000 when the retained earnings of S ltd were Rs. 500,000.
   S Ltd has share capital of Rs. 3,000,000.

b. H Ltd sold its entire holding in S Ltd on 30 September 20X4 for Rs. 9,500,000.

c. S Ltd does not qualify to be treated as a discontinued operation under IFRS5.

Prepare the consolidated statement of profit or loss for the year ended 31 December 20X4.

Step 1: Reflect the pattern of ownership

Answer

	H	S (9/12)	Group
Statements of profit or loss	Rs.000	Rs.000	Rs.000
Revenue	22,950	6,600	29,550
Expenses	(10,000)	(3,750)	(13,750)
Operating profit	12,950	2,850	15,800
Profit on disposal (W)			
Profit before tax			
Tax	(5,400)	(1,612)	(7,012)
Profit after tax	7,550	1,238	

Profit attributable to:	Rs.000
Owners of the parent	
Non-controlling interest (10% of 1,238)	124
Profit for the year	

Step 2: Key workings

Answer

W1: Net assets summary

	At date of disposal	At date of acquisition
	Rs.000	Rs.000
Share capital	3,000	3,000
Retained earnings (W2)	3,088	500
Net assets	6,088	3,500

W2: Retained earnings at date of disposal	Rs.000
Retained earnings at start of year	1,850
Profit for the period up to the date of disposal (9/12 × 1,650,000)	1,238
	3,088

W3: Goodwill	Rs.000
Cost of investment	3,750
Non-controlling interest at acquisition (10% × 3,500,000 (W1))	350
	4,100
Net assets at acquisition (see above)	(3,500)
	600

Step 3: Profit on disposal

Answer

W4: Profit on disposal	Rs.000
Sale proceeds	9,500
Derecognise:	
Net assets at date of disposal (W1)	6,088
NCI at date of disposal (10% × 6,088,000 (W1))	(609)
	(5,479)
Goodwill (W3)	(600)
	3,421

Step 4: Complete the answer

Answer

H Plc: Consolidated statement of profit or loss for the year ended 31 December 20X4

	H	S (9/12)	Group
Statements of profit or loss	Rs.000	Rs.000	Rs.000
Revenue	22,950	6,600	29,550
Expenses	(10,000)	(3,750)	(13,750)
Operating profit	12,950	2,850	15,800
Profit on disposal (W)			3,421
Profit before tax			19,221
Tax	(5,400)	(1,612)	(7,012)
Profit after tax	7,550	1,238	12,209

Profit attributable to:	Rs.000
Owners of the parent (balancing figure)	12,085
Non-controlling interest (10% of 1,238)	124
Profit for the year	12,209

2 PART DISPOSALS

Section overview

- Part disposal with loss of control
- Part disposal with no loss of control

2.1 Part disposal with loss of control

As stated previously there are two major tasks in constructing a statement of profit or loss for a period during which there has been a disposal of a subsidiary:

- The statement of profit or loss must reflect the pattern of ownership of subsidiaries in the period.
- When control is lost, the statement of profit or loss must show the profit or loss on disposal of the subsidiary.

When a parent makes a part disposal of an interest in a subsidiary it will be left with a residual investment. The accounting treatment for a part disposal depends on the nature of the residual investment.

If a part disposal results in loss of control the parent must recognise a profit or loss on disposal in the consolidated statement of profit or loss.

The pattern of ownership must reflect the nature of the residual investment.

IFRS calculation of profit on disposal has been shown before but is repeated here for your convenience.

Illustration: Profit (loss) on disposal

	Rs.
Recognise:	
Proceeds	X
Fair value of residual interest (only for part disposals)	X
	X
Derecognise:	
Net assets of subsidiary	X
Non-controlling interest	(X)
Share of net assets	(X)
Unimpaired goodwill	(X)
	X

Example: Profit on part disposal of a subsidiary

H Ltd acquired 90% of the equity shares of S Ltd for Rs.120 million.

Goodwill on consolidation was Rs.18m

There had been no impairment of goodwill since the date of acquisition.

H Ltd sold a 50% holding (leaving it with a 40% holding) for Rs.100 million. This transaction resulted in H Ltd losing control of S ltd.

The fair value of the residual investment (i.e. the remaining 40%) was estimated to be Rs.70

The carrying value of the net assets of S Ltd at 31 December Year 9 was Rs.124 million.

The gain on disposal recognised in profit or loss should be calculated as follows:

Recognised:	Rs. m
Consideration received for shares in S Ltd on 31 December	100.0
Fair value of residual investment	70.0
	170.0
Derecognised:	
Net assets de-recognised	124.0
NCI (10% × 124 million)	(12.4)
	111.6
Goodwill derecognised	18.0
Net assets sold	(129.6)
Gain on disposal, reported in profit or loss	40.4

Practice question **2**

Paprika, the holding company of a large group, had bought 90% of the issued capital Saffron several years ago.

Both companies prepare accounts to 31 December each year.

On 31 October Year 5 Paprika sold 50% of its shareholding in Saffron for Rs. 540,000.

At this date, the carrying value of the net assets of Saffron was Rs. 800,000 and the carrying value of the goodwill relating to the acquisition of Saffron (all attributable to the parent company) was Rs. 100,000.

The fair value of the remaining investment in S is estimated at Rs.500,000.

What gain or loss should be recognised on the disposal of the shares in Saffron?

The same step by step approach shown earlier can be used to prepare answers to questions requiring a consolidated statement of profit or loss when there is a part disposal of a subsidiary during the year and that part disposal results in a loss of control.

Work through the following example carefully.

Example: Facts

Example: Part disposal (loss of control but leaving significant influence)

The following financial statements are to the year-end 31 December 20X4

	H	S
Statements of profit or loss	Rs.000	Rs.000
Revenue	22,950	8,800
Expenses	(10,000)	(5,000)
Operating profit	12,950	3,800
Tax	(5,400)	(2,150)
Profit after tax	7,550	1,650
Statement of changes in equity	Rs.000	Rs.000
Retained earnings b/f	3,760	1,850
Profit after tax	7,550	1,650
Retained earnings c/f	11,310	3,500

a. H Ltd bought 90% of S Ltd 4 years ago for Rs. 3,750,000 when the retained earnings of S ltd were Rs. 500,000.
S Ltd has share capital of Rs. 3,000,000.

b. H Ltd sold 50% of S Ltd on 30 September 20X4 for Rs. 5,000,000.

c. The remaining 40% investment in S Ltd held by H Ltd resulted in H Ltd having significant influence over S Ltd. This residual investment was estimated to have a fair value of Rs.3,500,000

d. S Ltd does not qualify to be treated as a discontinued operation under IFRS5.

Required

Prepare the consolidated statement of profit or loss for the year ended 31 December 20X4.

Step 1: Reflect the pattern of ownership

Answer

	H	S (9/12)	Group
Statements of profit or loss	Rs.000	Rs.000	Rs.000
Revenue	22,950	6,600	29,550
Expenses	(10,000)	(3,750)	(13,750)
Operating profit	12,950	2,850	15,800
Share of profits of associate ($40\% \times {}^{3}/_{12} \times 1{,}650$)			165
Profit on disposal (W)			
Profit before tax			
Tax	(5,400)	(1,612)	(7,012)
Profit after tax	7,550	1,238	

Profit attributable to:	Rs.000
Owners of the parent	
Non-controlling interest (10% of 1,238)	124
Profit for the year	

Step 2: Key workings

Answer

W1: Net assets summary

	At date of disposal	At date of acquisition
	Rs.000	Rs.000
Share capital	3,000	3,000
Retained earnings (W2)	3,088	500
Net assets	6,088	3,500

W2: Retained earnings at date of disposal	Rs.000
Retained earnings at start of year	1,850
Profit for the period up to the date of disposal (9/12 × 1,650,000)	1,238
	3,088

W3: Goodwill	Rs.000
Cost of investment	3,750
Non-controlling interest at acquisition (10% × 3,500,000 (W1))	350
	4,100
Net assets at acquisition (see above)	(3,500)
	600

Step 3: Profit on disposal

Answer

W4: Profit on disposal	Rs.000
Recognise	
Sale proceeds	5,000
Fair value of residual investment	3,500
	8,500
Derecognise:	
Net assets at date of disposal (W1)	6,088
NCI at date of disposal (10% × 6,088,000 (W1))	(609)
	(5,479)
Goodwill (W3)	(600)
	2,421

Step 4: Complete the answer

Answer

H Plc: Consolidated statement of profit or loss for the year ended 31 December 20X4

	H	S (9/12)	Group
Statements of profit or loss	Rs.000	Rs.000	Rs.000
Revenue	22,950	6,600	29,550
Expenses	(10,000)	(3,750)	(13,750)
Operating profit	12,950	2,850	15,800
Share of profits of associate ($40\% \times {}^{3}/_{12} \times 1{,}650$)			165
Profit on disposal (W)			2,421
Profit before tax			18,386
Tax	(5,400)	(1,612)	(7,012)
Profit after tax	7,550	1,238	11,374

Profit attributable to:	Rs.000
Owners of the parent (balancing figure)	11,250
Non-controlling interest (10% of 1,238)	124
Profit for the year	11,374

2.2 Part disposal with no loss of control

A part disposal which does not result in loss of control is a transaction between the owners of the subsidiary. In this case the parent does not recognise a profit or loss on disposal in the consolidated statement of profit or loss. Instead the parent recognises an equity adjustment.

Example: Part disposal with no loss of control

The following financial statements are to the year-end 31 December 20X4

	H	S
Statements of profit or loss	Rs.000	Rs.000
Revenue	22,950	8,800
Expenses	(10,000)	(5,000)
Operating profit	12,950	3,800
Tax	(5,400)	(2,150)
Profit after tax	7,550	1,650
Statement of changes in equity	Rs.000	Rs.000
Retained earnings b/f	3,760	1,850
Profit after tax	7,550	1,650
Retained earnings c/f	11,310	3,500

a. H Ltd bought 90% of S Ltd 4 years ago for Rs. 3,750,000 when the retained earnings of S ltd were Rs. 500,000.
S Ltd has share capital of Rs. 3,000,000.

b. H Ltd sold 10% of S Ltd on 30 September 20X4 for Rs. 1,000,000.

Required

Prepare the consolidated statement of profit or loss for the year ended 31 December 20X4 and calculate the equity adjustment necessary to reflect the change in ownership.

Step 1: Reflect the pattern of ownership and complete the statement of profit and loss

This is straightforward as the parent has held a subsidiary for the whole year. The only complication is that the results have to be time apportioned so that the relevant NCI can be measured.

Profit on disposal is **NOT** recognised where there is no loss of control.

Answer

	H	S	Group
Statements of profit or loss	Rs.000	Rs.000	Rs.000
Revenue	22,950	8,800	31,750
Expenses	(10,000)	(5,000)	(15,000)
Profit before tax	12,950	3,800	16,750
Tax	(5,400)	(2,150)	(7,550)
Profit after tax	7,550	1,650	9,200

Profit attributable to:	Rs.000
Owners of the parent (as a balancing figure)	8,993
Non-controlling interest	
(10% × 1,650 × $^{9}/_{12}$)	124
(20% × 1,650 × $^{3}/_{12}$)	83
	207
Profit for the year	9,200

Step 2: Key workings

Answer

W1: Net assets summary

	At date of disposal	At date of acquisition
	Rs.000	Rs.000
Share capital	3,000	3,000
Retained earnings (W2)	3,088	500
Net assets	6,088	3,500

W2: Retained earnings at date of disposal	Rs.000
Retained earnings at start of year	1,850
Profit for the period up to the date of disposal (9/12 × 1,650,000)	1,238
	3,088

W3: Goodwill	Rs.000
Cost of investment	3,750
Non-controlling interest at acquisition (10% × 3,500,000 (W1))	350
	4,100
Net assets at acquisition (see above)	(3,500)
	600

Step 3: Equity adjustment

Answer

W4: Profit on disposal	Rs.000
Sale proceeds	1,000
Net assets sold to the NCI (10% × 6,088,000 (W1))	(609)
	391

The double entry to record the equity adjustment is as follows:

	Debit	Credit
Cash	1,000	
Non-controlling interest		609
Retained earnings		391

3 DISPOSAL OF A SUBSIDIARY WHICH DOES NOT CONTAIN A BUSINESS

Section overview

- Background
- New rules

3.1 Background

This section explains an amendment to IFRS 10 and IAS 28. The amendment must be applied for annual periods beginning on or after 1 January 2016. Earlier application is permitted but must be disclosed.

The amendment concerns a situation where a parent loses control of a subsidiary that does not contain a business (as defined in IFRS 3) by selling an interest to an associate (or joint venture) accounted for using the equity method.

Such a transaction is the same as selling an asset to the associate (or joint venture).

Usually, if a parent loses control of a subsidiary, the parent must:

- derecognise the assets and liabilities of the former subsidiary from the consolidated statement of financial position.
- recognise any investment retained in the former subsidiary at its fair value when control is lost; and
- recognise the gain or loss associated with the loss of control in the statement of profit or loss.

In the case of a part disposal, the parent must measure any residual investment at its fair value with any gain or loss being recognised in the statement of profit or loss.

3.2 New rules

If the subsidiary sold does not contain a business (as defined in IFRS 3) by selling an interest to an associate (or joint venture) accounted for using the equity method the gain or loss resulting from the transaction is recognised in the parent's profit or loss only to the extent of the unrelated investors' interests in that associate or joint venture.

The remaining part of the gain is eliminated against the carrying amount of the investment in that associate or joint venture.

Also any residual investment must be revalued to fair value and usually the gain or loss is recognised in profit or loss.

The residual investment might be an associate (or joint venture) accounted for using the equity method. In that case the remeasurement gain or loss is recognised in profit or loss only to the extent of the unrelated investors' interests in the new associate or joint venture.

The remaining part of that gain is eliminated against the carrying amount of the investment retained in the former subsidiary.

Example: Loss of control of a subsidiary (that does not contain a business) by selling it to an associate

H Ltd owns 100% of S Ltd (a company which does not contain a business).

H Ltd owns 20% of A Ltd.

H Ltd sold 70% of S Ltd to A Ltd for Rs.210 million.

The fair value of the identifiable net assets in S Ltd at the date of the sale was Rs.100 million.

The fair value of the residual investment at the date of disposal was Rs.90 million.

The gain on disposal recognised in profit or loss should be calculated as follows:

	Rs. m
Consideration received for shares in S Ltd	210.0
Fair value of the residual interest	90.0
	300.0
Net assets de-recognised	(100.0)
Gain on disposal	200.0

H Ltd recognises the gain to the extent of the unrelated investors' interests. H Ltd 's interests and those of unrelated investors after the disposal are as follows:

Interests in A Ltd:	
H Ltd	20%
Unrelated investors	80%
Total	100%
Interests in S Ltd:	
H Ltd	
Direct interest	30%
Indirect interest (20% of 70%)	14%
	44%
Unrelated investors (80% of 70%)	56%
Total	100%

Example (continued): Loss of control of a subsidiary (that does not contain a business) by selling it to an associate

The gain must be analysed into that part which relates to the actual sale and that part which relates to the revaluation of the residual investment.

	Total	Sale	Revaluation
	Rs. m	Rs. m	Rs. m
Consideration received	210.0	210.0	90.0
Fair value of the residual interest	90.0		
	300.0		
Net assets de-recognised	(100.0)	(70.0)	(30.0)
Gain on disposal	200.0	140.0	60.0

The recognition of the gain is based on the ownership interests as follows:

	Sale	Revaluation
	Rs. m	Rs. m
Gain on disposal	140.0	60.0
Interests in A Ltd:		
H Ltd (20%)	28.0	
Unrelated investors (80%)	112.0	
Interests in S Ltd:		
H Ltd (44%)		26.0
Unrelated investors (56%)		34.0

The double entry to account for the disposal may be summarised as:

	Dr (Rs. m)	Cr (Rs. m)
Cash	210.0	
Net assets		100.0
Investment in S (90 – 26)	64.0	
Investment in A		28.0
Gain on disposal (reported in profit or loss) (112.0 + 34.0)		146.0
	274.0	274.0

4 IFRS 5 AND DISPOSALS

Section overview

- IFRS 5: Discontinued operations
- Presentation of discontinued operations
- Discontinued operations and disposals

4.1 IFRS 5: Discontinued operations

This was covered in an earlier chapter but is repeated here for your convenience.

IFRS 5 *Non-current assets held for sale and discontinued operations* sets out requirements for disclosure of financial information relating to discontinued operations.

A discontinued operation is a disposal group that satisfies extra criteria. (IFRS 5 does not say as much but this is a helpful way to think of it).

Definition

Discontinued operation - A component of an entity that either has been disposed of or is classified as held for sale and:

1. **represents a separate major line of business or geographical area of operations,**
2. **is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or**
3. **is a subsidiary acquired exclusively with a view to resale.**

A component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

A disposal group might be, for example, a major business division of a company.

4.2 Presentation of discontinued operations

Presentation in the statement of profit or loss

The following must be disclosed for discontinued operations:

- ❑ a single amount on the face of the statement of profit or loss comprising the total of:
  - the post-tax profit or loss of discontinued operations; and
  - the post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation.

4.3 Discontinued operations and disposals

A disposal might satisfy the discontinued operations criteria.

This will not affect measurement but will affect presentation.

The consolidation of the subsidiary up to the date of disposal is not carried out on a line by line basis. Instead, the profit after tax for this period combined with the profit (loss) on disposal and shown as a single figure.

The answer to the previous example is used below to show the difference.

Example: Disposal of subsidiary – Not a discontinued operation (as seen before)

H Ltd: Consolidated statement of profit or loss for the year ended 31 December 20X4

	H	S (9/12)	Group
Statements of profit or loss	Rs.000	Rs.000	
Revenue	22,950	6,600	29,550
Expenses	(10,000)	(3,750)	(13,750)
Operating profit	12,950	2,850	15,800
Profit on disposal (W)			3,421
Profit before tax			19,221
Tax	(5,400)	(1,612)	(7,012)
Profit after tax	7,550	1,238	12,209

Profit attributable to:	Rs.000
Owners of the parent (balancing figure)	12,085
Non-controlling interest (10% of 1,238)	124
Profit for the year	12,209

Example: Disposal of subsidiary – As a discontinued operation

H Ltd:
Consolidated statement of profit or loss for the year ended 31 December 20X4

	Group
Statements of profit or loss	Rs.000
Revenue	22,950
Expenses	(10,000)
Profit before tax	12,950
Tax	(5,400)
Profit for the period from continuing operations	7,550
Profit for the year from discontinued operations (1,238 + 3,421)	4,659
Profit for the year	12,209
Profit attributable to:	Rs.000
Owners of the parent (balancing figure)	12,085
Non-controlling interest (10% of 1,238)	124
Profit for the year	12,209

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

	Rs.
Proceeds received	460,000
Net assets disposed of at carrying value	400,000
Attributable to non-controlling interests (20%)	(80,000)
	320,000
Unimpaired goodwill attributable to P	21,200
Gain to equity owners of P on disposal of S	341,200
Gain on disposal, reported in profit or loss	118,800

Goodwill on the acquisition attributable to P:
= Rs.330,000 - (80% × Rs.280,000) = Rs.106,000

Goodwill remaining after accumulated impairment (20% × Rs.106,000) = Rs.21,200.

Solution **2**

	Rs.
Proceeds received from sale of shares	540,000
Fair value of remaining investment in S	500,000
	1,040,000
Net assets disposed of at carrying value	800,000
Attributable to non-controlling interests (20%)	(80,000)
	720,000
Unimpaired goodwill attributable to P	100,000
Gain to equity owners of P on disposal of S	(820,000)
Gain on disposal, reported in profit or loss	220,000

CHAPTER 25

Other group standards

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

PRESENTATION OF FINANCIAL STATEMENTS INCLUDING PUBLIC SECTOR ACCOUNTING

A 2 IAS 27: Separate financial statements

A 6 IFRS 12: Disclosure of interests in other entities

1 IAS 27 SEPARATE FINANCIAL STATEMENTS

Section overview

- Introduction to IAS 27
- Preparation of separate financial statements
- Disclosure

1.1 Introduction to IAS 27

IAS 27 contains accounting and disclosure requirements for investments in subsidiaries, joint ventures and associates when an entity prepares separate financial statements.

IAS 27 requires an entity preparing separate financial statements to account for those investments at cost or in accordance with IFRS 9 *Financial Instruments*.

IAS 27 does say which entities must produce separate financial statements.

Definition

Separate financial statements: Those presented by a parent or an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with IFRS 9 Financial Instruments

Separate financial statements are those presented in addition to consolidated financial statements or in addition to financial statements in which investments in associates or joint ventures are accounted for using the equity method.

However, if a company is exempt from the need to consolidate or account for an investment using the equity method the separate financial statements are its only financial statements.

1.2 Preparation of separate financial statements

Separate financial statements must be prepared in accordance with all applicable IFRSs.

Investments in subsidiaries, joint ventures and associates must be accounted for in separate financial statements, either:

- ❑ at cost; or
- ❑ in accordance with IFRS 9.

A company must apply the same accounting for each category of investments.

A recent amendment issued in August 2014 extends this choice to allow an entity to use the equity method in addition to the other two methods. The amendment applies for annual periods beginning on or after 1 January 2016. However, earlier application is permitted but if used it must be disclosed.

Investments accounted for at cost are subject to the rules in IFRS 5 when they are classified as held for sale.

IAS 28 Investments in Associates and Joint ventures allows a company to measure its investments in associates or joint ventures at fair value through profit or loss. Such investments must be accounted for in the same way in its separate financial statements.

Dividends are recognised in profit or loss in separate financial statements when the right to receive the dividend is established.

1.3 Disclosure

All applicable IFRSs apply when providing disclosures in separate financial statements as well as the following requirements.

When a parent prepares separate financial statements, it must disclose:

- ❑ the fact that the financial statements are separate financial statements;
- ❑ a list of significant investments in subsidiaries, joint ventures and associates, including:
  - the name of those investees.
  - the principal place of business (and country of incorporation, if different) of those investees.
  - its proportion of the ownership interest (and its proportion of the voting rights, if different) held in those investees.
- ❑ a description of the method used to account for the investments listed.

In addition, if a parent is exempt from preparing consolidated financial statements and elects not to do so, and instead prepares separate financial statements, it must disclose:

- ❑ the fact that the financial statements are separate financial statements;
- ❑ that the exemption from consolidation has been used;
- ❑ the name and principal place of business (and country of incorporation, if different) of the entity whose consolidated financial statements that comply with IFRS have been produced for public use; and
- ❑ the address where those consolidated financial statements are obtainable.

2 IFRS 12: DISCLOSURE OF INTERESTS IN OTHER ENTITIES

Section overview

- Introduction to IFRS 12
- Significant judgements and assumptions
- Interests in subsidiaries
- Interests in joint arrangements and associates
- Structured entities

2.1 Introduction to IFRS 12

The objective of IFRS 12 is to require companies to disclose information that enables users of their financial statements to evaluate:

- the nature of, and risks associated with, its interests in other entities; and
- the effects of those interests on its financial position, financial performance and cash flows.

This requires disclosure of:

- the significant judgements and assumptions it has made in determining the nature of its interest in another entity or arrangement, and in determining the type of joint arrangement in which it has an interest; and
- information about its interests in:
  - subsidiaries;
  - joint arrangements and associate); and
  - structured entities that are not controlled by the entity (unconsolidated structured entities).

IFRS 12 sets out required disclosures but disclosure of additional information might be necessary to meet IFRS 12's objective.

IFRS 12 must be applied by a company that has an interest in any of the following:

- subsidiaries;
- joint arrangements (i.e. joint operations or joint ventures);
- associates;
- unconsolidated structured entities.

2.2 Significant judgements and assumptions

A company must disclose information about significant judgements and assumptions it has made (and changes to those judgements and assumptions) in determining:

- that it has control of another entity;

- ❑ that it has joint control of an arrangement or significant influence over another entity; and
- ❑ the type of joint arrangement (i.e. joint operation or joint venture) when the arrangement has been structured through a separate vehicle.

To comply with the above a company must disclose, for example, significant judgements and assumptions made in determining that:

- ❑ it does not control another entity even though it holds more than half of the voting rights of the other entity;
- ❑ it controls another entity even though it holds less than half of the voting rights of the other entity;
- ❑ it does not have significant influence even though it holds 20% or more of the voting rights of another entity;
- ❑ it has significant influence even though it holds less than 20% of the voting rights of another entity.

2.3 Interests in subsidiaries

A company must disclose information that enables users of its consolidated financial statements

- ❑ to understand:
  - the composition of the group; and
  - the interest that non-controlling interests have in the group's activities and cash flows; and
- ❑ to evaluate:
  - the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group;
  - the nature of, and changes in, the risks associated with its interests in consolidated structured entities;
  - the consequences of changes in its ownership interest in a subsidiary that do not result in a loss of control; and
  - the consequences of losing control of a subsidiary during the reporting period.

When the financial statements of a subsidiary used in the preparation of consolidated financial statements are as of a date or for a period that is different from that of the consolidated financial statements, a company must disclose:

- ❑ the date of the end of the reporting period of the financial statements of that subsidiary; and
- ❑ the reason for using a different date or period.

Non-controlling interests

A company must disclose for each of its subsidiaries that have non-controlling interests that are material to the reporting entity:

- ❑ the name of the subsidiary;

- the principal place of business (and country of incorporation if different) of the subsidiary;
- the proportion of ownership interests held by non-controlling interests;
- the proportion of voting rights held by non-controlling interests, if different from the proportion of ownership interests held;
- the profit or loss allocated to non-controlling interests of the subsidiary during the reporting period;
- accumulated non-controlling interests of the subsidiary at the end of the reporting period; and
- summarised financial information about the subsidiary.

The nature and extent of significant restrictions

A company must disclose:

- any significant restrictions on its ability to access or use the assets and settle the liabilities of the group, such as:
  - those that restrict the ability of a parent or its subsidiaries to transfer cash or other assets to (or from) other entities within the group;
  - guarantees or other requirements that may restrict dividends and other capital distributions being paid, or loans and advances being made or repaid, to (or from) other entities within the group; and
- the carrying amounts in the consolidated financial statements of the assets and liabilities to which those restrictions apply.

Consequences of losing control of a subsidiary during the reporting period

A company must disclose the gain or loss arising on the loss of control of a subsidiary during the period together with the line item(s) in profit or loss in which the gain or loss is recognised (if not presented separately).

2.4 Interests in joint arrangements and associates

A company must disclose information that enables users of its financial statements to evaluate:

- the nature, extent and financial effects of its interests in joint arrangements and associates, including the nature and effects of its contractual relationship with the other investors with joint control of, or significant influence over, joint arrangements and associates; and
- the nature of, and changes in, the risks associated with its interests in joint ventures and associates.

Nature, extent and financial effects of interests in joint arrangements and associates

A company must disclose:

- for each material joint arrangement and associate:
  - the name of the joint arrangement or associate.

- the nature of the entity's relationship with the joint arrangement or associate;
- the principal place of business (and country of incorporation, if applicable and different from the principal place of business) of the joint arrangement or associate.
- the proportion of ownership interest or participating share held by the entity and, if different, the proportion of voting rights held (if applicable).

❑ for each material joint venture and associate that is material to the reporting entity:

- whether the investment in the joint venture or associate is measured using the equity method or at fair value.
- summarised financial information about the joint venture or associate.
- if the joint venture or associate is accounted for using the equity method, the fair value of its investment in the joint venture or associate, if there is a quoted market price for the investment.

❑ financial information about the entity's investments in joint ventures and associates that are not individually material:

- in aggregate for all individually immaterial joint ventures and, separately,
- in aggregate for all individually immaterial associates.

A company must also disclose:

❑ the nature and extent of any significant restrictions on the ability of joint ventures or associates to transfer funds to the entity in the form of cash dividends, or to repay loans or advances made by the entity.

❑ when the financial statements used in applying the equity method are as of a date or for a period that is different from that of the entity:

- the date of the end of the reporting period of the financial statements of that joint venture or associate; and
- the reason for using a different date or period.

❑ the unrecognised share of losses of a joint venture or associate, both for the reporting period and cumulatively, if the entity has stopped recognising its share of losses of the joint venture or associate when applying the equity method.

Risks associated with an entity's interests in joint ventures and associates

A company must disclose:

❑ commitments that it has relating to its joint ventures separately from the amount of other commitments

❑ contingent liabilities incurred relating to its interests in joint ventures or associates (unless the probability of loss is remote)

2.5 Structured entities

Definition

Structured entity: An entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.

A structured entity might be consolidated or unconsolidated depending on the results of the analysis of whether control exists.

Consolidated structured entities

A company must disclose the terms of any contractual arrangements that could require the parent or its subsidiaries to provide financial support to a consolidated structured entity.

A company must also disclose any support given where there is no contractual obligation and any intention to provide financial or other support to a consolidated structured entity.

Unconsolidated structured entities

A company must disclose information that enables users of its financial statements:

- to understand the nature and extent of its interests in unconsolidated structured entities; and
- to evaluate the nature of, and changes in, the risks associated with its interests in unconsolidated structured entities.

CHAPTER 26

Foreign currency

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 22 IAS 21: The effects of changes in foreign exchange rates

1 IAS 21: THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

Section overview

- The scope of IAS 21
- The two main accounting issues
- Terms and definitions used in IAS 21: currency definitions
- Terms and definitions used in IAS 21: other definitions

1.1 The scope of IAS 21

Many businesses have transactions and investments that are denominated in a foreign currency.

- Individual companies often enter into transactions in a foreign currency. These transactions need to be translated into the company's own currency in order to record them in its ledger accounts. For example:
  - a Pakistani company may take out a loan from a French bank in euros but will record the loan in its ledger accounts in rupees; or
  - a Pakistani company may sell goods to a Japanese company invoiced in yen but will record the sale and the trade receivable in rupees in its ledger accounts.
- Groups often contain overseas entities. A parent company might own a foreign subsidiary or associate. This foreign entity will normally maintain its accounting records and prepare its financial statements in a currency that is different from the currency of the parent company and the group's consolidated accounts.
  - For example, if a Pakistani company has a US subsidiary, the financial statements of the US subsidiary will be prepared in US dollars, but will need to be translated into rupees for the purpose of preparing the group's consolidated financial statements.

The rules on accounting for foreign currency items are concerned with translating or converting items from one currency into another currency, at an appropriate rate of exchange between the currencies. The rules are mostly contained in IAS 21 *The effects of changes in foreign exchange rates*. The rules in IAS 21 can be divided into two areas:

- Transactions affecting individual entities. IAS 21 deals with the translation of these transactions when they occur and at subsequent reporting dates when re-translation at a different exchange rate may be necessary.
- Foreign operations (subsidiaries, associates etc) which affect the consolidated financial statements. The rules in IAS 21 explain how to translate the financial statements of the foreign subsidiaries, associates or joint ventures. Once translated, the normal consolidation rules or equity accounting rules will apply.

One area that IAS 21 does not deal with is the translation of any transactions and balances that fall within the scope of IAS 39/IFRS 9 on financial instruments. For

example, if a company takes out a forward foreign exchange contract to hedge against foreign currency exposure, the accounting treatment is covered by the rules in IAS 39, because a forward contract is a financial instrument.

1.2 The two main accounting issues

Transactions and assets and liabilities in foreign currencies are translated or converted from the foreign currency into the currency of the reporting entity. The process of translation would be quite simple if exchange rates between currencies remained fixed. However, exchange rates are continually changing. The translated valuation of foreign currency assets or liabilities in the statement of financial position might therefore change if they are translated at different times.

The two main accounting issues when accounting for foreign currency items are:

- What exchange rate(s) should be used for translation?
- How to account for the gains or losses that arise when exchange rates change?

Before looking at these accounting rules in detail, it is important to understand the precise meaning of some key terms used in IAS 21.

1.3 Terms and definitions used in IAS 21: currency definitions

IAS 21 identifies three types of currency: the presentation currency, the functional currency and foreign currency.

Definitions

Presentation currency: The currency in which the financial statements of an entity are presented

Functional currency: The currency of the primary economic environment in which an entity operates.

Foreign currency: A currency other than the functional currency of the entity

Presentation currency

An entity is permitted to present its financial statements in any currency. This reporting currency is often the same as the functional currency, but does not have to be.

Functional currency

When a reporting entity records transactions in its financial records, it must identify its functional currency and make entries in that currency. It will also, typically, prepare its financial statements in its functional currency. This rule applies to stand-alone entities, parent companies and foreign operations (such as a foreign subsidiary or a branch). When financial statements prepared in a functional currency are translated into a different presentation currency, the translation of assets and liabilities must comply with the rules in IAS 21.

IAS 21 describes the functional currency as:

- The currency that mainly influences:

- sales prices for goods and services
- labour, material and other costs of providing goods or services.

❑ The currency in which funds are generated by issuing debt and equity

❑ The currency in which receipts from operating activities are usually retained.

The functional currency is not necessarily the currency of the country in which the entity operates or is based, as the next example shows.

Example: Presentation and functional currencies

P is a UK-registered mining company whose shares are traded on the London Stock Exchange. Its operating activities take place in the gold and diamond mines of South Africa.

(a) What is the presentation currency of P?

(b) What is its functional currency?

(c) P bought specialised mining equipment from the US, invoiced in US dollars. What type of currency is the US dollar, using the IAS 21 definitions?

Answer

(a) The presentation currency (reporting currency) is sterling (UK pounds). This is a requirement of the UK financial markets regulator for UK listed companies.

(b) The functional currency is likely to be South African rand, even though the company is based in the UK. This is because its operating activities take place in South Africa and so the company will be economically dependent on the rand if the salaries of most of its employees, and most operating expenses and sales are in rand.

(c) The US dollars are 'foreign currency' for the purpose of preparing P's accounts.

IAS 21 requires P to prepare its financial statements in its functional currency (rand).

However, P is permitted to use sterling as its presentation currency. If it does use sterling as its presentation currency (which it will do, given the UK rules), the translation of assets and liabilities from rand to sterling must comply with the rules in IAS 21.

1.4 Terms and definitions used in IAS 21: other definitions

Exchange rate definitions

IAS 21 uses the following terms to describe which exchange rate should be used in the translation.

Definitions

Exchange rate: The rate of exchange between two currencies

Spot rate: The exchange rate at the date of the transaction

Closing rate: The spot exchange rate at the end of the reporting period

For example, suppose that on 16 November a German company buys goods from a US supplier, and the goods are priced in US dollars. The financial year of the company ends on 31 December, and at this date the goods have not yet been paid for.

- The spot rate is the euro/dollar exchange rate on 16 November, when the transaction occurred.
- The closing rate is the exchange rate at 31 December.

Other definitions

IAS 21 also includes some other terms and definitions.

Definitions

Foreign operation: This is a subsidiary, associate, joint venture or branch whose activities are conducted in a country or currency different from the functional currency of the reporting entity.

Net investment in a foreign operation: The amount of the reporting entity's interest in the net assets of a foreign operation.

Exchange difference: A difference resulting from translating the same assets, liabilities, income or expenses from one currency into another currency at different exchange rates.

Monetary items: Units of currency held, or assets and liabilities to be received or paid (in cash), in a fixed number of currency units. Examples of monetary items include cash itself, loans, trade payables, trade receivables and interest payable.

Non-monetary items are not defined by IAS 21, but they are items that are not monetary items. They include tangible non-current assets, investments in other companies, investment properties and deferred taxation (which is a notional amount of tax rather than an actual amount of tax payable.)

2 THE INDIVIDUAL ENTITY: ACCOUNTING RULES

Section overview

- Introduction
- Initial recognition: translation of transactions
- Reporting at the end of each reporting period and gain or loss arising on translation
- Reporting at the settlement of a transaction

2.1 Introduction

An individual company may have transactions that are denominated in a foreign currency. These must be translated into the company's functional currency for the purpose of recording the transactions in its ledger accounts and preparing its financial statements.

These transactions may have to be translated on several occasions. When a transaction or asset or liability is translated on more than one occasion, it is:

- translated at the time that it is originally recognised;, and
- re-translated at each subsequent occasion.

Re-translation may be required, after the transaction has been recognised initially:

- at the end of a financial year (end of a reporting period);
- when the transaction is settled (which may be either before, or after the end of the financial year).

On each subsequent re-translation, an exchange difference will occur. This gives rise to a gain or loss on translation from the exchange difference.

2.2 Initial recognition: translation of transactions

On initial recognition, a transaction in a foreign currency must be translated at the **spot rate** on the date of the transaction.

If the company purchases goods on most days in the foreign currency, it might be administratively difficult to record every transaction at the actual spot rate. For practical reasons, IAS 21 therefore allows entities to use an **average rate** for a time period, provided that the exchange rate does not fluctuate significantly over the period.

For example, an entity might use an average exchange rate for a week or a month for translating all the foreign currency-denominated transactions in that time period.

These rules apply when an entity:

- buys or sells goods or services that will be paid for in a foreign currency;
- borrows or lends money when the interest payments and repayments of principal are in a foreign currency;

- purchases or disposes of non-current assets in another currency; or
- receives dividends and other payments in another currency.

Example: Initial recognition

A Pakistani company (with the rupee as its functional currency) has a financial year ending on 31 December.

It buys goods from an Australian supplier (with the Australian dollar as its functional currency) on 1 December 20X6 invoiced in A$10,000.

The Australian supplier is eventually paid in March 20X7.

Exchange rates over the period were as follows:

1 December 20X6 Rs.75/A$1

The purchase/inventory and the trade payable should be recorded initially by translating the transaction at the spot rate of Rs.75/A$1.

This gives a translated value of Rs. 750,000 for recording in the ledger accounts (Rs.75 × A$10,000).

On 1 December 20X6

	Debit	Credit
Purchases	Rs. 750,000	
Payables (Rs. 75 × A$10,000)		Rs. 750,000

Being the initial recognition of a purchase of inventory in a foreign currency

Note that for practical purposes, if the entity buys items in A$ frequently, it may be able to use an average spot rate for a period, for all transactions during that period.

For example, if the Pakistani company bought items from Australia on an ongoing basis it might adopt a policy of translating all purchases in a month at the average rate for that month.

2.3 Reporting at the end of each reporting period and gain or loss arising on translation

Transactions in a foreign currency are recognised initially at the spot rate on the date of the transaction.

Balances resulting from such transactions may still 'exist' in the statement of financial position at the end of the financial period.

Exchange rates change over time and the exchange rate at the end of the reporting period will not be the same as the spot rate on the date of the transaction.

Retranslation of items at a later date will lead to gains or losses if the rates have moved.

The gain or loss is the difference between the original and re-translated value of the item.

- There is an exchange **gain** when an asset increases in value on re-translation, or when a liability falls in value.
- There is an exchange **loss** when an asset falls in value on re-translation, or when a liability increases in value.

The rules in IAS 21 for reporting assets and liabilities at the end of a subsequent reporting period make a distinction between:

- monetary items, such as trade payables and trade receivables, and
- non-monetary items, such as non-current assets and inventory.

The rules are as follows, for entities preparing their individual financial statements:

Asset or liability	Accounting treatment	Treatment of exchange difference
Monetary items	Re-translate at the closing rate.	Recognised in P&L
Non-monetary items carried at cost	No re-translation. The transaction is left at the original spot rate.	Not applicable
Non-monetary items carried at fair value	Re-translate at the exchange rate ruling at the date of the fair value adjustment.	Recognised in the same location as the revaluation gain or loss

Example: Subsequent measurement of monetary amount

A Pakistani company (with the rupee as its functional currency) has a financial year ending on 31 December.

It buys inventory from an Australian supplier (with the Australian dollar as its functional currency) on 1 December 20X6 invoiced in A$10,000.

The Australian supplier is eventually paid in March 20X7.

Exchange rates over the period were as follows:

1 December 20X6 Rs.75/A$1

31 December 20X6 Rs.78/A$1

The transaction would be recorded as follows:

On 1 December 20X6

	Debit	Credit
Purchases	Rs. 750,000	
Payables (Rs. 75 × A$10,000)		Rs. 750,000

Being the initial recognition of a purchase of inventory in a foreign currency

On 31 December 20X6

	Debit	Credit
Statement of profit or loss	Rs. 30,000	
Payables		Rs. 30,000

Being the recognition of the exchange loss arising on the retranslation of a payable denominated a foreign currency.

Working

	Rs.
Liability on initial recognition	750,000
Exchange loss (balancing figure)	30,000
Liability on retranslation at the year-end (Rs. 78 × A$10,000)	780,000

In the above example the Pakistani company had purchased inventory. Even if this were still held at the year-end it would not be retranslated as it is a non-monetary asset.

Sometimes there might be a movement on the carrying amount of a balance denominated in a foreign currency during a period. The exchange difference could be calculated by applying the above approach. However, this can be time consuming where there is a lot of movements. An easier approach is to find the exchange difference as a balancing figure.

Example: Retranslation of monetary item with movement on the account

A Pakistani company whose functional currency is the rupee paid $90,000 into a dollar account on 30 June.

The company paid an additional $10,000 into the account on 30 September.

There were no other movements on this account.

Exchange rates over the period were as follows:

30 June: Rs.100/$.

30 September Rs.99/$.

31 December (year-end): Rs.95/$.

The exchange difference arising at 31 December can be calculated as follows:

	Exchange difference: gain or (loss)		
a	On re-translating June amount	Rs.	Rs.
	$90,000 at rate of 100	9,000,000	
	$90,000 at closing rate of 95	8,550,000	
	Exchange loss		450,000
b	On re-translating September amount:		
	$10,000 at average rate of 99	990,000	
	$10,000 at closing rate of 95	950,000	
	Exchange loss		40,000
	Exchange loss		490,000

There is an exchange loss because the company has a dollar asset but the dollar has weakened against the rupee over the period.

This approach might be cumbersome if there are more than a few movements on an account. The following approach simply records all items at the appropriate rates and identifies the exchange difference as a balancing figure.

	$	Rate	Rs.
Balance at start (30 June)	90,000	100	9,000,000
Amount paid in (30 Sept.)	10,000	99	990,000
Exchange loss			(490,000)
Balance at end (31 Dec.)	100,000	95	9,500,000

Example: Retranslation of monetary item with movement on the account

A Pakistani company whose functional currency is the rupee borrowed $90,000 on 30 June.

The company recognised an interest accrual of $10,000 at its year-end (31 December).

There were no other movements on this account.

Exchange rates over the period were as follows:

30 June: Rs.100/$.

Average for the period Rs.99/$.

31 December (year-end): Rs.95/$.

There is no rule in IAS 21 as to what rate should be used for the accrual of interest. The accrual could be deemed to arise over the period in which case the average rate would be used or it could be treated as a year-end transaction in which case the closing rate would be used. The profit for the period is not affected by the choice of rate as there would be a compensating adjustment in the amount of the exchange difference.

This is demonstrated below.

Exchange difference (interest at closing rate)

	$	Rate	Rs.
Balance at start (30 June)	90,000	100	9,000,000
Interest	10,000	95	950,000
Exchange gain			(450,000)
Balance at end (31 Dec.)	100,000	95	9,500,000

Exchange difference (interest at average rate)

	$	Rate	Rs.
Balance at start (30 June)	90,000	100	9,000,000
Interest	10,000	99	990,000
Exchange gain			(490,000)
Balance at end (31 Dec.)	100,000	95	9,500,000

There is an exchange gain because the company has a dollar liability but the dollar has weakened against the rupee over the period.

The balancing figure approach can be used in any situation where there are movements on an amount denominated in a foreign currency.

For example, when consolidating foreign subsidiaries the parent consolidated the subsidiary's net assets at the start of the period (in last year's consolidated statement of financial position) and its profit for the period (in this year's consolidated statement of profit or loss. These two figures will sum to the subsidiary's net assets at the end of the period in the foreign currency but not when translated into rupees. The difference is an exchange gain or loss.

This will be covered in a later section.

Revaluations of non-current assets

A non-current asset in a foreign currency might be re-valued during a financial period.

For example, a Pakistani company might own an office property in Thailand. The cost of the office would have been translated at the spot rate when the property was originally purchased. However, it might subsequently have been revalued. The revaluation will almost certainly be in Thai baht. This revalued amount must be translated into the functional currency of the entity (in this example, rupees).

Any gain or loss arising on retranslation of this property is recognised in the same place as the gain or loss arising on the revaluation that led to the retranslation.

- If a revaluation gain had been recognised in other comprehensive income in accordance with IAS 16, the exchange difference would also be recognised in other comprehensive income.
- If a revaluation gain had been recognised in profit or loss in accordance with IAS 40, the exchange difference would also be recognised in profit or loss.

Example: Subsequent measurement of monetary amount

A Pakistani company (with the rupee as its functional currency) has a financial year ending on 31 December.

It bought a building in Bahrain on 1 December 20X6 for 100,000 Bahraini dinar (BD).

The building was revalued to BD 120,000 on 31 December 20X6 as permitted by IAS 16.

Exchange rates:

1 December 20X6 Rs.275/BD1

31 December 20X6 Rs.290/BD1

The transaction would be recorded as follows:

On 1 December 20X6

	Debit	Credit
Property, plant and equipment	27,500,000	
Payables (Rs. 275 × BD100,000)		27,500,000

Being the initial recognition of building bought in a foreign currency

On 31 December 20X6

	Debit	Credit
Property, plant and equipment (5,800,000 + 1,500,000)	7,300,000	
Other comprehensive income		7,300,000

Being the recognition of revaluation gain and exchange gain on retranslation of carrying amount of a building denominated a foreign currency.

Example (continued): Subsequent measurement of monetary amount

Working

	BD	Rate	Rs.
Building on initial recognition	100,000	275	27,500,000
Revaluation (year-end)	20,000	290	5,800,000
Exchange gain			1,500,000
Building at year end	120,000	290	34,800,000

If the building was an investment property, revalued following the rules in IAS 40 the credit of Rs.7,300,000 would be to the statement of profit or loss.

Practice question **1**

A Pakistani company bought a machine from a German supplier for €200,000 on 1 March when the exchange rate was Rs. 120/€.

By 31 December, the end of the company's accounting year, the exchange rate was Rs. 110/€.

At 31 December, the Pakistani company had not yet paid the German supplier any of the money that it owed for the machine.

Required

Show the amounts that must be recognised to record this transaction.

2.4 Reporting at the settlement of a transaction

The settlement of a foreign currency transaction involves a receipt or payment in foreign currency. The receipt or payment is a transaction in its own right and must be recorded at the rate ruling at the date of the receipt or payment.

There will be exchange difference when the exchange rate at the date of settlement is different to that at the date of initial recognition of the receivable or payable in question. This is recognised in the statement of profit or loss.

Example: Settlement of a transaction

A Pakistani company sells goods to a customer in Saudi Arabia for SR 72,000 on 12 September, when the exchange rate was Rs.28/SR (Saudi riyal).

It received payment on 19 November, when the exchange rate was Rs.30/SR.

The financial year-end is 31 December.

The sale will be initially translated at the spot rate giving rise to revenue and receivables of Rs. 2,016,000 (SR 72,000 × Rs.28).

The receipt of the payment is recorded at Rs. 2,160,000 (SR 72,000 × Rs.30).

The necessary double entries are as follows:

On 19 September

	Debit	Credit
Receivables	2,016,000	
Revenue		2,016,000

On 19 November

	Debit	Credit
Cash	2,160,000	
Receivables		2,016,000
Exchange gain (statement of profit or loss)		144,000

3 THE FOREIGN OPERATION: ACCOUNTING RULES

Section overview

- Three stages in the consolidation process
- The translation stage
- The consolidation stage
- Consolidation example
- Consolidated statement of profit or loss and other comprehensive income
- Disposal of a foreign subsidiary

3.1 Three stages in the consolidation process

If a company has a foreign operation (such as a foreign subsidiary) that prepares its accounts in a functional currency that is different from the group's presentation currency, there are three stages in the accounting process, for the purpose of preparing consolidated financial statements (or including the foreign associate or joint venture in the financial statements of the reporting entity).

Stage	Description
Adjust and update	▪ Ensure that the individual financial statements of the foreign entity are correct and up-to-date. ▪ If any adjustments are required to correct the financial statements of the foreign entity, these should be made in the statements of the foreign entity and in its own functional currency.
Translate	▪ The assets and liabilities of the foreign entity should be translated into the presentation currency of the parent company. (As explained earlier, the presentation currency of the parent company might be the same or might be different from its functional currency.) ▪ The rules for translation are explained below.
Consolidate	▪ After translation, all the financial statements are now in the same currency. ▪ Normal group accounting principles are now used to prepare the consolidated accounts of the group.

Given the time pressure in the exam you might consider setting up a proforma answer to allow you to consolidate translated figures as you go along. In other words try to do stage 2 and part of stage 3 together. This will allow you to build quickly the easier part of the answer leaving time to concentrate on the trickier parts.

3.2 The translation stage

The rules set out below apply where the functional currency of the foreign entity is not a currency suffering from hyperinflation. (Hyperinflation is where the country's rate of inflation is very high. When there is hyperinflation, IAS 29 provides special accounting rules, which are described later.)

The normal rules for translation, contained in IAS 21, are as follows:

(1) **The statement of financial position**

- The assets and liabilities of the foreign operation are translated at the **closing rate** for inclusion in the consolidated statement of financial position.
- This is different to the rule for transactions arising at the individual entity level. Both monetary and non-monetary amounts of subsidiaries are translated at the closing rate.
- This rule also applies to **purchased goodwill** arising on the acquisition of a foreign subsidiary.

(2) **The statement of profit or loss**

- Income and expenses are translated at the rates ruling at the date of the transaction (**spot rates**) for inclusion in the consolidated statement of profit or loss.
- For practical reasons, **average rates** for a period may be used as long as they provide a reasonable approximation of the spot rates when the transactions took place. Average rates are widely used in practice.

(3) **Exchange differences**

- All resulting exchange differences are recognised in other comprehensive income for the period and are credited (gain) or debited (loss) to a **separate reserve** within the equity section of the consolidated statement of financial position, and this reserve is maintained within equity until the foreign operation is eventually disposed of.
- Gains or losses are therefore reported as gains or losses in other comprehensive income and movements in the separate reserve, and not as a gain or loss in profit or loss and an increase or reduction in retained earnings.

The gain or loss on translation

The exchange differences on translation (see (3) above) result in a gain or loss. These gains or losses arise from a combination of two factors:

- ❑ Income and expense items are translated at the exchange rates ruling during the period (or an average rate as an approximation) but assets and liabilities are translated at closing rates. The profit is therefore calculated at the actual (average) exchange rates, but the accumulated profit in the

consolidated statement of financial position is re-translated at the closing rate.

- The net assets of the subsidiary were translated at last year's closing rate at the end of the previous financial year. These net assets have now been retranslated and included in this year's statement of financial position at this year's closing rate.

IAS 21 states that these differences on translation are not recognised in profit or loss because changes in the exchange rates for these items have little or no effect on cash flows from operations. It would therefore be misleading to include them in profit or loss.

Example: Exchange difference arising on retranslation of a foreign subsidiary

A Pakistani parent company has a Singapore subsidiary, which is 80% owned.

The following information is available about the subsidiary for the year to 31 December:

	S$
Opening net assets, 1 January	16,000
Retained profit for the year	6,000
Closing net assets, 31 December	22,000

Relevant Rs./S$ exchange rates are as follows:

1 January	Rs.75/$
Average for the year	Rs.80/$
31 December	Rs.85/$

The exchange difference arising can be calculated as follows:

Exchange difference

	$	Rate	Rs.
Opening net assets	16,000	75	1,200,000
Retained profit for the year	6,000	80	480,000
Exchange gain			190,000
Closing net assets	22,000	85	1,870,000

Note that the Rs. 190,000 would be reported as a gain in other comprehensive income.

The amount attributable to the parent of Rs. 152,000 (80% of Rs. 190,000) would then be recognised in a currency translation reserve.

The amount attributable to the non-controlling interest is Rs. 38,000 (20% of Rs. 190,000). This would be recognised in the non-controlling interest balance in the statement of financial position.

Practice question **2**

A Pakistani parent company has a US subsidiary, which is 100% owned.

The following information is available about the subsidiary for the year to 31 December Year 5:

Opening net assets, 1 January	$20,000
Profit for the year	$10,000
Closing net assets, 31 December	$30,000
Dividends paid	$0

Relevant Rs./$ exchange rates are as follows:

1 January Year 5	Rs.100/$
Average for the year	Rs.106/$
31 December Year 5	Rs.110/$

Required

Calculate the total gain or loss on translation for the year.

Analyse it into:

a. the gain or loss on re-translating profit in the year; and
b. the gain or loss on re-translating the opening net assets.

3.3 The consolidation stage

After the translation stage, the financial statements of the overseas entity are in the presentation currency of the parent company.

Consolidation can proceed as normal. However, there are several issues to be aware of:

- Goodwill must be retranslated at each reporting date; and
- A foreign exchange reserve must be included in the consolidated statement of financial position for the cumulative exchange differences.

Purchased goodwill and foreign subsidiaries

A net assets working can be constructed for the subsidiary. This should be constructed in the foreign currency to identify the net asset balances in the foreign currency at the dates of consolidation and acquisition. These are then translated into the parent's currency using the appropriate rate. This will be shown later.

IAS 21 requires that goodwill and any fair value adjustments arising on the acquisition of a foreign subsidiary are to be treated as part of the assets and liabilities of the foreign subsidiary. The rules already described apply to these items.

This means that:

- Goodwill arising on the purchase of the foreign subsidiary (and also any fair value adjustments to the value of assets of the subsidiary) should be stated in the functional currency of the foreign subsidiary.

- The goodwill and fair value adjustments will therefore be translated each year at the **closing exchange rate**.

A gain or loss on translation will therefore arise (as described above for other assets and liabilities).

The effect of this rule is that goodwill and the acquisition of a foreign operation is re-stated over time because it is re-translated every year at the new closing exchange rate.

The rationale behind this accounting rule is that the amount paid for the investment in the subsidiary has been based on the expected future earnings stream. The goodwill relates to a business which operates in the economic environment of another country and should therefore be expressed in the functional currency of the foreign subsidiary.

Example: Goodwill arising on the acquisition of a foreign subsidiary and its subsequent retranslation

A Pakistani parent company bought 80% of the shares of a Singapore company on 1 January at a cost of Rs. 1,125,000.

The new subsidiary had retained earnings of S$11,000 at the date of acquisition. It had share capital of S$5,000.

There were no fair value adjustments at the date of acquisition.

The parent recognises a proportionate share of non-controlling interest.

Relevant Rs./S$ exchange rates are as follows:

1 January	Rs.75/$
31 December	Rs.85/$

Goodwill is first calculated in the foreign currency as at the date of acquisition using the rates appropriate to that date.

Goodwill arising on acquisition	$	Rate	Rs.
Cost of investment	15,000	75	1,125,000
Less net assets acquired			
80% × (S$ 5,000 + S$11,000)	(12,800)	75	(960,000)
Goodwill	2,200	75	165,000
Retranslation at 31 December	2,200	85	187,000
Exchange gain			22,000

The Company would recognise goodwill of Rs. 187,000 in the consolidated statement of financial position at 31 December.

The exchange gain of Rs. 22,000 would be reported as a gain in other comprehensive income.

The amount attributable to the parent is the full Rs. 22,000 as it only relates to the parent's investment in the subsidiary.

Practice question **3**

A Pakistani holding company acquired 100% of the capital of a US subsidiary on 30 September Year 6 at a cost of $800,000.

The fair value of the net assets of the subsidiary at that date was $300,000.

The holding company prepares financial statements at 31 December each year.

Relevant exchange rates are as follows:

30 September Year 6 Rs. 100/$

31 December Year 6 Rs.120/$

Required

Show how the goodwill would be accounted for at 31 December.

3.4 Consolidation example

The following example looks at the whole process of foreign currency consolidation, beginning with the translation of the foreign subsidiary's accounts and finishing with their consolidation into the parent group accounts.

Numbers from this example were used the previous two examples so you will be familiar with these.

Example:

H bought 80% of S (a company in Singapore) on 31 December 2014 (one year ago) when S had retained earnings of S$ 11,000.

Statements of financial position at 31 December 2015

	H	S
	Rs.	S$
Investment in S	1,125,000	
Property, plant and equipment	800,000	10,000
Current assets	1,500,000	14,000
	3,425,000	24,000
Share capital	1,000,000	5,000
Retained earnings	2,025,000	17,000
	3,025,000	22,000
Current liabilities	400,000	2,000
	3,425,000	24,000
Retained earnings b/f	1,425,000	11,000
Retained earnings in the year	600,000	6,000
Retained earnings c/f	2,025,000	17,000

The following exchange rates are relevant:

31 December 2014 (date of acquisition)	**Rs. 75/S$**
Average for the year	**Rs. 80/S$**
31 December 2014	**Rs. 85/S$**

Prepare a consolidated statement of financial position at 31 December 2015.

This text will guide you through the answer process. Many of the numbers are straightforward but some are little trickier to find.

Remember the three steps described earlier.

Step 1: Deal with any adjustments to the accounts of the subsidiary and parent, e.g. inter-company trading transactions and inter-company loans. Apply the normal rules for dealing with these.

There are no adjustments in this example so we can proceed to step 2.

Step 2: When the financial statements of the subsidiary have been updated and adjusted as necessary, translate the subsidiary's accounts into the reporting currency

Example: Step 2

The subsidiary's statement of financial position is translated at the closing rate.

Working 1: Translation working

S statement of financial position at 31 December 2015

	S		S
	S$	Rate	Rs.
Property, plant and equip.	10,000	85	850,000
Current assets	14,000	85	1,190,000
	24,000	85	2,040,000
Share capital	5,000		
Retained earnings	17,000		
	22,000	Balance	1,870,000
Current liabilities	2,000	85	170,000
	24,000	85	2,040,000

The main purpose of this working is to identify values for the assets and liabilities of the subsidiary so that they can be consolidated.

There is no need to translate the share capital and reserves at the closing rate. These will be considered later when we look at the net assets summary.

In the above answer we have identified the sum of the share capital and reserves as a balancing figure. This figure is based on the net assets at the reporting date translated at the closing rate. Therefore it must include the exchange differences. We will need to identify these separately.

Step 3: Carry out the consolidation. Some of the numbers are very straightforward – get the easy marks first by setting up a proforma answer and filling in the blanks as far as you can. Only then go on to look at the more difficult numbers (goodwill, retained earnings, exchange differences etc.)

Example: Step 3 (easy numbers)

Consolidated statement of financial position at 31 December 2015

	H	S (W1)	S
	Rs.	Rs.	Rs.
Goodwill			
Property, plant and equipment	800,000	850,000	1,650,000
Current assets	1,500,000	1,190,000	2,690,000
Share capital	1,000,000		1,000,000
Retained earnings	2,025,000		
Translation reserve			
NCI			
Current liabilities	400,000	170,000	570,000

We now need to start on the more difficult numbers.

We now need to start on the more difficult numbers. It is useful (though not essential) to construct a net asset summary to help with these numbers.

Example: Step 3 (continued)

Working 2: Net asset summary of S

	Net assets at the date of consolidation	Net assets at the date of acquisition	Post-acquisition
	S$.	S$.	
Share capital	5,000	5,000	
Retained earnings	17,000	11,000	
Net assets (S$)	22,000	16,000	
Rate	85	75	
Net assets (Rs.)	1,870,000	1,200,000	670,000

This information can now be used to calculate NCI and goodwill.

The post-acquisition amount of Rs. 670,000 is not that useful as it is the sum of post-acquisition profits plus exchange differences and these need to be separated. However, it could be used to quickly finish off the statement of financial position if you have no time to identify the separate reserves.

Example: Step 3 (continued) NCI and goodwill

The fact pattern from this example was used to illustrate the calculation of goodwill earlier in this section. It is repeated here for your convenience.

Non-controlling interest			Rs.
20% of Rs. 1,870,000 (W2)			374,000

Goodwill arising on acquisition	$	Rate	Rs.
Cost of investment	15,000	75	1,125,000
Less net assets acquired			
80% × (S$ 16,000)	12,800	75	960,000
Goodwill	2,200	75	165,000
Retranslation at 31 December	2,200	85	187,000
Exchange gain			22,000

The exchange gain of Rs. 22,000 would be reported as a gain in other comprehensive income.

The amount attributable to the parent is the full Rs. 22,000 as it only relates to the parent's investment in the subsidiary.

The next step is to calculate the consolidated equity balances. These are:

- consolidated retained earnings; and
- translation reserve.

The exchange difference working is useful for both of these calculations.

Example: Step 3 (continued): Exchange difference on retranslation

The fact pattern from this example was used to illustrate the calculation of the exchange difference in an earlier section (3.2). It is repeated here for your convenience.

Exchange difference	$	Rate	Rs.
Opening net assets	16,000	75	1,200,000
Retained profit for the year	6,000	80	480,000
Exchange gain			190,000
Closing net assets	22,000	85	1,870,000

The Rs. 190,000 would be reported as a gain in other comprehensive income.

The amount attributable to the parent of Rs. 152,000 (80% of Rs. 190,000) would then be recognised in a currency translation reserve.

The amount attributable to the non-controlling interest is Rs. 38,000 (20% of Rs. 190,000). This would be recognised in the non-controlling interest balance in the statement of financial position.

Example: Step 3 (continued) Total exchange difference

Exchange difference arises on the retranslation of the goodwill and on the retranslation of the financial statements of the subsidiary.

Exchange difference

	Total	Attributable to parent	Attributable to NCI
	Rs.	Rs.	Rs.
On goodwill	22,000	22,000	nil
On net assets of S	190,000	152,000	38,000
Closing net assets	212,000	174,000	38,000

The Rs. 212,000 is reported as a gain in other comprehensive income.

The amount attributable to the parent of Rs. 174,000 is recognised in a currency translation reserve.

The amount attributable to the non-controlling interest is Rs. 38,000 is recognised in the non-controlling interest balance in the statement of financial position.

The next step is to calculate the equity balances for inclusion on the statement of financial position.

Example: Step 3 (continued) Equity balances

These can be calculated as follows (by using a working which is in fact an extract from the statement of changes in equity).

	Retained earnings	Non-controlling interest	Translation reserve
	Rs.	Rs.	Rs.
Balance at start	1,425,000	240,000	
Profit for the year	984,000	96,000	
All of H	600,000		
Share of S:			
80% of (6,000 × Rs. 80)	384,000		
20% of (6,000 × Rs. 80)		96,000	
	984,000	96000	
Exchange difference		38,000	174,000
Balance at end	2,409,000	374,000	174,000

The non-controlling interest calculation is not needed but is shown for completeness.

The consolidated statement of financial position can now be completed as follows:

Example: Step 3 Completion

Consolidated statement of financial position at 31 December 2015

	H	S (W1)	S
	Rs.	Rs.	Rs.
Goodwill			187,000
Property, plant and equipment	800,000	850,000	1,650,000
Current assets	1,500,000	1,190,000	2,690,000
			4,527,000
Share capital	1,000,000		1,000,000
Retained earnings	2,025,000		2,409,000
Translation reserve			174,000
NCI			374,000
Current liabilities	400,000	170,000	570,000
			4,527,000

An aside

Note that in the above the retained earnings (Rs. 2,409,000) and the translation reserve (Rs.174,000) sum to Rs. 2,583,000.

This can be proved by using the post-acquisition balance found in the net asset working.

Example: Step 3 (continued) Proof of consolidated reserves total

Consolidated reserves (total)	Rs.
All of H	2,025,000
Share of S (post acquisition) = 80% × Rs.670,000 (W2)	536,000
Exchange difference on retranslation of goodwill	22,000
	2,583,000

3.5 Consolidated statement of profit or loss and other comprehensive income

This section continues and expands (slightly) the previous example to show how to prepare the consolidated statement of profit or loss and other comprehensive income.

This is quite straightforward once the exchange differences arising in the period have been calculated.

Example: Consolidated statement of profit or loss and other comprehensive income

H bought 80% of S (a company in Singapore) on 31 December 2014 (one year ago).

The following exchange rates is relevant:

Average for the year	Rs. 80/S$

Statements of profit and loss for the year ended 31 December 2015

	H	S
	Rs.	S$
Revenue	2,200,000	14,000
Expenses	(1,600,000)	(8,000)
Profit	600,000	6,000

Consolidated statement of profit or loss and other comprehensive income is prepared as follows.

Translation working

Example: Step 2

The subsidiary's statement of financial position is translated at the closing rate.

Working 1: Translation working

S statement of profit or loss for the year ending 31 December 2015

	S		S
	S$	Rate	Rs.
Revenue	14,000	80	1,120,000
Expenses	(8,000)	80	(640,000)
Profit	6,000	80	480,000

Consolidation

Example: Step 3

Consolidated statement of profit or loss and other comprehensive income for the year ending 31 December 2015

Statement of profit or loss

	H	S (W1)	S
	Rs.	Rs.	Rs.
Revenue	2,200,000	1,120,000	3,320,000
Expenses	(1,600,000)	(640,000)	(2,240,000)
Profit	600,000	480,000	1,080,000

Other comprehensive income:	
Exchange gain (as before – Rs.22,000 + Rs. 190,000)	212,000
Total comprehensive income for the year	1,292,000
Profit attributable to:	
Parent (balance)	984,000
Non-controlling interest (20% × Rs. 480,000)	96,000
	1,080,000
Other comprehensive income attributable to:	
Parent (Rs.22,000 + (80% × Rs. 190,000))	174,000
Non-controlling interest (20% × Rs. 190,000)	38,000
Total comprehensive income for the year	212,000

3.6 Disposal of a foreign subsidiary

Most of the accounting rules for the disposal of a foreign subsidiary, or for the partial disposal of a foreign subsidiary, are set out in IFRS 10.

However IFRS 10 does not deal with the accounting treatment of the balance on the separate equity reserve account when a foreign subsidiary is disposed of. This matter is dealt with by IAS 21.

- When the entire investment in a foreign subsidiary is disposed of, the cumulative balance in the separate equity reserve (which represents amounts previously recognised in other comprehensive income) should now be reclassified from equity to profit and loss.
- If there was a non-controlling interest in the subsidiary, the NCI is derecognised in the consolidated statement of financial position. Amounts previously recognised in other comprehensive income and attributed to NCI must not be reclassified and recognised in profit or loss of the reporting entity.
- When a proportion of an investment in a foreign subsidiary is disposed of, a proportionate share of the amounts previously recognised in other comprehensive income (the cumulative balance in the separate equity reserve) should now be reclassified from equity to profit or loss.

When income previously recognised as other comprehensive income is reclassified as a gain or loss to profit or loss as a re-classification adjustment, there must be an offsetting loss or gain in other comprehensive income, to avoid double-counting of the gain (or loss).

Example: Disposal

A company held 100% of the equity of a subsidiary S, but sold the entire investment on 1 June when the carrying value of the net assets S and the purchased goodwill were Rs.30 million. The consideration received from selling the shares was Rs.37 million.

The company had previously recognised exchange gains of Rs.2 million in other comprehensive income on its investment in S.

Required

Show the amount to be recognised in the statement of profit or loss in respect of this disposal.

Answer

The company should recognise Rs.9 million in profit or loss for the financial period when the disposal occurs as follows:

	Rs.m
Consideration received from sale of shares	37.0
Carrying value of net assets of S	30.0
Gain	7.0
Exchange gain previously recognised in other comprehensive income (reclassification adjustment)	2.0
Total gain recognised in profit or loss	9.0

A debit of Rs.2 million should be recognised in other comprehensive income, to avoid double counting of the income previously recognised as other comprehensive income but now reclassified in profit or loss.

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

On initial recognition

The machine and resulting liability are recognised initially at Rs. 24,000,000 (€200,000 × Rs.120).

31 December

The liability is a monetary amount and must be retranslated at the closing rate. This results in an amount of Rs. 22,000,000 (€200,000 × Rs.110).

This is achieved by recognising an exchange gain of Rs. 2,000,000.

On 31 December

	Debit	Credit
Payables	Rs. 2,000,000	
Statement of profit or loss		Rs. 2,000,000

The machine is a non-monetary item carried at cost. Therefore, it is not re-translated.

Solutions **2**

a Exchange difference

	$	Rate	Rs.
Opening net assets	20,000	100	2,000,000
Profit for the year	10,000	106	1,060,000
Exchange gain			240,000
Closing net assets	30,000	110	3,300,000

The entire profit for the year is included in accumulated profit at the end of the year, because no dividends were paid during the year.

b Exchange difference: gain or (loss)

		Rs.	Rs.
a	On re-translating the opening net assets:		
	$20,000 at opening rate of 100	2,000,000	
	$20,000 at closing rate of 110	2,200,000	
			200,000
b	On re-translating the profit for the year:		
	$10,000 at average rate of 106	1,060,000	
	$10,000 at closing rate of 110	1,100,000	
			40,000
	Exchange gain arising		240,000

Solutions **3**

Goodwill arising on acquisition	$	Rate	Rs.
Cost of investment	800,000	100	80,000,000
Minus: Net assets acquired	300,000	100	30,000,000
Goodwill	500,000	100	50,000,000
Retranslation at 31 December	500,000	120	60,000,000
Exchange gain			10,000,000

CHAPTER 27

IAS 7: Statements of cash flows

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

PRESENTATION OF FINANCIAL STATEMENTS INCLUDING PUBLIC SECTOR ACCOUNTING

A 1 Presentation of financial statements (IAS 7)

1 STATEMENTS OF CASH FLOWS: INTRODUCTION

Section overview

- Purpose of statements of cash flows
- Format
- Direct method: Accruals based figures
- Working capital adjustments: Introduction

1.1 Purpose of statements of cash flows

IAS 1 states that a statement of cash flows is a part of a complete set of the financial statements of an entity. It provides information about:

- the cash flows of the entity during the reporting period, and
- the changes in cash and cash equivalents during the period.

A statement of cash flows groups inflows and outflows of cash under three broad headings:

- cash from operating activities;
- cash used in (or obtained from) investing activities;
- cash paid or received in financing activities.

It also shows whether there was an increase or a decrease in the amount of cash held by the entity between the beginning and the end of the period.

Illustration: Statement of cash flows

Cash from operating activities	X/(X)
Cash used in (or obtained from) investing activities	X/(X)
Cash paid or received in financing activities.	X/(X)
Net cash inflow (or outflow) during the period	X/(X)
Cash and cash equivalents at the beginning of the period	X/(X)
Cash and cash equivalents at the end of the period	X/(X)

A statement of cash flows reports the change in the amount of cash and cash equivalents held by the entity during the financial period.

Cash and cash equivalents

Definition: Cash, cash equivalents and cash flows

Cash comprises cash on hand and demand deposits.

Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Cash flows are inflows and outflows of cash and cash equivalents.

IAS 7 does not define a quantitative threshold for 'readily convertible'. However, normally investments that may be converted into cash within 90 days are treated as readily convertible into cash.

1.2 Format

IAS 7 does not include a format that must be followed. However it gives illustrative examples of formats that meet the requirements in the standard.

This section provides examples of these.

Illustration: Statement of cash flows

	Rs.	Rs.
Net cash flow from operating activities		**75,300**
Cash flows from investing activities:		
Acquisition of shares (debentures, etc.)	(5,000)	
Purchase of property, plant and machinery	(35,000)	
Proceeds from sale of non-current assets	6,000	
Interest received/dividends received	1,500	
Net cash used in investing activities		(32,500)
Cash flows from financing activities:		
Proceeds from issue of shares	30,000	
Proceeds from new loan	10,000	
Repayment of loan	(17,000)	
Dividends paid to shareholders	(25,000)	
Net cash used in financing activities		(2,000)
Net increase/decrease in cash and cash equivalents		40,800
Cash and cash equivalents at the beginning of the year		5,000
Cash and cash equivalents at the end of the year		45,800

Operating cash flows

IAS 7 permits two methods of presenting the cash flows from operating activities:

- the direct method, and
- the indirect method.

For clarity, what this means is that there are two approaches to arriving at the figure of ***Rs. 75,300*** in the above example.

IAS 7 allows entities to use either method of presentation. It encourages entities to use the direct method. However, the indirect method is used more in practice.

The two methods differ only in the way that they present the cash flows for cash generated from operations. In all other respects, the figures in the statement of cash flows using the direct method are identical to the figures in a statement using the indirect method – cash flows from investing activities and financing activities are presented in exactly the same way.

The indirect method

The indirect method identifies the cash flows from operating activities by adjusting the profit before tax figure. It arrives at the cash from operating activities figure indirectly by reconciling a profit figure to a cash figure.

The starting point for the statement of cash flows for a company is the operating profit after deducting interest but before taxation.

This profit figure is adjusted to calculate the amount of cash received by the business or the amount of cash paid out as a consequence of its trading operations.

The adjustments are to remove the effect of:

- Non-cash items, for example:
  - Depreciation and amortisation (depreciation of intangible non-current assets);
  - Profit or loss on disposal of non-current assets; and
- Accruals based figures, for example:
  - Interest expense or income;
  - Movement on working capital items (receivables, payables and inventory).

The following illustration shows how the net cash flow from operating activities figure seen in the previous example was arrived at using the indirect method.

Illustration: The indirect method

Statement of cash flows: indirect method	**Rs.**	**Rs.**
Cash flows from operating activities		
Profit before taxation	80,000	
Adjustments for:		
Depreciation and amortisation charges	20,000	
Interest charges in the statement of comprehensive income	2,300	
Gains on disposal of non-current assets	(6,000)	
Losses on disposal of non-current assets	4,500	
	100,800	
Increase in trade and other receivables	(7,000)	
Decrease in inventories	2,000	
Increase in trade payables	3,000	
Cash generated from operations	98,800	
Taxation paid (tax on profits)	(21,000)	
Interest charges paid	(2,500)	
Net cash flow from operating activities		**75,300**

The direct method

The direct method calculates the cash flow from operating activities by calculating cash received from customers, cash paid to suppliers and so on.

The following illustration shows how the net cash flow from operating activities figure seen in the previous example was arrived at using the direct method.

Illustration: The direct method

Statement of cash flows: direct method	**Rs.**
Cash flows from operating activities	
Cash receipts from customers	348,800
Cash payments to suppliers	(70,000)
Cash payments to employees	(150,000)
Cash paid for other operating expenses	(30,000)
Cash generated from operations	98,800
Taxation paid (tax on profits)	(21,000)
Interest charges paid	(2,500)
Net cash flow from operating activities	75,300

The figures in the two statements are identical from 'Cash generated from operations' down to the end. The only differences are in the presentation of the cash flows that produced the 'Cash generated from operations'.

IAS 7 allows some variations in the way that cash flows for interest and dividends are presented in a statement of cash flows, although the following should be shown separately:

- interest received
- dividends received
- interest paid
- dividends paid.

1.3 Direct method: Accruals based figures

Interest

The interest liability at the start of the year and the interest charge during the year is the most the business would pay. If the business had paid nothing it would owe this figure. The difference between this amount and the liability at the end of the year must be the amount that the business has paid.

Example: Interest paid

A company had liabilities in its statement of financial position at the beginning and at the end of 2014, as follows:

	Interest (Rs.)
Beginning of 2014	4,000
End of 2014	3,000

During the year, interest charges in the income statement were Rs. 22,000.

The interest payment for inclusion in the statement of cash flows can be calculated as follows:

	Rs.
Liability at the start of the year	4,000
Charge for the year	22,000
Total amount payable in the year	26,000
Liability at the end of the year	(3,000)
Cash paid	23,000

Taxation

The tax paid is the last figure in the operating cash flow calculation.

Example: Taxation paid

A company had liabilities in its statement of financial position at the beginning and at the end of 2014, as follows:

	Taxation (Rs.)
Beginning of 2014	53,000
End of 2014	61,000

During the year, taxation on profits was Rs. 77,000.

The tax payment (cash flows) for inclusion in the statement of cash flows can be calculated as follows:

	Rs.
Taxation liability at the start of the year	53,000
Charge for the year	77,000
Total amount payable	130,000
Taxation liability at the end of the year	(61,000)
Cash paid	69,000

Deferred taxation

A question might include deferred taxation.

A deferred tax balance might be an asset or a liability. Deferred tax liability is more common (in practice and in questions) so this discussion will be about liabilities.

A deferred tax liability is an amount that a company expects to pay in the future. Therefore it has had no cash effect to date.

Any movement on the deferred tax liability will be due to a double entry to tax expense in the profit or loss section of the statement of comprehensive income.

There are two possible courses of action in dealing with deferred tax. Either:

- ignore it entirely and work with numbers that exclude the deferred tax (in effect this was what happened in the example above where there was no information about deferred tax); or
- include it in every tax balance in the working.

The second approach is usually used.

Example: Deferred tax

A company had liabilities in its statement of financial position at the beginning and at the end of 2014, as follows:

	Taxation (Rs.)	Deferred taxation (Rs.)
Beginning of 2014	53,000	20,000
End of 2014	61,000	30,000

The tax expense for the year in the statement of profit or loss was Rs. 87,000. This was made up of the current tax expense of Rs. 77,000 and the deferred tax of Rs. 10,000.

The tax payment (cash flows) for inclusion in the statement of cash flows can be calculated as follows:

		Rs.
Liability at the start of the year	(53,000 + 20,000)	73,000
Charge for the year	(77,000 + 10,000)	87,000
Total amount payable in the year		160,000
Liability at the end of the year	(61,000 + 30,000)	(91,000)
Cash paid		69,000

1.4 Working capital adjustments: Introduction

Definition

Working capital is current assets less current liabilities.

The previous section showed that taxation and interest cash flows can be calculated by using a figure from the statement of comprehensive income and adjusting it by the movement on the equivalent balances in the statement of financial position.

This section shows how this approach is extended to identify the cash generated from operations by making adjustments for the movements between the start and end of the year for elements of working capital, namely:

- trade receivables and prepayments;
- inventories; and
- trade payables and accruals.

Any change in the balance of each line item of working capital from one period to another will affect a firm's cash flows. For example, if a company's accounts receivable increase at the end of the year, this means that the firm collected less money from its customers than it recorded in sales during the same year. This is a negative event for cash flow and may contribute to the "Net changes in current assets and current liabilities" on the firm's cash flow statement to be negative. On the flip side, if accounts payable were also to increase, it means a firm is able to pay its suppliers more slowly, which is a positive for cash flow.

Assuming that the calculation of the cash flow from operating activities starts with a profit (rather than a loss) the adjustments are as follows:

Balance	Increase in balance from start to the end of the year	Decrease in balance from start to the end of the year
Receivables	Subtract from profit before tax	Add back to profit before tax
Inventory	Subtract from profit before tax	Add back to profit before tax
Payables	Add back to profit before tax	Subtract from profit before tax

Practice question **1**

A company made an operating profit before tax of Rs. 16,000 in the year just ended.

Depreciation charges were Rs. 15,000.

There was a gain of Rs. 5,000 on disposals of non-current assets and there were no interest charges. Values of working capital items at the beginning and end of the year were:

	Receivables	Inventory	Trade payables
Beginning of the year	Rs. 9,000	Rs. 3,000	Rs. 4,000
End of the year	Rs. 6,000	Rs. 5,000	Rs. 6,500

Taxation paid was Rs. 4,800.

Required

Calculate the amount of cash generated from operations, as it would be shown in a statement of cash flows using the indirect method.

2 CASH FLOWS FROM INVESTING ACTIVITIES

Section overview

- Cash paid for the purchase of property, plant and equipment
- Cash from disposals of property, plant and equipment
- Cash paid for the purchase of investments and cash received from the sale of investments

2.1 Cash paid for the purchase of property plant and equipment

This is the second part of a statement of cash flows, after cash flows from operating activities.

The most important items in this part of the statement are cash paid to purchase non-current assets and cash received from the sale or disposal of non-current assets but it also includes interest received and dividends received on investments.

Movement on non-current assets might be summarised as follows:

Illustration: Movement on non-current assets

	Rs.
At cost or valuation, at the beginning of the year	X
Disposals during the year (cost)	(X)
Upward/(downward) revaluation during the year	X/(X)
	X
Additions to non-current assets (balancing figure)	X
At cost or valuation, at the end of the year	X

Alternatively carrying amount (NBV) can be used	Rs.
Non-current assets at the beginning of the year at NBV	X
Depreciation	(X)
Disposals during the year (NBV)	(X)
Upward/(downward) revaluation during the year	X/(X)
	X
Additions to non-current assets (balancing figure)	X
Non-current assets at the end of the year at NBV	(X)

Example: Cash paid for property, plant and equipment

The statements of financial position of Grand Company at the beginning and end of 2014 include the following information:

Property, plant and equipment	2013	2014
	Rs.	Rs.
At cost/re-valued amount	1,400,000	1,900,000
Accumulated depreciation	(350,000)	(375,000)
Carrying value	1,050,000	1,525,000

During the year, some property was revalued upwards by Rs. 200,000. An item of equipment was disposed of during the year at a profit of Rs. 25,000. This equipment had an original cost of Rs. 260,000 and accumulated depreciation of Rs. 240,000 at the date of disposal.

Depreciation charged in the year was Rs. 265,000.

Example (continued): Cash paid for property, plant and equipment

Additions may be calculated as follows:

	Cost	NBV
Balance at the start of the year	1,400,000	1,050,000
Disposals during the year:		
At cost	(260,000)	
At carrying amount: (260,000 – 240,000)		(20,000)
Depreciation		(265,000)
Revaluation	200,000	200,000
	1,340,000	965,000
Additions (balancing figure)	560,000	560,000
Balance at the end of the year	1,900,000	1,525,000

The revaluation recognised in the year can be found by comparing the opening and closing balances on the revaluation surplus account. There might also be revaluation double entry recognised as a gain or loss in other comprehensive income (incremental depreciation). You need to total revaluation recognised in the year so you may have to add or net both amounts.

2.2 Cash from disposals of property, plant and equipment

A statement of cash flows should include the net cash received from any disposals of non-current assets during the period.

This might have to be calculated from the gain or loss on disposal and the carrying amount of the asset at the time of its disposal.

Illustration: Disposal of property, plant and equipment

	Rs.
At cost (or re-valued amount at the time of disposal)	X
Accumulated depreciation, at the time of disposal	(X)
Net book value/carrying amount at the time of disposal	X
Gain or (loss) on disposal	X/(X)
Net disposal value (= **assumed cash flow**)	X

2.3 Cash paid for the purchase of investments and cash received from the sale of investments

A statement of cash flows should include the net cash paid to buy investments in the period and the cash received from the sale of investment in the period.

It is useful to remember the following relationship:

Illustration: Movement on investments

	Rs.
Carrying amount at the start of the year	X
Disposals	(X)
Additions	X
Revaluation	X/(X)
Carrying amount at the end of the year	X

3 CASH FLOWS FROM FINANCING ACTIVITIES

Section overview

- Examples of cash flows from financing activities
- Cash from new share issues
- Cash from new loans/cash used to repay loans
- Dividend payments to equity shareholders
- Repayments on finance leases

3.1 Examples of cash flows from financing activities

Examples of cash flows from financing activities are listed below:

Cash payments	Cash receipts
Cash payments to redeem/buy back shares	Cash proceeds from issuing shares
Cash payments to repay a loan or redeem bonds	Cash proceeds from a loan or issue of bonds
Cash payments to a lessor under a finance lease agreement that represent a reduction in the remaining finance lease obligation (= a reduction in the creditors for finance leases)	

Dividends are also usually included within cash flows from financing activities, in this part of the statement of cash flows. (Some entities may also include interest payments in this section, instead of including them in the section for cash flows from operating activities.)

3.2 Cash from new share issues

The cash raised from new share issues can be established by comparing the equity share capital and the share premium in the statements of financial position at the beginning and the end of the year.

Illustration: Cash from new share issues

	Rs.
Share capital + Share premium at the end of the year	X
Share capital + Share premium at the beginning of the year	X
Cash obtained from issuing new shares in the year	X

Example: Cash from new share issues

The statements of financial position of Company P at 1 January and 31 December included the following items:

	1 January 2014	31 December 2014
	Rs.	Rs.
Equity shares	600,000	750,000
Share premium	800,000	1,100,000

There was a 1 for 6 bonus issue during the year funded out of retained earnings. The bonus issue was followed later in the year by a rights issue to raise cash for the purchase of new plan.

(The information about the bonus issue means that for every 6 shares held at the start of the year one new share was issued. Therefore, the share capital changed from Rs. 600,000 to Rs. 700,000. The double entry to achieve this was Dr Retained earnings and Cr Share capital).

The cash obtained from issuing shares during the year is calculated as follows.

	Rs.
Share capital + Share premium at the end of 2014	1,850,000
Share capital + Share premium at the beginning of 2014	(1,400,000)
Bonus issue (600,000 × 7/6)	(100,000)
Cash obtained from issuing new shares in 2014	350,000

If a bonus issue is funded out of share premium it can be ignored because the balances on the two accounts are added together so the total would not be affected.

3.3 Cash from new loans/cash used to repay loans

Cash from new loans or cash paid to redeem loans in the year can be calculated simply by looking at the difference between the liabilities for loans and bonds at the beginning and the end of the year.

- An increase in loans or bonds means there has been an inflow of cash.
- A reduction in loans or bonds means there has been a payment (outflow) of cash.

Remember to add any loans, loan notes or bonds repayable within one year (current liability) to the loans, loan notes or bonds repayable after more than one year (non-current liability) to get the total figure for loans, loan notes or bonds.

Illustration: Cash from loans

	Rs.
Loans at end of year (current and non-current liabilities)	X
Loans at beginning of year (current and non-current liabilities)	X
Cash inflow or outflow	X

Note: The same calculation can be applied to bonds or loan notes that the company might have issued. Bonds and loan notes are long-term debt.

3.4 Dividend payments to equity shareholders

These should be the final dividend payment from the previous year and the interim dividend payment for the current year. The dividend payments during the year are shown in the statement of changes in equity (SOCIE).

You might be expected to calculate dividend payments from figures for retained earnings and the profit after tax for the year.

If there have been no transfers to the retained earnings reserve from the revaluation reserve in the year, the equity dividend payments can be calculated as follows:

Illustration:

	Rs.
Retained earnings reserve at the beginning of the year	X
Profit for the year after tax	X
Increase in the retained earnings reserve	X
Retained earnings reserve at the end of the year	(X)
Equity dividend payments	X

Practice questions **2**

From the following information, calculate the cash flows from investing activities for Company X in 2014.

	Beginning of 2014	End of 2014
	Rs.	Rs.
Share capital (ordinary shares)	400,000	500,000
Share premium	275,000	615,000
Retained earnings	390,000	570,000
	1,065,000	1,685,000
Loans repayable after more than 12 months	600,000	520,000
Loans repayable within 12 months or less	80,000	55,000

The company made a profit of Rs. 420,000 for the year after taxation.

Required

Calculate for 2014, for inclusion in the statement of cash flows:

(a) the cash from issuing new shares

(b) the cash flows received or paid for loans

(c) the payment of dividend to ordinary shareholders.

3.5 Repayments on finance leases

When non-current assets are acquired under a finance lease, the lessee makes payments under the lease agreement. For accounting purposes, payments under finance leases are treated:

- partly as interest payments; and
- partly as repayment of the lease finance.

For the purposes of the statement of cash flows:

- The interest element in the lease payments is treated as an interest payment. It is included either as a cash flow from operating activities or a cash flow from financing activities
- The repayment of the lease liability is treated as a repayment of a debt, and is included as a cash flow from financing activities.

4 CONSOLIDATED STATEMENT OF CASH FLOWS

Section overview

- The special features of a consolidated statement of cash flows
- Illustrative format

4.1 The special features of a consolidated statement of cash flows

A consolidated statement of cash flows is prepared largely from the consolidated statement of financial position, statement of profit or loss and other comprehensive income and statement of changes in equity. The rules for preparing a group statement of cash flows are similar to the rules for a statement of cash flows for an individual entity.

However, there are additional items in a consolidated statement of cash flows that are not found in the statement of cash flows of an individual company. The most significant of these are cash flows (or adjustments to profit before tax) relating to:

- non-controlling interests;
- associates (or JVs);
- and acquiring or disposing of subsidiaries during the year.

Exchange rate differences

A gain or loss arising from exchange rate differences is not a cash flow item. When the indirect method is used to present cash flows from operating activities, it is therefore necessary to make an adjustment to get from 'profit' to 'cash flow'.

- A loss arising from exchange rate differences (shown in the example that follows as a 'foreign exchange loss') must be added back.
- A gain arising from exchange rate differences must be subtracted.

4.2 Illustrative format

It might be useful to look at the format of a consolidated statement of cash flows, to see where these items appear. The indirect method is used here to present the cash flows from operating activities.

Illustration: X Plc: Consolidated statement of cash flows for the year ended 31 December 20X7

	Rs. 000	Rs. 000
Cash flows from operating activities		
Profit before tax	440	
Adjustments for:		
Depreciation and amortisation charges	450	
Loss on disposal of plant and machinery	50	
Share of profit of associates and joint ventures	(100)	
Foreign exchange loss	40	
Investment income	(25)	
Interest expense	25	
	880	
Increase in trade and other receivables	(80)	
Increase in inventories	(60)	
Increase in trade payables	40	
Cash generated from operations	780	
Interest paid	(30)	
Income taxes paid	(200)	
Net cash from operating activities		550
Cash flows from investing activities		
Acquisition of subsidiary, net of cash acquired (note 1)	(450)	
Purchase of property, plant and equipment (note 2)	(220)	
Proceeds from the sale of equipment	30	
Interest received	25	
Dividends received from associates	45	
Net cash used in investing activities		(570)
Cash flows from financing activities		
Proceeds from the issue of share capital	500	
Proceeds from long-term loan	100	
Redemption of debt securities	(150)	
Payment of finance lease liabilities	(80)	
Dividends paid to non-controlling interests	(70)	
Dividends paid to parent company shareholders	(200)	
Net cash inflow from financing activities		100
Net increase in cash and cash equivalents		80
Cash and cash equivalents at the start of the year (note 3)		150
Cash and cash equivalents at the end of the year (note 3)		230

Notes to the statement of cash flows

Illustration: Notes to the statement of cash flows

Note 1: Acquisition of subsidiary

During the year, the group acquired a subsidiary A Limited. The fair value of assets acquired and liabilities assumed were as follows:

	Rs. 000
Cash	50
Inventories	90
Trade receivables	60
Property, plant and equipment	870
Trade payables	(70)
Long-term loan	(200)
Total purchase price	800
Minus cash of A Limited	(50)
	750
Shares issued as part of the purchase price	(300)
Cash flow on acquisition net of cash acquired	450

Note 2: Property, plant and equipment

During the year, the group acquired property, plant and equipment with a total cost of Rs. 400,000, of which Rs. 180,000 was acquired by means of finance leases. Cash payments of Rs. 220,000 were made to acquire property, plant and equipment.

Note 3: Cash and cash equivalents

Cash and cash equivalents consist of cash in hand, bank balances, and money market investments. Cash and cash equivalents in the statement of cash flows comprise the following amounts in the statement of financial position:

	20X7	20X6
	Rs. 000	Rs. 000
Cash in hand and balances with banks	120	110
Short-term investments	210	80
Cash and cash equivalents as previously reported	330	190
Effect of exchange rate changes	-	(40)
Cash and cash equivalents as re-stated	330	150

5 NON-CONTROLLING INTERESTS AND ASSOCIATES (OR JVS) IN THE STATEMENT OF CASH FLOWS

Section overview

- Obtaining the required figures for cash flows
- Non-controlling interests and the group statement of cash flows
- Dividends paid to non-controlling interests and foreign exchange adjustments
- Associates (or JVs) and the group statement of cash flows
- Calculating dividends received from an associate (or JV)

5.1 Obtaining the required figures for cash flows

The cash flows and adjustments in a group statement of cash flows are obtained from the other group financial statements. You should expect an examination question to provide you with an opening and closing consolidated statement of financial position, together with the related consolidated statement of profit or loss and other comprehensive income, and possibly a statement of changes in equity. Other relevant information may also be provided.

A group statement of cash flows reports the cash flows that affect the group's consolidated cash (and cash equivalents). Any transactions not affecting the group cash position should not be shown in the statement of cash flows , except (with the indirect method) where a non-cash item is presented as an adjustment to the profit before tax to calculate the 'Cash generated from operations'.

5.2 Non-controlling interests and the group statement of cash flows

Unless there is an acquisition or a disposal of a subsidiary during the year, the only cash flow relating to non-controlling interests is the amount of dividends paid to the non-controlling interests by subsidiaries.

This might have to be calculated as a balancing figure, using the following calculation:

Illustration: Dividends paid to NCI

	Rs.
Non-controlling interest in group net assets at the beginning of the year	X
Non-controlling interest in profits after tax for the year	(X)
	X
Dividends paid to non-controlling interests (balancing figure)	(X)
Non-controlling interest in group net assets at the end of the year	X

The dividends paid to non-controlling interests by subsidiaries are usually included in the 'Cash flows from **financing activities**' part of the statement of cash flows. (This is the same part of the statement of cash flows where dividends paid to the parent company shareholders are usually shown.)

Example: Dividends paid to NCI

The following information has been extracted from consolidated financial statements of P, a holding company which prepares accounts to 31 December. P has a subsidiary Q, for which a final dividend is declared before the end of the financial year.

	20X7	20X6
	Rs. 000	Rs. 000
Non-controlling interest in group net assets	1,510	1,380
Non-controlling interest in consolidated profit after taxation	250	470

Required

What figure should appear in the consolidated statement of cash flows for the year to 31 December 20X7 for the dividends paid to non-controlling interests?

Under what heading will this figure appear in the group statement of cash flows?

Answer

	Rs. 000
Non-controlling interest in group net assets at the beginning of the year	1,380
Non-controlling interest in profits after tax for the year	250
	1,630
Dividends paid to non-controllinginterests (balancing figure)	(120)
Non-controlling interest in group net assets at the end of the year	1,510

The dividend paid of Rs. 120,000 will be disclosed as a cash flow from financing activities.

Practice question **3**

The following information has been extracted from the consolidated financial statements of P, a holding company which prepares accounts to 31 December each year:

	Year 4	Year 3
	Rs. 000	Rs. 000
Dividends payable to non-controlling interests	200	320
Non-controlling interests in group equity	1,560	1,380
Non-controlling interest in profit for the year	240	220

Required

What figure will appear in the consolidated statement of cash flows for the year to 31 December Year 4 for dividend paid to non-controlling interests?

Practice question **4**

The following information has been extracted from the consolidated financial statements of X Plc:

	Year 4	Year 5
	Rs. 000	Rs. 000
NCI dividends payable at 31 December	20	25
NCI share of group profits after tax for the year	270	300
NCI share in group net assets as at 31 December	600	630

Required

What figure will appear in the consolidated statement of cash flows for the year to 31 December Year 5 in respect of non-controlling interests?

Practice question **5**

The consolidated financial statements of Entity P for the year ended 31 March Year 6 showed the following balances:

Non-controlling interests in the consolidated statement of financial position at 31 March Year 6 are Rs. 6 million (Rs. 3.6 million at 31 March Year 5).

Non-controlling interests in the consolidated profit for the year ended 31 March Year 6 is Rs. 2 million.

During the year ended 31 March Year 6, the group acquired a new 75% subsidiary whose net assets at the date of acquisition were Rs. 6.4 million.

On 31 March Year 6, the group revalued all its properties and the non-controlling interest in the revaluation surplus was Rs. 1.5 million.

There were no dividends payable to non-controlling interests at the beginning or end of the year.

Required

What is the dividend paid to non-controlling interests that will be shown in the consolidated statement of cash flows of Entity P for the year ended 31 March Year 6?

5.3 Dividends paid to non-controlling interests and foreign exchange adjustments

If there is a gain or loss on translation for a foreign subsidiary, the non-controlling interest has a share of this exchange gain or loss. This means that the amount shown as the non-controlling interest in the consolidated statement of financial position includes the non-controlling interest share of any foreign exchange gains or is after deducting any foreign exchange losses.

A gain or loss arising from exchange rate differences is not a cash flow, but it changes the amount for non-controlling interest in the consolidated statement of

financial position. When the figures for non-controlling interest in the opening and closing statements of financial position are used to calculate dividend payments to non-controlling interests, we must therefore remove the effect of exchange rate differences during the year.

The calculation of the dividends paid to the non-controlling interests should then be calculated as follows:

Illustration: Dividends paid to NCI

	Rs.
Non-controlling interest in group net assets at the beginning of the year	X
Non-controlling interest in profits after tax for the year	X
Add non-controlling interest share of foreign exchange gain (or subtract NCI share of a loss)	X/(X)
	X
Dividends paid to non-controlling interests (as a balancing figure)	X
Non-controlling interest in group net assets at the end of the year	X

5.4 Associates (or JVs) and the group statement of cash flows

When a group has an interest in an associate entity, the consolidated statement of cash flows must show the cash flows that occur between the associate (or JV) and the group. The consolidated statement of cash flows shows the effect on the group's cash position of transactions between the group and its associate (or JV).

The cash held by an associate (or JV) is not included in the group's cash figure in the consolidated statement of financial position. This is because the equity method of accounting does not add the associate's (or JV's) cash to the cash of the holding company and subsidiaries. As far as cash flows are concerned, the associate (or JV) is outside the group. (The same principles apply to other investments accounted for under the equity method, such as joint ventures accounted for by the equity method).

Share of profit (or loss) of an associate (or JV)

In the consolidated statement of profit or loss, the group profit includes the group's share of the profits of associates (or JVs). These profits are not a cash flow item. When the indirect method is used to present the cash flows from operating activities, an adjustment is therefore needed to get from 'profit' to 'cash flow'.

- The group's share of the profit of an associate (or JV) must be deducted from profit.
- The group's share of the loss of an associate (or JV) must be added to profit.

Cash flows involving associates (or JVs)

The cash flows that might occur between a group and an associate (or JV), for inclusion in the consolidated statement of cash flows are as follows:

- **Investing activities**
  - cash paid to acquire shares in an associate (or JV) during the year
  - cash received from the disposal of shares in an associate (or JV) during the year
  - dividends received from an associate during the year.
- **Financing activities**
  - cash paid as a new loan to or from an associate (or JV) during the year
  - cash received as a repayment of a loan to or from an associate (or JV) during the year.

Note that dividends received from an associate (or JV) are shown as cash flows from investing activities; whereas dividends paid to non-controlling interests in subsidiaries are (usually) shown as cash flows from financing activities.

5.5 Calculating dividends received from an associate (or JV)

In an examination, you may be required to calculate the dividends received from an associate (or JV), using information in the opening and closing consolidated statements of financial position and the consolidated statement of profit or loss. The technique is similar to the calculation of dividends paid to non-controlling interests.

Illustration: Dividends received from an associate (or JV)

	Rs.
Group investment in net assets of associate (or JV) at the beginning of the year	X
Group share of associate's (or JV's) profits before tax	(X)
	X
Dividends received from associate (or JV) in the year	(X)
Group investment in net assets of associate (or JV) at the end of the year	X

Example: Dividends received from an associate (or JV)

The following information has been extracted from the consolidated financial statements of P for the year ended 31 December 20X7. The group has neither purchased nor disposed of any investment during this period.

Group statement of profit or loss

	Rs. 000
Group operating profit	1,468
Share of associate's profit after tax	136
	1,604
Tax on profit on ordinary activities:	
Income taxes: group	(648)
Profit on ordinary activities after tax	956

Group statement of financial position at 31 December

	20X7	20X6
	Rs. 000	Rs. 000
Investments in associates		
Share of net assets	932	912

Required

(a) What figure should appear in the group statement of cash flows for the year to 31 December 20X7 for the associate?

(b) Under which heading would you expect this figure to appear in the group statement of cash flows?

Answer

(a)

	Rs. 000
Group investment in net assets of associate at the beginning of the year	912
Group share of associate's profits after tax	136
	1,048
Dividends received from associate in the year (as a balancing figure)	(116)
Group investment in net assets of associate at the end of the year	932

(b) The cash flow of Rs. 116,000 will be shown as a cash flow from investing activities in the group statement of cash flows.

Practice question **6**

The following information has been extracted from the consolidated financial statements of P, a holding company which prepares accounts to 31 December each year:

Consolidated statement of financial position (extract):

	Year 4	Year 3
	Rs. 000	Rs. 000
Investments in associated undertakings	932	912
Current assets		
Dividend receivable from associate	96	58

Consolidated statement of profit or loss (extract):

Investments in associated undertakings	Year 4
	Rs. 000
Group operating profit	1,468
Share of operating profit of associate	136
	1,604
Income taxes:	(648)
Profit after tax	956

Required

Calculate the figure that will appear in the consolidated statement of cash flows for the year to 31 December Year 4 in respect of dividend received from associates?

6 ACQUISITIONS AND DISPOSALS OF SUBSIDIARIES IN THE STATEMENT OF CASH FLOWS

Section overview

- Acquisition of a subsidiary in the statement of cash flows
- Note to the statement of cash flows on acquisitions
- Avoiding double counting when a subsidiary has been acquired
- Disposal of a subsidiary in the statement of cash flows

6.1 Acquisition of a subsidiary in the statement of cash flows

When a subsidiary is acquired:

- the group gains control of the assets and liabilities of the subsidiary, which might include some cash and cash equivalents, and
- the group pays for its share of the subsidiary, and the purchase consideration might consist partly or entirely of cash.

In the group statement of cash flows, a single figure is shown (under the heading 'Cash flows from investing activities') for the net effect of the cash flows from acquiring the subsidiary. This net effect is:

Illustration: Cash paid for a subsidiary

	Rs.
Cash element in the purchase consideration	X
Minus: Cash assets of the subsidiary at the acquisition date	(X)
Cash payment on acquisition of subsidiary, net of cash received	X

This net cash payment is the amount shown in the group statement of cash flows.

Example: Cash paid for a subsidiary

Blue Group acquired 80% of the shares in Green Entity on 5 September 20X6, when the net assets of Green Entity were Rs. 800,000, including Rs. 25,000 in cash and cash equivalents. The purchase consideration was Rs. 700,000, consisting of Rs. 500,000 in new shares of Blue (the holding company) and Rs. 200,000 in cash.

The cash flow shown in the group statement of cash flows for the year to 31 December 20X6 is:

	Rs.
Cash element in the purchase consideration	200,000
Minus: Cash assets of the subsidiary at the acquisition date	(25,000)
Cash payment on acquisition of subsidiary, net of cash received	175,000

Note that in the above example, even though only 80% of the shares in Green Entity have been acquired, the full **Rs.** 25,000 of cash held by the subsidiary is brought into the group statement of financial position at the acquisition date. The figure deducted from the cash in the purchase consideration is therefore 100% of the subsidiary's cash and cash equivalents acquired.

6.2 Note to the statement of cash flows on acquisitions

In an examination, it is useful to prepare a statement summarising the cash flow effects of an acquisition. This statement is actually required by IAS 7, and should be presented as a note to the statement of cash flows.

The statement should be presented as follows:

Illustration: Note to the cash flow statements re acquisition

	Rs.
Assets of the subsidiary at the acquisition date, at fair value	X
Liabilities of the subsidiary at the acquisition date	(X)
Net assets of the subsidiary at the acquisition date	X
Minus non-controlling interest in the subsidiary at this date (% Non-controlling interest × Net assets)	(X)
Purchased goodwill	X
Fair value of net assets acquired	X
Satisfied by:	
New shares in holding company	X
Cash	X
Purchase consideration	X

The total purchase consideration equals the fair value of the net assets acquired.

The cash of the subsidiary at the acquisition date (C_2) is then deducted from the cash paid (C_1) to arrive at the figure that appears in the statement of cash flows for the 'Acquisition net of cash received'

Example: Note to the cash flow statements re acquisition

A typical note to the statement of cash flows, using illustrative figures, might appear as follows for a subsidiary in which 80% of the shares are acquired:

	Rs. 000
Net assets acquired:	
Cash (C_2)	3
Trade receivables	85
Inventories	139
Property, plant and equipment	421
Trade payables	(68)
Bank loan	(100)
	480
Non-controlling interest (20% × 480)	(96)
	384
Purchased goodwill	76
Fair value of net assets acquired	460
Satisfied by:	
Issue of shares	152
Cash paid (C_1)	308
	460

Extract from statement of cash flows

Investing activities

Acquisition of subsidiary net of cash received (Rs. 308,000 – Rs. 3,000) Rs. 305,000

In the statement of cash flows itself, the cash payment on the acquisition of the subsidiary is not Rs. 308,000, because the cash flow is shown as the payment minus the cash held by the subsidiary at the acquisition date (which is cash brought into the group by acquiring the subsidiary).

In this example, the cash brought into the group on acquisition, as a part of the net assets of the subsidiary, is Rs. 3,000.

6.3 Avoiding double counting when a subsidiary has been acquired

Cash flow information is often calculated from information in the opening and closing statements of financial position.

If there is an acquisition during the year, it is important to make an adjustment to the calculation for the assets or liabilities in the subsidiary that were acquired. Unless this adjustment is made, the assets and liabilities in the subsidiary at the acquisition date will be counted twice and the calculations will be incorrect.

An adjustment will be needed for every item of asset or liability acquired, **except for** cash and cash equivalents.

Inventory, trade receivables, trade payables

When the indirect method is used to present cash flows from operating activities, the changes in receivables, inventory and trade payables are shown as adjustments to the profit figure, to get to a figure for cash flow.

When preparing a statement of cash flows for an individual company, the changes in these items are calculated by calculating the difference in the figure in the closing statement of financial position and the corresponding value in the opening statement of financial position.

However, when a subsidiary has been acquired, the working capital brought into the group (receivables plus inventory minus trade payables of the acquired subsidiary) is paid for in the purchase price to acquire the subsidiary. As we have seen, this is treated as a separate item in the investing activities section of the statement of cash flows.

To avoid double counting of the effects of the working capital in the subsidiary at the acquisition date, we need to deduct from the value in the closing statement of financial position, **or** add to the value in the opening statement of financial position:

- the receivables in the net assets of the subsidiary acquired, as at the acquisition date
- the inventory in the net assets of the subsidiary acquired, as at the acquisition date, and
- the trade payables in the net assets of the subsidiary acquired, as at the acquisition date.

Example: Adjustment to calculation

D Group is preparing a group statement of cash flows for the year using the indirect method. In the group opening and closing statements of financial position, inventories were:

At the beginning of the year	**Rs. 120,000**
At the end of the year	**Rs. 190,000**

During the year, the group acquired a 75% interest in a new subsidiary, Entity S, which had inventories of Rs. 40,000 at the acquisition date.

Required

What figure should be shown in the group statement of cash flows as the adjustment for the increase or decrease in inventories?

Answer

	Rs.
Group inventories at the beginning of the year	120,000
Add: Inventories acquired in the subsidiary	40,000
	160,000
Adjustment for increase in inventories on acquisition of new subsidiary	30,000
Group inventories at the end of the year	190,000

Inventories have increased by Rs. 30,000 after allowing for the Rs. 40,000 of inventories brought into the group when the subsidiary was purchased.

This would usually be shown as a working on the face of the answer as (Rs. 190,000 – (120,000 + 40,000))

Purchases of non-current assets

When non-current assets are shown at their carrying amount (net book value) and a subsidiary has been acquired during the year, purchases of non-current assets (assumed to be cash payments) are calculated as follows.

Example: Cash paid to buy non-current assets

	Rs.
Non-current assets at carrying amount, at the beginning of the year	240,000
Net book value of disposals of non-current assets during the year	(30,000)
Depreciation charge for the year	(40,000)
Cash paid to acquire non-current assets during the year (second balancing figure)	55,000
Non-current assets acquired on acquisition of the subsidiary	65,000
Total additions (first balancing figure)	120,000
Non-current assets at carrying amount, at the end of the year	290,000

Other items

Similar principles can be applied to all other assets and liabilities to find the cash effect, for example to calculate loan repayments and repayments of leasing obligations

Example: Tax paid

The Spot Group had the following items in its opening and closing group statements of financial position at the beginning and at the end of 20X6:

	At 1 January 20X6	At 31 December 20X6
	Rs. 000	Rs. 000
Current tax payable	250	325
Deferred tax (liability)	136	165

The Spot Group acquired a 60% holding in a subsidiary, Entity B, on 7 May 20X6. The total tax liability of Entity B at this date was Rs. 120,000. The total charge for taxation in the consolidated statement of profit or loss of the Spot Group for the year to 31 December 20X6 was Rs. 950,000.

Required

What was the cash payment for taxation during the year, for inclusion on the group statement of cash flows?

Answer

The tax liability in the subsidiary when it was acquired should be deducted from the closing tax liability for the group (or added to the opening tax liability for the group) to avoid double counting.

	Rs. 000
Group tax liability at the beginning of the year	386
Tax liability acquired in the subsidiary	120
Group tax charge in the year	950
	1,456
Tax paid in the year	(966)
Group tax at the end of the year (325 + 165)	490

Note

To calculate the tax payment for the year, you should take the entire tax charge at the beginning and at the end of the year – both current tax and deferred tax.

Example: dividends paid to non-controlling interest when a subsidiary has been acquired

The Spot Group had the following items in its opening and closing group statements of financial position at the beginning and at the end of 20X6:

	At 1 January 20X6	At 31 December 20X6
	Rs. 000	Rs. 000
Non-controlling interest	350	415

The Spot Group acquired a 60% holding in a subsidiary, Entity B, on 7 May 20X6. The net assets of Entity B at this date were Rs. 800,000 at fair value. The profit attributable to non-controlling interests in the group's statement of profit or loss for the year to 31 December 20X6 was Rs. 270,000.

Required

What dividends were paid to the non-controlling interests during the year to 31 December 20X6?

Answer

Again, to avoid double counting we need to:

a. deduct the non-controlling interest acquired from the value for non-controlling interest in the closing consolidated statement of financial position, or

b. (as shown below) add the non-controlling interest acquired to the non-controlling interest in the opening consolidated statement of financial position.

	Rs. 000
Non-controlling interest at the beginning of the year	350
Non-controlling interest acquired in the subsidiary (40% × 800)	320
Non-controlling interest share of profits for the year	270
	940
Dividends paid to non-controlling interest during the year	(525)
Non-controlling interest at the end of the year	415

The cash outflow will be shown as a cash flow from financing activities.

Example: adjustment for the impairment of goodwill

The Spot Group had the following items in its opening and closing group statements of financial position at the beginning and at the end of 20X6:

	At 1 January 20X6	At 31 December 20X6
	Rs. 000	Rs. 000
Goodwill	600	540

The Spot Group acquired a 60% holding in a subsidiary, Entity B, on 7 May 20X6. Purchased goodwill arising on the acquisition of Entity B was Rs. 110,000. The Spot Group uses the indirect method to present its group statement of cash flows.

Required

What is the impairment to goodwill for the year, and where would it appear in the group statement of cash flows?

Answer

The impairment of goodwill is a non-cash item that reduces profit. When the indirect method is used to present cash flows from operating activities, any impairment of assets during the year and charged against profit must be added back to the profit figure (in the same way that depreciation and amortisation charges are added back).

When a subsidiary is acquired during the year, the calculation of the impairment must allow for the purchased goodwill in the newly-acquired subsidiary. An adjustment is needed to avoid double-counting.

	Rs. 000
Goodwill at the beginning of the year	600
Goodwill acquired in the subsidiary	110
	710
Impairment	(170)
Goodwill at the end of the year	540

6.4 Disposal of a subsidiary in the statement of cash flows

The procedures for reporting the cash effect of disposals of subsidiaries in a group statement of cash flows are similar to those used for acquisitions, except that the process applies in reverse.

In the group statement of cash flows, the cash received from the disposal is the cash actually received from the disposal, minus any cash in the subsidiary at the disposal date.

A note to the statement of cash flows should show the details of the disposal, including the cash received from the sale minus the cash in the subsidiary at the disposal date.

The assets and liabilities disposed of, and the non-controlling interest leaves the group on the disposal.

Example: Disposal

Entity D disposed of its 80% interest in the equity capital of Entity S for a cash sum of Rs. 550 million. The statement of financial position of Entity S at the date of disposal showed the following balances:

	Rs. 000
Tangible non current assets	500
Inventories	200
Trade receivables	300
Trade payables	(200)
Taxation (including deferred taxation)	(80)
Bank overdraft	(320)
	400

D acquired its interest in S at the date of incorporation of that company, so no goodwill arose.

Required

Prepare a statement summarising the effect of the disposal as a note to the consolidated statement of cash flows.

Answer

Cash received from the sale of the shares in the subsidiary is Rs. 550,000. However, a note to the statement of cash flows should present the details of the net assets disposed of, the proceeds from the sale, and the profit or loss on disposal.

The profit or loss is the difference between the value of the net assets disposed of and the proceeds from the sale. It is a balancing figure, in the same way that the purchased goodwill is the balancing figure in a similar note to the statement of cash flows when a subsidiary has been acquired.

In this example, the subsidiary had a bank overdraft when it was disposed of. The cash in the subsidiary at the date of disposal was therefore a negative amount. The group no longer has the bank overdraft, which means that its cash flow position improved by selling off the subsidiary.

In the statement of cash flows itself, the cash proceeds from the disposal of the subsidiary (net of cash 'lost') is the cash from the disposal proceeds plus the bank overdraft that is no longer in the group (Rs. 550,000 + Rs. 320,000 = Rs. 870,000).

	Rs. 000
Net assets disposed of:	
Tangible non current assets	500
Inventories	200
Trade receivables	300
Trade payables	(200)
Taxation	(80)
Bank overdraft	(320)
	400
Non-controlling interest (20% × 400)	(80)
	320
Profit on disposal	230
Proceeds	550
Satisfied by:	
Cash	550

Extract from the statement of cash flows

Investing activities

Sale of subsidiary (550 + 320)	870

To avoid double counting of the effects of the working capital in the subsidiary at the disposal date, we need to deduct from the value in the opening statement of financial position, **or** add to the value in the closing statement of financial position:

- the receivables in the net assets of the subsidiary sold as at the date of disposal;
- the inventory in the net assets of the subsidiary sold as at the date of disposal; and
- the trade payables in the net assets of the subsidiary sold as at the date of disposal.

Example: Disposal

Suppose that the group in the previous example uses the indirect method of computing the cash flow from operating activities. Inventories were Rs. 1,600,000 in the opening group statement of financial position at the beginning of the year and Rs. 1,500,000 in the closing group statement of financial position.

Required

What figure in respect of inventories would be used as an adjustment in calculating the cash flows from operating activities?

Answer

	Rs. 000
Group inventories at the beginning of the year	1,600
Inventories disposed of in the subsidiary	(200)
	1,400
Adjustment for increase in inventories	100
Group inventories at the end of the year	1,500

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

	Rs.	Rs.
Cash flows from operating activities		
Profit before taxation	16,000	
Adjustments for:		
Depreciation and amortisation charges	15,000	
Gains on disposal of non-current assets	(5,000)	
	26,000	
Decrease in trade and other receivables	3,000	
Increase in inventories	(2,000)	
Increase in trade payables	2,500	
Cash generated from operations	29,500	
Taxation paid (tax on profits)	(4,800)	
Net cash flow from operating activities		24,700

Solution **2**

Workings

Proceeds from new issue of shares	Rs.
Share capital and share premium:	
At the end of the year (500,000 + 615,000)	1,115,000
At the beginning of the year (400,000 + 275,000)	675,000
Proceeds from new issue of shares during the year	440,000

Repayment of loans	Rs.
Loans repayable:	
At the end of the year (520,000 + 55,000)	575,000
At the beginning of the year (600,000 + 80,000)	680,000
Repayment of loans during the year	105,000

Payment of dividends	Rs.
Retained earnings at the beginning of the year	390,000
Profit after taxation for the year	420,000
	810,000
Retained earnings at the end of the year	(570,000)
Dividends paid during the year	240,000

Cash flows from financing activities can now be presented as follows.

Cash flows from financing activities	Rs.	Rs.
Proceeds from issue of shares	440,000	
Repayment of loans	(105,000)	
Dividends paid to shareholders	(240,000)	
Net cash from financing activities		95,000

Solution **3**

Dividend paid to non-controlling interest is as follows:

	Rs. 000
Opening balances (320 + 1,380)	1,700
Share of profit for the year	240
	1,940
Closing balances (200 + 1,560)	(1,760)
Dividend paid	180

Solution **4**

Dividend paid to non-controlling interest is as follows:

	Rs. 000
Balances at start of Year 5 (20+ 600)	620
Attributable to NCI in profit or loss for the year	300
	920
Balances at end of Year 5 (25 + 630)	655
Cash paid to NCI	(265)

Solution **5**

Dividend paid to non-controlling interest is as follows:

	Rs. m
Opening balance, NCI	3.6
NCI in profit for the year	2.0
Effect of acquisition: addition to NCI (25% × Rs. 6.4)	1.6
Revaluation surplus: addition to NCI	1.5
	8.7
Closing balance, NCI	6.0
Dividend paid to NCI (balancing figure)	(2.7)

Solution **6**

Dividend from associate is as follows:

	Rs. 000
Opening balances (912 + 58)	970
Share of profit after tax for the year	136
	1,106
Closing balances (932 + 96)	(1,028)
Dividend received	78

CHAPTER 28

IAS 33: Earnings per share

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply application abilities of the requirements of the international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse the financial data in order to arrive at arriving at firm decisions on about the accounting treatment and reporting of the same.**

FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 26 IAS 33: Earnings per share

1 P/E RATIO AND EARNINGS PER SHARE (EPS)

Section overview

- The need for a standard on earnings per share
- IAS 33: Earnings per share

1.1 The need for a standard on earnings per share

Earnings per share

Earnings are profits available for equity (ordinary shareholders). Earnings per share (EPS) is a measure of the amount of earnings in a financial period for each equity share.

As its name implies, EPS is calculated as reported earnings divided by the number of ordinary shares in issue.

The price/earnings ratio

The price/earnings ratio (P/E ratio) is a key stock market ratio. It is a measure of the company's current share price (market price) in relation to the EPS. The P/E ratio is calculated as follows:

Formula: Price earnings ratio

$$\text{P/E ratio} = \frac{\text{Market value of share}}{\text{Earnings per share}}$$

The P/E ratio can be used by investors to assess whether the shares of a company appear expensive or cheap. A high P/E ratio usually indicates that the stock market expects strong performance from the company in the future and investors are therefore prepared to pay a high multiple of historical earnings to buy the shares.

EPS is used by investors as a measure of the performance of companies in which they invest – or might possibly invest. Investors are usually interested in changes in a company's EPS over time – trends – and also in the size of EPS relative to the current market price of the company's shares.

EPS should therefore be calculated by all companies in a standard way, so that investors can obtain a reliable comparison between the EPS and P/E ratios of different companies.

1.2 IAS 33: Earnings per share

The rules for calculating EPS are set out in IAS 33 **Earnings per share**

The concept of EPS is quite straightforward. It is simply the profit for the year (adjusted for a few things) divided by the weighted average number of ordinary shares in that year.

IAS 33 specifies the profit figure that should be used and explains how to calculate the appropriate number of shares when there have been changes in share capital during the period under review.

IAS 33 also describes the concept of dilution which is caused by the existence of potential ordinary shares.

Each of these issues is dealt with in later sections.

Objective of IAS 33

The objective of IAS 33 is to set out principles for:

- the calculation of EPS; and
- the presentation of EPS in the financial statements.

The purpose of standardising the calculation and presentation of EPS is to make it easier for the users of financial statements to compare the performance of:

- different entities in the same reporting period; and
- the same entity for different reporting periods over time.

Scope of IAS 33

IAS 33 applies only to **publicly-traded entities** or those which are about to be publicly traded. A publicly-traded entity is an entity whose shares are traded by the investing public, for example on a stock exchange.

Most publicly-traded entities prepare consolidated financial statements as well as individual financial statements. When this is the case, IAS 33 requires disclosure only of EPS based on the figures in the consolidated financial statements.

Definition

Definition

An ordinary share is an equity instrument that is subordinate to all other classes of equity instruments.

The ordinary shares used in the EPS calculation are those entitled to the residual profits of the entity, after dividends relating to all other shares have been paid. As stated earlier, if you are given an examination question on this topic, preference shares are not ordinary shares because they give more rights to their holders than ordinary shares.

Preference shares and EPS

Preference shares are not ordinary shares. The interest of preference shareholders in the company is pre-defined as opposed to that of ordinary shareholders who have a residual interest in the company. Since EPS is a measure of earnings per ordinary share in a financial year, preference shares are excluded from the number of shares.

The dividends paid to preference shareholders must therefore be excluded from the total earnings for the period. A broad definition of 'earnings' is therefore profit after tax less preference dividends paid.

Basic and diluted earnings per share

IAS 33 requires entities to calculate:

- the basic earnings per share on its continuing operations
- the diluted earnings per share on its continuing operations.

Additional requirements apply to earnings relating to discontinued operations.

Diluted EPS and basic EPS will usually differ when there are potential ordinary shares in existence.

Definition

A potential ordinary share is a financial instrument or other contract that may entitle its holder to ordinary shares at some time in the future.

IAS 33 gives the following examples of potential ordinary shares:

- financial liabilities or equity instruments that are convertible into new ordinary shares at some time in the future (convertible debentures, convertible preference shares);
- share options and warrants. Options and warrants are financial instruments that give the holder the right (but not the obligation) to purchase new ordinary shares at some time in the future, at a fixed price;
- shares that will be issued if certain contractual conditions are met, such as contractual conditions relating to the purchase of a business.

The chapter explains the calculation of basic EPS and then the calculation of diluted EPS.

2 CALCULATING BASIC EPS

Section overview

- Basic EPS
- Total earnings
- Changes in the number of shares during a period
- Issue of shares at full market price
- Bonus issues of shares
- Rights issues of shares

2.1 Basic EPS

Basic earnings per share is calculated by dividing the profit or loss on ***continuing operations*** by the weighted average number of ordinary shares in issue during the period.

The calculation of the basic EPS is as follows:

Formula: Basic EPS

$$\frac{\text{Net profit (or loss) attributable to ordinary shareholders during a period}}{\text{weighted average number of shares in issue during the period}}$$

As you can see above IAS 33 gives guidance on:

- the earnings figure that must be used being the net profit (or loss) attributable to ordinary shareholders during a period (commonly referred to as ***total earnings***); and
- the number of shares to be used in the calculation being the weighted average number of shares in issue during the period. Changes in share capital during a period must be taken into account in arriving at this number. IAS 33 provides guidance on how to do this.

2.2 Total earnings

The total earnings figure is the profit or loss from continuing operations after deducting tax and preference dividends (and in the case of consolidated financial statements, after excluding the earnings attributable to non-controlling interests). Total earnings include any income from associates (i.e. any share of profits or losses of associates).

When there is a net loss, total earnings, and therefore, the EPS are negative.

Earnings from discontinued operations are dealt with separately. An EPS from any **discontinued operations** must also be disclosed, but this does not have to be disclosed on the face of the statement of profit or loss. Instead, it may be shown in a note to the financial statements.

The total earnings figure must be adjusted for the interests of preference shareholders before in can be used in EPS calculations.

Preference shares

Preference shares must be classified as equity or liability in accordance with the rules in IAS 32: *Financial Instruments: Presentation.*

If a class of preference shares is classified as equity, any dividend relating to that share is recognised in equity. Any such dividend must be deducted from the profit or loss from continuing operations as stated above.

If a class of preference shares is classified as liability (redeemable preference shares), any dividend relating to that share is recognised as a finance cost in the statement of profit or loss. It is already deducted from the profit or loss from continuing operations and no further adjustment need be made.

Example: Basic EPS

In the year ended 31 December Year 1, Entity G made profit after tax of Rs. 3,500,000.

Of this, Rs. 3,000,000 was from continuing operations and Rs. 500,000 from discontinued operations.

It paid ordinary dividends of Rs. 150,000 and preference dividends of Rs. 65,000.

The preference shares were correctly classified as liabilities in accordance with IAS 32.

Entity G had 1 million ordinary shares in issue throughout the year.

Entity G's basic EPS for the year ended 31 December Year 1 is calculated as follows:

$$\text{EPS} = \frac{\text{Net profit (or loss) attributable to ordinary shareholders during a period}}{\text{weighted average number of shares in issue during the period}}$$

$$= \frac{\text{Rs. 3,000,000}}{\text{1,000,000}} = \text{Rs. 3 per share (EPS from continued operations)}$$

$$= \frac{\text{Rs. 500,000}}{\text{1,000,000}} = \text{Rs. 0.5 per share (EPS from discontinued operations)}$$

Example: Basic EPS

In the year ended 31 December Year 1, Entity G made profit after tax of Rs. 3,500,000.

Of this, Rs. 3,000,000 was from continuing operations and Rs. 500,000 from discontinued operations.

It paid ordinary dividends of Rs. 150,000 and preference dividends of Rs. 65,000.

The preference shares were correctly classified as equity in accordance with IAS 32.

Entity G had 1 million ordinary shares in issue throughout the year.

Entity G's basic EPS for the year ended 31 December Year 1 is calculated as follows:

$$\text{EPS} = \frac{\text{Net profit (or loss) attributable to ordinary shareholders during a period}}{\text{weighted average number of shares in issue during the period}}$$

$$= \frac{\text{Rs. 3,000,000} - \text{Rs. 65,000}}{\text{1,000,000}} = \text{Rs. 2.94 per share (continued operations)}$$

$$= \frac{\text{Rs. 500,000}}{\text{1,000,000}} = \text{Rs. 0.5 per share (discontinued operations)}$$

Cumulative preference shares

There is a further complication concerning preference shares. Some preference shares are cumulative preference shares. This means that if a company fails to declare a preference dividend in a period the holders are entitled to receive the missed dividend sometime in the future. In other words, their right to receive a dividend accumulates when a dividend is not declared. If there are cumulative preference shares in issue the dividend must be deducted from profit or loss from continuing operations regardless of whether the dividend has been declared or not.

Example: Cumulative preference shares

In the year ended 31 December Year 1, Entity G made profit after tax from continuing operations of Rs. 3,500,000.

Entity G has Rs. 1,000,000 10% preference share capital in issue. (This would entitle investors to receive a dividend of Rs. 100,000 (10% of Rs. 1,000,000) if declared).

Entity G had 1 million ordinary shares in issue throughout the year.

Entity G's basic EPS for the year ended 31 December Year 1 is calculated as follows:

$$\text{EPS} = \frac{\text{Net profit (or loss) attributable to ordinary shareholders during a period}}{\text{weighted average number of shares in issue during the period}}$$

$$= \frac{\text{Rs. 3,500,000} - \text{Rs. 100,000}}{\text{1,000,000}} = \text{Rs. 3.4 per share}$$

Note that the Rs. 100,000 deducted above would be deducted irrespective of whether a dividend had been declared or not. However, if these had been non-cumulative then the dividend would have been deducted only in case of declaration by the company.

Increasing rate preference shares:

These are preference shares that provide for a low initial dividend to compensate an entity for selling the preference shares at a discount, or an above-market dividend in later periods to compensate investors for purchasing preference shares at a premium.

According to the rules contained in IAS 32: *Financial instruments: Presentation* and IAS 39: *Financial instruments: Recognition and measurement* the discount or premium arising on the issue of increasing rate preference shares is amortised using the effective interest method and treated as a preference dividend for the purposes of calculating earnings per share. In addition, there may be other elements amortised such as transaction costs.

All these elements should be deducted in arriving at the earnings attributed to ordinary equity holders.

Example: Increasing rate preference shares

Entity D issued non-convertible, non-redeemable class A cumulative preference shares of Rs. 100 par value on Year 1.

The class A preference shares are entitled to a cumulative annual dividend of Rs. 7 per share starting in Year 4.

At the time of issue, the market rate dividend yield on the class A preference shares was 7% per annum.

Thus, Entity D could have expected to receive proceeds of approximately Rs. 100 per class A preference share if the dividend rate of Rs. 7 per share had been in effect at the date of issue.

There was, however, to be no dividend paid for the first three years after issue.

In consideration of these dividend payment terms, the class A preference shares were issued at Rs. 81.63 per share, i.e. at a discount of Rs. 18.37 per share.

(The issue price can be calculated by taking the present value of Rs. 100, discounted at 7 per cent over a three-year period).

The imputed dividends attributable to preference shares that need to be deducted from earnings to determine the profit or loss attributable to ordinary equity holders are calculated as follows:

Example (continued): Increasing rate preference shares

Analysis

The shares are non-redeemable and would be classified as equity.

The original issue discount is amortised to retained earnings using the effective interest method and treated as a preference dividend for earnings per share purposes.

The following imputed dividend per class A preference share is deducted to determine the profit or loss attributable to ordinary equity holders of the parent in order to calculate basic earnings per share.

Year	Opening carrying amount of preference shares (Rs.)	Imputed dividend (Rs.)	Closing carrying amount (Rs.)	Dividend paid (Rs.)
1	81.63	5.71	87.34	-
2	87.34	6.12	93.46	-
3	93.46	6.54	100.00	-
Year 4 onwards	100	7.00	107.00	(7)

Early conversion of preference shares

An entity may achieve early conversion of convertible preference shares by improving the original conversion terms or paying additional consideration.

Where this is the case, the excess amount transferred as a result of the improvement of conversion terms is treated as a return to the preference shareholders and must be deducted in arriving at earnings attributable to ordinary equity holders.

Illustration: Deduction

Deduction	=	Fair value of ordinary shares issued (consideration paid)	–	Fair value of ordinary shares issuable under original terms

Repurchase of preference shares

Where the fair value of consideration paid to preference shareholders exceeds the carrying value of the preference shares repurchased, the excess is a return to the preference shareholders and must be deducted in calculating profits attributable to ordinary equity holders.

Where the carrying value of preference shares repurchased exceeds the fair value of consideration paid, the excess is added in calculating profit attributable to ordinary equity holders.

In respect of preference shares that are classified as liabilities, the above adjustments, where these are relevant, would have already been made in arriving at the profit or loss for the period.

Participating securities and two-class ordinary shares

The equity of some entities includes:

- instruments that participate in dividends with ordinary shares according to a predetermined formula (for example, two for one) with an upper limit on the extent of participation (for example, up to, but not beyond, a specified amount per share), or
- a class of ordinary shares with a different dividend rate from that of another class of ordinary shares.

Profit or loss for the period is allocated to the different classes of shares and participating equity instruments in accordance with their dividend rights or other rights to participate in undistributed earnings.

To calculate basic earnings per share:

Step 1: Adjust profit or loss attributable to ordinary equity holders of the parent entity as previously discussed.

Step 2: Allocate the profit or loss to ordinary shares and participating equity instruments to the extent that each instrument shares in earnings as if all of the profit or loss for the period had been distributed. The total profit or loss allocated to each class of equity instrument is determined by adding together the amount allocated for dividends and the amount allocated for a participation feature.

Step 3: Divide the total amount of profit or loss allocated to each class of equity instrument by the number of outstanding instruments to which the earnings are allocated to determine the earnings per share for the instrument.

Example: Participating securities

X Limited has non-convertible preference shares in issue.

These have the right to participate in any additional dividends after ordinary shares have been paid at a dividend of Rs. 2.10 per share in a 20:80 ratio with ordinary shares

The following information relates to the financial year just ended.

Profit attributable to equity shareholders	Rs. 100,000
Number of ordinary shares	10,000
Number of non-convertible preference shares	6,000
Non-cumulative annual dividend on preference shares (before any dividend is paid on ordinary shares)	Rs. 5.50 per share

The earnings attributable to ordinary shareholders is as follows:

R	Rs.
Profit attributable to equity holders of the parent entity	100,000
Less dividends paid:	
Preference (6,000 shares × Rs. 5.50 per share)	33,000
Ordinary (10,000 shares × Rs. 2.1 per share)	21,000
	(54,000)
Undistributed earnings	46,000

Note: It is irrelevant whether the ordinary dividend has been paid or not. The point is that the ordinary shareholders would be entitled to Rs. 2.1 per share before a further distribution to the preference shareholders could take place.

Allocation of the undistributed earnings

Let A be the allocation of undistributed earnings per ordinary share.
Let B be the allocation per preference share.

Therefore, the undistributed earnings belongs to each group as follows:

(10,000A) + (6,000B) = Rs. 46,000

But B's entitlement is one quarter that of A's so the equation simplifies to:

(10,000A) + (0.25 × 6,000A) = Rs. 46,000

Therefore A = Rs. 4

Therefore B = Rs. 1

Final allocation

	Participating preference share		Ordinary share	
	Per share	Total (× 6,000)	Per share	Total (× 10,000)
Distributed earnings	Rs. 5.50	33,000	Rs. 2.10	21,000
Undistributed earnings	Rs. 1.00	6,000	Rs. 4.00	40,000
Total	Rs. 6.50	39,000	Rs. 6.10	61,000
	EPS		EPS	

2.3 Changes in the number of shares during a period

IAS 33 gives guidance on how to incorporate changes in share capital during a period into the calculation of the weighted average of shares that must be used in the EPS calculation.

There are different ways in which the number of shares may change:

- Issues for full consideration (issue or redemption) of shares at a full market price).
- Issues for no consideration (issue or redemption) of shares with no change in net assets), for example:
  - Bonus issues
  - Share splits (where one share is split into several others)
  - Reverse share splits (share consolidation)
  - Bonus elements in other issues (see later discussion on rights issues)
- Rights issues (issue of shares for consideration but at less than the full market price of the share).

IAS 33 gives guidance on each of these.

Overall approach

At this point we will provide an overall approach designed to enable you to deal with complicated situations where there has been more than one capital change in the period.

Step 1: Write down the number of shares at the start of the year.

Step 2: Write down the date of the first capital change and the number of shares in existence after that capital change. Repeat this step until all capital changes have been dealt.

Step 3: Multiply each number of shares by the fraction of the year that it was in existence.

Step 4: Add up the results from step 4 to give the weighted average number of shares.

Note: If any capital change is due to or contains a bonus issue multiply each preceding number of shares by the bonus fraction.

This will not make much sense to you at first but it will become clear as you study later examples.

Example: Time apportionment to find weighted average

On 1 January a company had 5,000,000 ordinary shares in issue.
On 1 April, 1,000,000 new shares were issued.
On 1 July an extra 1,000,000 shares came into existence
On 1 November 500,000 more shares were issued.
(All issues were at full market price – the implication of this will be explained in more detail in the next section).
The weighted average number of shares is calculated as follows.

Date	Number of shares	Time factor	Weighted average number
1 January to 31 March	5,000,000	× 3/12	1,250,000
New issue on the 1 April	1,000,000		
1 April to 30 June	6,000,000	× 3/12	1,500,000
New issue on the 1 July	1,000,000		
1 July to 31 October	7,000,000	× 4/12	2,333,333
New issue on the 1 November	500,000		
1 November until 31 December	7,500,000	× 2/12	1,250,000
			6,333,333

2.4 Issue of shares at full market price

The consideration received is available to boost earnings. Therefore, the shares are included from the date of issue to ensure consistency between the numerator (top) and denominator (bottom) of the EPS calculation.

As explained above, the starting point for the weighted average number of shares is the number of shares in issue at the beginning of the period. This is then adjusted for any shares issued during the period and a time weighting factor must then be applied to each figure.

There is no adjustment to comparatives resulting from an issue at full price.

Example: Issue of shares at full market price

Company A has a financial year ending 31 December.
On 1 January Year 1 there were 6,000,000 ordinary shares in issue.
On 1 April, it issued 1,000,000 new shares at full market price.
Total earnings in Year 1 were Rs. 27,000,000.
EPS in Year 1 is calculated as follows.

Date	Number of shares	Time factor	Weighted average number
1 January to 31 March	6,000,000	× 3/12	1,500,000
New issue on the 1 April	1,000,000		
1 April to 31 December	7,000,000	× 9/12	5,250,000
			6,750,000

EPS = Rs. 27,000,000/6,750,000 shares = Rs. 4

Practice question **1**

Company B has a financial year ending 31 December.

On 1 January Year 3, there were 9,000,000 ordinary shares in issue.

On 1 May, Company B issued 1,200,000 new shares at full market price.

On 1 October, it issued a further 1,800,000 shares, also at full market price.

Total earnings in Year 3 were Rs. 36,900,000.

Required

Calculate the EPS for the year to 31 December Year 3.

Partly paid shares

The number of ordinary shares is calculated based on the number of fully paid shares. In order to do this partly paid shares are included as an equivalent number of fully paid shares to the extent they are entitled to participate in dividends.

Example: Issue of shares at full market price

Company A has a financial year ending 31 December.

On 1 January Year 1 there were 6,000,000 ordinary shares in issue.

1,000,000 of these shares were partly paid to 75% of their value which entitles them to 75% dividend as compared to a fully paid share.

On 1 April, the remaining 25% of the value of the partly paid shares was received.

Total earnings in Year 1 were Rs. 24,750,000.

EPS in Year 1 is calculated as follows.

Date	Number of shares	Time factor	Weighted average number
1 January to 31 March	6,000,000	× 3/12	1,500,000
Receipt of partly of balance on partly paid shares (25% of 1,000,000)	250,000		
1 April to 31 December	6,250,000	× 9/12	4,687,500
			6,187,500

EPS = Rs. 24,750,000/6,187,500 shares = Rs. 4

2.5 Bonus issues of shares

A bonus issue of shares (also called a scrip issue or a capitalisation issue) is an issue of new shares to existing shareholders, in proportion to their existing shareholding, for no consideration. In other words, the new shares are issued 'free of charge' to existing shareholders.

The new shares are created by converting equity reserves in the statement of financial position, often some or all of the share premium account, into ordinary share capital.

No cash is raised from a bonus issue, therefore is no earnings boost from the issue. Bonus issued shares are treated as if they have always been in issue.

The new number of shares (i.e. the number of shares after the bonus issue) can be found by multiplying the number of shares before the bonus issue by the bonus issue fraction.

The bonus issue fraction is

Formula: Bonus issue fraction

$$\frac{\text{Number of shares in holding after the bonus issue}}{\text{Number of shares in holding before the bonus issue}}$$

Example: Bonus fraction

A company has 4,000,000 shares in issue.

It made a 1 for 4 bonus issue (25%)

The bonus fraction is

$$\frac{\text{Number of shares in holding after the bonus issue}}{\text{Number of shares in holding before the bonus issue}}$$

$$\frac{4+1}{4} = \frac{5}{4}$$

Number of shares in issue after the bonus issue:

$$4{,}000{,}000 \times 5/4 = 5{,}000{,}000$$

The above example is very straightforward but it illustrates an approach of wider applicability.

Example: Bonus issue

Company C has a 31 December financial year end.

On 1 January Year 5 it has 4,000,000 shares in issue.

On 1 July Year 5 it made a 1 for 4 bonus issue.

The financial results for Company C in Year 4 and Year 5 were as follows.

	Year 5	Year 4
Total earnings	Rs. 20,000,000	Rs. 20,000,000

There were no share issues in Year 4.

Basic EPS in Year 4 was: Rs. 20,000,000/4,000,000 shares = Rs. 5 per share.

Basic EPS for Year 5 financial statements can be calculated as follows

The weighted average number of shares in the current year (using the method explained earlier) is calculated as:

Date	Number of shares	Time factor	Bonus fraction	Weighted average number
1 January to 30 June	4,000,000	× 6/12	× 5/4	2,500,000
Bonus issue on 1 July	1,000,000			
1 July to 31 December	5,000,000	× 6/12		2,500,000
				5,000,000

Remember that if a capital change is due to a bonus issue each preceding must be multiplied by the bonus fraction.

This must be done so that the new shares issued are not time apportioned. The new shares are included from 1 July to 31 December so they must also be included in the period(s) before this.

There is a much easier way to arrive at the number of shares in this example. It is simply the number in issue at the end of the year. However, this only works if the bonus issue is the only capital change in a year. In such cases do it this way but if there is more than one capital change in a period you must use the longer method shown above.

Basic EPS in Year 5 is: Rs. 20,000,000/5,000,000 shares = Rs. 4 per share.

In the above example nothing changed between Year 4 and Year 5 except for the number of shares, yet the EPS figures calculated indicate deterioration from Rs. 5 per share to Rs. 4 per share.

Comparatives

There is no time apportionment for a bonus issue. This means that all comparative figures must be restated into the same terms to take account of the bonus. Unless a suitable adjustment is made to the EPS calculation, the comparison of EPS in the current year (after the bonus issue) with EPS in the previous year (before the bonus issue) would be misleading.

In order to ensure that the EPS in the year of the bonus issue is comparable with the previous year's EPS, IAS 33 requires that the weighted average number of shares should be calculated as if the bonus shares had always been in issue.

This means that:

- the current period's shares are adjusted as if the bonus shares were issued on the first day of the year; and
- the comparative EPS for the previous year is restated on the same basis.

The restatement of the comparatives is easily achieved by multiplying it by the inverse of the bonus fraction.

Example (continued): Bonus issue – restatement of comparatives

Company C made a 1 for 4 bonus issue in Year 5.

Basic EPS in Year 4 was: Rs. 20,000,000/4,000,000 shares = Rs. 5 per share.

This is restated by multiplying it by the inverse of the bonus fraction as follows:

Rs. 5 per share ×4/5 = Rs. 4 per share

The figures presented in Company C's Year 5 accounts would be:

	Year 5	Year 4
Earnings per share	Rs. 4	Rs. 4

Practice question **2**

Company D has a 31 December year end and had 2,000,000 ordinary shares in issue on 1 January Year 2.

On 31 March Year 2, it issued 500,000 ordinary shares, at full market price.

On 1 July Year 2, Company D made a 1 for 2 bonus issue.

In Year 1, the EPS had been calculated as Rs. 30 per share.

In Year 2, total earnings were Rs. 85,500,000.

Required

Calculate the EPS for the year to 31 December Year 2, and the comparative EPS figure for Year 1.

Comparatives are also restated for share consolidation and share splits.

2.6 Rights issues of shares

A rights issue of shares is an issue of new shares for cash, where the new shares are offered initially to current shareholders in proportion to their existing shareholdings.

The issue price of the new shares in a rights issue is always below the current market price for the shares already in issue. This means that they include a bonus element which must be taken into account in the calculation of the weighted average number of shares. Also note that any comparatives must be restated by multiplying them by the inverse of the rights issue bonus fraction.

The rights issue bonus fraction is calculated as follows:

Formula: Rights issue bonus issue fraction

$$\frac{\text{Actual cum rights price}}{\text{Theoretical ex rights price}}$$

The **actual cum-rights price** is the market price of the shares before the rights issue.

The **theoretical ex-rights price** is the price that the shares ought to be, in theory, after the rights issue. It is a weighted average price of the shares before the rights issue and the new shares in the rights issue.

The calculation of the theoretical ex rights price looks a little complicated at first but it is always done this way. This is demonstrated in the following example.

Example:

Company E had 3,600,000 shares in issue on 1 January Year 2.

It made a 1 for 4 rights issue on 1 June Year 2, at a price of Rs. 40 per share. (After the rights issue, there will be 1 new share for every 4 shares previously in issue).

The share price just before the rights issue was Rs. 50.

Total earnings in the financial year to 31 December Year 2 were Rs. 25,125,000.

The reported EPS in Year 1 was Rs. 6.4.

EPS for the year to 31 December Year 2 and the adjusted EPS for Year 1 for comparative purposes are calculated as follows:

Theoretical ex-rights price	Rs.
4 existing shares have a 'cum rights' value of (4 × Rs. 50)	200
1 new share is issued for	40
5 shares after the issue have a theoretical value of	240

Therefore, the theoretical ex-rights price = Rs. 240/5 = Rs. 48

Rights issue bonus fraction:

Actual cum rights price/Theoretical ex rights price = 50/48.

Weighted average number of shares

Date	Number of shares	Time factor	Rights fraction	Weighted average number of shares
1 January to 31 May	3,600,000	× 5/12	× $^{50}/_{48}$	1,562,500
Rights issue on 1 June	900,000			
1 June to 31 December	4,500,000	× 7/12		2,625,000
				4,187,500

Calculation of EPS

EPS Year 2 = Rs. 25,125,000/4,187,500 = Rs. 6 per share
Comparative EPS in Year 1 = Rs. 6.4 × (Rs. 48/Rs. 50) = Rs. 6.14 per share

Practice question **3**

Company F had 3 million ordinary shares in issue on 1 January Year 7.

On 1 April Year 7, it made a 1 for 2 rights issue of 1,500,000 ordinary shares at Rs. 20 per share.

The market price of the shares prior to the rights issue was Rs. 50.

An issue of 400,000 shares at full market price was then made on 1 August Year 7.

In the year to 31 December Year 7, total earnings were Rs. 17,468,750. In Year 6 EPS had been reported as Rs. 3.5.

Required

Calculate the EPS for the year to 31 December Year 7, and the adjusted EPS for Year 6 for comparative purposes.

3 DILUTED EPS

Section overview

- The meaning of dilution
- IAS 33 and diluted EPS
- Diluted EPS: convertible preference shares and convertible bonds
- Diluted EPS: options and warrants
- Diluted EPS: Employee share options
- Potential ordinary shares that are not dilutive
- Contingently issuable shares
- Actual conversion during the year

3.1 The meaning of dilution

'Dilution' means 'watering down' or 'reduction in strength'.

An entity might have potential ordinary shares in issue. There is a possibility that these will become actual ordinary shares at some time in the future.

For example, if an entity has issued some convertible bonds or convertible preference shares, these might be converted into ordinary shares at some time in the future.

Similarly, holders of share options or warrants might exercise their right at a future date to subscribe for new shares at a fixed price.

If potential shares become actual ordinary shares, the earnings figure will be shared with a larger number of ordinary shares. This would dilute the EPS.

3.2 IAS 33 and diluted EPS

IAS 33 requires publicly-traded companies to calculate a diluted EPS in addition to their basic EPS for the current year (with a comparative diluted EPS for the previous year), allowing for the effects of all dilutive potential ordinary shares.

Potential ordinary shares might not dilute the EPS. The diluted EPS calculation only includes potential ordinary shares that would be dilutive. Note: potential ordinary shares are 'dilutive' when there might have been a reduction or 'dilution' in EPS if they had been actual ordinary shares during the financial period.

Diluted EPS is calculated by adjusting the earnings and number of shares figures used in the basic EPS calculation.

Earnings is adjusted to remove the effect of dividends or interest that have been recognised during the year for the potential ordinary shares, and for any other income or expense that would alter as a result of the conversion of the potential ordinary shares into actual ordinary shares.

The main items of dividend or interest to adjust for are dividends on convertible preference shares and interest on convertible debentures (convertible bonds).

The dividend or interest reduces total earnings. However, if they had already been converted into ordinary shares (and the calculation of diluted EPS is based on this assumption) the dividends or interest would not have been payable. Total earnings would therefore have been higher. To calculate the diluted EPS, total earnings are adjusted to allow for this.

The weighted average number of shares must also be adjusted. The method of making this adjustment is different for:

- convertible bonds or convertible preference shares; and
- share options or warrants.

3.3 Diluted EPS: convertible preference shares and convertible bonds

When there are convertible bonds or convertible preference shares, diluted EPS is calculated as follows, by making adjustments to total earnings and the number of shares in issue used in the basic EPS calculation.

Total earnings

Total earnings are adjusted because the entity would not have to pay the dividend or interest on the convertible securities.

- For **convertible preference shares**, add back the preference dividend paid in the year. Total earnings will be increased by the preference dividend saved.
- For **convertible bonds**, add back the interest charge on the bonds in the year less the tax relief relating to that interest. Total earnings will increase by the interest saved less tax.

Number of shares

The weighted average number of shares is increased, by adding the maximum number of new shares that would be created if all the potential ordinary shares were converted into actual ordinary shares.

The additional number of shares is calculated on the assumption that they were in issue from the beginning of the year or from the date of issue whichever is later.

Example: Diluted EPS (convertible bonds)

Company G has 12,000,000 ordinary shares and Rs. 4,000,000 5% convertible bonds in issue.

As at 31 December Year 2, there have been no new issues of shares or bonds for several years.

The bonds are convertible into ordinary shares in Year 3 or Year 4, at the following rates:

At 30 shares for every Rs. 100 of bonds if converted at 31 December Year 3

At 25 shares for every Rs. 100 of bonds if converted at 31 December Year 4

Total earnings for the year to 31 December Year 2 were Rs. 36,000,000.

Tax is payable at a rate of 30% on profits.

The basic EPS and diluted EPS for Year 2 are calculated as follows:

Basic EPS:

Year to 31 December Year 2: Rs. 36,000,000/12 million = Rs. 3 per share

Diluted EPS:

	Number of shares	Earnings (Rs.)	EPS (Rs.)
Basic EPS figures	12,000,000	36,000,000	3
Dilution:			
Number of shares 4,000,000 × 30/100	1,200,000		
Add back interest:			
5% × Rs. 4,000,000		200,000	
Less tax at 30%		(60,000)	
Adjusted figures	13,200,000	36,140,000	2.74

Diluted EPS: Rs. 36,140,000/13,200,000 = Rs. 2.74 per share

Note: The number of potential shares is calculated using the conversion rate of 30 shares for every Rs. 100 of bonds, because this conversion rate produces more new shares than the other conversion rate, 25 shares for every Rs. 100 of bonds. (IAS 33 provides for use of most dilutive option when multiple conversion options are available).

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New issue of convertibles in the year

If new convertibles are issued during the course of the year, the additional number of shares and the earnings adjustment are included only from the time that the convertibles were issued.

Example: Diluted EPS (New issue of convertibles in the year)

Company H has 10,000,000 ordinary shares in issue.

There has been no new issue of shares for several years. However, the company issued Rs. 2,000,000 of convertible 6% bonds on 1 April Year 5.

These are convertible into ordinary shares at the following rates:

On 31 March Year 10	25 shares for every Rs. 100 of bonds
On 31 March Year 11	20 shares for every Rs. 100 of bonds

Tax is at the rate of 30%.

In the financial year to 31 December Year 5 total earnings were Rs. 40,870,000.

The Year 5 basic EPS and diluted EPS are calculated as follows:

Basic EPS

Year 5 = Rs. 40,870,000/10,000,000 = Rs. 4.087 per share

Diluted EPS:

	Number of shares	Earnings (Rs.)	EPS (Rs.)
Basic EPS figures	10,000,000	40,870,000	4.087
Dilution:			
Number of shares			
2 million × 25/100 × 9/12	375,000		
Add back interest:			
6% × Rs. 2,000,000 × 9/12		90,000	
Less tax at 30%		(27,000)	
Adjusted figures	10,375,000	40,933,000	3.94

Diluted EPS: Rs. 40,933,000/10,375,000 = Rs. 3.94 per share

3.4 Diluted EPS: options and warrants

A different situation applies with share options and share warrants.

Options (warrants) are contracts issued by a company which allow the holder of the option to buy shares off the company at some time in the future at a pre-agreed price.

If the option holder exercises this right the number of shares would increase and the company would receive the cash paid for the shares and this would be available to invest in the business and in turn this would be expected to boost its earnings. However, it is impossible to predict how total earnings will be affected when the cash is eventually received.

This presents a problem. Including the shares in the diluted EPS calculation without adjusting the earnings would be inconsistent but it is not possible to adjust the earnings.

IAS 33 solves this problem in quite a neat way. The amount that would be received on exercise of the options is treated as cash received from selling shares at full price with the remaining shares having been given away. The shares sold at full price are not considered to be dilutive as any cash would be invested to earn the same return as earned in the period. It is only the free shares that are dilutive.

The following steps must be taken:

Step 1: Calculate the cash that would be received if the options are exercised.

Step 2: Calculate the number of shares that could be sold at (average) full market price to raise the same amount of cash. (Divide the figure from step 1 by the average share price in the period).

Step 3: Identify the number of shares that will be issued if all the options are exercised.

Step 4: Subtract the number of shares in step 2 from the number at step 3. These shares are treated as having been given away for free and is added to the existing number of shares in issue, to obtain the total shares for calculating the diluted EPS.

Example: Diluted EPS (options)

Company J had total earnings during Year 3 of Rs. 25,000,000.

It has 5,000,000 ordinary shares in issue.

There are outstanding share options on 400,000 shares, which can be exercised at a future date, at an exercise price of Rs. 25 per share.

The average market price of shares in Company J during Year 3 was Rs. 40.

The diluted EPS for Year 3 may be calculated as follows:

Step 1:	Cash proceeds from exercise of the options	
	400,000 × Rs. 25	Rs. 10,000,000
Step 2:	Divide by the average share price in the period	Rs. 40
	Shares issued at full price	(250,000)
Step 3	Number of shares issued on exercise of the option	400,000
Step 4	Shares issued for free	150,000

Diluted EPS calculation

	Number of shares	Earnings (Rs.)	EPS (Rs.)
Basic EPS figures	5,000,000	25,000,000	5
Dilution:			
Number of shares	150,000		
Adjusted figures	5,150,000	25,000,000	4.85

Diluted EPS: Rs. 25,000,000/5,150,000 = Rs. 4.85 per share

Options are only included in the diluted EPS calculation if the average share price in the year is greater than the exercise price of the option. If this were not the case the option would not be exercised. (Nobody would pay an exercise price of Rs. 100 for something worth only Rs. 80).

- When the exercise price of the option is less than the share price they are said to be ***in the money***.
- When the exercise price of the option is more than the share price they are said to be ***out of the money***.

In the money options are always dilutive. Out of the money options are always not dilutive (or antidilutive as IAS 33 describes them).

3.5 Diluted EPS: Employee share options

Employee share options that have vested are treated in exactly the same way as any other option as explained above.

Unvested options

The situation in respect of unvested options is a little more complicated. When a company issues options to its employees it recognises an expense for options over the vesting period in accordance with IFRS 2. This means that the company will recognise an expense in the future for those options which are unvested at the reporting date.

This expense represents the service of the employee that will be consumed and used by the company in the future.

Thus, the company will receive cash when the option is exercised and service until it vests. IAS 33 requires that the future "service" received per share be added to the exercise price for the purpose of calculating the number of dilutive shares.

The following steps must be taken:

Step 1: Calculate the cash that would be received if the options are exercised and the future expense that is expected to be charged to profit or loss.

Step 2: Calculate the number of shares that could be sold at full market price to raise an amount of cash equal to the future benefit identified at step 1. (Divide the figure from step 1 by the average share price in the period).

Step 3: Identify the number of shares that will be issued if all the options are exercised.

Step 4: Subtract the number of shares in step 2 from the number at step 3. These shares are treated as having been given away for free and is added to the existing number of shares in issue, to obtain the total shares for calculating the diluted EPS.

Example: Diluted EPS (employee share options)

Company K had total earnings during Year 5 of Rs. 30,000,000.

It has 6,000,000 ordinary shares in issue.

There are unvested employee share options on 500,000 shares, which can be exercised at a future date, at an exercise price of Rs. 210 per share.

The future expense that the company expects to recognise in respect of these options up to the vesting date is Rs. 15,000,000.

The average market price of shares in Company J during Year 5 was Rs. 300.

The diluted EPS for Year 3 may be calculated as follows:

Step 1:	Estimate the future benefit	
	Cash proceeds from exercise	
	500,000 × Rs. 210	Rs. 105,000,000
	Future employee service	Rs. 15,000,000
		Rs. 120,000,000
Step 2:	Divide by the average share price in the period	Rs. 300
	Shares issued at full price	400,000
Step 3	Number of shares issued on exercise of the option	500,000
Step 4	Shares issued for free	100,000

Diluted EPS calculation

	Number of shares	Earnings (Rs.)	EPS (Rs.)
Basic EPS figures	6,000,000	30,000,000	5
Dilution:			
Number of shares	100,000		
Adjusted figures	6,100,000	30,000,000	4.91

Diluted EPS: Rs. 30,000,000/6,100,000 = Rs. 4.91 per share

3.6 Potential ordinary shares that are not dilutive

Only dilutive potential ordinary shares are included in the dilutive EPS calculation.

When there are several types of potential ordinary share in issue, they should be ranked in order of dilution, with the most dilutive potential ordinary shares ranked first. In order to carry out the ranking the earnings per incremental share is found for each potential ordinary share. This is the earnings adjustment that would be necessarily divided by the number of shares that would come into being if the share were included in the calculation of diluted EPS.

Note that in the money options always rank first as they increase the number of shares in the calculation without affecting the earnings.

A diluted EPS should then be calculated in stages, taking in one potential ordinary share at a time, to establish whether any of them are not dilutive.

The following example illustrates the technique.

Example: Order of dilution

The following information relates to Company L for the year ended 31 December Year 5.

Number of ordinary shares in issue	5,000,000
Reported earnings in the year	Rs. 15,000,000
Average market price of shares during the year	Rs. 80
Potential ordinary shares:	
Options	600,000 options, with an exercise price of Rs. 60
4% convertible bond: Rs. 5,000,000	Each bond is convertible in Year 10 into ordinary shares at the rate of 40 new shares for every Rs. 100 of bonds
100,000 7% convertible preference shares of Rs. 10 each	Each preference share is convertible in Year 9 into ordinary shares at the rate of 1 ordinary share for every 20 preference shares
Tax rate = 30%	

Diluted EPS for the year to 31 December Year 5 can be calculated as follows.

Example (continued): Order of dilution

If all the options are exercised, the cash received will be 600,000 × Rs. 60 = Rs. 36,000,000.

This would purchase 450,000 shares (Rs. 36,000,000/Rs. 80) at the average market price in Year 5.

The dilutive increase in the number of shares would therefore be (600,000 – 450,000) = 150,000.

	Increase in earnings.	Increase in number of shares	Earnings per incremental share	Ranking
	Rs.		Rs.	
Options	0	150,000	0.00	1st
Convertible bonds				
4% × Rs. 5,000,000	200,000			
less tax 30%	(60,000)			
	140,000			
Rs. 5,000,000 × 40/100		2,000,000		
	140,000	2,000,000	0.07	2nd
Preference shares				
7% × Rs. 1,000,000	70,000			
100,000 × 1/20		5,000		
(7% × Rs. 1,000,000)	70,000	5,000	14.0	3rd

Diluted EPS is calculated as follows (taking these three dilutive potential ordinary shares in order of their ranking):

	Earnings	Number of shares	EPS	
	Rs.		Rs.	
As reported, basic EPS	15,000,000	5,000,000	3.000	
Options	0	150,000		
Diluted EPS, options only	15,000,000	5,150,000	2.913	Dilutive
Convertible bonds	140,000	2,000,000		
Diluted EPS, options and convertible bonds	15,140,000	7,150,000	2.12	Dilutive
Convertible preference shares	70,000	5,000		
Diluted EPS, options and all convertibles	15,210,000	7,155,000	2.13	Not dilutive

The convertible preference shares are not dilutive, and the reported diluted EPS should be Rs. 2.12 (and not Rs. 2.13).

3.7 Contingently issuable shares

A company might enter into a contract where it will issue shares on the occurrence of some future event. Such shares have no effect on the basic EPS calculation until the condition is actually met.

They are taken into account in the diluted EPS only if the conditions leading to their issue have been satisfied. For this purpose the reporting date is treated as the end of the contingency period.

Contingently issuable shares are included in the diluted EPS calculation from the later of the beginning of the period or the date of the contingently issuable share agreement.

Example: Contingently issuable shares

Company M has 12,000,000 ordinary shares in issue.

As at 31 December Year 2, there have been no new issues of shares or bonds for several years.

Company M acquired a new business during Year 1. As part of the purchase agreement Company M would issue a further 1,000,000 shares to the vendor on 30 June Year 3 if the share price was Rs. 500 at that date.

The share price was Rs. 600 on 31 December Year 2.

Earnings for the year to 31 December Year 2 were Rs. 100,000,000.

Basic EPS:

31 December Year 2: Rs. 100,000,000/12,000,000 = Rs. 8.33 per share

Diluted EPS:

	Number of shares	Earnings (Rs.)	EPS (Rs.)
Basic EPS figures	12,000,000	100,000,000	8.33
Dilution:			
Number of shares	1,000,000		
Adjusted figures	13,000,000	100,000,000	7.69

Diluted EPS: Rs. 100,000,000/13,000,000 = Rs. 7.69 per share

Shares that are issuable after a period of time are not contingently issuable shares because passage of time is a certainty. When there is an agreement to issue shares at a point of time in the future they must be included in the diluted EPS calculation.

3.8 Actual conversion during the year

If a conversion right is exercised during the year, interest paid to the holders of the convertible bond ceases on the date upon which they exercise their right to the shares and the new shares are included as part of the weighted average number of shares used in the basic EPS calculation.

When this happens, the new shares issued and the resulting interest saving must be included in the diluted EPS calculation as an adjustment for the period before the right was exercised.

Example: Diluted EPS (Conversion right exercised in the year)

Company N has 10,000,000 ordinary shares and Rs. 2,000,000 of convertible 6% bonds in issue at the start of the year.

The conversion right was exercised on 1 April resulting in the issue 500,000 new shares.

Tax is at the rate of 30%.

In the financial year to 31 December total earnings were Rs. 40,870,000.

The basic EPS and diluted EPS are calculated as follows:

Basic EPS

	Number of shares
At start of the year	10,000,000
Conversion:	
Number of shares	
500,000 × 9/12	375,000
Weighted average	10,375,000

Basic EPS: Rs. 40,870,000/10,375,000 = Rs. 3.94 per share

Diluted EPS:

	Number of shares	Earnings (Rs.)	EPS (Rs.)
Basic EPS figures	10,375,000	40,870,000	3.94
Dilution:			
Number of shares up to the date of conversion			
500,000 × 3/12	125,000		
Add back interest up to the date of conversion			
6% × Rs. 2,000,000 × 3/12		30,000	
Less tax at 30%		(9,000)	
Adjusted figures	10,500,000	40,891,000	3.89

Diluted EPS: Rs. 40,891,000/10,500,000 = Rs. 3.89 per share

This is difficult to understand but imagine two identical convertible bonds that allow conversion at any time over a period.

- Bond A is converted during the year.
- Bond B is held for a future conversion.

The conversion of Bond A has an impact on the basic EPS from the date of conversion.

An adjustment is made in respect Bond B for the whole period in the diluted EPS calculation.

If no further adjustment is made Bond A is shown as being less dilutive than Bond B because it is only included from the date of conversion. How can actual shares be less dilutive than potential shares?

In order to correct this anomaly, an adjustment must be made in respect of Bond A in the diluted EPS calculation for the part of the year before conversion.

4 IAS 33: PRESENTATION AND DISCLOSURE REQUIREMENTS

Section overview

- Presentation requirements
- Disclosure requirements
- Alternative measures of earnings per share

4.1 Presentation requirements

An entity should present in the statement of profit or loss:

- ❑ the basic EPS and
- ❑ the diluted EPS
- ❑ for the profit or loss from **continuing operations**.

For consolidated accounts, this is the EPS and diluted EPS attributable to the owners of the parent company.

The basic EPS and diluted EPS should be presented with equal prominence for all the periods presented (the current year and the previous year). These figures are presented at the end of the statement of profit or loss.

If the entity presents a separate statement of profit or loss:

- ❑ the EPS and diluted EPS should be shown in this statement, and
- ❑ not in the statement of comprehensive income.

If there is a **discontinued operation**, the basic EPS and diluted EPS from discontinued operation should be shown either on the face of the statement of profit or loss or in a note to the financial statements.

The basic and the diluted EPS should be presented, even if it is a negative figure (even if it is a loss per share).

4.2 Disclosure requirements

IAS 33 also requires disclosure in a note to the financial statements of the following:

- ❑ The total amounts used as the numerators (total earnings figures) to calculate the basic EPS and diluted EPS, and a reconciliation of these numerator figures to the profit or loss for the period
- ❑ The total amounts used in the denominators (weighted average number of shares) to calculate the basic EPS and diluted EPS, and a reconciliation of these two denominator figures to each other.

4.3 Alternative measures of earnings per share

IAS 33 allows an entity to disclose an alternative measure of EPS in addition to the EPS calculated in accordance with IAS 33. For example, EPS could be calculated after adjusting earnings for large and unusual items.

If an alternative EPS figure is presented, IAS 33 states that:

- a reconciliation must be shown between the earnings figure used in the alternative measure and the amounts shown in the statement of profit or loss
- the alternative EPS must use the same weighted average number of shares as the IAS 33 calculation
- basic and diluted EPS should both be disclosed with equal prominence, and
- the alternative figure must only be shown in the notes, **not** on the face of the statement of profit or loss.

5 EARNINGS PER SHARE AS A PERFORMANCE MEASURE

Section overview

- Earnings per share and trends
- Limitations of earnings per share

5.1 Earnings per share and trends

Investors and their advisers pay close attention to an entity's net profit for the period. However, profit for the period can include large and unusual items and also the results of discontinued operations. This may make it volatile: liable to fluctuate rapidly up and down. Users can then find it difficult to assess trends in the profit figure or to use the current year's profit to predict an entity's performance in future years.

The trend (improvement or deterioration) in an entity's published EPS figure can sometimes be a more reliable indicator of future performance. There are a number of reasons for this.

- The standard version of both basic and diluted EPS is based on profit from continuing operations. This means that the results of discontinued operations (which may distort total profit) are excluded.
- An entity may also choose to present one or more alternative versions of EPS. These normally exclude large or unusual items so that EPS is based on 'normal' recurring earnings.
- EPS measures an entity's performance from the viewpoint of investors. It shows the amount of earnings available to each ordinary shareholder. This means that EPS takes the effect of preference dividends (if any) into account. It also takes share issues into account.
- Diluted EPS can provide an 'early warning' of any changes to an investor's potential return on their investment due to future share issues.

5.2 Limitations of earnings per share

EPS is probably the single most important indicator of an entity's performance. It is a very useful measure when it is used as the starting point for a more detailed analysis of an entity's performance.

However, EPS can have serious limitations:

- Not all entities use the same accounting policies. It may not always be possible to make meaningful comparisons between the EPS of different entities.
- EPS does not take account of inflation, so that growth in EPS over time might be misleading.
- EPS measures an entity's profitability, but this is only part of an entity's overall performance. An entity's cash flow can be just as important as its

profit (and more essential to its immediate survival). Changes in the value of assets (holding gains) can also be an important part of performance for some entities.

- Diluted EPS is often described as an 'early warning' to investors that the return on their investment may fall sometime in the future. However, diluted EPS is based on current earnings, not forecast earnings. This means that it may not be a reliable predictor of future EPS.

One of the main problems with EPS can be the way that it is used by investors and others. Users often rely on EPS as the main or only measure of an entity's performance. Management know this and try to make EPS appear as high as possible. They may attempt to manipulate the figure by using 'creative accounting'. They may also make decisions which increase EPS in the short term but which damage the entity in the longer term.

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

Date	Number of shares	Time factor	Weighted average number
1 January to 30 April	9,000,000	× 4/12	3,000,000
New issue on 1 May	1,200,000		
1 May to 30 September	10,200,000	× 5/12	4,250,000
New issue on 1 October	1,800,000		
1 October to 31 December	12,000,000	× 3/12	3,000,000
			10,250,000

EPS = Rs. 36,900,000/10,250,000 = Rs. 3.6

Notes

(1) The first new share issue is in May, after 4 months. Therefore the number of shares at the beginning of the year is given a time factor of × 4/12.

(2) There are 5 months between the two share issues. Therefore, the time factor to apply to the number of shares after the first issue is × 5/12.

(3) The total number of shares in issue from 1 October to the end of the year (three months) is 12,000,000. These are given a time weighting of × 3/12.

Solution **2**

The weighted average number of shares in Year 2 is calculated as follows.

Date	Number of shares	Time factor	Bonus fraction	Weighted average number
1 January to 31 March	2,000,000	× 3/12	× 3/2	750,000
Issue at full price on 31 March	500,000			
1 April to 30 June	2,500,000	× 3/12	× 3/2	937,500
Bonus issue on 1 July	1,250,000			
1 July to 31 December	3,750,000	× 6/12		1,875,000
				3,562,500

EPS in Year 2 = Rs. 85,500,000/3,562,500 = Rs. 24 per share.

The Year 1 EPS restated as: Rs. 30 × 2/3 = Rs. 20.

Solution **3**

After the rights issue, there will be 1 new share for every 2 shares previously in issue

Theoretical ex-rights price

		Rs.
2 existing shares have a 'cum rights' value of	(2 × Rs. 50)	100
1 new share is issued for		20
3 shares after the issue have a theoretical value of		120

Theoretical ex-rights price = Rs. 120/3 = Rs. 40.

Rights issue bonus fraction:

Actual cum rights price/Theoretical ex rights price = 50/40

Weighted average number of shares

Date	Number of shares	Time factor	Rights fraction ×	Weighted average number of shares
1 January to 31 March	3,000,000	× 3/12	50/40	937,500
Rights issue on 1 April	1,500,000			
1 April to 31 July	4,500,000	× 4/12		1,500,000
Issue at full price on 1 August	400,000			
1 August to 31 December	4,900,000	× 5/12		2,041,667
				4,479,167

Calculation of EPS

EPS Year 7 = Rs. 17,468,750/4,479,167 = Rs. 3.9 per share

EPS Year 6 = Rs. 3.5 × 40/50 = Rs. 2.8

CHAPTER 29

Analysis and interpretation of financial statements

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

1 PURPOSE OF FINANCIAL RATIO ANALYSIS

Section overview

- Introduction to interpretation
- Ratio analysis as a tool
- Categories of financial ratios
- Users and their information needs

1.1 Introduction to interpretation

Financial statements are used to make decisions. They are used by a number of different groups including shareholders and investors, and also by lenders, as well as by management. The financial statements contain a large number of figures, but the figures themselves do not necessarily have much meaning to a user of the financial statements. However, the figures can be analysed and interpreted by calculating financial ratios.

Financial ratios can help the user of the financial statements to assess:

- the financial position of the entity; and
- its financial performance.

Using ratios: comparisons

Financial ratios can be used to make comparisons:

- Comparisons within financial statements. (For example if revenue has increased by 10% it might be expected that gross profit increase by a similar amount).
- Comparisons over a number of years. By looking at the ratios of a company over a number of years, it might be possible to detect improvements or deterioration in the financial performance or financial position of the entity. Ratios can therefore be used to make comparisons over time, and to identify changes or trends
- Comparisons with the similar ratios of other, similar companies for the same period.
- In some cases, perhaps, comparisons with 'industry average' ratios.

Categories of financial ratios

The main financial ratios can be classified as:

- financial performance: return on capital, profitability and use of assets
- working capital 'turnover' ratios;
- liquidity ratios;
- debt ratios;
- investor ratios.

This is discussed in far more detail in the following sections

1.2 Ratio analysis as a tool

It is difficult to assess a company's financial performance by analysing the financial results for one year. Better information is obtained by making comparisons with financial performance in the previous year, or perhaps over several periods (trend analysis).

Ratio analysis is a key tool used for performance analysis, because ratios summarise financial information, often by relating two or more items to each other, and they present financial information in a more understandable form. Ratios also identify significant relationships between different figures in the financial statements.

Illustration: Good or bad?

For example, knowing that the profit of a company is Rs.50,000 is not particularly useful information on its own, because the expected amount of profit should be dependent on the size of the business and the amount of its sales turnover.

If the company generated a profit of Rs.50,000 from Rs.150,000 of sales, then it has performed well.

However, if a profit of Rs.50,000 has been made from sales of Rs.5 million, then the profit level is much weaker.

The profit margin (the ratio of profit to sales) is a basic and widely-used ratio for analysing the strength of a company's financial performance.

A ratio on its own does not provide useful information. Ratios are useful because they provide a basis for **making comparisons**. Comparisons might indicate that performance or the financial position is better or worse than it should be, or is getting better or worse than in the past.

Illustration: Comparisons

For example, suppose that a company measures its profit margin in the current year as 20%. Is this good or bad? To evaluate performance, the current year profit margin of 20% should be interpreted, by comparing it with:

a. **last year's profit margin, or the company's profit margin for the past few years**

b. **the budgeted profit margin (available to investors, perhaps, through company announcements)**

c. **the industry average (the average profit margin for companies in the industry)**

d. **the profit margin reported by individual competitors.**

For example, if the budgeted profit margin was 25%, an actual profit margin of 20% might suggest that management have under-performed in the period

Note that a ratio does not **explain** why any under-performance or out-performance has occurred. Ratios are used to indicate areas of good or weak performance, but management then have to investigate to identify the cause.

Example: Possible explanations

A company achieved a profit margin of 6% in the year just ended. This was less than the budgeted profit margin of 10%, and less than the profit margin in the previous year, which was 8%.

The actual profit margin of 6% indicates disappointing performance, but management should investigate the cause or causes.

For example, they might find that any of the following reasons might explain the low profit margin:

a. Increased competition has forced down sales prices and so reduced profit margins.

b. Advances in technology have lowered costs but prices have come down even more.

c. Raw material costs have risen and the higher costs could not be passed on to the customers.

d. There have been higher employment costs due to pay rises for manufacturing employees, but these could not be passed on to the customers.

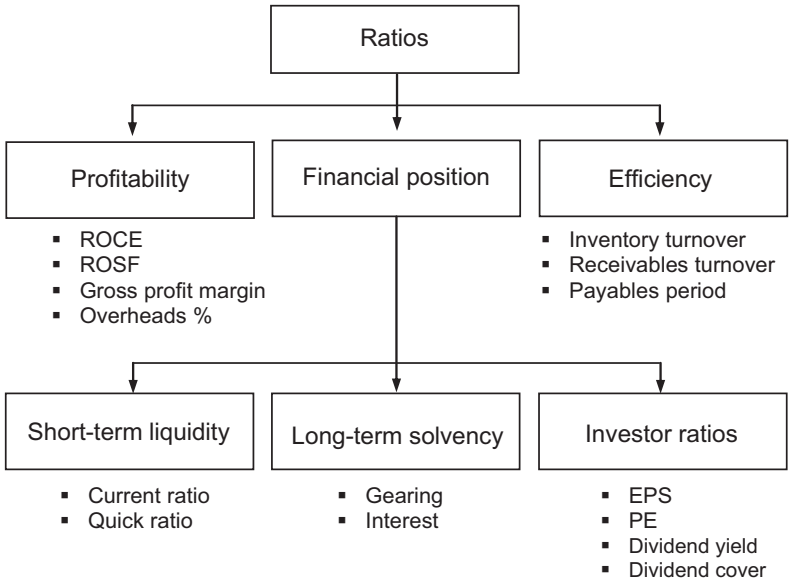
e. The company buys most of its supplies from foreign countries, and adverse movements in exchange rates for its purchases have increased costs and reduced profit margins.

f. There has been a change in the company's sales mix, and the company has sold a larger proportion of cheaper and lower-margin products than expected.

1.3 Categories of financial ratios

The basic financial ratios should already be familiar to you. Ratios can be divided into five categories:

Illustration:



The main ratios will be considered in more detail. For the purpose of your examination, you need to know how to calculate each ratio, but you must also understand why each ratio, or each category of ratios, might be of particular interest to a specific user group.

An examination question may ask you to provide an analysis of financial statements for a particular user. It will not tell you which ratios to calculate. Instead, you will have to decide for yourself which ratios may provide useful information for that user. Therefore you should learn to identify and select the appropriate ratios for each user group, and then analyse what the ratio appears to show, from the point of view of that user.

1.4 Users and their information needs

There are several groups of people who may use financial statements. They include:

- ❑ investors and potential investors;
- ❑ lenders;
- ❑ employees;
- ❑ suppliers;
- ❑ customers;
- ❑ government and government agencies;
- ❑ the general public.

Each user group has different information needs, but as a general rule financial statements prepared in accordance with IFRSs should provide all user groups with most of their needs. Each group is interested in financial performance, financial position and cash flows, but some users are mainly interested in performance and profitability, while others may be more interested in liquidity and gearing or other matters.

For example:

- A private investor needs to know whether to continue to hold shares or to sell them. He or she will tend to be most interested in profitability ratios (such as gross and net profit margin and return on capital employed) and investor ratios (such as earnings per share, dividend cover and price earnings ratio).
- A potential acquirer needs information about an entity's profitability and probably also information about whether or not the entity is managed efficiently. The acquirer's management is likely to focus on profit margins, return on capital employed, asset turnover and working capital ratios.
- A bank that has been approached to lend money to an entity needs to know whether it will receive interest payments when these are due and whether the money that it lends will eventually be repaid. A bank manager will normally be most interested in cash flows and liquidity ratios (current ratio, acid test ratio) gearing and interest cover. A potential lender will also be interested in predicting future performance as without sales there will be no cash.

Any analysis should focus on the needs of the user. What do they need to know? What are they interested in? What decision do they need to make?

The table below lists the user groups, indicates the information that they require from published reports and accounts, and suggests which items in the financial statements will be of most interest to each group.

User	Information needs	Items of interest
Investors/ potential investors	▪ Risks and returns relating to their investment ▪ Security of dividend payments ▪ Information to make decisions about buying, selling or holding shares ▪ Future growth prospects.	▪ Trend analysis: changes in revenue, costs and profits over the past few years ▪ Dividend cover ▪ Events and announcements after the reporting period ▪ Share price ▪ Corporate governance reports. Narrative business review. ▪ Net asset value per share

User	Information needs	Items of interest
Employees	▪ Stability of the company (job security and job prospects) ▪ Information about the company's ability to pay bonuses or higher salaries.	▪ Profitability and cash position ▪ Increases in salaries (%) relative to increases in profit and dividends ▪ Directors' remuneration
Lenders (banks, bondholders)	▪ Whether the entity has sufficient cash flow to repay loans ▪ The entity's ability to pay interest ▪ The adequacy of collateral/ security for loans and bonds	▪ Cash flow ▪ Total borrowing by the entity: financial gearing ▪ Interest cover ▪ New charges created over the entity's assets
Suppliers	▪ The entity's ability to settle its liabilities ▪ The entity's ability to survive and continue as a customer	▪ Net current assets ▪ Growth record
Customers	▪ The entity's ability to survive and continue as a supplier	▪ Growth record ▪ Cash flow
Government	▪ The entity's contribution to the economy ▪ Regulation of activities ▪ Taxation ▪ Obtaining government statistics	▪ Revenue and profit ▪ Market share
General public	▪ Environmental and social awareness ▪ Contributions to the local economy	▪ Environmental and social reports ▪ Directors' report ▪ Narrative business review

Management are not included as a user group because they should have access to much more detailed information about the company's financial position and performance, from internal reports and budgets.

2 RETURN ON CAPITAL, PROFITABILITY AND ASSET TURNOVER

Section overview

- Return on capital employed
- Return on shareholder capital
- Return on assets
- Analysing return: profitability and asset utilisation
- Profit/sales ratio (and cost/sales ratios)
- Asset turnover ratio
- Percentage annual growth in sales
- Dupont analysis

2.1 Return on capital employed

The aim of 'profitability ratios' is to assess the financial performance of a profit-making entity and the return that it makes on the capital invested.

Profit-making companies should try to make a profit that is large enough in relation to the amount of money or capital invested in the business. The most important profitability ratio is probably return on capital employed or ROCE.

For a single company:

Formula:

$$\text{ROCE} = \frac{\text{Profit before interest and taxation}}{\text{(Share capital and reserves + long-term debt capital + preference share capital)}} \times 100\%$$

Capital employed is the share capital and reserves, plus long-term debt capital such as bank loans, bonds and loan stock.

Where possible, use the average capital employed during the year. This is usually the average of the capital employed at the beginning of the year and end of the year.

Example: Return on capital employed

The following figures relate to Company X for Year 1.

	1 January Year 1	31 December Year 1
	Rs.	Rs.
Share capital	200,000	200,000
Share premium	100,000	100,000
Retained earnings	500,000	600,000
Bank loans	200,000	500,000
	1,000,000	1,400,000

	Rs.
Profit before tax	210,000
Income tax expense	(65,000)
Profit after tax	145,000

Interest charges on bank loans were Rs.30,000.

ROCE is calculated as follows:

ROCE = 240,000 (**W1**)/1,200,000 (**W2**) × 100 = 20%

W1	**Profit before interest and tax**	Rs.
	Profit before tax	210,000
	Add back interest deducted	30,000
	Profit before interest and tax	240,000

W2	**Capital employed**	Rs.
	Capital employed at the beginning of the year	1,000,000
	Capital employed at the end of the year	1,400,000
		2,400,000
		÷2
	Average capital employed	1,200,000

This ROCE figure can be compared with the ROCE achieved by the company in previous years, and with the ROCE achieved by other companies, particularly competitors.

Groups of companies and ROCE

To calculate the ROCE for a group of companies, it is necessary to decide what to do with any non-controlling interest (minority interest). Since capital employed includes all the debt capital in the group, it makes sense to include the non-controlling interest (minority interest) in the capital employed.

ROCE should therefore be measured as profit before interest and tax as a proportion of total capital employed, including the non-controlling interest.

2.2 Return on shareholder capital

Return on shareholder capital (ROSC) measures the return on investment that the shareholders of the company have made. This ratio normally uses the values of the shareholders' investment as shown in the statement of financial position (rather than market values of the shares).

Formula: Return on shareholder capital

$$\text{ROSC} = \frac{\text{Profit after taxation and preference dividend}}{\text{Share capital and reserves}} \times 100$$

The average value of shareholder capital should be used if possible. This is the average of the shareholder capital at the beginning and the end of the year.

Profit after tax is used as the most suitable measure of return for the shareholders, since this is a measure of earnings (available for payment as dividends or for reinvestment in the business).

Example: Return on shareholder capital

The following figures relate to Company X for Year 1.

	1 January Year 1	31 December Year 1
	Rs.	Rs.
Share capital	200,000	200,000
Share premium	100,000	100,000
Retained earnings	500,000	600,000
Shareholder capital	800,000	900,000
Bank loans	200,000	500,000
	1,000,000	1,400,000

	Rs.
Profit before tax	210,000
Income tax expense	(65,000)
Profit after tax	145,000

Interest charges on bank loans were Rs.30,000.

ROSC is calculated as follows:

ROSC = 145,000/850,000 **(W2)** × 100 = 17.06%

W1	**Shareholder capital**	Rs.
	Shareholder capital at the beginning of the year	800,000
	Shareholder capital at the end of the year	900,000
		1,700,000
		÷2
	Average shareholder capital	850,000

Groups of companies and ROSC

When calculating the ROSC for a group of companies, the main focus of attention is normally the return on the investment of the shareholders in the parent company. The ROSC should therefore be calculated as:

Formula: Return on shareholder capital of a group

$$\text{ROSC} = \frac{\text{Profit after taxation and non-controlling interest}}{\text{Equity attributable to equity holders of the parent company}} \times 100$$

The share capital and reserves should not include the non-controlling interest in the equity reserves.

Using ROCE or ROSC

- It is not necessary to calculate both these ratios. The ratio that you calculate should be the ratio that is of the greatest interest to the particular user or user group. For example, management may be most interested in ROCE, but an equity investor would be interested in ROSC.
- ROCE or ROSC could be compared to real interest rates that are currently available to investors in the market. For example, if a company has a ROCE of 3% when interest rates of 5% are available in the bond markets, a shareholder might be advised to consider selling his shares. However, it is important to remember that bond yields are returns calculated from the market price of bonds; whereas ROCE and ROSC are calculated from financial statements and are not market rates of return.
- Bank overdrafts might be included as part of capital employed in the ROCE ratio, because many companies 'roll over' their overdraft facility and use it as long-term funding. When a bank overdraft is large, the interest cost of the overdraft might be high, and it would therefore be appropriate to include the bank overdraft 'below the line' in capital employed, because the overdraft interest is included 'above the line' in profit before interest and tax.
- A company may be able to 'manipulate' its ROCE or ROSC ratios by using accounting policies or financing strategies, such as:
  - using operating leases or finance leases
  - choosing to re-value non-current assets or choosing the historical cost model
  - timing the acquisition of non-current assets or the timing of new financing so as to have the minimal adverse impact on ROCE.

2.3 Return on assets

Formula: Return on assets

$$\text{ROA} = \frac{\text{Profit before interest and taxation}}{\text{Assets}} \text{ X } 100\%$$

The normal convention is to use 'total assets' which includes both current and non-current assets. However, other variations are sometimes used such as non-current assets only.

2.4 Analysing return: profitability and asset utilisation

The size of the return on capital employed, or the size of the return on shareholders' capital, depends on two factors:

- the profitability of the goods or services that the entity has sold
- the volume of sales that the entity has achieved with the capital and assets it has employed: this is known as asset utilisation or asset turnover.

2.5 Profit/sales ratio (and cost/sales ratios)

The profit/sales ratio is the ratio of the profit that has been achieved for every Rs.1 of sales.

Formula: Profit/sales ratio

$$\text{Profit/sales ratio} = \frac{\text{Profit}}{\text{Sales}} \times 100$$

Profit/sales ratios are commonly used by management to assess financial performance, and a variety of different figures for profit might be used.

The definition of profit can be any of the following:

- Profit before interest and tax
- Gross profit (sales minus the cost of sales) = 'gross profit ratio'
- Net profit (profit after tax) = 'net profit ratio'.

It is important to be consistent in the definition of profit, when comparing performance from one year to the next.

The gross profit ratio is often useful for comparisons between companies in the same industry, or for comparison with an industry average.

It is also useful to compare the net profit ratio with the gross profit ratio. A high gross profit ratio and a low net profit ratio indicate high overhead costs for administrative expenses and selling and distribution costs.

Example: Profit to sales ratios

The following figures relate to Company X for Year 1.

	Rs.
Profit before tax	210,000
Income tax expense	(65,000)
Profit after tax	145,000

Interest charges on bank loans were Rs.30,000.

Sales during the year were Rs.5,800,000.

Profit to sales ratios are calculated as follows:

a) If profit is defined as profit before interest and tax:

= 240,000 (**W1**)/5,800,000 × 100 = 4.14%

b) If profit is defined as profit after interest and tax:

= 145,000 (**W1**)/5,800,000 × 100 = 2.5%

W1 **Profit before interest and tax**	Rs.
Profit before tax	210,000
Add back interest deducted	30,000
Profit before interest and tax	240,000

It is also useful to monitor the ratio of different types of cost to sales. The following ratios can be useful to highlight an unexpected change in a period or to indicate a difference between the company and another in a similar industry:

- Cost of sales/Sales) × 100%
- Administration costs/Sales) × 100%
- Selling and distribution costs/Sales) × 100%

2.6 Asset turnover ratio

The asset turnover ratio is the ratio of sales to capital employed.

It measures the amount of sales achieved during the period for each **Rs.**1 of investment in assets.

Formula: Asset turnover ratio

$$\text{Asset turnover ratio} = \frac{\text{Sales}}{\text{Share capital + reserves + long term debt}} \times 100$$

It is measured as a multiple (so many times a year).

The asset turnover ratio is also the ratio of sales to (assets – current liabilities). This is because capital employed = total assets minus liabilities excluding long-term debt.

Example: Asset turnover ratio

The following figures relate to Company X for Year 1.

Average capital employed (as given before) Rs.1,200,000

Profit before interest and tax = 240,000 (as given before)

Sales during the year were Rs.5,800,000.

ROCE = 240,000 /1,200,000 × 100 = 20% (as given before)

Asset turnover

Asset turnover ratio = Rs.5,800,000/Rs.1,200,000 = 4.83 times.

Note that: ROCE = Profit/sales ratio × Asset turnover ratio (where profit is defined as profit before interest and taxation).

Using the figures shown earlier:

ROCE	=	Profit/sales	×	Sales/capital employed
$\frac{240,000}{1,200,000}$	=	$\frac{240,000}{5,800,000}$	×	$\frac{5,800,000}{1,200,000}$
20%	=	4.14%	×	4.83 times

2.7 Percentage annual growth in sales

It can be useful to measure the annual growth (or decline) in sales, measured as a percentage of sales in the previous year.

For example, if sales in the year just ended were **Rs.**5,800,000 and sales in the previous year were **Rs.**5,500,000, the annual growth in sales has been (**Rs.**300,000/**Rs.**5,500,000) × 100% = 5.45%.

2.8 Dupont analysis

Another way of interpreting the ROCE is through DuPont analysis.

DuPont Analysis is an expression which breaks ROCE into three parts as follows:

Illustration: Dupont equation

ROCE =

$$\frac{\text{Profit}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets}} \times \frac{\text{Assets}}{\text{Capital employed}} = \frac{\text{Profit}}{\text{Capital employed}}$$

The DuPont equation provides a broader picture of the return the company is earning on its capital employed. It indicates where a company's strength lies and where there is a room for improvement.

Example: Dupont analysis

Company A and B operate in the same market and are of the same size. Both earn a return of 15% on equity.

The following table shows their respective net profit margin, asset turnover and financial leverage.

	Company A	Company B
Net profit margin	10%	10%
Asset turnover	1	1.5
Financial leverage	10.5	1

Although both the companies have a return on equity of 15% their underlying strengths and weaknesses are quite opposite.

Company B is better than company A in using its assets to generate revenues but it is unable to capitalize this advantage into higher return on equity due to its lower financial leverage.

Company A can improve by using its total assets more effectively in generating sales and company B can improve by raising some debt.

3 WORKING CAPITAL EFFICIENCY RATIOS

Section overview

- Purpose of working capital efficiency ratios
- Average time to collect (receivables days or days sales outstanding)
- Average time for holding inventory (inventory turnover)
- Average time to pay suppliers
- Cash operating cycle/working capital cycle

3.1 Purpose of working capital efficiency ratios

Working capital efficiency ratios measure the efficiency with which the entity has managed its receivables, inventory and trade payables. The ratios are usually measured in terms of an average number of days.

The working capital ratios are a useful measure of whether the entity has too much or too little invested in working capital.

Excessive investment in working capital is indicated by a long cash cycle (a long working capital cycle) that appears to be getting even longer. When too much is invested in working capital, the return on capital employed and ROSC will be lower than they should be.

Under-investment in working capital is an indication of possible liquidity difficulties. When working capital is low in comparison with the industry average, this might indicate that current assets are being financed to an excessive extent by current liabilities, particularly trade payables and a bank overdraft.

(The cash cycle, also called the operating cycle and the working capital cycle) is explained later).

3.2 Average time to collect (receivables days or days' sales outstanding)

This ratio estimates the time that it takes on average to collect the payment from customers after the sale has been made. It could be described as the average credit period allowed to customers or the 'average collection period'.

Formula: Average time to collect (average collection period or average receivables days)

$$\text{Average time to collect} = \frac{\text{Trade receivables}}{\text{Credit sales}} \times 365 \text{ days}$$

Trade receivables should be the average value of receivables during the year. This is the average of the receivables at the beginning of the year and the receivables at the end of the year.

However, the value for receivables at the end of the year is also commonly used.

Sales are usually taken as total sales for the year. However, if sales are analysed into credit sales and cash sales, it is probably more appropriate to use the figure for credit sales only.

The average time to collect money from credit customers should not be too long. A long average time to collect suggests inefficient collection of amounts due from receivables.

3.3 Average time for holding inventory (inventory turnover)

This ratio is an estimate of the average time that inventory is held before it is used or sold.

Formula: Average time for holding inventory (Inventory holding period or average inventory days)

$$\text{Average inventory days} = \frac{\text{Inventory}}{\text{Cost of sales}} \times 365 \text{ days}$$

In theory, inventory should be the average value of inventory during the year. This is the average of the inventory at the beginning of the year and the inventory at the end of the year.

However, the value for inventory at the end of the year is also commonly used, particularly in examinations.

3.4 Average time to pay suppliers

The average time to pay suppliers may be calculated as follows:

Formula: Average time to pay suppliers (Average payables days)

$$\text{Average time to pay} = \frac{\text{Trade payables}}{\text{Purchases}} \times 365 \text{ days}$$

Trade payables should be the average value of trade payables during the year. This is the average of the trade payables at the beginning of the year and the trade payables at the end of the year.

However, the value for trade payables at the end of the year is also commonly used

When the cost of purchases is not available, the **cost of sales** should be used instead. This figure is obtained from the profit and loss information in the statement of comprehensive income.

Example: Working capital efficiency ratios

The following information is available for Company Y for Year 1.

	1 January Year 1	31 December Year 1
	Rs.	Rs.
Inventory	300,000	360,000
Trade receivables	400,000	470,000
Trade payables	150,000	180,000

Sales in Year 1 totalled Rs.3,000,000 and the cost of sales was Rs.1,800,000.

The Working capital efficiency ratios are calculated as follows:

Efficiency ratios

Average days to collect = [435,000/3,000,000] × 365 days = 52.9 days

Inventory turnover period = [330,000/1,800,000] × 365 days = 66.9 days

Average time to pay = [165,000/1,800,000] × 365 days = 33.5 days.

Workings

Average inventory = [Rs.300,000 + Rs.360,000]/2 = Rs.330,000

Average trade receivables = [Rs.400,000 + Rs.470,000]/2 = Rs.435,000

Average trade payables = [Rs.150,000 + Rs.180,000]/2 = Rs.165,000.

Turnover ratios (multiples)

Turnover ratios can be used as an alternative way of telling the same story as the efficiency ratios. These show the number of times a balance in the statement of financial position is ***turned over*** in the period.

They are multiples which provide the same insight as the efficiency ratios but in a different way.

Formulae: Working capital turnover ratios

$$\text{Receivables turnover} = \frac{\text{Credit sales}}{\text{Trade receivables}}$$

$$\text{Inventory turnover} = \frac{\text{Cost of sales Inventory}}{\text{Inventory}}$$

$$\text{Payables turnover} = \frac{\text{Purchases}}{\text{Trade payables}}$$

3.5 Cash operating cycle/working capital cycle

The cash operating cycle or working capital cycle is the average time of one cycle of business operations:

- from the time that suppliers are paid for the resources they supply
- to the time that cash is received from customers for the goods (or services) that the entity makes (or provides) with those resources and then sells.

A cash cycle or operating cycle is measured as follows.

Illustration: Cash operating cycle

	Days/weeks/ months
Average inventory holding period	X
Average trade receivables collection period	X
	X
Average period of credit taken from suppliers	(X)
Operating cycle	X

The working capital ratios and the length of the cash cycle should be monitored over time. The cycle should not be allowed to become unreasonable in length, with a risk of over-investment or under-investment in working capital.

A positive working capital cycle balances incoming and outgoing payments to minimise net working capital and maximise free cash flow. For example, a company that pays its suppliers in 30 days but takes 60 days to collect its receivables has a working capital cycle of 30 days. This 30 day cycle usually needs to be funded through a bank operating line, and the interest on this financing is a carrying cost that reduces the company's profitability.

Growing businesses require cash, and being able to free up cash by shortening the working capital cycle is the most inexpensive way to grow. Sophisticated buyers review closely a target's working capital cycle because it provides them with an idea of the management's effectiveness at managing their balance sheet and generating free cash flow.

Example: Constructing a cash operating cycle

The following figures have been extracted from a company's accounts:

Statement of profit or loss	**Rs.**
Sales	1,200,000
Cost of sales:	
Opening inventory	250,000
Purchases	1,000,000
	1,250,000
Closing inventory	(250,000)
Cost of sales	(1,000,000)
Gross profit	200,000

Statement of financial position	
Trade receivables	400,000
Trade payables	166,667

Average inventory holding period:

= (Average inventory/Annual cost of sales) × 365

= (250,000/1,000,000) × 365 = 91 days

Average receivables collection period:

= (Average trade receivables/Annual sales) × 365

= (400,000/1,200,000) × 365 = 122 days

Average payables period:

= (Average trade payables/Annual purchases) × 365

= (166,667/1,000,000) × 365 = 61 days

Cash operating cycle:	Days
Average inventory holding period	91
Average trade receivables collection period	122
Average period of credit taken from suppliers	(61)
	152

4 LIQUIDITY RATIOS

Section overview

- The meaning of liquidity
- Current ratio
- Quick ratio or acid test ratio
- Liquidity ratios and consolidated accounts

4.1 The meaning of liquidity

Liquidity means having cash or access to cash readily available to meet obligations to make payments.

For the purpose of ratio analysis, liquidity is measured on the assumption that the only sources of cash available are:

- cash in hand or in the bank, plus
- current assets that will soon be converted into cash during the normal cycle of trade.

It is also assumed that the only immediate payment obligations faced by the entity are its current liabilities.

There are two ratios for measuring liquidity:

- current ratio
- quick ratio, also called the acid test ratio.

The more suitable ratio for use depends on whether inventory is considered a liquid asset that will soon be used or sold, and converted into cash from sales.

4.2 Current ratio

The current ratio is the ratio of current assets to current liabilities.

Formula: Current ratio

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

The amounts of current assets and current liabilities in the statement of financial position at the end of the year may be used. It is not necessary to use average values for the year.

It is sometimes suggested that there is an 'ideal' current ratio of 2.0 times (2:1).

However, this is not necessarily true and in some industries, much lower current ratios are normal. It is important to assess the liquidity ratios by considering:

- changes in the ratio over time
- the liquidity ratios of other companies in the same period
- the industry average ratios.

Liquidity should be monitored by looking at changes in the ratio over time.

4.3 Quick ratio or acid test ratio

The quick ratio or acid test ratio is the ratio of current assets excluding inventory to current liabilities. Inventory is excluded from current assets on the assumption that it is not a very liquid item.

Formula: Quick ratio

$$\text{Quick ratio} = \frac{\text{Current assets excluding inventory}}{\text{Current liabilities}}$$

The amounts of current assets and current liabilities in the statement of financial position at the end of the year may be used. It is not necessary to use average values for the year.

This ratio is a better measurement of liquidity than the current ratio when inventory turnover times are very slow, and inventory is not a liquid asset.

It is sometimes suggested that there is an 'ideal' quick ratio of 1.0 times (1:1).

However, this is not necessarily true and in some industries, much lower quick ratios are normal. As indicated earlier, it is important to assess liquidity by looking at changes in the ratio over time and comparisons with other companies and the industry norm.

4.4 Liquidity ratios and consolidated accounts

Liquidity ratios are more informative when they are calculated for individual companies. When liquidity ratios are calculated from a consolidated statement of financial position, they are average measures for all the companies in the group. The average liquidity ratios for the group might hide the fact that there may be poor liquidity in some of the subsidiaries in the group.

5 DEBT RATIOS

Section overview

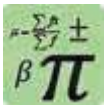
- Gearing ratio (leverage)
- Interest cover ratio

Debt ratios are used to assess whether the total debts of the entity are within control and are not excessive.

5.1 Gearing ratio (leverage)

Gearing, also called leverage, measures the total long-term debt of a company as a percentage of either:

- the equity capital in the company, or
- the total capital of the company.



Formula: Debt to equity ratio

$$\text{Debt to equity ratio} = \frac{\text{Long term debt}}{\text{Share capital + reserves}} \times 100$$

Alternatively:

Formula: Gearing ratio

$$\text{Gearing ratio} = \frac{\text{Long term debt}}{\text{Share capital + reserves + long term debt}} \times 100$$

It is usually appropriate to use the figures from the statement of financial position at the end of the year. However, a gearing ratio can also be calculated from average values for the year.

When there are preference shares, it is usual to include the preference shares within debt capital.

A company is said to be **high-geared** or **highly-leveraged** when its debt capital exceeds its share capital and reserves. This means that a company is high-geared when the gearing ratio is above either 50% or 100%, depending on which method is used to calculate the ratio.

A company is said to be **low-geared** when the amount of its debt capital is less than its share capital and reserves. This means that a company is low-geared when the gearing ratio is less than either 50% or 100%, depending on which method is used to calculate the ratio.

A high level of gearing may indicate the following:

- The entity has a high level of debt, which means that it might be difficult for the entity to borrow more when it needs to raise new capital.

- High gearing can indicate a risk that the entity will be unable to meet its payment obligations to lenders, when these obligations are due for payment.

The gearing ratio can be used to monitor changes in the amount of debt of a company over time. It can also be used to make comparisons with the gearing levels of other, similar companies, to judge whether the company has too much debt, or perhaps too little, in its capital structure.

Gearing and consolidated accounts

The gearing ratio for a group of companies is difficult to interpret, because the debt will be spread over several entities in the group.

When measuring gearing, the total capital or equity capital (the denominator in the ratio) should include non-controlling interests (minority interests).

5.2 Interest cover ratio

Interest cover measures the ability of the company to meet its obligations to pay interest.

Formula: Interest cover

$$\text{Interest cover} = \frac{\text{Profit before interest and tax}}{\text{Interest charges in the year}}$$

Profit before interest and taxation is calculated by adding the interest charges for the year to the figure for profit before taxation.

An interest cover ratio of less than 3.0 times is considered very low, suggesting that the company could be at risk from too much debt in relation to the amount of profits it is earning.

Example: Gearing ratios

The following information is available for Company Z for Year 6

At 31 December Year 6

	Rs.000
Total assets	5,800
Share capital	1,200
Reserves	2,400
	3,600
Long-term liabilities (Bank loans)	1,500
	5,100
Current liabilities	700
	5,800

For the year to 31 December Year 6	Rs.000
Profit before interest and taxation	700
Interest	(230)
	470
Taxation	(140)
Profit after taxation	330

The following ratios can be calculated to shed light on the company's gearing in Year 6 (compared to previous years or to other companies).

Gearing ratio: 1,500/5,100 × 100 = 29.4%

Debt to equity ratio: 1,500/3,600 × 100 = 41.7%

Interest cover: 700/230 = 3.04 times

6 INVESTOR RATIOS

Section overview

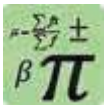
- Earnings per share (EPS)
- Price earnings ratio (P/E ratio)
- Dividend yield
- Dividend cover

Investor ratios are of interest to investors in shares and bonds and their advisers. Some of these measure stock market performance. Earnings per share (EPS) and the price earnings ratio (P/E ratio) were described in an earlier chapter.

6.1 Earnings per share (EPS)

EPS is normally viewed as a key measure of an entity's financial performance. It measures the profit earned for each equity share of the entity.

Basic EPS is calculated as follows:



Formula: Basic EPS

$$\frac{\text{Net profit (or loss) attributable to ordinary shareholders during a period}}{\text{weighted average number of shares in issue during the period}}$$

6.2 Price-earnings ratio (P/E ratio)

The price/earnings (P/E) ratio measures how expensive or cheap a share is in relation to its annual earnings. A P/E ratio of 10, for example, means that investors are prepared to pay a price for the share equal to 10 years of earnings (at the level of EPS in the previous year). A high P/E ratio is usually a sign of confidence in an entity, because it suggests that its earnings are expected to grow in future years. A low P/E ratio usually means that an entity's future prospects for EPS growth are expected to be poor, so that investors do not put a high value on the shares.

The P/E ratio is calculated as follows:

Formula: Price earnings ratio

$$\text{P/E ratio} = \frac{\text{Market value of share}}{\text{Earnings per share}}$$

6.3 Dividend yield

The dividend yield measures the dividend paid by an entity in relation to its price. It is calculated as follows:

Formula: Dividend yield

$$\text{Dividend yield} = \frac{\text{Dividend per share}}{\text{Current market price per share}} \times 100$$

This is a measure of the return that a shareholder can obtain (the dividend received) in relation to the current value of the investment in the shares (the price of the shares). A high dividend yield might seem attractive to investors, but in practice companies with a high dividend yield might have a relatively low share price.

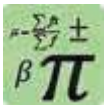
There are two things to note:

- Dividend yield reflects the dividend policy of the entity, not its actual performance. Management decides on the amount of the dividend and this may not only depend on earnings, but on the amount that must be retained for future investment in EPS growth.
- The ratio is based on the most recent dividend, but the current share price may move up and down in response to the market's expectations about future dividends. This may lead to distortion in the ratio.

6.4 Dividend cover

The dividend cover ratio measures the number of times that an entity's dividends are 'covered' by profits (how many times an entity could pay the current level of dividend from its available profits).

It is calculated as follows:



Formula: Dividend cover

$$\text{Dividend cover} = \frac{\text{Earnings per share}}{\text{Dividend per share}}$$

or

$$= \frac{\text{Earnings}}{\text{Dividends}}$$

A low dividend cover (for example, less than 2), suggests that dividends may be cut if there is a fall in profits.

Example: Dividend yield and dividend cover

The following amounts relate to Entity Q.

The current market price of its equity shares is Rs.5.50 per share.

Profit for the most recent period was Rs.1.4 million and equity dividends paid were Rs.450,000.

There are 1.2 million Rs.1 equity shares in issue.

Earnings per share = $\frac{1,400,000}{1,200,000}$ = Rs.1.17.

P/E ratio = $\frac{5.50}{1.17}$ = 4.7

Dividend per share = $\frac{450,000}{1,200,000}$ = 0.38c

Dividend yield = $\frac{0.38}{5.50} \times 100\%$ = 6.9%

Dividend cover = $\frac{1,400,000}{450,000}$ = 3.1 times or $\frac{1.17}{0.38}$ = 3.1 times

7 LIMITATIONS OF INTERPRETATION TECHNIQUES

Section overview

- Introduction
- Differences in accounting policy
- Current cost accounts and current purchasing power accounts
- Other limitations in the use of financial ratios
- Using historical information
- Related party relationships and transactions
- Using figures from the statement of financial position
- Non-financial information
- Other information

7.1 Introduction

There are several limitations or weaknesses in the use of interpretation techniques for analysing the financial position and financial performance of companies. Some of these are limitations of ratio analysis (the method of interpretation most often used) and some are limitations of financial statements and financial information.

Most of the data for calculating financial ratios comes from the financial statements.

- The reliability of ratios is therefore affected by the reliability of the financial statements themselves.
- In addition, when ratios are used to compare different companies, the comparability is affected if companies use different accounting policies to prepare their financial statements.

In addition, when comparing a ratio against that of a competitor or the industry average, it is important to remember that, even within an industry, companies can have different characteristics. It is very important to remember this when you are analysing the financial statements of a company, and possibly comparing its performance and financial position with other companies.

7.2 Differences in accounting policy

One of the uses of financial ratios is to compare the financial position and performance of one company with those of similar companies for the same period.

Comparisons between companies might not be reliable, however, when companies use different accounting policies, or have different judgements in applying accounting policies or making accounting estimates. For example:

- Entities might have different policies about the revaluation of non-current assets.

- Entities might use different methods of depreciation.
- Entities might use different judgements in estimating the expected profitability on incomplete construction contracts.
- Entities might use different judgements in assessing whether a liability should be treated as a provision or a contingent liability.

IAS 8 states that an entity should not change its accounting policies unless the change is required by an accounting standard or it will result in more relevant and reliable information. Therefore changes should not happen often.

Where there has been a change in an accounting policy, IAS 8 also requires comparative figures to be restated and information to be disclosed. However, changes in accounting policies and accounting estimates can still make it difficult to compare the financial statements of an entity over time, particularly if analysis is based on extracts rather than the full published financial statements.

7.3 Current cost accounts and current purchasing power accounts

Historical cost accounts can also be misleading because they do not accurately show the effects of inflation over time. They do not take into consideration changes in the real value of money.

The biggest problem is the valuation of non-current assets. Companies have different policies towards the revaluation of non-current assets. Some companies revalue some categories of non-current assets regularly, and in particular land and buildings. However, not all categories of non-current assets are revalued.

When the rate of inflation is quite high, many non-current assets are probably under-valued in the financial statements, in comparison with their current net replacement value.

In addition, when the rate of inflation is high, the reported profit with historical cost accounting will be higher than it would be using an 'inflation accounting' system such as current cost accounting (CCA) or current purchasing power (CPP) accounting.

With CCA and CPP accounting, particularly during a period of high inflation:

- The reported profit will be less (or the loss will be higher) than with historical cost accounting (HCA).
- The asset turnover or asset utilisation will be lower, because asset valuations are higher with CCA and CPP than with historical cost accounting (even when some non-current assets are re-valued in HCA).
- The return on capital employed will be lower, because the reported profit will be lower and the value of capital employed will be higher.

7.4 Other limitations in the use of financial ratios

There are other problems with the use of financial ratios, particularly where these are used to compare the performance and position of different entities or of an entity with an industry average.

- It is possible to calculate the same ratio in different ways. For example, there are several variations of return on capital employed (ROCE) and gearing. Comparisons can be misleading if different calculations are used.
- Even where two entities operate in the same industry, comparisons can be misleading. Entities can operate in different markets (for example, high volume/low margin sales and low volume/high margin sales). The size of an entity can affect the way it operates and therefore its ratios. For example, large entities can often negotiate more favourable terms with suppliers than small ones.
- Financial statements are published infrequently. If ratios are used to study trends and developments over time, they are only useful for trends or changes over one year or longer, and not changes in the short term.
- Ratios can only indicate **possible** strengths or weaknesses in financial position and financial performance. They might raise questions about performance, but do not provide answers. They are not easy to interpret, and changes in financial ratios over time might not be easy to explain.

It can be argued that financial position and financial performance should be analysed using market values rather than accounting values. For example, it can be argued that investment yield is more relevant for the assessment of financial performance than return on capital employed.

7.5 Using historical information

Financial statements are often used to predict the future performance of an entity. Where comparative figures are available for several years it may be possible to extrapolate trends and to base forecasts on these. If comparative figures are only available for one or two years, predictions may be unreliable.

There may be some limited information about future transactions in the notes to the financial statements. For example, details of contingent liabilities and non-adjusting events after the reporting period must be disclosed. However, published financial statements present historical information.

Generally, financial statements do not reflect future transactions or events. They do not anticipate the effect of significant changes to the entity after the financial statements have been authorised for issue. These may include events beyond the control of management (for example, the liquidation of a major customer) or events that could not possibly have been foreseen at the time the most recent financial statements were issued.

It should also be remembered that financial statements are not normally published until several months after the year end. The financial statements are often out of date by the time that they become available.

7.6 Related party relationships and transactions

A user of financial statements will normally expect the financial statements to reflect transactions that have taken place on normal commercial terms (‘at arm’s length’). The user of the financial statements would want to be informed if:

- transactions have taken place that were not at 'arm's length', or
- there are parties that could enforce transactions on the entity that are not on an 'arm's length' basis.

For example, an entity might sell an asset such as a property to another company owned by one of its directors on more favourable terms than it would sell to a third party.

In this situation, the financial performance or financial position reported by the financial statements would be misleading. There is a special relationship between the parties to the business transactions. This is referred to as a 'related party relationship'.

Related party relationships and transactions are a normal part of business and there is nothing wrong with entering into them. However, a related party relationship can have an effect on the profit or loss, or on the financial position of an entity, because related parties might enter into transactions with each other on terms that other entities or individuals (unrelated parties) would not. For example, where an entity sells goods to a related party, its profits may not be comparable with those of a similar entity that only trades with third parties on normal commercial terms.

7.7 Using figures from the statement of financial position

In practice, ratio calculations are often based on figures in the year-end statement of financial position. These may be very similar to average values for the period, but this is not always the case.

Some businesses are seasonal and make a high proportion of their sales at a specific time of year (for example, in the few months before a national holiday period). Seasonal businesses often arrange their year-ends so that they fall when inventories and receivables are at their lowest (probably just after the main period for sales). Where this happens, ratios such as inventory turnover will be lower than they would be if they were based on the average figure for the year. This means that ratios may not be strictly comparable with those of other businesses or with industry averages.

Major purchases of assets can have a significant effect on figures in the statement of financial position and on ratios if they take place near the end of the accounting period.

- The carrying value of non-current assets is unusually high, because cost has increased, but a full year's depreciation has not been charged.
- Return on capital employed and asset turnover are reduced, because assets have increased but revenue and profits have not. New assets should generate increased profits, but they have not yet been owned for long enough to do so.

7.8 Non-financial information

One of the most serious limitations of traditional financial statements is that they only reflect the financial effects of transactions. Items are not recognised unless they can be measured reliably in money terms.

There are two problems here:

- Businesses and the transactions that they enter into are becoming increasingly complex. Much information that is relevant to users cannot be expressed easily in monetary terms or in numbers.
- Businesses increasingly accept that they are not only accountable to investors and lenders, but to a much wider group of people, or 'stakeholders'. Stakeholders can include customers, suppliers, employees, the local community as a whole and (for some large public entities) society as a whole. These groups are often more interested in the non-financial effects of an entity's activities, (for example, its effect on the natural environment), than in its financial performance.

Most large and listed entities now include a Business Review, or an Operating and Financial Review (sometimes called Management Discussion and Analysis) in their published financial statements. This is a narrative report which sets out management's analysis of the business. Such a review is a legal requirement for many companies within the European Union.

At present entities reporting under IFRSs do not have to publish any non-financial information of this kind. Recently the IASB issued a non-mandatory "Practice Statement on Management Commentary". It is up to companies or individual legal jurisdictions to decide whether to follow this guidance.

Useful non-financial information

Useful non-financial information could include the following:

- a description of the business, objectives and strategies of the entity
- a narrative review of the performance of the business during the period
- a description of the main risks and uncertainties facing the entity and the ways in which these risks are managed
- details of any significant factors or events that may have an impact on the entity's performance in future
- details of any significant factors or events that may have an impact on the entity's cash flows in future
- information about key relationships with other entities and transactions with related parties, including management
- a description of the entity's research and development activities (if any) and of any material intangible assets, including internally generated intangible assets that have not been recognised in the balance sheet
- additional explanations of amounts included in the financial statements, where appropriate (for example, where these are based on estimates)
- information about the entity's policies in relation to environmental matters, in relation to its employees and on social and community issues.

7.9 Other information

Size of company

Large companies should be able to benefit from economies of scale and so should be more profitable than smaller companies in the same industry and market. Larger companies should also attract better management, so (in theory) the business should be run more efficiently, and so should achieve higher profit margins.

Market area

Companies operating in the same industry may achieve very different results because they operate in different sectors or segments of the market. For example, two companies selling furniture might have very different profit margins because they operate in different parts of the market. One company may be selling antique furniture at high profit margins and the other may be selling self-assembly furniture in larger volumes but with lower profit margins.

Stage in the supply chain

Companies operating in the same industry may operate at different stages in the supply chain. A supplier of raw materials, a manufacturer and a retailer would be expected to have very different financial ratios, even though they may operate in the same industry.

For example, it would be difficult to compare the financial ratios of a timber supplier, a furniture manufacturer and a furniture retailer.

Timing of transactions

The timing of a key transaction can distort financial ratios. For example, a company may acquire a subsidiary at the end of the financial year. The subsidiary would then be consolidated in the group statement of financial position but its profits would not be included in group profit or loss because they are all pre-acquisition profits.

Ratios that compare profit figures with items in the statement of financial position will therefore be distorted, unless a suitable adjustment is made to allow for the transaction.

Year-end date

In most countries, companies are allowed to decide for themselves what their financial year-end date should be. The choice of dates can affect the financial ratios. For example a manufacturer of ski equipment will probably have some very busy trading months (during the ski-ing holiday season) and some very quiet months. If it selects the end of the high-selling season as its year-end, its inventory levels will be abnormally low and its receivables balance may be abnormally high.

Such ‘distortions’ in the financial statements can be eliminated by calculating ratios using a monthly average for any measures taken from the statement of financial position, such as inventory, receivables and trade payables.

Management strategy

Financial ratios should be interpreted in the context of all other relevant information that is available about the company. For example, management may have decided on a strategy of cutting profit margins in the short term in order to win market share. This would affect the current profit margin, but in the long run should result in higher sales and more profits.

8 FINANCIAL RATIOS AND EXAMINATION TECHNIQUE

Section overview

- Introduction
- Approach to questions
- Avoiding pitfalls

8.1 Introduction

Examination questions on financial ratio analysis usually require sound examination technique to construct a good answer. The following guidelines suggest the approach you should take and indicate the mistakes and pitfalls to avoid.

At this level, you are unlikely to get a question that simply asks you just to calculate ratios. You may be asked to consider the accounting treatment of particular items in the financial statements and the effect that this will have on the entity's ratios.

For example, if an entity has incorrectly treated a sale and repurchase transaction as a 'genuine' sale and not as a loan secured on an asset, then there will be a significant effect on the entity's ratios. For example, the gearing ratio will not show the true position of the entity's debt as it will exclude the secured loan. Return on capital employed will also be affected as the incorrect treatment of the transaction removes the asset from the statement of financial position, thus increasing ROCE.

Additionally, consider the points below which provide specific guidance on aspects of the question that you may have to answer.

8.2 Approach to questions

Analyse the requirement

Start by recognising the person or organisation who has asked for the financial analysis.

- ❑ Who is the user?
- ❑ What information is the user interested in? Why has the user requested the report?
- ❑ How should the information be presented to the user – in the form of a memo or a more formal report? Don't forget there are presentation marks available for well-presented reports.

Background information

Establish some of the basic 'background' information.

- ❑ What industry does the company operate in?
- ❑ Note the financial year end. This may possibly be significant.

- Is the business seasonal? If so, seasonal trading may 'distort' the year-end figures in the statement of financial position, particularly for inventory, receivables, cash and payables.
- Have there been any key transactions during the year that may affect comparisons with previous years? For example, has the company raised a substantial amount of new finance, or has it acquired a major new subsidiary, entered a new market with a new product, or disposed of a business operation?

Review of the financial information

Before calculating **any** financial ratios, perform a thorough review of the financial information provided. Look for items that will affect the measurement of key financial ratios.

Statement of financial position:

- Non-current assets.
  - (1) Have there been any revaluations? Check the revaluation reserve. Has it changed since the previous year? (This can also be checked by looking at the statement of profit or loss and other comprehensive income.)
  - (2) Capital expenditure. Has the company incurred significant capital expenditure? Look at the increase in non-current assets since the previous year. How has the expansion been financed? Look at share capital and reserves, and at levels of debt.
- Investments.
  - (1) Has the company invested in a new industry?
  - (2) Has the company acquired a new subsidiary or invested in a new associate or joint venture? If so, consider the timing of the acquisition – if an acquisition happened in mid-year the subsidiary's profits will have been included in profit or loss for only six months but it will be included in full in the year-end group statement of financial position.
- Working capital.
  - (1) Has the total working capital increased or decreased in proportion with the increase or decrease in sales turnover (compared with the previous year)?
  - (2) Look at the amounts of current assets and current liabilities. Does the company have net current assets or net current liabilities?
- Loans.
  - (1) Have any loans been repaid in the year? If so, how was the repayment financed?
- Share capital and reserves
  - (1) Have there been any new issues of shares during the year? If so, is it clear why the new shares were issued? For example, have new

shares been issued to raise money to repay debt? Or to finance an expansion of the business?

(2) Have there been any significant changes in reserves during the year?

Statement of profit or loss

Compare sales growth with profit growth. Are they about the same rates of growth? If not, you may need to think about reasons for the different growth rates.

- Interest. Is the interest charge high in relation to the amount of debt in the statement of financial position? If it is high, has any debt been repaid in the year?
- Dividends. Look at the amount of dividend payments, the dividend cover, and the trend in dividend payments over the past few years.
- Did the company make a profit or a loss?
- Are there any unusual 'one-off' items in profit or loss? If so, what are they?

You should have an expectation in your mind about the measurements and ratios that you should expect to find. If the actual measurements or ratios are different from what you expect, you may need to think about the reasons for the unexpected results.

For example, you may expect the company to be profitable. If it made a loss, you will need to look for the reasons.

Calculate financial ratios

Having reviewed the financial information, you should calculate relevant key ratios.

- Present the ratios you have calculated as an appendix to your memo or report.
- Show the formulae and numbers you have used to calculate the ratios. Do not just write down the ratio by copying it from your calculator. The examiner will want to see where your figure came from, to make sure that you understand what you are doing.
- Be selective. Only calculate a ratio if it will add to your answer. Do not simply calculate as many ratios as possible.
- Go for variety in the ratios you select.
- If the examination question provides some financial ratios, look for ratios that have not been given. Could any of the 'missing' ratios be significant?

Further information

An examination question might ask for suggestions about what further information might be helpful. If so, set up your answer as an appendix to your memo or report, and build your answer as you work through your answer to the question. Examples of information that might be 'missing' include the following:

- Additional information to calculate further ratios, such as the share price for calculating the P/E ratio or dividend yield
- Segmental analysis
- Industry average figures, for making comparisons with similar companies in the same industry
- Changes in management policy (such as changes in the credit terms offered to customers)
- The accounting policies used
- Reasons for specific changes not explained by the information given in the question.

Writing your answer

Make comments that are relevant to the question. Always think about the requirements of the question when you write your answer. You will not earn marks for anything that is not relevant.

- Make sure you answer all the requirements of the question. If you don't you will lose marks.
- Use short sentences and bullet points.

8.3 Avoiding pitfalls

There are a number of common mistakes in writing answers to an interpretation question.

- Most marks in the exam are likely to be for specific, relevant comments rather than solely for computations. **Do not calculate too many ratios** as it is time-consuming and you will not have time to write your answer. Be selective and only calculate a ratio if it will add value to your answer.
- Good points can be identified by looking at absolute changes in the figures between one year and the next. For example, if sales have increased 25%, it would be expected that inventory, receivables and payables should have increased in line with the increase in sales.
- Use all the information. Some valuable information about the company is usually given in the introductory paragraph in an examination question. Make sure that you read and use this information.
- When making comparisons, make sure that the 'benchmark' you select for the comparison is suitable. For example, if two companies are being compared:
  - Are they the same size?
  - Do they operate in exactly the same area of the market?
  - Are their financial statements for the same time period?
- When making an observation about differences (such as differences in comparison with another company, or the previous year), suggest reasons for the difference. Don't just make an observation without making a

comment. For example, stating that “There has been a fall in non-current asset” has no value on its own. A better answer would be “Non-current assets have decreased despite a rise in sales.” You might then go on to comment that non-current assets are being over-used and are not being replaced, perhaps because of the poor cash position of the company.

- The highest marks will be awarded for linking together the information that you analyse. For example: “Interest charges have remained more or less the same as in the previous year, despite a decrease in the debt in the statement of financial position. This may be explained by the company repaying a large amount of debt shortly before the year end.”
- Structure your answer around each of the requirements in the question. In many cases, profitability and long term solvency could be used as main headings within your answer.
- Use the company name in your answer. This will help you to focus your mind on the circumstances of the company, and avoid writing about financial ratios in general terms (and so failing to answer the question).

CHAPTER 30

Sundry standards and interpretations

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 6 IFRS 6: Exploration for and evaluation of mineral resources

B (a) 10 IFRS 14: Regulatory deferral accounts

B (a) 12 IAS 2: Inventories

B (a) 32 IAS 41: Agriculture

B (a) 40 IFRIC 12: Service concession arrangements

B (a) 50 SIC 7: Introduction of the euro

B (a) 55 SIC 29: Disclosure – service concession arrangements

1 IAS 2: INVENTORY

Section overview

- Definition of inventory
- Measurement rule
- Cost formulas
- Net realisable value
- Disclosure requirements

1.1 Definition of inventory

The nature of inventories varies with the type of business. Inventories are:

- Assets held for sale. For a retailer, these are items that the business sells – its stock-in trade. For a manufacturer, assets held for sale are usually referred to as 'finished goods'
- Assets in the process of production for sale ('work-in-progress' for a manufacturer)
- Assets in the form of materials or supplies to be used in the production process ('raw materials' in the case of a manufacturer).

IAS 2: Inventories sets out the requirements to be followed when accounting for inventory.

1.2 Measurement rule

IAS 2 requires that inventory must be measured in the financial statements at the **lower** of:

- cost, or
- net realisable value (NRV).

The standard gives guidance on the meaning of each of these terms.

Purchase cost

IAS2 states that 'the cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

The **purchase cost** of inventory will consist of the following:

- the purchase price
- plus import duties and other non-recoverable taxes (but excluding recoverable sales tax)
- plus transport, handling and other costs directly attributable to the purchase (carriage inwards), if these costs are additional to the purchase price.

The purchase price **excludes** any settlement discounts, and is the cost after deduction of trade discount.

Conversion costs

When materials purchased from suppliers are converted into another product in a manufacturing or assembly operation, there are also conversion costs to add to the purchase costs of the materials. Conversion costs must be included in the cost of finished goods and unfinished work in progress.

Conversion costs consist of:

- costs directly related to units of production, such as costs of direct labour (i.e. the cost of the labour employed to perform the conversion work)
- fixed and variable **production** overheads, which must be allocated to costs of items produced and closing inventories. (Fixed production overheads must be allocated to costs of finished output and closing inventories on the basis of the **normal production capacity** in the period)
- other costs incurred in bringing the inventories to their present location and condition.

Production overheads include:

- costs of indirect labour, including the salaries of the factory manager and factory supervisors
- depreciation costs of non-current assets used in production
- costs of carriage inwards, if these are not included in the purchase costs of the materials

Only production overheads are included in costs of finished goods inventories and work-in-progress. Administrative costs and selling and distribution costs must not be included in the cost of inventory.

Note that the process of allocating costs to units of production is usually called absorption. This is usually done by linking the total production overhead to some production variable, for example, time, wages, materials or simply the number of units expected to be made.

Normal production capacity

Production overheads must be absorbed based on normal production capacity even if this is not achieved in a period.

Normal capacity is the production expected to be achieved on average over a number of periods under normal circumstances, though the actual level of production may be used if it approximates to normal capacity.

If actual production capacity is unusual in a particular period the overhead might be under or over absorbed. The amount of fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased so that inventories are not measured above cost.

Variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities.

Example: Normal production capacity

A business plans for production overheads of Rs. 1,000,000 per annum.

The normal level of production is 100,000 units per annum.

Due to supply difficulties the business was only able to make 75,000 units in the current year.

Other costs per unit were Rs. 126.

The cost per unit is:	Rs.
Other costs	126
Production overhead ($^{\text{Rs. 1,000,000}}/_{\text{100,000 units}}$)	10
Unit cost	136

Note:	Rs.
The amount absorbed into inventory is (75,000 × Rs. 10)	750,000
Total production overhead	1,000,000
The amount not absorbed into inventory	250,000

The Rs. 250,000 that has not been included in inventory is expensed (i.e. recognised in the statement of comprehensive income).

1.3 Cost formulas

With some inventory items, particularly large and expensive items, it might be possible to recognise the actual cost of each item.

In practice, however, this is unusual because the task of identifying the actual cost for all inventory items is impossible because of the large numbers of such items.

A system is therefore needed for measuring the cost of inventory.

The historical cost of inventory is usually measured by one of the following methods:

- First in, first out (FIFO)
- Weighted average cost (AVCO)

First-in, first-out method of measurement (FIFO)

With the first-in, first-out method of inventory measurement, it is assumed that inventory is consumed in the strict order in which it was purchased or manufactured. The first items that are received into inventory are the first items that go out.

Since it is assumed that the first items received into inventory are the first units that are used, it follows that the value of inventory at any time should be the cost of the most recently-acquired units of inventory.

Weighted average cost (AVCO) method

With the weighted average cost (AVCO) method of inventory measurement it is assumed that all units are issued at the current weighted average cost per unit.

A new average cost is calculated whenever more items are purchased and received into store. The weighted average cost is calculated as follows:

Formula: Calculation of new weighted average after each purchase

$$\frac{\text{Cost of inventory currently in store + Cost of new items received}}{\text{Number of units currently in store + Number of new units received}} = \text{New weighted average}$$

Items 'currently in store' are the items in store immediately before the new delivery is received.

The retail method

The retail method is often used in the retail industry for measuring inventories of large numbers of rapidly changing items with similar margins for which it is impracticable to use other costing methods.

Cost is determined by reducing the sales value of the inventory by the appropriate percentage gross margin.

1.4 Net realisable value

Definition

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.

Net realisable value is the amount that can be obtained from selling the inventory in the normal course of business, less any further costs that will be incurred in getting it ready for sale or disposal.

- Net realisable value is usually higher than cost. Inventory is therefore usually valued at cost.
- However, when inventory loses value, perhaps because it has been damaged or is now obsolete, net realisable value will be lower than cost.

The cost and net realisable value should be compared for each separately-identifiable item of inventory, or group of similar inventories, rather than for inventory in total.

Net realisable value might be lower than cost so that the cost of inventories may not be recoverable in the following circumstances:

- inventories are damaged;
- inventories have become wholly or partially obsolete; or,
- selling prices have declined.

Accounting for a write down

When the cost of an item of inventory is less than its net realisable value the cost must be written down to that amount.

1.5 Disclosure requirements

IAS 2 requires the following disclosures in notes to the financial statements.

- The accounting policy adopted for measuring inventories, including the cost measurement method used.
- The total carrying amount of inventories, classified appropriately. (For a manufacturer, appropriate classifications will be raw materials, work-in-progress and finished goods.)
- The amount of inventories carried at net realisable value or NRV.
- The amount of inventories written down in value, and so recognised as an expense during the period.
- Details of any circumstances that have led to the write-down of inventories to NRV.
- The amount of any reversal of any write-down that is recognized as a reduction in the amount of inventories recognized as expense in the period.
- The circumstances or events that led to the reversal of a write-down of inventories.

2 IAS 41: AGRICULTURE

Section overview

- Scope and definitions
- Accounting treatment
- Government grants
- Disclosure requirements

2.1 Scope and definitions

Scope

IAS 41 *Agriculture* covers the following **agricultural activities**:

- ❑ biological assets, except for bearer plants;
- ❑ agricultural produce at the point of harvest; and
- ❑ government grants for agriculture (in certain situations).

IAS 41 does not apply to:

- ❑ the harvested agricultural product (IAS 2 *Inventory* applies);
- ❑ land relating to the agricultural activity (IAS 16 or IAS 40 applies);
- ❑ bearer plants related to agricultural activity (however, IAS 41 does apply to the produce on those bearer plants).
- ❑ intangible assets related to agricultural activity (IAS 38 *Intangible assets* applies).

Definitions

The following definitions are relevant to IAS 41:

Definitions

Agricultural activities – the management by an entity of the biological transformation and harvest of biological assets:

a. for sale; or

b. into agricultural produce; or

c. into additional biological assets.

Biological asset – a living animal or plant, such as sheep, cows, rice, wheat, potatoes and so on.

Biological transformation means the processes of growth, production, degeneration and procreation that cause changes in the quality or the quantity of a biological asset

Agricultural produce is the harvested product of the entity's biological assets.

Harvest – the detachment of produce from a biological asset or the cessation of a biological asset's life.

Illustration: Definitions

A farmer has a field of lambs ('**biological** assets').

As the lambs grow they go through **biological transformation**.

As sheep they are able to procreate and lambs will be born (**additional biological assets**) and the wool from the sheep provides a source of revenue for the farmer (**'agricultural produce').**

Once the wool has been sheared from the sheep ('**harvested**'), IAS 2 requires that it be accounted for as regular inventory.

Definitions

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.

Illustration: Definitions (further examples)

Biological assets	Agricultural produce	Products that result from processiong after harvest
sheep	wool	yarn, carpet etc.
trees in a timber plantation	felled trees	logs, lumber
dairy cattle	milk	cheese
cotton plants	harvested cotton	thread, clothing etc.
sugarcane	harvested cane	sugar
tobacco plants	picked leaves	cured tobacco
tea bushes	picked leaves	tea
fruit tress	picked fruit	processed fruit
oil palm	picked fruit	palm oil
rubber trees	harvested latex	rubber products

Plants such as tea bushes, grape vines, oil palms and rubber trees, usually meet the definition of a bearer plant and are within the scope of IAS 16 *Property, Plant and equipment*. However, the produce growing on bearer plants, for example, tea leaves, grapes, oil palm fruit and latex, is within the scope of IAS 41.

Note that there is no "animal" equivalent of a bearer plant. Thus, cows kept for milk are within the scope of IAS 41.

2.2 Accounting treatment

Recognition of a biological asset or agricultural produce

An entity should recognise a biological asset or agricultural produce when (and only when):

- ❑ the entity controls the asset as a result of past events
- ❑ it is probable that future benefits will flow from the asset to the entity, and
- ❑ the fair value or cost of the asset can be measured reliably.

Measurement

- ❑ A **biological asset** should be measured initially and subsequently at the end of each reporting period at its **fair value minus ultimate selling costs** (unless the fair value cannot be measured reliably). The gain or loss arising on initial recognition and subsequent revaluation should be included in profit or loss for the period in which it arises.
- ❑ **Agricultural produce** harvested from an entity's biological assets is measured at its **fair value minus estimated ultimate selling costs**. The gain or loss on initial recognition is included in the profit or loss for that period. Ultimate selling costs include commissions to brokers and dealers, levies to regulators, transfer taxes and duties.
- ❑ Fair value is the quoted price in an active market. It is presumed that fair values can be measured reliably for biological assets. If this is not so, the biological asset should be measured at its cost minus any accumulated depreciation or impairment.

Example: Accounting treatment

Using the earlier example of a sheep farmer, lambs should initially be measured when they are born at their fair value minus costs to sell.

As they grow and their value changes, this gain or loss should be reflected in the biological asset value and also in profit and loss.

The sheep may be used for obtaining wool. Once the wool has been sheared from the sheep, as an agricultural produce the wool should be valued at fair value minus costs to sell.

If the wool is then turned into yarn or carpet its value is then transferred to inventory and IAS 2 will provide any further accounting rules.

2.3 Government grants

Agricultural entities (for example, farms) often benefit from government grants in the form of cash payments. An unconditional grant relating to a biological asset that is being measured at fair value should be recognised as income when the grant becomes receivable.

A grant may be dependent on certain conditions being met. For example, the entity may be asked not to engage in a specific agricultural activity. In such cases, the grant should be recognised only when the conditions are met.

If the biological asset has been measured at cost because fair value could not be measured reliably, then the requirements of IAS 20 *Accounting for government grants* should be applied.

2.4 Disclosure requirements

The IAS 41 disclosure requirements include the following:

- the aggregate gain or loss arising during the current period on initial recognition of biological assets and agricultural produce and from the change in fair value less costs to sell of biological assets.
- a description of each group of biological assets;
- information about biological assets whose title is restricted or that are pledged as security
- commitments for development or acquisition of biological assets
- financial risk management strategies
- reconciliation of changes in the carrying amount of biological assets, showing separately changes in value, purchases, sales, harvesting, business combinations, and foreign exchange differences;

If fair value cannot be measured reliably, additional required disclosures include:

- description of the assets
- an explanation of the circumstances
- if possible, a range within which fair value is highly likely to lie
- depreciation method
- useful lives or depreciation rates
- gross carrying amount and the accumulated depreciation, beginning and ending

If the fair value of biological assets previously measured at cost now becomes available, certain additional disclosures are required.

Disclosures relating to government grants include the nature and extent of grants, unfulfilled conditions, and significant decreases expected in the level of grants.

3 IFRS 6: EXPLORATION FOR AND EVALUATION OF MINERAL RESOURCES

Section overview

- Background
- Selection of accounting policies
- Initial recognition and measurement
- Subsequent measurement
- Presentation
- Impairment
- Disclosure

3.1 Background

The group accounts of listed entities in the EU had to be prepared according to IFRS for all accounting periods beginning on or after 1 January 2005. This regulation applied to some very large energy companies with securities listed on EU stock markets.

In the run up to conversion, it was noted that there was no IFRS that dealt with this area, but there were significant entities which engaged in such activities.

There were different views held globally on the accounting solution and this led to a number of different accounting treatments.

IFRS 6

IFRS 6 specifies the financial reporting for the exploration for and evaluation of mineral resources. IFRS 6 applies to expenditure incurred on exploration for and evaluation of mineral resources but not to those expenditures incurred:

- before the exploration for and evaluation of mineral resources (e.g. expenditures incurred before the entity has obtained the legal rights to explore a specific area); or
- after the technical feasibility and commercial viability of extraction are demonstrable

Definitions

Exploration and evaluation assets are exploration and evaluation expenditures recognised as assets in accordance with the entity's accounting policy.

Exploration and evaluation expenditures are expenditures incurred by an entity in connection with the expenditures for and evaluation of mineral resources before the technical feasibility and commercial viability of extracting a mineral resource are demonstrable.

3.2 Selection of accounting policies

IAS 8 sets out criteria which must be applied by a company when needs to develop an accounting policy for a transaction not covered by a specific IFRS.

IFRS 6 exempts companies from applying these criteria in developing an accounting policy for the recognition and measurement of exploration and evaluation assets.

In other words, companies are free to develop an accounting policy (within the broader guidance of IFRS6) without reference to other parts of IFRS. This is particularly useful when a company involved in this industry adopts IFRS because they may be able to carry on using their pre IFRS accounting policy

Changes in accounting policies

An entity is allowed to change accounting policies for exploration and evaluation expenditures when the change makes information used as a basis of decision making:

- more relevant and no less reliable; or
- more reliable and no less relevant

To justify a change, The company must demonstrate that the change brings the financial statements closer to meeting the IAS 8 criteria but the change need not achieve full compliance with those criteria

3.3 Initial recognition and measurement

Exploration and evaluation assets are measured at cost. A company must determine a policy of specifying which expenditures are recognised as exploration and evaluation assets and apply this policy consistently in doing this.

Expenditures which might be specified include:

- acquisition of exploration rights;
- topographical, geological, geochemical and geophysical studies;
- exploratory drilling;
- trenching;
- sampling; and
- activities in relation to evaluating the technical feasibility and commercial viability of extracting a mineral resource

Expenditures related to the development of mineral resources must not be recognised as exploration and evaluation assets. *The Conceptual Framework* and *IAS 38 Intangible Assets* provide guidance on the recognition of assets arising from development.

IAS 37 applies to the recognition of any obligations for removal and restoration that are incurred as a consequence of exploration for and evaluation of mineral resources.

3.4 Subsequent measurement

A company must apply one of the following to exploration and evaluation assets:

- cost model; or
- revaluation model

If the revaluation model is applied (IAS 16 or IAS 38 model), it must be consistent with the classification of the expenditure as tangible or intangible

This means that a revaluation model for expenditure classified as an intangible is only possible if there is a fair value that can be measured with reference to an active market

3.5 Presentation

Exploration and evaluation assets must be classified according to the nature of the assets acquired as:

- tangible (e.g. vehicles and drilling rigs); or
- intangible (e.g. drilling rights).

The classification must be applied consistently.

An exploration and evaluation asset is reclassified from this category when the technical feasibility and commercial viability of extracting a mineral resource are demonstrable. In such cases they must be assessed for impairment before reclassification.

3.6 Impairment

Exploration and evaluation assets must be:

- allocated to cash-generating units (CGUs) or groups of CGUs for the purpose of assessing such assets for impairment (the CGU; and
- assessed for impairment when there are indications that the carrying amount may exceed recoverable amount

Exploration and evaluation assets are unlikely to generate cash flows independently from other assets so as such they are similar to goodwill. Therefore IFRS 6 requires them to be allocated to CGUs groups for the purpose of impairment testing. They are not tested individually for impairment

Indicators of impairment include (the list is not exhaustive):

- expiry of the period of the exploration right without expectation of renewal;
- expenditure on further exploration/evaluation in the specific area previously not budgeted/planned;
- non discovery of commercially viable quantities of mineral resources;
- a decision to discontinue activities in the specific area;
- indication that the carrying amount of the exploration and evaluation asset is unlikely to be recovered in full from successful development or by sale

3.7 Disclosure

Entities must disclose information that identifies and explains the amounts recognised arising from the exploration and evaluation of mineral resources

- accounting policies for exploration and evaluation expenditures, and recognition as assets;
- amounts of assets, liabilities, income and expense and operating and investing cash flows arising from the exploration for and evaluation of mineral resources
- Exploration and evaluation assets must be treated as a separate class of assets (IAS 16 or IAS 38 disclosures apply depending on classification).

4 IFRS 14: REGULATORY DEFERRAL ACCOUNTS

Section overview

- Introduction
- Overview of requirements

4.1 Introduction

Some countries regulate prices that can be charged for certain goods and services. Such goods and services are said to be "rate regulated".

Definitions

Rate-regulated activities: An entity's activities that are subject to rate regulation.

Rate regulation: A framework for establishing the prices that can be charged to customers for goods or services and that framework is subject to oversight and/or approval by a rate regulator.

Regulatory deferral account balance: The balance of any expense (or income) account that would not be recognised as an asset or a liability in accordance with other Standards, but that qualifies for deferral because it is included, or is expected to be included, by the rate regulator in establishing the rate(s) that can be charged to customers.

In the absence of an accounting standard on a topic, entities that adopt IFRS must formulate an accounting policy in accordance with guidance given in IAS 8. This has led to divergence in practice.

The IASB are engaged in a project on this area but in the meantime have issued IFRS 14 as an interim measure.

4.2 Overview of requirements

IFRS 14 permits a first-time adopter within its scope to continue to account for regulatory deferral account balances in its first IFRS financial statements in accordance with its previous GAAP when it adopts IFRS.

However, IFRS 14 introduces limited changes to some previous GAAP accounting practices for regulatory deferral account balances, which are primarily related to the presentation of these accounts. It requires entities to present regulatory deferral account balances as separate line items in the statement of financial position and to present movements in those account balances as separate line items in the statement of profit or loss and other comprehensive income.

IFRS 14 also requires specific disclosures to identify the nature of, and risks associated with, the rate regulation that has resulted in the recognition of regulatory deferral account balances.

5 SERVICE CONCESSION ARRANGEMENTS

Section overview

- IFRIC 12: Service concession arrangements
- Recognition of a financial asset
- Recognition of an intangible asset
- SIC 29: Service concession arrangements: disclosures

5.1 IFRIC 12: Service concession arrangements

Background

Some governments have introduced schemes to attract private sector participation in public service infrastructure (roads, bridges, tunnels etc.).

For example, an entity in the private sector might construct a facility and then run it for the government.

Typically an arrangement within the scope of IFRIC 12 involves a private sector entity (an operator):

- ❑ constructing (or upgrading) infrastructure used to provide a public service;
- ❑ operating and maintaining that infrastructure for a specified period of time; and
- ❑ being paid for its services over the period of the arrangement

Terminology

Grantor – government body that contract with an operator.

Operator – private sector participant in a "service concession arrangement"

An important feature of service concession arrangements is that the operator has a contractual obligation to provide services to the public on behalf of the public sector entity.

This interpretation gives guidance to operators on how they must account for public-to-private service concession arrangements (also known as "build-operate-transfer" (BOT) arrangements, and "rehabilitate-operate-transfer" (ROT)). It does not give guidance on grantor accounting.

Scope

Service concession arrangements are in the scope of IFRIC 12 if:

- ❑ the grantor controls (or regulates):
  - what services must be provided by the operator;
  - to whom the services are provided; and
  - at what price; and
- ❑ the grantor controls the significant residual interest in the infrastructure at the end of the term of the arrangement (if any)

Other common features of service concession arrangements include the following:

- The contract sets out initial prices to be levied by the operator and regulates price revisions
- The operator is obliged to hand over the infrastructure to the grantor in a specified condition at the end of the arrangement

IFRIC 12 applies to both:

- infrastructure that the operator constructs or acquires from a third party for the purpose of the service arrangement; and
- existing infrastructure to which the grantor gives the operator access for the purpose of the service arrangement

The issue

IFRIC 12 gives guidance to operators on how they must account for service concession arrangements. Specifically it provides rules on:

- how the operator should account for:
  - its rights over the infrastructure asset;
  - any other assets provided to the operator by the grantor;
  - consideration under the arrangement;
  - construction or upgrade services;
  - operation services;
  - borrowing costs; and
- subsequent accounting treatment of any financial asset and/or intangible asset arising under the arrangement

Consensus

The infrastructure asset must not be recognised as PP&E by the operator. The operator does not control the asset but merely operates it.

The operator has access to operate the asset in order to provide the public service on behalf of the grantor.

A grantor might transfer other assets to an operator to be kept or dealt with as it wishes.

- Such assets are not government grants (IAS 20) if they are part of the consideration for the arrangement.
- The assets are recognised as operator's assets (measured at fair value on initial recognition).
- The operator must recognise a liability for any obligations assumed in exchange for the assets.

Consensus: Consideration for construction (upgrade) is recognised at its fair value

Consideration may be rights to:

- a financial asset; or
- an intangible asset

5.2 Recognition of a financial asset

A financial asset must be recognised when the operator has an unconditional contractual right to receive cash or another financial asset from or at the direction of the grantor.

Such an unconditional contractual right exists where the grantor contractually guarantees to pay the operator:

- specified or determinable amounts; or
- any shortfall between amounts received from users of the public service and specified or determinable amounts

IAS 32 and IAS 39 (IFRS 9) and IFRS 7 apply.

Example: Service concession arrangement resulting in recognition of a financial asset

X Limited is an operator in a service concession arrangement.

Terms

X Limited will construct a road (completed in 2 years).

X Limited to maintain and operate the road for 8 years (i.e. years 3–10).

X Limited to resurface the road at the end of year 8.

The government is to pay X Limited Rs. 200 million per year in years 3–10. (The right to receive cash flows is a financial asset).

Further information:

All cash flows take place at the end of the year

X Limited's cost of borrowing is 6.7%

The fair values of the consideration received are as follows:

		Forecast costs	Mark-up	Fair value of consideration
1 – 2	Construction services	500 pa	5%	525 pa
3 to 10	Operation services	10 pa	20%	12 pa
8	Resurfacing	100	10%	110

The total fair values of consideration provided are:

	Rs. m
Construction services (2 × 525)	1,100
Operation services (8 × 12)	96
Resurfacing	110
	1,306
Total cash to be received (8 × 200)	1,600
Interest	294

The effective interest rate calculated as the IRR of amounts recognised as consideration and the cash flows from the government for the financial asset is 6.18%.

The above information can be used to construct the following amortisation table for the financial asset (all figures are in Rs. millions).

Year	Amortised cost b/f	Interest @ 6.18%	Income recognised in year	Cash	Amortised cost c/f
1	0	0	525	0	525
2	525	32	525	0	1,082
3	1,082	67	12	(200)	961
4	961	59	12	(200)	833
5	833	51	12	(200)	696
6	696	43	12	(200)	551
7	551	34	12	(200)	397
8	397	25	122	(200)	344
9	344	21	12	(200)	177
10	177	11	12	(200)	0

The interest income (at 6.18%) is recognised in profit or loss together with the other elements of income.

The amortised cost at each year end is recognised as a financial asset.

The following table shows the movement in the cash balances over the duration of the agreement (all figures are in Rs. millions).

Year	Cash b/f	Interest at 6.7%	Cash out	Cash in	Net cash flow	Cash c/f
1	0	0	(500)	0	(500)	(500)
2	(500)	(34)	(500)	0	(534)	(1,034)
3	(1,034)	(69)	(10)	200	121	(913)
4	(913)	(61)	(10)	200	129	(784)
5	(784)	(53)	(10)	200	137	(646)
6	(646)	(43)	(10)	200	147	(500)
7	(500)	(33)	(10)	200	157	(343)
8	(343)	(23)	(110)	200	67	(276)
9	(276)	(19)	(10)	200	171	(105)
10	(105)	(7)	(10)	200	183	78

Example (continued): Service concession arrangement resulting in recognition of a financial asset

The financial asset amortisation table and the cash table showing the net cash balances reflect the following double entries (only the first three years are shown.

Year 1	Debit	Credit
Financial asset	525	
Revenue (P&L)		525
Costs (P&L)	500	
Cash		500

Year 2	Debit	Credit
Financial asset (525 + 32)	557	
Revenue (P&L)		525
Interest income (P&L)		32
Costs (P&L)	500	
Interest expense (P&L)	34	
Cash		534

Year 3	Debit	Credit
Financial asset (67 + 12 – 200)		121
Revenue (P&L)		12
Interest income (P&L)		67
Costs (P&L)	10	
Interest expense (P&L)	69	
Cash	121	

5.3 Recognition of an intangible asset

An intangible asset is recognised to the extent that the operator receives a right (a licence) to charge users of the public service. A right to charge users of the public service is not an unconditional right to receive cash because the amounts are contingent on the extent that the public uses the service

Example: Service concession arrangement resulting in recognition of an intangible asset

X Limited is an operator in a service concession arrangement.

Terms

X Limited will construct a road (completed in 2 years).

X Limited to maintain and operate the road for 8 years (i.e. years 3–10) and charge a toll to road users. It is estimated that the toll will be Rs 200 million per annum and that operating costs will be Rs. 10 million per annum.

The right to charge a toll is an intangible asset.

Analysis

X Limited is providing a construction service to the grantor in exchange for a right to collect tolls from road users in years 3–10.

This right is an intangible asset paid for by providing construction services. It must be recognised at cost (fair value of consideration received or receivable for the construction services delivered.

X Limited recognises toll revenue when it collects tolls in years 3 to 10. The intangible asset recognised over years 1 and 2 must be amortised over years 3 to 10

Further information:

All cash flows take place at the end of the year

X Limited estimates the fair value of consideration received as equal to the forecast construction costs plus 5%. Construction revenue of Rs. 525 million and construction costs of Rs. 500 million is recognised in each of years 1 and 2.

X Limited capitalises the borrowing cost in the construction phase. X Limited's cost of borrowing is 6.7%.

Example (continued): Service concession arrangement resulting in recognition of an intangible asset

The following table shows the movement in the cash balances over the duration of the agreement (all figures are in Rs. millions).

Year	Cash b/f	Interest at 6.7%	Cash out	Cash in	Net cash flow	Cash c/f
1	0	0	(500)	0	(500)	(500)
2	(500)	(34)	(500)	0	(534)	(1,034)
3	(1,034)	(69)	(10)	200	121	(913)
4	(913)	(61)	(10)	200	129	(784)
5	(784)	(53)	(10)	200	137	(646)
6	(646)	(43)	(10)	200	147	(500)
7	(500)	(33)	(10)	200	157	(343)
8	(343)	(23)	(10)	200	167	(176)
9	(176)	(19)	(10)	200	171	(5)
10	(5)	(7)	(10)	200	183	178

The intangible asset on initial recognition is as follows:

	Rs. m
Year 1: Construction services	525
Year 2: Construction services	525
Year 2: Capitalised interest	34
Intangible asset on initial recognition	1,084
Useful life (years 3 to 10)	8 years
Annual amortisation charge (years 3 to 10)	135

Note that interest incurred after the intangible asset is brought into use must be expensed to profit or loss.

Example (continued): Service concession arrangement resulting in recognition of an intangible asset

The double entries over the first three years are as follows:

Year 1	Debit	Credit
Intangible asset	525	
Revenue (P&L)		525
Costs (P&L)	500	
Cash		500

Year 2	Debit	Credit
Intangible asset (525 + 34)	559	
Revenue (P&L)		525
Costs (P&L)	500	
Cash (500 + 34)		534

Year 3	Debit	Credit
Intangible asset		135
Revenue (P&L)		200
Costs (P&L) (10 + 135)	145	
Interest expense (P&L)	69	
Cash (200 – 69 – 10)	121	

Consensus: Sundry issues

Contractual obligations to restore the infrastructure to a specified level of serviceability before it is handed over to the grantor at the end of the service arrangement are recognised and measured in accordance with IAS 37.

Borrowing costs are recognised and measured in accordance with IAS 23 might lead to capitalisation of borrowing costs in the construction phase when the operator has a contractual right to receive an intangible asset.

5.4 SIC 29: Service concession arrangements: disclosures

IFRIC 12 does not contain any disclosure requirements. Disclosures for service concession arrangements are specified by SIC 29

An operator and a grantor must disclose:

- a description of the arrangement;
- significant terms that may affect the amount, timing and certainty of future cash flows;
- the nature and extent of:
  - rights to use specified assets;
  - obligations to provide or rights to expect provision of services;
  - obligations to acquire or build items of property, plant and equipment;
  - obligations to deliver or rights to receive specified assets at the end of the concession period;
  - renewal and termination options; and
  - other rights and obligations (e.g., major overhauls);
- changes in the arrangement occurring during the period; and
- how the service arrangement has been classified.

An operator must disclose revenue and profits (losses) recognised in the period on exchanging construction services for a financial asset or an intangible asset.

6 SIC 7: INTRODUCTION OF THE EURO

Section overview

- SIC 7: Introduction of the euro

6.1 SIC 7: Introduction of the euro

The issue

The euro was introduced on 1 January 1999.

The conversion rates between the euro and the first participating national currencies were irrevocably fixed at this date thus eliminating the risk of subsequent exchange differences related to these currencies from this date.

SIC 7 gives guidance on how IAS 21 should be applied at the date of changeover from a national currency to the euro.

These rules might seem to be a little irrelevant but they would also apply when any new country adopts the euro in the future. Furthermore, similar rules would also apply to any future monetary union that might occur.

Consensus

The requirements of IAS 21 regarding the translation of foreign currency transactions and financial statements of foreign operations should be strictly applied to a changeover.

This means that, in particular:

- foreign currency monetary assets and liabilities resulting from transactions must continue to be translated into the functional currency at the closing rate with any resultant exchange differences recognised as income or expense immediately;
- the exchange differences relating to the translation of financial statements of foreign operations, recognised in other comprehensive income, must be accumulated in equity and reclassified from equity to profit or loss only on the disposal or part disposal of investment.

CHAPTER 31

IFRS 1: First time adoption of IFRS

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with the international pronouncements and under the Companies Ordinance, 1984.**

LO 2 **Evaluate and analyse financial data in order to arrive at firm decisions on the accounting treatment and reporting of the same.**

FINANCIAL REPORTING AND ETHICS

Financial reporting

B (a) 2 IFRS 1: First-time adoption of international financial reporting standards

1 ACCOUNTING FOR THE TRANSITION TO IFRS

Section overview

- Introduction and terminology
- Opening IFRS statement of financial position
- Full retrospective application of IFRS
- Permitted exceptions to full retrospective application of IFRS
- Mandatory exceptions to full retrospective application of IFRS

1.1 Introduction and terminology

Changing from one GAAP to another is a major undertaking which has wide reaching implications for the company undertaking this step.

IFRS 1 First Time Adoption of International Financial Reporting Standards explains how the transition to IFRS should be accounted for.

Definitions

First time adopter: An entity that presents its first IFRS financial statements

First IFRS financial statements: The first annual financial statements in which an entity adopts IFRS by an explicit and unreserved statement of compliance with IFRS.

The first IFRS financial statements will include the current year, which is the first period published entirely according to IFRS and comparatives, which were originally published under previous GAAP, and have been restated into IFRS

A first-time adopter must prepare an opening statement of financial position according to IFRS as at the date of transition to IFRS.

Definitions

Date of transition to IFRSs: The beginning of the earliest comparative period for which an entity presents full comparative information under IFRS in its first IFRS financial statements.

Opening IFRS statement of financial position: An entity's statement of financial position at the date of transition to IFRSs.

The opening IFRS statement of financial position is prepared by full retrospective application of all IFRS extant at the end of first IFRS reporting period.

Definition

First IFRS reporting period: The latest reporting period covered by the entity's first IFRS financial statements.

Example: Terminology

A company is preparing its first IFRS financial statements for the year ending 31 December 2016.

The company operates in a regime that requires a single period of comparative information.

First IFRS reporting period	Year ended 31 December 2016
First IFRS financial statements:	Financial statements prepared to the above year-end
	All IFRSs extant at this date are applied retrospectively (subject to permitted exemptions and mandatory exceptions).
Date of transition to IFRSs	1 January 2015 (the start of the comparative period)
Opening IFRS statement of financial position:	An IFRS statement of financial position prepared as at the above date. (1 January 2015)

1.2 Opening IFRS statement of financial position

As stated above, the opening IFRS statement of financial position is prepared by full retrospective application (subject to permitted exemptions and mandatory exceptions) of all IFRS extant at the first IFRS reporting date. The standards extant at the reporting date are used to reconstruct the statement of financial position as at the date of transition. This means that if a rule in existence at the date of transition was changed by the first IFRS reporting date, it is the new rule that is applied in building the opening IFRS statement of financial position.

The opening IFRS statement of financial position becomes the basis for accounting moving forward. It is constructed at the start of the comparative period. The company will already have prepared and filed financial statements for this period under its previous GAAP. These have to be restated to IFRS to become the IFRS comparatives to the first IFRS financial statements.

Example: Terminology

A company is preparing its first IFRS financial statements for the year ending 31 December 2016.

The company operates in a regime that requires a single period of comparative information.

The company drafts its opening IFRS statement of financial position as at 1 January 2015.

It will have published financial statements under its previous GAAP to cover the year end 31 December 2015.

These are restated to become comparatives in the first IFRS financial statements.

1.3 Full retrospective application of IFRS

Full retrospective restatement means that all of the figures from the previous GAAP statement of financial position should be restated to what they would have been if IFRS had always been applied.

This means that in the opening IFRS statement of financial position, a first-time adopter must:

- recognise all assets and liabilities whose recognition is required by IFRSs;
- not recognise assets or liabilities if IFRSs do not permit such recognition;
- re-classify items recognised under the previous GAAP as one type of asset, liability or component of equity if IFRSs require that they should be classified differently; and
- apply IFRSs in measuring all assets and liabilities.

These adjustments are made at the date of transition and lead to restructuring of the comparative statement of financial position

Full retrospective restatement is a difficult task. IFRS must be applied in its entirety from the date of transition but there are two categories of exception to full retrospective restatement before this. These are:

- exemptions which are permitted; and
- exceptions which are mandatory.

1.4 Permitted exceptions to full retrospective application of IFRS

A first-time adopter may elect to use one or more available exemptions from the application of IFRSs.

There are possible exemptions to full retrospective application in a number of areas including the following:

- business combinations;
- cost of non-current assets (deemed cost);
- cumulative translation differences;
- investments in subsidiaries, associates and jointly controlled entities (IAS 27); and
- designation of previously recognised financial instruments.

Business combinations

The “business combination” exemption is actually a series of exemptions relating to:

- IFRS 3: Business combinations;
- Consolidation, equity accounting and joint arrangements (IFRS 10, IFRS 11 and IAS 28);
- IAS 21: The effects of Changes in Foreign Exchange Rates

The rules on business combinations must be applied to all transactions arising after the date of transition but do not have to be applied retrospectively.

However, IFRS 1 allows the rules to apply from any date before the date of transition. In effect, this means that a company could pick any date before the date of transition from which to start applying IFRS and if this is the case both IFRS 3 and IFRS 10 must be applied to all subsequent combinations.

Alternative rules apply if IFRS 3 is not applied retrospectively (Appendix C to IFRS 1). These include:

- assets and liabilities recognised under previous GAAP forms the basis for the recognition of assets and liabilities under IFRS at the date of transition (subject to adjustments);
- the carrying amount of assets and liabilities under previous GAAP is deemed cost for IFRS;
- goodwill written off is not reinstated;
- goodwill at transition is subject to impairment test.

IAS 21 requires that goodwill and fair value adjustments arising on acquisition of a foreign operation are retranslated at each reporting date. IFRS 1 allows that this requirement does not have to be applied to business combinations before the date of transition.

Deemed cost

This exemption applies to:

- Property, plant and equipment;
- Intangible assets (conditions apply);
- Investment property; and
- Exploration and evaluation assets for oil and gas under IFRS 6, and assets recorded in respect of rate-regulated activities

It might be difficult to retrospectively construct the IFRS cost of non-current assets at the date of transition.

IFRS 1 allows the use of one of the following to establish the IFRS cost of an asset at the date of transition:

- fair value;
- cost adjusted by changes in an inflation index;
- a fair value established at a date before the date of transition in accordance with previous GAAP;
- cost as determined under previous GAAP (oil and gas, rate-regulated activities).

Cumulative translation differences

IAS 21 requires cumulative translation differences (CTDs) arising on translation of foreign operations to be classified as a separate component of equity and recycled through the statement of profit or loss on disposal of the subsidiary.

A first time adopter does not have to identify CTDs that arose before the date of transition

Investments in subsidiaries, jointly controlled entities and associates

If an entity prepares separate financial statements *IAS 27* Separate *Financial Statements* requires it to account for investments in subsidiaries, jointly ventures and associates either:

- ❑ at cost;
- ❑ in accordance with IAS 39 (IFRS 9);or
- ❑ using the equity method as described in IAS 28

IFRS 1 allows one of the following amounts to be used to establish a cost for IFRS in the separate opening IFRS financial statements:

- ❑ cost determined in accordance with IAS 27; or
- ❑ deemed cost:
- ❑ fair value (determined in accordance with IAS 39) at the date of transition; or
- ❑ previous GAAP carrying amount at that date

Designation of previously recognised financial instruments

IAS 39 Financial Instruments: Recognition and Measurement allows classification on initial recognition of:

- ❑ a financial asset as fair value through profit or loss (conditions) or as available for sale; and
- ❑ a financial liability as fair value through profit or loss (conditions)

IFRS 1 allows such designation to be made at the date of transition

1.5 Mandatory exceptions to full retrospective application of IFRS

IFRS 1 prohibits the retrospective application of some IFRSs for the opening IFRS statement of financial position.

Exceptions that must be used concern the following:

- ❑ estimates;
- ❑ derecognition of financial assets and liabilities;
- ❑ hedge accounting;
- ❑ non-controlling interests;
- ❑ embedded derivatives; and
- ❑ government loans

Estimates

An entity must not apply hindsight to estimates at the date of transition (unless there is evidence that they were wrong)

The statement of financial position at the date of transition and restated comparatives must be constructed using estimates current as at those dates

Estimates might include:

- market values;
- exchange rates;
- interest rates;

Example: Estimates

A company is preparing its first IFRS financial statements for the year ending 31 December 2015.

The company operates in a regime that requires a single period of comparative information. This means that its date of transition is 1 January 2014.

The company had recognised a warranty provision in its previous GAAP financial statements for the year ended 31 December 2013.

This provision was based on an expectation that 5% of products would be returned.

During 2014 and 2015 7% of products were returned.

The opening IFRS statement of financial position includes a provision recognised and measured in accordance with IAS 37. This provision is based on estimated returns of 5% as this was the estimate current at that date.

The company is not allowed to base the measurement of the provision on 7% returns.

Derecognition

If an asset was derecognised under previous GAAP but would not have been under IFRS, full retrospective application would bring it back onto the statement of financial position. This is not allowed by IFRS 1.

The IAS 39/IFRS 9 derecognition rules must be applied prospectively for transactions occurring on or after the date of transition to IFRSs.

- non-derivative financial assets and liabilities derecognised in a period beginning before transition are not re-recognised; however
- an entity may apply the rules retrospectively from any date of its choosing but only if the information needed to apply IAS 39 was obtained at the date of the transaction.

Note that some financial assets that were derecognised before the date of transition might still be brought back onto the opening IFRS statement of financial position due to the rules requiring consolidation of special purpose vehicles. If a financial asset had been derecognised in a sale or transfer to an entity which

would be defined as a subsidiary under IFRS, that financial asset would be brought back into the opening IFRS statement of financial position by consolidation.

Hedge accounting

Hedge accounting relationships cannot be designated retrospectively

At transition;

- all derivatives are measured at fair value;
- deferred gains/losses previously reported as assets and liabilities are eliminated;
- hedge accounting can only be used if the hedge qualifies under rules in IFRS.

Non-controlling interests

IFRS 10 contains rules:

- on accounting for changes in ownership of a subsidiary that do and do not result in a loss of control; and
- that require total comprehensive income to be attributed to the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance;

These rules must be applied prospectively from the date of transition

If a first-time adopter elects to apply IFRS 3 retrospectively to past business combinations, it must also apply IFRS 10 from the same date

2 PRESENTATION AND DISCLOSURE

Section overview

- Presentation by a first time adopter
- Disclosure by a first time adopter

2.1 Presentation by a first time adopter

IFRS 1 requires that a first-time adopter must include at least one year of comparative information in its first IFRS financial statements. (This is why the date of transition to IFRS cannot be later than the beginning of the previous financial year).

Presentation

To comply with IAS 1 the first IFRS financial statements must include at least:

- ❑ 3 statements of financial position:
  - Current year (the date to which the first IFRS financial statements are prepared);
  - Last year (the comparatives to the first IFRS financial statements which were originally published under the previous GAAP);
  - Start of last year (date of transition).
- ❑ 2 statements of profit and loss and other comprehensive income (current year with comparatives);
- ❑ 2 statements of cash flows (current year with comparatives);
- ❑ 2 statements of changes in equity (current year with comparatives); and
- ❑ 2 sets of related notes to the financial statements (current year with comparatives).

2.2 Disclosure by a first-time adopter

The company must explain how the transition to IFRS affected its reported:

- ❑ financial position;
- ❑ financial performance; and
- ❑ cash flows.

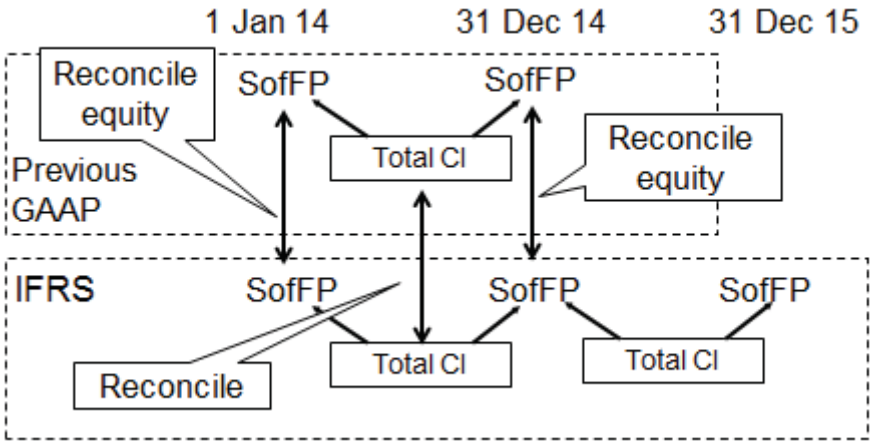
IFRS 1 requires that a company publish reconciliations of amounts in the previous GAAP financial statements to those in the IFRS financial statements.

The first IFRS financial statements must include:

- ❑ reconciliations of equity (net assets):
  - at the date of transition; and
  - at the end of latest period presented under previous GAAP;

- a reconciliation of the profit or loss for the latest period presented under previous GAAP

Illustration: Reconciliations



SofFP = Statement of financial position

Total CI = Total comprehensive income

IFRS 1 provides an illustrative example in columnar form.

The adjustment to each previous GAAP figure must be explained in notes to the financial statements.

A simple example follows to show the presentation for the reconciliation of net equity.

Example: Reconciliation of equity

A simplified example of a reconciliation of equity is shown below.

	Previous GAAP Rs.	IFRS adjustments Rs.	IFRSs Rs.
Property, plant and equipment	2,000	300	2,300
Intangible assets	400	(50)	350
Total non-current assets	2,400	250	2,650
Trade and other receivables	1,200	0	1,200
Inventory	800	(70)	730
Cash	50	0	50
Total current assets	2,050	(70)	1,980
Total assets	4,450	180	4,630
Loans	800	0	800
Trade payables	415	0	415
Current tax liability	30	0	30
Deferred tax liability	25	220	245
Total liabilities	1,270	220	1,490
Total assets less total liabilities	3,180	(40)	3,140
Issued capital	1,000	0	1,000
Revaluation reserve	0	190	190
Retained earnings (balance)	2,180	(230)	1,950
Total equity	3,180	(40)	3,140

CHAPTER 32

Specialised financial statements

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 4 **Prepare financial statements of specialised entities (including small and medium sized entities in accordance with the Companies Ordinance, 1984 and the applicable reporting framework, retirement benefit funds in accordance with international pronouncements) and be able to demonstrate an understanding of reporting requirements under the laws specific to insurance, banking companies and mutual funds.**

SPECIALISED FINANCIAL STATEMENTS

C 1 Small and medium sized entities

C 2 Banks

C 3 Mutual funds

C 4 Insurance companies

C 5 IAS 26: Accounting and reporting by retirement benefit plans

1 IFRS FOR SMALL AND MEDIUM-SIZED ENTITIES (SMES)

Section overview

- Introduction
- IFRS for SMEs
- IFRS for SMEs section by section
- Comprehensive review of the IFRS for SMEs

1.1 Introduction

International accounting standards are written to meet the needs of investors in international capital markets. Most companies adopting IFRSs are large listed entities. The IASB has not stated that IFRSs are only aimed at quoted companies, but certainly the majority of adopters are large entities. In many countries IFRSs are used as national GAAP which means that unquoted small and medium-sized entities (SMEs) have to apply them.

There is an argument that all entities should apply the same accounting standards in order to give a fair presentation of the affairs of the entity. However in some cases, many of the IFRSs are complex and can be difficult for SMEs to apply, particularly in areas such as financial instruments. Additionally, not all the information required by IFRSs for disclosure is needed by the users of the SME's financial statements.

Some commentators therefore suggest that SMEs and public entities should be allowed to use simplified or differing standards as the nature of their business is different from large quoted entities.

The users of financial statements of SMEs are different from the users of the financial statements of quoted companies. The only 'user groups' that use the financial statements of an SME are normally:

- its shareholders/owners;
- lenders;
- senior management; and
- possibly, government departments and agencies.

A SME is often owned and managed by a small number of entrepreneurs, and may be a family-owned and family-run business. Large companies, in contrast, are run by professional boards of directors, who must be held accountable to their shareholders.

Because there are big differences between SMEs and large quoted companies, it is not clear whether there is any reason why SMEs should comply with IFRSs. There are arguments in favour of using IFRSs for SMEs, and arguments against.

Arguments against the use of IFRSs by SMEs

There are several reasons why SMEs **should not** adopt IFRSs for the preparation of their financial statements.

- Some IFRSs deal with subjects that are of little or no relevance to SMEs, such as accounting standards on consolidation, associates, joint ventures, deferred tax, construction contracts and standards that deal with complex issues of fair value measurement.
- The costs of complying with IFRSs can be high. Large companies are able to bear the cost, which might not be significant relative to their size. For SMEs, the cost is proportionately much higher, and it is doubtful whether the benefits of complying with IFRSs would justify the costs.
- There are not many users of financial statements of SMEs, and they use the financial statements for a smaller range of decisions, compared to investors in international capital markets. So would it be a waste of time (as well as cost) to comply with IFRSs?

Arguments in favour of the use of IFRSs by SMEs

There are also reasons why SMEs **should** adopt IFRSs for the preparation of their financial statements.

- If SMEs use different accounting rules and requirements to prepare their financial statements, there will be a 'two-tier' system of accounting. This could make it difficult to compare results of larger and smaller companies, should the need arise. Confidence in the quality of financial reporting might be affected adversely.
- If SMEs prepared financial statements in accordance with their national GAAP, it will be impossible to compare financial statements of companies in different countries. If SMEs grow in size and eventually obtain a stock market quotation, they will have some difficulty in the transition from national GAAP to IFRSs.
- It has also been argued that full statutory accounts for SMEs would be in the public interest, and might help to protect other stakeholders in the company (such as suppliers, customers, lenders and employees).

Considerations in developing standards for SMEs

The aim of developing a set of accounting standards for SMEs is that they allow information to be presented that is relevant, reliable, comparable and understandable. The information presented should be suitable for the uses of the managers and directors and any other interested parties of the SME.

Additionally, many of the detailed disclosures within full IFRSs are not relevant and the accounting standards should be modified for this. The difficulty is getting the right balance of modification, too much and the financial statements will lose their focus and will not be helpful to users.

1.2 IFRS for SMEs

The standard consists of 230 pages of text, arranged into 35 sections that cover all of the recognition, measurement, presentation and disclosure requirements for SMEs. There is no cross reference to other IFRS (with one exception relating to financial instruments).

The IFRS for SMEs imposes a lesser burden on SMEs due to:

- some topics in IFRSs being omitted because they are not relevant to typical SMEs
- the simplification of many of the recognition and measurement requirements available in full IFRSs
- substantially fewer disclosures.

The IFRS for SMEs does not address the following topics:

- earnings per share (i.e. there is no equivalent to IAS 33);
- interim accounting (i.e. there is no equivalent to IAS 34);
- segment reporting (i.e. there is no equivalent to IFRS 8);
- special accounting for assets held for sale (i.e. there is no equivalent to IFRS 5).

The omission of equivalent rules to those in IAS 33, IAS 34 and IFRS 8 is not surprising as they are relevant to listed entities. As the next section explains, such entities cannot be SMEs.

Stand-alone document

The IFRS for SMEs is a stand-alone document. This means that it contains all of the rules to be followed by SMEs without referring to other IFRSs. For example it sets out rules for property, plant and equipment without specifying that the rules are similar or dissimilar to those found in IAS 16.

In the following pages we provide an overview of the sections of the IFRS for SMEs and often refer to similarity or difference to equivalent other IFRSs. This is not what the IFRS for SMEs does but we adopt the approach to make it easier for you to gain an understanding of the main features of the standard.

The IFRS for SMEs is derived from rules in other IFRS. You will note that it uses the same terminology and that many of the rules are identical. However, in several cases the rules in other IFRSs from which the IFRS for SMEs derives have been changed whereas the equivalent rules in this standard have not been changed. For example the rules on joint ventures are based on the standard (IAS 31) that preceded IFRS 11 which you covered earlier. You should not interpret this as meaning that the standard is out of date. It simply means that there is a difference between the rules for SMEs and those followed by other entities. Changes to the main body of standards will not necessarily result in a revision to the IFRS for SMEs.

1.3 IFRS for SMEs section by section

Section 1: Small and medium-sized entities

Definition

Small and medium-sized entities are entities that:

a. do not have public accountability, and

b. publish general purpose financial statements for external users. Examples of external users include owners who are not involved in managing the business, existing and potential creditors, and credit rating agencies.

An entity has **public accountability** if:

a. its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments; or

b. it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses (e.g. banks and insurance companies).

The decision as to which entities are required or permitted to apply the standard will lie with the regulatory and legislative authorities in each jurisdiction.

Section 2: Concepts and pervasive principles

This section is drawn from the *IASB Framework for the preparation and presentation of financial statements*. This was the document that preceded the *IASB Conceptual Framework* with which you are already familiar.

The section states that the objective of financial statements of a small or medium-sized entity is to provide information about the financial position, performance and cash flows of the entity that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs. Financial statements also show the results of the stewardship of management (the accountability of management for the resources entrusted to it).

The section lists the following qualitative characteristics of information in financial statements:

- ❑ understandability;
- ❑ relevance;
- ❑ materiality;
- ❑ reliability;
- ❑ substance over form;
- ❑ prudence;
- ❑ completeness;
- ❑ comparability; and
- ❑ timeliness.

The section contains guidance on financial position (including the definitions of assets, liabilities and equity) and on financial performance (including the definitions of income and expenses) which is the same as in the conceptual framework. The recognition criteria are also the same.

The IFRS for SMEs contains guidance on measurement that is not found in either the original or the new frameworks.

An entity must measure assets and liabilities at historical cost unless another section in the IFRS for SMEs requires initial measurement on another basis such as fair value.

Most non-financial assets that an entity initially recognised at historical cost are subsequently measured on other measurement bases. For example:

- property, plant and equipment is measured at the lower of depreciated cost and recoverable amount;
- inventories are measured at the lower of cost and selling price less costs to complete and sell; and
- an entity recognises an impairment loss relating to non-financial assets that are in use or held for sale.

This guidance is intended to ensure that an asset is not measured at an amount greater than the entity expects to recover from the sale or use of that asset.

Most liabilities other than financial liabilities are measured at the best estimate of the amount that would be required to settle the obligation at the reporting date.

Assets and liabilities, or income and expenses, must not be offset unless required or permitted by another section in the IFRS for SMEs.

Section 3: Financial statement presentation

Financial statements must 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 *Section 2 Concepts and Pervasive Principles*.

The application of the IFRS for SMEs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation of the financial position, financial performance and cash flows of SMEs.

Application of the IFRS for SMEs by an entity with public accountability cannot result in a fair presentation in accordance with this IFRS.

An entity whose financial statements comply with the IFRS for SMEs must make an explicit and unreserved statement of such compliance in the notes. Financial statements must not be described as complying with the IFRS for SMEs unless they comply with all the requirements of this IFRS.

A complete set of financial statements of an entity reporting under the IFRS for SMEs is similar to that required by full IFRS and comprises:

- a statement of financial position;

- ❑ either a single statement of profit or loss and other comprehensive income, or a separate statement of profit or loss and a separate statement of other comprehensive income;
- ❑ a statement of changes in equity (or a statement of income and retained earnings);
- ❑ a statement of cash flows;
- ❑ notes including a summary of significant accounting policies; and
- ❑ comparative information.

Section 4: Statement of financial position

The rules in IFRS for SMEs on statements of financial position are very similar to those found in IAS 1.

One difference is that line items required for assets held for sale or liabilities of disposal groups held for sale are not required.

Section 5: Statement of comprehensive income and income statement

The rules in IFRS for SMEs on statements of financial performance are very similar to those found in IAS 1.

An entity must present its total comprehensive income either:

- ❑ in a single statement; or
- ❑ in two statements

An entity must present its total comprehensive income for a period either:

- ❑ in a single statement of comprehensive income, in which case the statement of comprehensive income presents all items of income and expense recognised in the period, or
- ❑ in two statements (an income statement and a statement of comprehensive income) in which case the income statement presents all items of income and expense recognised in the period except the following three categories of gain or loss that must be recognised in total comprehensive income in accordance with the IFRS for SMEs:
  - gains and losses arising on translating the financial statements of a foreign operation (*Section 30: Foreign currency translation*).
  - some actuarial gains and losses (*Section 28: Employee benefits*).
  - some changes in fair values of hedging instruments (*Section 12: Other financial instruments*).

An income statement is what the IFRS for SMEs calls a statement of profit or loss.

Section 6: Statement of changes in equity and statement of income and retained earnings

An SME must present either:

- a statement of changes in equity (SOCIE); or
- a statement of income and retained earnings (if the only changes in equity in the period arise from profit or loss, dividends paid, corrections of errors and changes in accounting policy).

The statement of income and retained earnings is an income statement with a closing section which shows the following:

- retained earnings at the beginning of the reporting period;
- dividends declared and paid or payable during the period;
- restatements of retained earnings for corrections of prior period errors;
- restatements of retained earnings for changes in accounting policy; and
- retained earnings at the end of the reporting period.

Section 7: Statement of cash flows

There are no significant differences between the rules in section 7 and those in IAS 7.

Section 8: Notes to the financial statements

There are no significant differences between the IFRS for SMEs rules on notes to the financial statements and those found in IAS 1.

Section 9: Consolidated and separate financial statements

This section derives from the standards that were replaced by the project that led to the publication of IFRS 10. However, there are no significant, practical differences between the IFRS for SMEs rules on subsidiaries and consolidation and those found in the other IFRS.

Each set of rules would result in the recognition of the same entities as subsidiaries and result in the same consolidated financial statements in most (but not all) cases. It is possible that the more detailed guidance on control in IFRS 10 would lead to the consolidation of some entities that might not be considered as subsidiaries according to the IFRS for SMEs rules. However, most SMEs are unlikely to be involved in the sort of investment that IFRS 10 would further identify.

Section 10: Accounting policies, estimates and errors

The rules in IFRS for SMEs on accounting policies, estimates and errors are very similar to those found in IAS 8. However, there is no requirement to disclose the impact of a new standard in issue but not yet effective.

Sections 11 and 12: Introduction to IFRS for SMEs in respect of financial instruments

Section 11 and Section 12 together deal with recognising, derecognising, measuring and disclosing financial instruments (financial assets and financial liabilities).

Section 11 applies to basic financial instruments and is relevant to all entities.

Section 12 applies to other, more complex financial instruments and transactions.

An entity must apply either:

- the provisions of both Section 11 and Section 12 in full, or
- the recognition and measurement provisions of IAS 39 (now IFRS 9).

Section 11: Basic financial instruments

This section applies to all entities.

A financial instrument is a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

An entity must recognise a financial asset or a financial liability only when the entity becomes a party to the contractual provisions of the instrument.

Measurement of financial assets and liabilities on initial recognition is at the transaction price (including transaction costs) with the following exceptions:

- financial assets and liabilities that are measured at fair value through profit or loss) are measured at their fair value (which is usually the transaction price) with transaction costs expensed to profit or loss;
- financing transactions (for example in connection with the sale of goods if payment is deferred beyond normal business terms or is financed at a rate of interest that is not a market rate) where the financial asset or financial liability is measured at the present value of the future payments.

Subsequent measurement at the end of each reporting period is as follows:

- Debt instruments are measured at amortised cost using the effective interest method with the following exceptions:
  - Debt instruments that are classified as current assets or current liabilities are measured at the undiscounted amount;
  - If an arrangement constitutes a financing transaction, the debt instrument is measured at the present value of the future payments.
- Investments in shares must be measured at fair value with all gains and losses recognised through profit or loss.

Section 12: Other financial instruments issues

This section applies to only to those entities which have complex financial instruments. This includes derivatives and any instrument with an embedded derivative.

An entity must recognise a financial asset or a financial liability only when the entity becomes a party to the contractual provisions of the instrument.

When a financial asset or financial liability is recognised initially, an entity must measure it at its fair value, which is normally the transaction price.

At the end of each reporting period, an entity must measure all financial instruments within the scope of Section 12 at fair value and recognise changes in fair value in profit or loss.

This section includes a simplified hedge accounting regime which can only be used to account for hedges of the following risks:

- ❑ interest rate risk of a debt instrument measured at amortised cost;
- ❑ foreign exchange or interest rate risk in a firm commitment or a highly probable forecast transaction;
- ❑ price risk of a commodity that it holds or in a firm commitment or highly probable forecast transaction to purchase or sell a commodity;
- ❑ foreign exchange risk in a net investment in a foreign operation.

Section 13: Inventories

There are no significant differences between the IFRS for SMEs rules on accounting for inventory and those found in IAS 2.

Section 14: Investments in associates

The section 14 rules on identifying investments in associates are very similar to those found in IAS 28.

Section 14 allows an entity to account for all of its associates using one of the following:

- ❑ cost model;
- ❑ equity method; or
- ❑ fair value model.

Section 15: Investments in joint ventures

Definition

A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control.

Joint control is the contractually agreed sharing of control over an economic entity.

Joint control only exists when the strategic financial and operating decisions relating to the economic activity require the unanimous consent of the entities sharing control (the joint venturers).

Joint control is the key factor in deciding whether a joint venture exists. The following characteristics are common to all types of joint venture:

- ❑ two or more joint venturers are bound by a contractual arrangement (usually in writing); and
- ❑ the contractual arrangement establishes joint control.

The IFRS for SMEs identifies three broad types of joint venture:

- ❑ jointly-controlled operations

- jointly-controlled assets
- jointly-controlled entities.

An entity with a jointly-controlled operation must recognise:

- the assets that it controls and the liabilities that it incurs, and
- the expenses that it incurs and its share of the income that it earns from the sale of goods or services by the joint venture.

An entity with an interest in jointly-controlled assets must recognise:

- its share of the jointly controlled assets, classified according to the nature of the assets;
- any liabilities that it has incurred;
- its share of any liabilities incurred jointly with the other venturers in relation to the joint venture;
- any income from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and
- any expenses that it has incurred in respect of its interest in the joint venture.

An entity with an interest in jointly-controlled entity must account for all of its jointly-controlled entities using one of the following:

- cost model;
- equity method; or
- fair value model.

Section 16: Investment property

The section 14 rules on identifying investment properties are very similar to those found in IAS 40.

Section 14 requires that investment properties must be measured at fair value (cost model not allowed, unless fair value cannot be measured reliably without undue cost or effort).

Section 17: Property, plant and equipment

This section applies to accounting for property, plant and equipment and investment property whose fair value cannot be measured reliably without undue cost or effort.

Most of the section 17 rules are similar to the IAS 16 rules. However, there are some differences.

- All assets within the scope of this section must be measured subsequently using the cost model. Revaluation is not allowed.
- Residual value, useful life and depreciation need to be reviewed only if there is an indication they may have changed since the most recent annual reporting date. (IAS 16 requires an annual review).

Section 18: Intangible assets other than goodwill

The section 18 rules on accounting for intangible assets are similar to the IAS 38 rules. However, there are some differences.

- All assets within the scope of this section must be measured subsequently using the cost model. Revaluation is not allowed.
- All research and development costs must be expensed as incurred. There is no capitalisation of internally generated intangible assets.

All intangible assets must be amortised over their estimated useful lives. If this cannot be estimated a useful life of 10 years is assumed. This means that there is no requirement to test unamortised intangibles for impairment on an annual basis.

Section 19: Business combinations and goodwill

The section 19 rules on accounting for business combinations and goodwill are similar to the IFRS 3 rules. However, there are some differences.

- Acquisition costs are capitalised under this standard whereas they must be expensed under IFRS 3.
- Goodwill is amortised over its estimated useful life. If this cannot be estimated a useful life of 10 years is assumed. This means that there is no requirement to test goodwill for impairment on an annual basis.

Section 20: Leases

There are no significant differences between the IFRS for SMEs rules on leases and those found in IAS 17.

Section 21: Provisions and contingencies

There are no significant differences between the IFRS for SMEs rules on provisions and contingencies and those found in IAS 37.

Section 22: Liabilities and equity

The section 22 rules on equity and liabilities are similar to the IAS 32 rules though IAS 32 does envisage more complex scenarios. Both sets of rules would lead to the same classification of an instrument as debt or equity and both sets of rules require split accounting (into debt and equity components) on the initial recognition of an issue of convertible debt.

Both sets of rules require that any gain or loss on transactions involving an entity's own equity must be recognised as a movement in equity. Section 22 applies the same rational to transactions involving a parent's controlling interest in a subsidiary that do not result in a loss of control. The carrying amount of the non-controlling interest is adjusted to reflect the change in the parent's interest in the subsidiary's net assets. Any difference between the amount by which the non-controlling interest is so adjusted and the fair value of the consideration paid or received, if any, shall be recognised directly in equity and attributed to equity holders of the parent.

Section 23: Revenue

This section is based closely on IAS 18, IAS 11. There are no significant differences between the section 23 rules and the rules in those standards.

Section 24: Government grants

The section 24 rules on accounting for government grants are similar to the IAS 20 rules. However, section 24 does not seem to allow deduction of a capital grant from the asset to which it relates.

Section 25: Borrowing costs

Borrowing costs must be recognised as expenses and cannot be capitalised as required by IAS 23.

Section 26: Share-based payment

The section 26 rules on accounting for share-based payment are similar to the IFRS 2 rules.

One difference is that section 26 allows the directors to make an estimate of the fair value of equity instruments granted when there is no observable market price and a reliable measure of fair value is impracticable.

Section 27: Impairment of assets

The section 27 rules on impairment of assets are similar to those in IAS 2 for inventories and those in IAS 36 for impairment of other non-financial assets.

Section 28: Employee benefits

The section 28 rules on accounting for employee benefits are very similar to those found in IAS 19 with no significant differences worth mentioning.

Section 29: Income tax

This is one area where there are significant differences.

There was an ED proposing major changes to IAS 12 in issue when the IFRS for SMEs was published. The tax rules in this section were based on those in the ED. The ED was subsequently withdrawn and IAS 12 was not revised. This means that the rules in section 29 are based on concepts which the IASB chose not to follow in IAS 12 and are more complex than those in IAS 12.

These rules are not explained further in this text.

Section 30: Foreign currency translation

The section 30 rules on foreign currency translation are similar to the IAS 21 rules.

One difference is that section 30 does not permit recycling of the cumulative translation difference in respect of an investment in a foreign entity when that entity is disposed of.

Section 31: Hyperinflation

The section 31 rules on hyperinflation are very similar to the IAS 21 rules.

This is not relevant to Pakistani companies.

Section 32: Events after the end of the reporting period

There are no significant differences between the IFRS for SMEs rules on events after the end of the reporting period and those found in IAS 10.

Section 33: Related party disclosures

There are no significant differences between the IFRS for SMEs rules for related parties and those found in IAS 24.

Section 34: Specialised activities

IFRS for SMEs provides guidance on:

- Agriculture (drawn from IAS 41);
- Extractive industries (refers back to the property, plant and equipment, intangibles other than goodwill, and provisions sections of the IFRS);
- Service concession arrangements (drawn from, but much simplified, IFRIC 12).

Section 35: Transition to the IFRS for SMEs

This section applies to a first-time adopter of IFRS for SMEs. This could be a company changing from local accounting rules or from full IFRS.

The guidance is similar to that provided by IFRS 1 for first time adoption of full IFRS.

These rules are not described further in this chapter.

1.4 Comprehensive review of the IFRS for SMEs

The IFRS for SMEs was issued in July 2009. At that time the IASB stated its plan to undertake an initial comprehensive review of the IFRS for SMEs to assess the first two years' experience that entities would have had in implementing it and to consider whether there is a need for any amendments.

Companies started using the IFRS for SMEs in many jurisdictions in 2010. Consequently, the IASB commenced its initial comprehensive review in 2012.

This review led to the publication of an exposure draft of proposed amendments to the IFRS for SMEs (ED/2013/9) in October 2013.

The ED proposes 57 amendments which affect IFRS for SMEs. Further minor editorial amendments which have no effect on IFRS for SMEs were also proposed. These were made largely to ensure consistency of terminology and wording throughout the IFRS for SMEs.

The 57 amendments fall into several broad categories:

- amendments to incorporate new and revised IFRSs:
- amendments that change the IFRS for SMEs;
- new guidance;
- new exemptions;
- disclosure simplifications; and
- minor clarifications.

Note that there were no changes proposed resulting from the issue of IFRS 10, IFRS 11, IFRS 12, IFRS 13 and IFRS 9. This implies that the IASB are content with the IFRS for SMEs in this area and see no need to align the rules in the light of changes to the other standards.

One major change proposed is the alignment of section 29 on income tax with IAS 12. The reason for the difference was explained in the previous section.

2 IFRS4: INSURANCE CONTRACTS

Section overview

- Background
- Insurance risk
- Objective of IFRS 4
- Selection of accounting policies

2.1 Background

The group accounts of listed entities in the EU had to be prepared according to IFRS for all accounting periods beginning on or after 1 January 2005. This regulation applied to some very large insurance companies in the EU.

In the run up to conversion, the insurance industry identified a problem. IFRS contained no rules on accounting for insurance contracts. IAS 8 specifies criteria for an entity to use in developing an accounting policy if no IFRS applies specifically to an item. The industry believed that this would lead to difficulties and divergent accounting across the industry.

The IASB launched the insurance contract project, intending that this would be completed in two phases.

Phase 1 was intended as a temporary solution to the problem faced by insurers and this resulted in the publication of IFRS 4 in 2004. Phase 2 was expected to be completed in 2005/6 but this has not happened yet. The project team has been working assiduously on this for many years. Their failure to complete the project to date is a reflection on how complex insurance issues can be and also the need for US GAAP and IFRS to converge in this area.

2.2 Insurance risk

Definition

Insurance contract: A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. (See Appendix B for guidance on this definition.)

Insurance risk: Risk, other than financial risk, transferred from the holder of a contract to the issuer.

Financial risk: The risk of a possible future change in one or more of 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, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

Note that if a product does not fall into this definition then IAS 39 (IFRS 9) would probably apply to it.

2.3 Objective of IFRS 4

IFRS4 was published to introduce:

- ❑ limited improvements to accounting practices for insurance contracts prior to Phase 2 of the project; and
- ❑ requirements for disclosure of information that identifies and explains amounts in the financial statements arising from insurance contracts, and helps users to understand the amount, timing and uncertainty of future cash flows under such contracts.

IFRS 4 applies to insurers and must be followed in accounting for:

- ❑ insurance contracts issued; and
- ❑ reinsurance contracts issued and held.

Definition

Reinsurance contract: An insurance contract issued by one insurer (the reinsurer) to compensate another insurer (the cedant) for losses on one or more contracts issued by the cedant.

2.4 Selection of accounting policies

IAS 8 specifies criteria for an entity to use in developing an accounting policy if no IFRS applies specifically to an item. However, IFRS 4 exempts an insurer from applying those criteria to its accounting policies for:

- ❑ insurance contracts that it issues; and
- ❑ reinsurance contracts that it holds.

However, IFRS 4 does not exempt insurers from certain implications of the IAS 8 criteria. Specifically, an insurer:

- ❑ must not:
  - recognise a liability for catastrophe provisions or equalisation provisions relating to future claims that are not in existence at the reporting date;
  - offset reinsurance assets and related insurance liabilities; or
  - offset income/expense from reinsurance contracts against the expense/income from the related insurance contracts; but
- ❑ must:
  - remove an insurance liability when, and only when, it is extinguished, discharged, cancelled or expired;
  - carry out a liability adequacy test; and
  - consider whether its reinsurance assets are impaired

Changes in accounting policies

An insurer is allowed to change accounting policies for insurance contracts when the change makes information used as a basis of decision making:

- more relevant and no less reliable; or
- more reliable and no less relevant

In particular an insurer cannot introduce any of the following practices, although it may continue using accounting policies that involve them:

- measuring insurance liabilities on an undiscounted basis
- measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current market-based fees for similar services
- using non-uniform accounting policies for the insurance liabilities of subsidiaries.

Prudence

An insurer need not change accounting policies for insurance contracts to eliminate excessive prudence.

If an insurer already measures its insurance contracts with sufficient prudence, it must not introduce additional prudence.

3 INSURANCE COMPANIES

Section overview

- Introduction to accounting by insurance companies
- Financial statements of insurance companies
- Other statements and disclosures

3.1 Introduction to accounting by insurance companies

Insurance companies, in Pakistan, are subject to the *Insurance Ordinance, 2*000 which requires all insurance companies to prepare the following statutory accounts at each year-end:

- in the case of a life insurer,-
  - a statement of assets and liabilities for each statutory fund operated by the life insurer and the shareholders' fund;
  - a statement of profits and losses for the shareholders' fund;
  - a statement of cash flows for each statutory fund operated by the life insurer and the shareholders' fund;
  - a revenue account for each statutory fund operated by the life insurer;
  - a statement of premiums for each statutory fund operated by the life insurer;
  - a statement of claims for each statutory fund operated by the life insurer;
  - a statement of expenses for each statutory fund operated by the life insurer; and
  - a statement of investment income for each statutory fund operated by the life insurer.
- in the case of a non-life insurer,
  - a statement of assets and liabilities;
  - a statement of profits and losses;
  - a statement of cash flows;
  - a statement of premiums;
  - a statement of claims;
  - a statement of expenses;
  - a statement of investment income; and
  - a statement of claims analysis

Insurance companies must also pay regard to the requirements of the Companies Ordinance 1984 in so far as they are not inconsistent with the Insurance Ordinance, 2000. Therefore, insurance companies must prepare financial statements in accordance with IFRS just like any other type of company.

Summary

All insurance companies operating in Pakistan must prepare their accounts in accordance with the following:

- the *Companies Ordinance, 1984*;
- the *Insurance Ordinance, 2000*;
- *SEC (Insurance) Rules, 2002*; and
- IFRS as notified in the official Gazette by the *Securities and Exchange Commission of Pakistan* for listed companies under section 234(3)(i) of the *Companies Ordinance 1984.*

3.2 Financial statements of insurance companies

Insurance companies: Statement of financial performance

Illustration: Statement of comprehensive income format for an insurance company

Statement of comprehensive income for the year ended XX/XX/XXXX

	Property	Health	Motor	Rs. m
Net premium revenue	X	X	X	X
Net claims	(X)	(X)	(X)	(X)
Expenses	(X)	(X)	(X)	(X)
Net commission	X	X	X	X
Underwriting result	X	X	X	X
Investment income				X
Other income				X
General and administration expenses				(X)
				X
Profit before tax				X
Taxation				(X)
Profit after tax				X
Other comprehensive income				X
				X

Insurance companies: Statement of financial position

Illustration: Statement of financial position format for an insurance company

Statement of financial position as at XX/XX/XXXX

	Rs. m
Share capital and reseves	
Share capital	X
Retained profits	X
Reserves	X
	X
Underwriting provisions	
Provision for outstanding claims	X
Provision for unearned premium	X
Commision income unearned	X
Total underwriting provisons	X
Deferred liabilites	
Staff retirement benefit	X
Creditors and accruals	
Premium received in advance	X
Amounts due to other insurers/reinsurers	X
Accrued expenses	X
Other creditors and accruals	X
	X
Other liabilities	X
TOTAL EQUITY AND LIABILITIES	X
ASSETS	
Cash and bank balances	X
Investments	X
Other assets	X
Premiums due but unpaid	X
Amounts due from other insurers/reinsurers	X
Accrued investment income	X
Reinsurance recoveries against outstanding claims	X
Deferred commission expense	X
Prepayments	X
Sundry receivables	X
	X
Fixed assets (non-current assets)	X
	X

3.3 Other statements and disclosures

The following examples have been partially populated with numbers to show the summation logic in the notes.

Statement of premiums

Illustration: Statement of premiums

Company name
Financial year ended: 31 December XXXX
Statement of claims

Business underwritten inside Pakistan

	Premium written Rs. A	Unearned premium Opening Rs. B	Unearned premium Closing Rs. C	Premium earned Rs. D=A+B-C	Reinsurance ceded Rs. E	Prepaid reinsurance Opening Rs. F	Prepaid reinsurance Closing Rs. G	Reinsurance expense Rs. H=E-F+G	Net premium Rs. I=D-H
Direct and faculative									
Fire and property damage	1,000	100	110	990	300	30	35	305	685
Marine, aviation and transport	250	80	160	170	120	15	10	115	55
Motor act				-				-	-
Liability				-				-	-
Worker's compensation				-				-	-
Credit and suretyship				-				-	-
Accident and health				-				-	-
Miscellaneous				-				-	-
Total	1,250	180	270	1,160	420	45	45	420	740
Treaty									
Proportional (*)	10	-	-	10	-	-	-	-	10
Non - proportional (*)	18	-	-	18	-	-	-	-	18
Total	28	-	-	28	-	-	-	-	28
Grand total	1,278	180	270	1,188	420	45	45	420	768

Statement of expenses

Illustration: Statement of expenses

Company name
Financial year ended: 31 December XXXX
Statement of claims

Business underwritten inside Pakistan

	Commission paid or payable	Deferred commission		Net commission expense	Other management expenses	Underwriting expenses	Commissions from reinsurance	Net underwriting expense
	Rs. A	Opening Rs. B	Closing Rs. C	Rs. D=A-B+C	Rs. E	Rs. F=D+E	Rs. G	Rs. H=F-G
Direct and faculative								
Fire and property damage	100	20	25	105	20	125	10	115
Marine, aviation and transport	450	30	20	440	40	480	30	450
Motor act	-	-	-	-	-	-	-	-
Liability	-	-	-	-	-	-	-	-
Worker's compensation	-	-	-	-	-	-	-	-
Credit and suretyship	-	-	-	-	-	-	-	-
Accident and health	-	-	-	-	-	-	-	-
Miscellaneous	-	-	-	-	-	-	-	-
Total	550	50	45	545	60	605	40	565
Treaty								
Proportional (*)	10	-	-	10	-	10	2	8
Non - proportional (*)	15	-	-	15	-	15	-	15
Total	25	-	-	25	-	25	2	23
Grand total	575	50	45	570	60	630	42	588

Statement of claims

Illustration: Statement of claims

Company name
Financial year ended: 31 December XXXX
Statement of claims

Business underwritten Inside Pakistan

	Claim paid	Outstanding claims		Claims expense	Reinsurance & other recoveries received	Reinsurance & other recoveries in respect of outstanding claims		Reinsurance & other recoveries revenue	Net claims expense
		Opening	Closing			Opening	Closing		
	Rs. A	Rs. B	Rs. C	Rs. D=A-B+C	Rs. E	Rs. F	Rs. G	Rs. H=E-F+G	Rs. I=D-H
Direct and faculative									
Fire and property damage	1,000	100	110	1,010	300	30	35	305	705
Marine, aviation and transport	250	80	160	330	120	15	10	115	215
Motor act	-	-	-	-	-	-	-	-	-
Liability	-	-	-	-	-	-	-	-	-
Worker's compensation	-	-	-	-	-	-	-	-	-
Credit and suretyship	-	-	-	-	-	-	-	-	-
Accident and health	-	-	-	-	-	-	-	-	-
Miscellaneous	-	-	-	-	-	-	-	-	-
Total	1,250	180	270	1,340	420	45	45	420	920
Treaty									
Proportional (*)	10	-	-	10	-	-	-	-	10
Non - proportional (*)	15	-	-	15	-	-	-	-	15
Total	25	-	-	25	-	-	-	-	25
Grand total	1,275	180	270	1,365	420	45	45	420	945

4 BANKS

Section overview

- Introduction to accounting by banks
- Banks: Statement of financial performance
- Banks: Statement of financial position
- Other statements and disclosures

4.1 Introduction to accounting by banks

Section 34 of the *Banking Companies Ordinance 1962* requires that every bank incorporated in Pakistan must prepare financial statements in accordance with the second schedule of the act.

The second schedule requirements are now published as in *BSD (Banking Supervision Department) circular No. 36* issued by the *State Bank of Pakistan*.

This also applies to banks incorporated overseas in respect of all business transacted through branches in Pakistan.

Banks must also pay regard to the requirements of the *Companies Ordinance 1984* in so far as they are not inconsistent with the *Banking Companies Ordinance 1962*. Therefore, banks must prepare financial statements in accordance with IFRS just like any other type of company.

Summary

All banks operating in Pakistan must prepare their accounts in accordance with the following:

- directives issued by the *State Bank of Pakistan*;
- the *Banking Companies Ordinance 1962*;
- IFRS as notified in the official Gazette by the *Securities and Exchange Commission of Pakistan* for listed companies under section 234(3)(i) of the *Companies Ordinance 1984*.

This is the case whether the bank is incorporated in Pakistan or outside Pakistan and whether it listed or no.

BSD circular No. 36

BSD circular No. 36 contains formats that must be used when preparing financial statements. The formats for the statement of financial performance (profit and loss account) and statement of financial position (balance sheet) are shown in the following sections.

4.2 Bank: Statement of financial performance

Illustration: Statement of comprehensive income format for a bank

Statement of comprehensive income for the year ended XX/XX/XXXX

	Rs. m
MARK-UP/INTEREST INCOME	
Mark-up/return/interest earned	X
Mark-up/return/interest expensed	(X)
Net mark-up/ interest income	X
Provision against non-performing loans and advances	(X)
Provision for diminution in the value of investments	(X)
Bad debts written off directly	(X)
	(X)
Net mark-up/ interest income after provisions and write offs	X
NON MARK-UP/INTEREST INCOME	
Fee, commission and brokerage income	X
Dividend income	X
Income from dealing in foreign currencies	X
Gain / (Loss) on sale of securities	X
Unrealised gain / (loss) on revalution of investments classified as held for trading	X
Other income	X
Total non-markup/interest Income	X
	X
NON MARK-UP/INTEREST EXPENSES	
Administrative expenses	X
Other provisions/write offs (to be specified)	X
Other charges	X
Total non-markup/interest expenses	(X)
	X
Extraordinary/unusual items (to be specified)	X
PROFIT/(LOSS) BEFORE TAXATION	X
Taxation	(X)
PROFIT/(LOSS) AFTER TAXATION	X
Unappropriated/unremitted profit/(loss) brought forward	X
Profit available for appropriation/unremitted profit/(loss)	X
	X

4.3 Bank: Statement of financial position

Illustration: Statement of financial position format for a bank

Statement of financial position as at XX/XX/XXXX

	Rs. m
ASSETS	
Non-current assets	
Cash and balances with treasury banks	X
Balances with other banks	X
Lendings to financial institutions	X
Investments	X
Advances	X
Operating fixed assets	X
Deferred tax assets	X
Other assets	X
	X
LIABILITIES	
Bills payable	X
Borrowings	X
Deposits and other accounts	X
Sub-ordinated loans	X
Liabilities against assets subject to finance lease	X
Deferred tax liabilities	X
Other liabilities	X
	X
NET ASSETS	X
REPRESENTED BY	
Share capital/ Head office capital account	X
Reserves	X
Unappropriated/ Unremitted profit	X
	X
Surplus/ (Deficit) on revaluation of assets	X
	X

4.4 Other statements and disclosures

Banks are subject to disclosure requirements that require them to provide information on accounting issues specific to banks including notes on

- non-performing advances;
- cash balances with treasury banks;
- balances with other banks
- investments (by type and by segment; and
- deposits and other accounts.

Non – performing advances

Illustration: Non – performing advances

Particulars of non-performing advances

Advances include Rs. XX million which, as detailed below, have been placed under non-performing status:

Category	Amount outstanding			Provision required and held		
	Domestic	Overseas	**Total**	Domestic	Overseas	**Total**
	Rs. m	Rs. m	Rs. m	Rs. m	Rs. m	Rs. m
Other assets especially mentioned	50		50	10		**10**
Sub-standard	200		200	15		**15**
Doubtful	300	35	335	30	5	**35**
Loss	400		400	400		**400**
	950	35	985	455	5	**460**

Provisions against non-performing advances

	Specific	General	Total
	Rs. m	Rs. m	Rs. m
Opening balance	400	100	500
Charge for the year	150	20	170
Amounts written off	(20)		(20)
Reversals	(70)		(70)
Closing balance	460	120	580

Illustration: Cash and balances with treasury banks

In hand	Rs. m
– local currency	X
– foreign currencies	X
	X
With State Bank of Pakistan	
– local currency current account	X
– local currency deposit account	X
– foreign currency current accounts	X
– foreign currency deposit accounts	X
	X
With National Bank of Pakistan	
– local currency current account	X
– local currency deposit account	X
	X
	X

The local currency account is maintained with the State Bank of Pakistan (SBP) as per the requirements of Section 36 of the State Bank of Pakistan Act, 1956, which requires banking companies to maintain a local currency cash reserve in a current account opened with the SBP at a sum not less than its demand laibilities as prescribed by the SBP.

Balances with other banks

Illustration: Balances with other banks

	Rs. m
In Pakistan	
– current accounts	X
– deposit accounts	X
	X
Outside Pakistan	
– current accounts	X
– deposit accounts	X
	X
	X

Investments

Disclosures must show investments by type (meaning how they are classified in the financial statements) and by segment (meaning the market segment that has been invested in.

The balances on both should agree.

Illustration: Investments

Investments by type	
Available-for-sale securities	Rs. m
Fully paid shares of listed companies	X
Fully paid shares of cooperative instituions	X
	X
Held to maturity investments	
Market treausry bills	X
Pakistan investment bonds	X
Non-banking financial institutions	X
	X
Less: Provision for dimunition on value of investment	(X)
Investments net of provisions	X
Surplus on revaluation of available-for-sale securities	X
Total investments	X
Investments by segment	
Federal government securities	Rs. m
Market treasury bills	X
Pakistan investment bonds	X
	X
Investment with other financial institutions	
Non-banking financial institutions	X

Fully paid up shares	
Listed companies	X
Unlisted companies	X
	X
	X
Less: Provision for dimunition on value of investment	(X)
Investments net of provisions	X
Surplus on revaluation of available-for-sale securities	X
Total investments	X

Deposits and other accounts

Illustration: Deposits and other accounts

	Rs. m
Customers	
Fixed deposits	X
Savings deposits	X
Current accounts – non-remunerative	X
Margin deposits	
	X
Financial institutions	
Remunerative deposits	X
Non-remunerative deposits	X
	X
	X
Particulars of deposits	
In local currencies	X
In foreign currencies	X
	X

5 MUTUAL FUNDS

Section overview

- Introduction to mutual funds
- Accounting issues
- Financial statements of mutual funds
- Other statements and disclosures

5.1 Introduction to mutual funds

The mutual funds industry is regulated by *The Securities and Exchange Commission of Pakistan (SECP)*.

A mutual fund is a collective investment scheme, which specialises in investing a pool of money collected from investors for the purpose of investing in shares, bonds and other securities. This gives small investors access to professionally managed, diversified portfolios of equities, debt instruments etc. that they would otherwise not be able to achieve.

Mutual funds are operated by asset management companies (AMCs). An AMC is a public limited company registered under *Companies Ordinance, 1984*.

Investors purchase units (shares) and receive a share of income based on the number of units (shares) which they own. The value of the units (shares) changes on an ongoing basis so the holders are exposed to capital gain or loss.

The value of a unit (share) is based on the net asset value at the date of the valuation and the number of units available.

Formula: Unit price

$$\text{Unit price} = \frac{\text{Current market value of all assets - liabilities}}{\text{Total number of units outstanding}}$$

Types of mutual funds

There are basically two types of mutual funds:

- Open-ended mutual funds:
  - Open-ended mutual funds (also called unit trusts) are funds which continually issue or redeem new units on demand.
  - Units may be purchased or redeemed at the prevailing net asset value.
  - Trading is through a management company which announces offer and redemption prices daily.
- Closed-ended mutual funds
  - Closed-ended mutual funds have a fixed number of units which are quoted on an exchange.
  - Units can be traded at the market rates set by the exchange.

5.2 Accounting issues

Accounting for interests in funds by the AMCs

A mutual fund is an entity controlled by the AMC that manages it. In the absence of rules to the contrary, an AMC which managed a fund would classify it as a subsidiary and therefore have consolidate it.

IFRS 10 contains an exemption from the general requirement to consolidated controlled entities in this circumstance.

An investment entity must not consolidate the entities that it controls but it must measure them at fair value through profit or loss in accordance with *IFRS 9: Financial Instruments*.

Nature of the units

Units in open ended mutual funds are redeemable on demand. This means that in the absence of further guidance they would be classified as liabilities in accordance with the definition of liabilities found in *IAS 32: Financial instruments: Presentation*. In that case, the statement of financial position of such a fund would have no equity.

IAS 32 contains rules under which instruments of this kind are classified as equity. It describes such instruments as puttable instruments and rules that they should be classified as equity as long as they meet certain criteria. These criteria are designed to include units of mutual funds but prevent other liabilities from being classified as equity when it would not be appropriate to do so.

5.3 Financial statements of mutual funds

Mutual funds: Statement of financial performance

Illustration: Statement of comprehensive income format for a mutual fund

Statement of comprehensive income for the year ended XX/XX/XXXX

	Rs. m
INCOME	
Mark-up/ interest income	X
Dividend income	X
Gain/(loss) on sale of investments	X
Other income	X
	X
EXPENSES	
Remuneration to management	X
Brokerage commissions and fees	X
Administrative and general expenses	X
Othe expenses	X
	(X)
NET INCOME FOR THE YEAR	X

Mutual funds: Statement of financial position

Illustration: Statement of financial position format for a mutual fund

Statement of financial position as at XX/XX/XXXX

	Rs. m
TOTAL EQUITY	
Certificate holder's equity	X
Reserves	X
Unappropriated profit/loss	X
Others	X
	X
LIABILITIES	
Payable to investment advisor	X
Others	X
	X
	X
ASSETS	
Cash and bank balances	X
Investments	X
Others	X
NET ASSETS	X

5.4 Other statements and disclosures

Mutual funds must provide information on distributions made in the period and explain the movement on unit holders' funds in the period.

Illustration: Distribution statement

Distribution statement for the year ended XX/XX/XXXX	
Undistributed Income brought forward	Rs. m
Realised	X
Unrealised	X
	X
Final distribution of Rs. X for the year ended xxx xxx	
Cash distributions	X
Bonus units	X
Net income for the year	X
Element of income/(loss) and capital gains/(losses) included in prices of units issued less those in units redeemed - amount representing unrealised (dimunition)/appreciation	X
Undistributed income carried forward	X
Undistributed income carried forward	
Realised	X
Unrealised	X
	X

Movement in unit holders' funds

Illustration: Movement in unit holders' funds

Movement in unit holders' fund for the year ended XX/XX/XXXX

	Rs. m
Net assets at beginning of the year (A)	X
Issue of xxxx ints	X
Redemption of xxxx units	X
(B)	X
A + B	X
Element of Income / (Loss) and Capital Gains / (Losses) included in prices of units issued less those in units redeemed	
- amount representing income/(loss) and capital gains/(losses) - transferred to income statement	X
- amount representing unrealised appreciation/(diminution) in value of investments transferred directly to distribution statement	X
	X
Net unrealised appreciation/(diminution) in value of investments calssified as 'available for sale"	X
Capital gain / (loss) on sale of investments	X
unrealized appreciation / (diminution) in value of investments at fair value through profit and loss- net	X
Other net income for the year	X
Element of income/(loss) and capital gains/(losses) included in prices of units issued less those in units redeemed - amount representing unrealised appreciation	X
Final distribution	
- cash distribution	X
- issue of bonus units	X
	X
Issue of xxx bonus units for the year ended xxxx	X
Net assets at the end of year	X

6 IAS 26: RETIREMENT BENEFIT PLANS

Section overview

- Scope
- Definitions
- Valuation of plan assets
- Defined contribution plans
- Defined benefit plans
- Disclosure
- Other statements

6.1 Scope

IAS 26 complements IAS 19, Employee Benefits which is concerned with the determination of the cost of retirement benefits in the financial statements of employers.

IAS 26 applies to the reports of retirement benefit plans whether they are:

- ❑ defined contribution plans; or
- ❑ defined benefit plans; and
- ❑ regardless of:
  - whether a fund has a separate legal identity; or
  - whether there are trustees.

All other IFRS apply to the reports of retirement benefit plans to the extent that they are not superseded by IAS 26.

Insured benefits

Retirement benefit plans with assets invested with insurance companies are within the scope of IAS 26 unless the contract with the insurance company is in the name of a specified participant or a group of participants and the retirement benefit obligation is solely the responsibility of the insurance company.

Outside scope

IAS 26 does not deal with other forms of employment benefits such as employment termination indemnities, deferred compensation arrangements, long-service leave benefits, special early retirement or redundancy plans, health and welfare plans or bonus plans.

Government social security type arrangements are also excluded from the scope of IAS 26.

6.2 Definitions

Definition

Retirement benefit plans are arrangements whereby an entity provides benefits for its employees on or after termination of service (either in the form of an annual income or as a lump sum) when such benefits, or the employer's contributions towards them, can be determined or estimated in advance of retirement from the provisions of a document or from the entity's practices.

A retirement benefit plan is a reporting entity separate from the employers of the participants in the plan.

Retirement benefit plans are known by a variety of names, for example, pension schemes, superannuation schemes; or retirement benefit schemes'

Definitions

Defined contribution plans are retirement benefit plans under which amounts to be paid as retirement benefits are determined by contributions to a fund together with investment earnings thereon.

Defined benefit plans are retirement benefit plans under which amounts to be paid as retirement benefits are determined by reference to a formula usually based on employees' earnings and/or years of service.

Funding is the transfer of assets to an entity (the fund) separate from the employer's entity to meet future obligations for the payment of retirement benefits.

Participants are the members of a retirement benefit plan and others who are entitled to benefits under the plan.

Net assets available for benefits are the assets of a plan less liabilities other than the actuarial present value of promised retirement benefits.

Actuarial present value of promised retirement benefits is the present value of the expected payments by a retirement benefit plan to existing and past employees, attributable to the service already rendered.

Vested benefits are benefits, the rights to which, under the conditions of a retirement benefit plan, are not conditional on continued employment.

6.3 Valuation of plan assets

Retirement benefit plan investments are carried at fair value.

The fair value of marketable securities is market value.

Where an estimate of fair value is not possible for plan asset the reason why this is the case must be disclosed.

Securities that have a fixed redemption value and that have been acquired to match the obligations of the plan may be carried at amounts based on their ultimate redemption value assuming a constant rate of return to maturity (amortised cost).

6.4 Defined Contribution Plans

Objective of report

The reporting objective is to provide information about the plan and the performance of its investments.

- The participants are interested in
  - the activities of the plan because they directly affect the level of future benefits; and
  - knowing whether contributions have been received and proper control has been exercised to protect the rights of beneficiaries.
- An employer is interested in the efficient and fair operation of the plan.

The reporting objective is usually achieved by providing a report including:

- a description of significant activities for the period and the effect of any changes relating to the plan, and its membership and terms and conditions;
- statements reporting on the transactions and investment performance for the period and the financial position of the plan at the end of the period; and
- a description of the investment policies.

Requirement

The report of a defined contribution plan must contain:

- a statement of net assets available for benefits; and
- a description of the funding policy.

6.5 Defined Benefit Plans

Objective of report

The reporting objective is to provide information about the financial resources and activities of the plan that is useful in assessing the relationships between the accumulation of resources and plan benefits over time.

This is usually achieved by providing a report including the following:

- a description of significant activities for the period and the effect of any changes relating to the plan, and its membership and terms and conditions;
- statements reporting on the transactions and investment performance for the period and the financial position of the plan at the end of the period;
- actuarial information either as part of the statements or by way of a separate report; and
- a description of the investment policies.

Requirement

The report must contain either:

- ❑ a statement that shows:
  - the net assets available for benefits;
  - the actuarial present value of promised retirement benefits, distinguishing between vested benefits and non-vested benefits; and
  - the resulting excess or deficit; or
- ❑ a statement of net assets available for benefits including either:
  - a note disclosing the actuarial present value of promised retirement benefits, distinguishing between vested benefits and non-vested benefits; or
  - a reference to this information in an accompanying actuarial report.

The report should explain:

- ❑ the relationship between the actuarial present value of promised retirement benefits; and the net assets available for benefits; and
- ❑ the policy for the funding of promised benefits.

If an actuarial valuation has not been prepared at the date of the report, the most recent valuation is used as a base and the date of the valuation disclosed.

Actuarial Present Value of Promised Retirement Benefits

The actuarial present value of promised retirement benefits is based on the benefits promised under the terms of the plan on service rendered to date using either:

- ❑ current salary levels; or
- ❑ projected salary levels

6.6 Disclosure

Specific requirement

The report of a retirement benefit plan (defined benefit or defined contribution) must contain the following information:

- ❑ a statement of changes in net assets available for benefits;
- ❑ a summary of significant accounting policies; and
- ❑ a description of the plan and the effect of any changes in the plan during the period.

Guidance

Reports provided by retirement benefit plans include the following, if applicable:

- ❑ a statement of net assets available for benefits disclosing:
  - assets at the end of the period suitably classified;
  - the basis of valuation of assets;
  - details of any single investment exceeding either 5% of the net assets available for benefits or 5% of any class or type of security;
  - details of any investment in the employer; and
  - liabilities other than the actuarial present value of promised retirement benefits;
- ❑ a statement of changes in net assets available for benefits showing the following:
  - employer contributions;
  - employee contributions;
  - investment income such as interest and dividends;
  - other income;
  - benefits paid or payable (analysed, for example, as retirement, death and disability benefits, and lump sum payments);
  - administrative expenses;
  - other expenses;
  - taxes on income;
  - profits and losses on disposal of investments and changes in value of investments; and
  - transfers from and to other plans;
- ❑ a description of the funding policy;

For defined benefit plans:

- ❑ the actuarial present value of promised retirement benefits (which may distinguish between vested benefits and non-vested benefits) based on the benefits promised under the terms of the plan on service rendered to date using either:
  - current salary levels; or
  - projected salary levels;
- ❑ a description of the significant actuarial assumptions made and the method used to calculate the actuarial present value of promised retirement benefits.

This information may be included in an accompanying actuarial report to be read in conjunction with the related financial information.

Description of the plan

A description of the plan must be provided either as part of the financial information or in a separate report.

It may contain the following:

- the names of the employers and the employee groups covered;
- the number of participants receiving benefits and the number of other participants, classified as appropriate;
- the type of plan - defined contribution or defined benefit;
- a note as to whether participants contribute to the plan;
- a description of the retirement benefits promised to participants;
- a description of any plan termination terms; and
- changes in any of the above during the period covered by the report.

It is not uncommon to refer to other documents that are readily available to users and in which the plan is described, and to include only information on subsequent changes in the report.

6.7 Other statements

Net assets available for benefits

Illustration: Net assets available for benefits

Statement of net assets available for benefits as at XX/XX/XXXX

	Rs. m
Investments	X
Cash at bank	X
Loan receivable from member	X
	X
Payable to outgoing members	X
Audit fee payable	X
	(X)
Net assets	X
Represented by:	
Members' account	X

Changes in net assets

Illustration: Changes in net assets

Statement of changes in net assets available for benefits for the year XX/XX/XXXX

		Rs. m
Contribution during the year		X
Net income for the year		X
		X
Less:	Paid to outgoing members	X
	Permanent withdrawals	X
		(X)
Increase in net assets during the year		X
Net assets at the beginning of the year		X
Net assets at the end of the year		X

CHAPTER 33

International public sector accounting standards (IPSAS)

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with international pronouncements and under the Companies Ordinance, 1984.**

PRESENTATION OF FINANCIAL STATEMENTS INCLUDING PUBLIC SECTOR ACCOUNTING

A 11 Overview of IPSASs and the conceptual framework for general purpose financial reporting by public sector entities

A 12 IPSAS 1 Presentation of financial statements

A 13 IPSAS Financial reporting under the cash basis of accounting (this IPSAS has not been given any number).

1 OVERVIEW OF INTERNATIONAL PUBLIC SECTOR ACCOUNTING STANDARDS

Section overview

- International federation of accountants (IFAC)
- International Public Sector Accounting Standards Board (IPSASB)
- Scope of IPSAS
- Authority of IPSAS

1.1 International federation of accountants (IFAC)

IFAC is the global organisation for the accountancy profession. It is dedicated to serving the public interest by strengthening the profession and contributing to the development of strong international economies.

IFAC is comprised of over 175 members and associates in 130 countries and jurisdictions, representing approximately 2.84 million accountants in public practice, education, government service, industry, and commerce.

As part of its public interest mandate, *IFAC* contributes to the development, adoption, and implementation of high-quality international public sector accounting standards through its support of the *International Public Sector Accounting Standards Board* (*IPSASB*).

1.2 International Public Sector Accounting Standards Board (IPSASB)

The *IPSASB*'s objective is to serve the public interest by developing high quality accounting standards and other publications for use by public sector entities around the world in the preparation of general purpose financial reports with the aim of enhancing the quality, consistency, and transparency of public sector financial reporting worldwide.

Definitions

Public sector: National governments, regional (e.g., state, provincial, territorial) governments, local (e.g., city, town) governments and related governmental entities (e.g., agencies, boards, commissions and enterprises).

General purpose financial reports: Financial reports intended to meet the information needs of users who are unable to require the preparation of financial reports tailored to meet their specific information needs

In fulfilling its objective, the *IPSASB* develops and issues the following publications:

- *International Public Sector Accounting Standards* (*IPSAS*) as the standards to be applied in the preparation of general purpose financial reports of public sector entities other than government business enterprises (see below).
- *Recommended Practice Guidelines* (*RPGs*) to provide guidance on good practice that public sector entities are encouraged to follow.
- Studies to provide advice on financial reporting issues in the public sector. They are based on study of the good practices and most effective methods for dealing with the issues being addressed.

- Other papers and research reports to provide information that contributes to the body of knowledge about public sector financial reporting issues and developments. They are aimed at providing new information or fresh insights and generally result from research activities such as: literature searches, questionnaire surveys, interviews, experiments, case studies and analysis.

Due process

The *IPSASB* issues exposure drafts of all proposed *IPSAS* and *RPGs* for public comment. In some cases, the *IPSASB* may also issue a Consultation Paper prior to the development of an exposure draft.

This provides an opportunity for those affected by *IPSASB* pronouncements to provide input and present their views before the pronouncements are finalised and approved.

In developing its pronouncements, the *IPSASB* seeks input from its consultative group and considers and makes use of pronouncements issued by:

- The *International Accounting Standards Board* (*IASB*) to the extent they are applicable to the public sector;
- National standard setters, regulatory authorities and other authoritative bodies;
- Professional accounting bodies; and
- Other organisations interested in financial reporting in the public sector.

The *IPSASB* works to ensure that its pronouncements are consistent with those of IASB to the extent those pronouncements are applicable and appropriate to the public sector.

1.3 Scope of IPSAS

As stated above IPSAS set out requirements dealing with transactions and other events in general purpose financial reports.

The IPSAS are designed to apply to the general purpose financial reports of all public sector entities other than government business enterprises GBEs.

Definition

Government business enterprise: An entity that has all the following characteristics:

a) is an entity with the power to contract in its own name;

b) has been assigned the financial and operational authority to carry on a business;

c) sells goods and services, in the normal course of its business, to other entities at a profit or full cost recovery;

d) is not reliant on continuing government funding to be a going concern (other than purchases of outputs at arm's length); and

e) is controlled by a public sector entity.

GBEs exist for a profit motive so should apply IFRS rather than IPSAS.

The *IPSASB* issues IPSAS dealing with financial reporting under the cash basis of accounting and the accrual basis of accounting. The *IPSASB* has also issued a comprehensive Cash Basis IPSAS that includes mandatory and encouraged disclosures sections. This is covered in a later section.

Accruals based IPSAS

The *IPSASB* has published many accrual based IPSAS that are based very closely on the equivalent IFRS. The *IPSASB* attempts, wherever possible, to maintain the accounting treatment and original text of the IFRSs unless there is a significant public sector issue which warrants a departure.

The *IPSASB* has also published accrual based IPSAS that deal with public sector financial reporting issues that are not addressed by IFRS.

The following table lists the accruals based IPSAS.

IPSAS	IFRS equivalent
IPSAS 1: Presentation of financial statements	IAS 1
IPSAS 2: Cash flow statements	IAS 7
IPSAS 3: Accounting policies, changes in accounting estimates and errors	IAS 8
IPSAS 4: The effects of changes in foreign exchange	IAS 21
IPSAS 5: Borrowing costs	IAS 23
IPSAS 6: Consolidated and separate financial statements	IAS 27
IPSAS 7: Investments in associates	IFRS 28
IPSAS 8: Interests in joint ventures	IAS 31 (now superseded)
IPSAS 9: Revenue from exchange transactions	IAS 18
IPSAS 10: Financial reporting in hyperinflationary economies	IAS 29
IPSAS 11: Construction contracts	IAS 11
IPSAS 12: Inventories	IAS 2
IPSAS 13: Leases	IAS 17
IPSAS 14: Events after the reporting date	IAS 10
IPSAS 15: Financial instruments: disclosure and presentation	IAS 32
IPSAS 16: Investment property	IAS 40
IPSAS 17: Property, plant, and equipment	IAS 16
IPSAS 18: Segment reporting	IFRS 8
IPSAS 19: Provisions, contingent liabilities and contingent assets	IAS 37
IPSAS 20: Related party disclosures	IAS 24
IPSAS 21: Impairment of non-cash-generating assets	None
IPSAS 22: Disclosure of information about the general government sector	None
IPSAS 23: Revenue from non-exchange transactions (taxes and transfers)	None

IPSAS	IFRS equivalent
IPSAS 24: Presentation of budget information in financial statements	None
IPSAS 25: Employee benefits	IAS 19
IPSAS 26: Impairment of cash-generating assets	IAS 36
IPSAS 27: Agriculture	IAS 41
IPSAS 28: Financial instruments: presentation	IAS 32
IPSAS 29: Financial instruments: recognition and measurement	IAS 39
IPSAS 30: Financial instruments: disclosures	IFRS 7
IPSAS 31: Intangible assets	IAS 38
IPSAS 32: Service concession arrangements	SIC 12
IPSAS 33: First time adoption of accruals basis	none
IPSAS 34: Separate financial statements	IAS 27 (revised)
IPSAS 35: Consolidated financial statements	IFRS 10
IPSAS 36: Investments in associates and joint ventures	IAS 28 (revised)
IPSAS 37: Joint arrangements	IFRS 11
IPSAS 38: Disclosure of interests in other entities	IFRS 12

Financial statements should be described as complying with IPSAS only if they comply with all the requirements of each applicable IPSAS.

1.4 Authority of IPSAS

The *IPSASB* does not have the power to require compliance with *IPSAS.* However, the *IPSASB* strongly encourages governments and national standard-setters to adopt *IPSAS* in order to both the quality and comparability of financial information reported by public sector entities around the world.

IPSAS has been adopted in many jurisdictions. In Pakistan, the federal government, all provincial governments, and district governments present their annual financial statements on the cash-basis *IPSAS*.

IPSAS has also been adopted and by many supranational organisations including:

- ASEAN (Association of South-East Asian Nations);
- Commonwealth Secretariat;
- Council of Europe;
- EC (European Commission);
- Organisation for Economic Cooperation and Development (the first body in the world to produce financial statements compliant with *IPSAS* in 2000).

2 THE CONCEPTUAL FRAMEWORK FOR GENERAL PURPOSE FINANCIAL REPORTING BY PUBLIC SECTOR ENTITIES

Section overview

- Introduction
- Chapter 1 – The role and authority of the conceptual framework.
- Chapter 2 – Objectives and users of general purpose financial reporting.
- Chapter 3 – Qualitative characteristics of financial information.
- Chapter 4 – Reporting entity.
- Chapter 5 – Elements in financial statements.
- Chapter 6 – Recognition of the elements of financial statements.
- Chapter 7 – Measurement of assets and liabilities in financial statements.
- Chapter 8 – Presentation in general purpose financial statements

2.1 Introduction

A conceptual framework is a system of concepts and principles that underpin the preparation of financial statements. These concepts and principles should be consistent with one another.

The *IPSASB* have published a conceptual framework called "The conceptual framework for general purpose financial reporting (GPFRs) by public sector entities".

This deals with concepts that apply to general purpose financial reporting (financial reporting) under the accrual basis of accounting.

This is made up of the following chapters:

- **Chapter 1** – The role and authority of the conceptual framework.
- **Chapter 2** – Objectives and users of general purpose financial reporting.
- **Chapter 3** – Qualitative characteristics of financial information.
- **Chapter 4** – Reporting entity.
- **Chapter 5** – Elements in financial statements.
- **Chapter 6** – Recognition of the elements of financial statements.
- **Chapter 7** – Measurement of assets and liabilities in financial statements.
- **Chapter 8** – Presentation in general purpose financial statements

2.2 Chapter 1 – The role and authority of the conceptual framework.

The *Conceptual Framework* establishes the concepts that underpin general purpose financial reporting (financial reporting) by public sector entities using the accrual basis of accounting when preparing and presenting general purpose financial reports.

The *Conceptual Framework* does not contain authoritative requirements that must be followed nor does it override the requirements of *IPSAS* or *RPGs*.

However, it might be useful in providing guidance on accounting for issues not dealt with by *IPSAS* or *RPGs*. In these circumstances,

2.3 Chapter 2 – Objectives and users of general purpose financial reporting.

The objective

Financial reporting is not an end in itself.

The objectives of financial reporting by public sector entities are to provide information about the entity that is useful to users of *GPFRs* for accountability purposes and for decision-making purposes.

Users

Governments and other public sector entities raise resources from taxpayers, donors, lenders and other resource providers for use in the provision of services to citizens and other service recipients.

These entities are accountable for their management and use of resources to those that provide them with resources, and to those that depend on them to use those resources to deliver necessary services.

Therefore, *GPFRs* of public sector entities are developed primarily to respond to the information needs of service recipients and resource providers who do not possess the authority to require tailored information.

Taxpayers do not provide funds on a voluntary basis so it might seem that they have little influence and therefore no need for information but the information provided about the use of the resources can inform voting decisions.

Information is needed to allow the assessments of such matters as:

- ❑ the performance of the entity during the reporting period in, for example:
  - meeting its service delivery and other operating and financial objectives;
  - managing the resources it is responsible for; and
  - complying with relevant budgetary, legislative, and other authority regulating the raising and use of resources;
- ❑ the entity's liquidity; and
- ❑ the sustainability of the entity's service delivery.

Information provided by general purpose financial reports might include

- ❑ financial position, financial performance and cash flows:
- ❑ budget information and compliance with legislation or other authority governing the raising and use of resources; and
- ❑ service delivery achievements.

2.4 Chapter 3 – Qualitative characteristics of financial information.

GPFRs present financial and non-financial information about economic and other phenomena.

The qualitative characteristics of information are the attributes that make that information useful for accountability and decision-making purposes.

The qualitative characteristics of information included in *GPFRs* of public sector entities are:

- relevance;
- faithful representation;
- understandability;
- timeliness;
- comparability; and
- verifiability.

Pervasive constraints on information provided are materiality, cost vs benefit, and achieving an appropriate balance between the qualitative characteristics.

2.5 Chapter 4 – Reporting entity.

A public sector reporting entity is a government or other public sector organisation, program or identifiable area of activity that prepares *GPFRs*.

Key characteristics of a reporting entity are that:

- it raises resources from (or for) constituents and/or uses resources to undertake activities for the benefit of those constituents; and
- there are service recipients or resource providers dependent on *GPFRs* of the entity for information for accountability or decision-making purposes.

2.6 Chapter 5 – Elements in financial statements.

Financial statements portray the financial effects of transactions and other events by grouping them into broad classes which share common economic characteristics. These broad classes are termed the elements of financial statements.

Element	Definition
An asset	A resource presently controlled by the entity as a result of a past event.
A liability	A present obligation of the entity for an outflow of resources that results from a past event.
Revenue	Increases in the net financial position of the entity, other than increases arising from ownership contributions.
Expense	Decreases in the net financial position of the entity, other than decreases arising from ownership distributions.
Ownership contributions	Inflows of resources to an entity, contributed by external parties in their capacity as owners, which establish or increase an interest in the net financial position of the entity.
Ownership distributions	Outflows of resources from the entity, distributed to external parties in their capacity as owners, which return or reduce an interest in the net financial position of the entity.

2.7 Chapter 6 – Recognition of the elements of financial statements.

The recognition criteria for an item are that:

- it satisfies the definition of an element; and
- it can be measured in a way that achieves the qualitative characteristics taking account of constraints on information.

2.8 Chapter 7 – Measurement of assets and liabilities in financial statements.

Measurement bases should be chosen to fairly reflect the cost of services, operational capacity and financial capacity of the entity in a manner that is useful in holding the entity to account, and for decision-making purposes.

The measurement basis chosen should enable users to assess:

- the cost of services provided in the period in historical or current terms;
- operational capacity (the capacity of the entity to support the provision of services in future periods through physical and other resources); and
- financial capacity (the capacity of the entity to fund its activities).

It is not possible to identify a single measurement basis that meets the above requirements:

Any of the following bases might be used depending on circumstance:

- historical cost;
- market value;
- replacement cost;
- net selling price; and
- value in use.

2.9 Chapter 8 – Presentation in general purpose financial statements

Presentation involves the selection, location and organisation of information that is reported in the *GPFRs*.

Presentation aims to provide information that contributes towards the objectives of financial reporting and achieves the qualitative characteristics while taking into account the constraints on information included in *GPFRs*.

3 IPSAS 1: PRESENTATION OF FINANCIAL STATEMENTS

Section overview

- General requirements
- Structure and content

3.1 General requirements

IPSAS 1 is based very closely on IAS 1 with many paragraphs being identical apart from changes to reflect public sector terminology and changes to references from *IFRS* to *IPSAS*.

Objective

The objective of *IPSAS 1* is to prescribe the basis for presentation of general purpose financial statements, to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities

Scope

IPSAS 1 must be applied to all general purpose financial statements prepared and presented under the accrual basis of accounting in accordance with *IPSAS*.

Components

A complete set of financial statements comprises:

- ❑ statement of financial position;
- ❑ statement of financial performance;
- ❑ statement of changes in net assets/equity;
- ❑ cash flow statement (*IPSAS 2* – not in this syllabus);
- ❑ a comparison of budget and accrual amounts when the entity makes its approved budget publicly available; and
- ❑ notes, comprising a summary of significant accounting policies and other explanatory notes.

Comparative information must be disclosed for all amounts unless IPSAS permits or requires otherwise.

Overall consideration

The standard describes the following overall considerations when presenting financial statements:

- ❑ fair presentation and compliance with *IPSAS*;
- ❑ going concern;
- ❑ consistency of presentation;
- ❑ materiality and aggregation; and
- ❑ offset.

Fair presentation and compliance with IPSAS;

Fair presentation requires the faithful representation of the effects of transactions, other events, and conditions in accordance with the definitions and recognition criteria set out in *IPSAS*.

The application of *IPSAS*, with additional disclosures when necessary, is presumed to result in fair presentation.

An entity whose financial statements comply with all the requirements of *IPSAS* must make an explicit and unreserved statement of such compliance in the notes.

Financial statements must generally be prepared annually. Disclosure is required if the date of the year-end changes, and financial statements are presented for a period other than one year.

3.2 Structure and content

Statement of financial position (balance sheet)

IPSAS 1 requires an entity to present current and non-current assets, and current and non-current liabilities, as separate classifications on the face of its statement of financial position unless a liquidity presentation provides more relevant and reliable information. In such cases, all assets and liabilities must be presented broadly in order of liquidity.

Some items may be presented using a current/non-current distinction and others in order of liquidity if this provides information that is more relevant and reliable.

Whichever method of presentation is adopted an entity must disclose the amount expected to be recovered or settled after more than twelve months for each asset and liability line item that combines current and non-current amounts.

IPSAS 1 provides a list of items that, **as a minimum**, must be shown on the face of the statement of financial position as a 'line item' (in other words, on a separate line in the statement):

Additional line items should be included in the statement of financial position when presenting them separately and is 'relevant to an understanding of the entity's financial position.

Statement of financial performance (income statement)

All items of revenue and expense recognised in a period must be included in surplus or deficit unless *IPSAS* requires otherwise.

The minimum line items that should be included on the face of the statement of financial performance are:

- ❑ revenue;
- ❑ finance costs;
- ❑ share of the surplus or deficit of associates and joint ventures accounted for using the equity method;
- ❑ pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to discontinued operations;
- ❑ surplus or deficit for the period;

Additional line items may be needed to achieve fair presentation of an entity's financial performance.

The surplus or deficit attributable to minority interests (non-controlling interests) and that attributable to the owners of the controlling entity must also be disclosed in the statement of financial performance as allocations for the period.

When items of revenue and expense are material, their nature and amount must be disclosed separately

Expenses should be analysed either by nature or by function.

Statement of changes in net assets (equity)

A statement of changes in net assets/equity must be presented showing:

- Surplus or deficit for the period;
- Each item of revenue and expense for the period that is recognised directly in net assets/equity, and the total of these items;
- The total revenue and expense for the period (calculated as the sum of the above);
- For each component of net assets/equity the effects of changes in accounting policies and corrections of errors.

The following must be disclosed either on the face of the statement of changes in net assets/equity or in the notes:

- amounts of transactions with owners acting in their capacity as owners, showing separately distributions to owners;
- the balance of accumulated surpluses or deficits at the beginning of the period and at the reporting date, and the changes during the period; and
- reconciliations of the carrying amount of each component of net assets/equity from the beginning to the end of the period.

Notes

The requirements are very similar to those set out in *IAS 1* and are not repeated here.

4 FINANCIAL REPORTING UNDER THE CASH BASIS OF ACCOUNTING

Section overview

- Introduction
- Financial statements
- Accounting policies and explanatory notes
- Budget comparison

4.1 Introduction

The cash basis of accounting recognises transactions and events only when cash (including cash equivalents) is received or paid by the entity.

Objective

This standard prescribes the manner in which general purpose financial statements should be presented under the cash basis of accounting.

The standard is comprised of two parts:

- **Part 1** is mandatory and sets out the requirements which are applicable to all entities preparing general purpose financial statements under the cash basis of accounting.
- **Part 2** is not mandatory but identifies additional accounting policies and disclosures that an entity is encouraged to adopt to enhance its financial accountability and the transparency of its financial statements.

Scope

An entity which prepares and presents financial statements under the cash basis of accounting should apply the requirements of part 1 of the standard. Compliance with part 1 of the standard should be disclosed.

The rules apply both to financial statements of an individual entity and to consolidated financial statements.

The standard does not apply to government business enterprises.

4.2 Financial statements

Financial statements under the cash basis consist of the following components:

- statement of cash receipts and payments;
- accounting policies and explanatory notes; and
- comparison of original budget, revised budget, and actual amounts on a comparable basis (only when the entity makes publicly available its approved budget).

Information to be presented in the statement of cash receipts and payments

The statement of cash receipts and payments should present the following amounts for the reporting period:

- total cash receipts showing separately a sub-classification of total cash receipts using a classification basis appropriate to the entity's operations;

- ❑ total cash payments showing separately a sub-classification of total cash payments using a classification basis appropriate to the entity's operations; and
- ❑ opening and closing cash balances.

Total cash receipts and total cash payments should be reported on a gross basis. However, they may be reported on a net basis when:

- ❑ they arise from transactions administered on behalf of other parties; or
- ❑ they are for items in which the turnover is quick, the amounts are large, and the maturities are short.

Payments made by a third party on behalf of the entity should be disclosed in separate columns on the face of the statement of cash receipts and payments:

4.3 Accounting policies and explanatory notes

Financial statements prepared under the cash basis provide readers with information about the sources of cash raised during the period, the purposes for which cash was used and the cash balances at the reporting date.

The measurement focus in the financial statements is balances of cash and changes therein. Notes to the financial statements may provide additional information about liabilities, such as payables and borrowings, and some non-cash assets, such as receivables, investments and property, plant and equipment.

The notes to the financial statements of an entity should:

- ❑ present information about the basis of preparation of the financial statements and the specific accounting policies selected and applied for significant transactions and other events; and
- ❑ provide additional information which is not presented on the face of the financial statements but is necessary for a fair presentation of the entity's cash receipts, cash payments and cash balances.

Notes to the financial statements should be presented in a systematic manner. Each item on the face of the statement of cash receipts and payments and other financial statements should be cross referenced to any related information in the notes.

General disclosures

Financial statements must generally be prepared annually. Disclosure is required if the date of the year-end changes, and financial statements are presented for a period other than one year.

An entity should disclose the date when the financial statements were authorised for issue and who gave that authorisation.

Comparative information should be disclosed for all numerical information required.

The presentation and classification of items in the financial statements should be retained from one period to the next.

An entity should disclose information on any restrictions on the use of cash balances and undrawn borrowing facilities.

An entity should disclose the following:

- the domicile and legal form of the entity, and the jurisdiction within which it operates;
- a description of the nature of the entity's operations and principal activities;
- a reference to the relevant legislation governing the entity's operations, if any; and
- the name of the controlling entity and the ultimate controlling entity of the economic entity (where applicable, if any).

The financial statements should be clearly identified and distinguished from other information in the same published document.

Foreign currency

Cash receipts and payments arising from transactions in a foreign currency should be recorded using the exchange rate at the date of the receipts and payments.

Cash balances held in a foreign currency should be reported using the closing rate.

4.4 Budget comparison

If an entity makes its approved budget publicly available it must present a comparison of the budget amounts for which it is held publicly accountable and actual amounts.

This could be presented either as a separate additional financial statement or using additional budget columns in the statement of cash receipts and payments.

CHAPTER 34

Accounting for hyperinflation

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 1 **Prepare financial statements in accordance with international pronouncements and under the Companies Ordinance, 1984.**

PRESENTATION OF FINANCIAL STATEMENTS INCLUDING PUBLIC SECTOR ACCOUNTING

A 8 IAS 29: Financial Reporting in Hyperinflationary Economies

FINANCIAL REPORTING AND ETHICS

Financial reporting

B(a) 51 **IFRIC 07: Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies**

1 IAS 29: FINANCIAL REPORTING IN HYPERINFLATIONARY ECONOMIES

Section overview

- Introduction
- Scope
- IAS 29 requirements

1.1 Introduction

Primary financial statements are normally prepared on the historical cost basis without taking into account:

- changes in the general level of prices or
- changes in specific prices of assets held (except to the extent that property, plant and equipment and investments may be revalued).

Some entities may present primary financial statements prepared on a current cost basis. Current cost accounts reflect the effects of specific price changes on the financial statements of the entity. They do not reflect the general rate of inflation.

The accounting problem

In a hyperinflationary economy money loses purchasing power at such a rate that comparison of amounts from transactions occurring at different times (even within the same accounting period) is misleading.

Reporting operating results and financial position in a hyperinflationary economy is not useful without restatement.

What is hyperinflation?

IAS 29 does not establish an absolute rate at which hyperinflation is deemed to arise.

Features of a hyperinflationary economy include (but are not limited to) the following:

- the general population prefers to keep its wealth in non-monetary assets or in a relatively stable foreign currency. Amounts of local currency held are immediately invested to maintain purchasing power;
- the general population regards monetary amounts not in terms of the local currency but in terms of a relatively stable foreign currency. Prices may be quoted in that currency;
- sales and purchases on credit take place at prices that compensate for the expected loss of purchasing power during the credit period, even if the period is short;
- interest rates, wages and prices are linked to a price index; and
- the cumulative inflation rate over three years is approaching, or exceeds, 100%.

It is a matter of judgement when restatement of financial statements in accordance with this standard becomes necessary.

1.2 Scope

IAS 29 must be applied to the primary financial statements (including the consolidated financial statements) of any entity whose functional currency is the currency of a hyperinflationary economy.

IAS 29 applies from the beginning of the reporting period in which an entity identifies the existence of hyperinflation in the country in whose currency it reports.

1.3 IAS 29 requirements

The financial statements of an entity that reports in the currency of a hyper-inflationary economy must be stated in terms of the measuring unit current at the statement of financial position date.

This applies to both:

- historical cost accounts; and,
- current cost accounts.

Comparatives should be restated in terms of the measuring unit current at the statement of financial position date.

The gain or loss on the net monetary position should be included in net income and separately disclosed.

It is not permitted to present the required information as a supplement to financial statements that have not been restated. Also, separate presentation of the financial statements before restatement is discouraged.

2 RESTATEMENT OF HISTORICAL COST FINANCIAL STATEMENTS

Section overview

- Statement of financial position
- Non-monetary items
- Equity balances
- Statement of profit or loss
- Gain or loss on net monetary position

2.1 Statement of financial position

All balances must be stated in terms of the measuring unit current at the statement of financial position date.

Not restated

Monetary items – No restatement is necessary as monetary items are already expressed in terms of the monetary unit current at the statement of financial position date.

Index linked assets and liabilities – The carrying value of these items will already have been adjusted for inflation. Such items are carried at the adjusted amount in the restated statement of financial position.

All other assets and liabilities are non-monetary.

2.2 Non-monetary items

Some non-monetary items will already be carried at the amount current at the statement of financial position date (eg net realisable value or market value). These are not restated.

All other non-monetary assets and liabilities are restated. There is a different treatment for items carried at cost and those not carried at cost.

Non-monetary items carried at cost (or cost less depreciation)

The restated cost (or cost less depreciation) is determined by applying the change in a general price index from the date of acquisition to the statement of financial position date. Both the cost and the accumulated depreciation will be restated. Thus the following are restated from the date of purchase:

- property, plant and equipment;
- investments;
- inventories of raw materials and merchandise;
- goodwill; and
- patents, trademarks and similar assets.

Inventories of partly-finished and finished goods are restated from the dates on which the costs of purchase and of conversion were incurred.

Non monetary items carried at amounts other than cost

Revalued items will be indexed from the date of revaluation. No asset must be valued in excess of its recoverable amount.

Equity accounted investments

Sometimes an entity may hold an investment in another entity that is accounted for under the equity method and whose functional currency is that of a hyperinflationary economy.

In these cases the statement of financial position and statement of profit or loss of the investee must be restated in accordance with this standard before applying the equity method.

Where the restated financial statements of the investee are expressed in a foreign currency they are translated at closing rates.

2.3 Equity balances

At the beginning of the first period of application of this standard:

- The components of owners' equity (except retained earnings and any revaluation surplus) are restated by applying a general price index from the dates the components were contributed/arose.
- Any revaluation surplus that arose in previous periods is eliminated.
- Restated retained earnings are derived from all the other amounts in the restated statement of financial position.

At the end of the first period and in subsequent periods, all components of owners' equity are restated by applying a general price index from the beginning of the period (or the date of contribution, if later).

Practical problems

If detailed records of the date and cost of acquisition of property, plant and equipment are not available, then an independent professional assessment can be made of the items value in the first period of restatement.

If a general price index is not available for the whole period (or periods) required then an estimated index can be used. This could be based on, say, movements in the exchange rate between the local currency and a relatively stable foreign currency.

2.4 Statement of profit or loss

The statement of profit or loss must be expressed in terms of the measuring unit current at the reporting date.

All items in the statement of profit or loss will be restated by applying the change in the general price index from the dates when the items of income and expenses occurred and the reporting date.

2.5 Gain or loss on net monetary position

During a period of inflation an entity will:

- suffer a loss if it holds net monetary assets during a period of inflation because the purchasing power of those assets will be eroded.
- make a gain if it holds net monetary liabilities because the burden of the liabilities is reduced by inflation.

This gain or loss on the net monetary position may be derived as the difference resulting from the restatement of non-monetary assets, owners' equity and statement of profit or loss items and the adjustment of index linked assets and liabilities.

The gain or loss may be estimated by applying the change in a general price index to the weighted average for the period of the difference between monetary assets and monetary liabilities.

3 RESTATEMENT OF CURRENT COST FINANCIAL STATEMENTS

Section overview

- Statement of financial position
- Statement of profit or loss
- Gain or loss on net monetary position

3.1 Statement of financial position

Items stated at current cost are not restated because they are already expressed in terms of the measuring unit current at the statement of financial position date.

Other items in the statement of financial position are restated.

3.2 Statement of profit or loss

The current cost statement of profit or loss, before restatement, generally reports costs current at the time at which the underlying transactions or events occurred.

Cost of sales and depreciation are recorded at current costs at the time of consumption;

Sales and other expenses are recorded at their money amounts when they occurred.

All amounts need to be restated into the measuring unit current at the statement of financial position date by applying a general price index.

3.3 Gain or loss on net monetary position

The gain or loss on the net monetary position is credited or charged to the statement of profit or loss.

4 OTHER ISSUES

Section overview

- Cash flow statement
- Corresponding figures
- Consolidated financial statements
- Economies ceasing to be hyperinflationary
- Disclosures

4.1 Cash flow statement

All items in the cash flow statement must be expressed in terms of the measuring unit current at the statement of financial position date.

4.2 Corresponding figures

Corresponding figures for the previous reporting period must be restated by applying a general price index so that the comparative financial statements are presented in terms of the measuring unit current at the end of the reporting period.

Information that is disclosed in respect of earlier periods must also be expressed in terms of the measuring unit current at the end of the reporting period.

This applies to financial statements based on a historical cost approach and on a current cost approach.

4.3 Consolidated financial statements

A parent that reports in the currency of a hyperinflationary economy may have subsidiaries that also report in the currencies of hyperinflationary economies.

The financial statements of any such subsidiary must be restated by applying a general price index of the country in whose currency it reports before they are included in the consolidated financial statements issued by its parent.

If the subsidiary is a foreign subsidiary, its restated financial statements are translated at closing rates.

If financial statements with different reporting dates are consolidated, all items, whether non-monetary or monetary, need to be restated into the measuring unit current at the date of the consolidated financial statements.

4.4 Economies ceasing to be hyperinflationary

When an economy ceases to be hyperinflationary, an entity will discontinue the preparation and presentation of financial statements prepared in accordance with IAS 29.

The amounts expressed in the measuring unit current at the end of the previous reporting period are used as the basis for the carrying amounts in subsequent financial statements.

4.5 Disclosures

An entity must disclose the following:

- the fact that the financial statements and the corresponding figures for previous periods have been restated for the changes in the general purchasing power of the functional currency and, as a result, are stated in terms of the measuring unit current at the statement of financial position date;
- whether the financial statements are based on a historical cost approach or a current cost approach; and
- the identity and level of the price index at the statement of financial position date and the movement in the index during the current and the previous reporting period.

5 IFRIC 7: APPLYING THE RESTATEMENT APPROACH UNDER IAS 29

Section overview

- IFRIC 7: Applying the restatement approach under IAS 29
- Deferred taxation

5.1 IFRIC 7: Applying the restatement approach under IAS 29

In the period in which an entity first identifies the existence of hyperinflation in the economy of its functional currency, it must apply the requirements of IAS 29 as if the economy had always been hyperinflationary.

This means that non-monetary items in the opening statement of financial position at the beginning of the earliest period presented must be restated to reflect the effect of inflation.

- Non-monetary amounts carried at historical cost are restated to reflect inflation form the date of recognition up to the date of the opening statement of financial position.
- Non-monetary amounts carried at revalued amounts are restated to reflect inflation form the date of revaluation up to the date of the opening statement of financial position.

Example: Restatement

Extracts of X Limited's IFRS statement of financial position at 31 December 2015 (before restatement) are as follows:

	2015	2014
	Rs. m	Rs. m
Non-current assets	300	400

All non-current assets were bought in 2013 (i.e. before that start of the comparative period).

X Limited identified that its functional currency was hyperinflationary in 2015.

X Limited has identified the following price indices and constructed the following conversion factors:

	Price indices
2015	223
2013	95

2015 conversion factor
(2013 prices to 2015 prices) = 223/95 =2.347

This conversion factor must be applied to non-current assets from the 2015 and 2014 financial statements to rebase the figure in terms of 2015 prices.

This results in the following restated amounts:

	2015 Rs. m	2014 Rs. m
Non-current assets		
300 × 2.347 and 400 × 2.347	704	939

5.2 Deferred taxation

Deferred tax is calculated by applying the rules in IAS 12 to the restated balances.

The comparative deferred tax balance is based on the figure that would have been in last year's restated financials adjusted for this year's price movement.

Example: Restatement – deferred tax

Extracts of X Limited's IFRS statement of financial position at 31 December 2015 (before restatement) are as follows:

	2015 Rs. m	2014 Rs. m
Non-current assets	300	400
Deferred tax liability	30	20

All non-current assets were bought in 2013 (i.e. before that start of the comparative period).

The deferred tax liability was calculated as follows

	2015 Rs. m	2014 Rs. m
Non-current assets	300	400
Tax base	200	333
Temporary difference	100	67
Tax rate	30%	30%
Deferred taxation	30	20

X Limited identified that its functional currency was hyperinflationary in 2015.

X Limited has identified the following price indices and constructed the following conversion factors:

	Price indices
2015	223
2014	135
2013	95

The following conversion factors are required:

2015 conversion factor (1)
(2013 prices to 2015 prices) = 223/95 =2.347

Used to restate non-current assets (as before)

2015 conversion factor (2)
(2014 prices to 2015 prices) = 223/135 = 1.652

Used to restate the deferred tax balance that would have been measured in 2014 if restated financial statements had been prepared into 2015 prices.

2014 conversion factor (3)
(2013 prices to 2014 prices) = 135/95 =1.421

Used to restate non-current assets to 2014 prices in order to calculate the deferred tax balance that would have been measured in 2014 if restated financial statements had been prepared.

The 2015 conversion factor (1) is applied to non-current assets from the 2015 and 2014 financial statements to restate the figure in terms of 2015 prices (as before):

	2015	2014
	Rs. m	Rs. m
Non-current assets		
300 × 2.347 and 400 × 2.347	704	939

The deferred tax liability as at 31 December 2015 is calculated as follows:

	2015
	Rs. m
Non-current assets	704
Tax base	200
Temporary difference	504
Tax rate	30%
Deferred taxation	151

The 2015 comparative deferred tax liability is calculated as follows:

	2014
	Rs. m
Non-current assets (rebased to 2014 prices using the 2014 conversion factor (3) 400 × 1.421	568
Tax base	333
Temporary difference	235

Tax rate	30%
Deferred taxation	71
Rebase to 2015 prices using the 2015 conversion factor (2)	× 1.652
Tax at 30%	117

The restated deferred tax balances are as follows:

	2015	2014
	Rs. m	Rs. m
Non-current assets		
300 × 2.347 and 400 × 2.347	704	939

CHAPTER 35

Islamic accounting standards

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 4 **Prepare financial statements of specialised entities (including small and medium sized entities in accordance with the Companies Ordinance, 1984 and the applicable reporting framework, retirement benefit funds in accordance with international pronouncements) and be able to demonstrate an understanding of reporting requirements under the laws specific to insurance, banking companies and mutual funds.**

SPECIALISED FINANCIAL STATEMENTS

C 6 Overview of Islamic accounting standards issued by ICAP

1 ISLAMIC ACCOUNTING STANDARDS

Section overview

- Introduction to Islamic finance
- IFAS 1: Murabaha
- IFAS 2: Ijarah
- IFAS on profit and loss sharing deposits

1.1 Introduction to Islamic finance

Note that the Islamic Finance Resource is an excellent website full of useful information and examples. It is recommended that you visit the site (http://ifresource.com).

The main principles of Islamic finance are that:

- ❑ Wealth must be generated from legitimate trade and asset-based investment (the use of money for the purposes of making money is expressly forbidden).
- ❑ Investment should have a social and an ethical benefit to wider society beyond pure return.
- ❑ Risk should be shared.
- ❑ Harmful activities (*haram*) should be avoided.

The intention is to avoid injustice, asymmetric risk and moral hazard (where the party who causes a problem does not suffer its consequences) and unfair enrichment at the expense of another party.

Permitted activities

Islamic banks are allowed to obtain their earnings through profit-sharing investments or fee-based returns. If a loan is given for business purposes the lender should take part in the risk. This usually involves the lender buying the asset and then allowing a customer to use the asset for a fee.

Specific guidance

The following activities are prohibited:

- ❑ Charging and receiving interest (riba).
  - Charging interest contradicts the principle that risk must be shared and is also contrary to the ideas of partnership and justice.
  - Using money to make money is forbidden.
  - Investment in companies that have too much borrowing is also prohibited. What constitutes "too much borrowing" is a matter for interpretation but is typically defined as debt totalling more than 33% of the stock market value over the last 12 months.
- ❑ Investments in businesses involved in alcohol, gambling, or anything else that the *Shariah* considers unlawful or undesirable (haram).

- Investments in transactions that involve speculation or extreme risk. (This is seen as gambling).
- Entering into contracts where there is uncertainty about the subject matter and terms of contracts (This includes a prohibition on short selling, i.e. selling something is not yet owned).

Financial institutions in Islamic countries face the problem of providing finance in ways which do not contravene the injunctions of *Shariah* regarding riba or interest.

There are a number of *Shariah* compliant financing methods which have become widely used. The absence of guidance on how to account for these products has led to diversity in practice thus reducing the usefulness of financial statements.

ICAP has produced several Islamic Financial Accounting Standards (IFAS) to provide appropriate guidance with the aim of improving comparability of financial statements.

1.2 IFAS 1: Murabaha

Introduction

The ideal mode of financing according to *Shariah* would be mudarabah or musharakah.

Definitions

Mudaraba

Mudaraba is a partnership in profit whereby one party provides capital (rab al maal) and the other party provides labour (mudarib).

In the context of lending, the bank provides capital and the customer provides expertise to invest in a project. Profits generated are distributed according in a predetermined ratio but cannot be guaranteed. The bank does not participate in the management of the business. This is like the bank providing equity finance.

The project might make a loss. In this case the bank loses out. The customer cannot be made to compensate the bank for this loss as that would be contrary to the mutual sharing of risk.

Musharaka

Relationship established under a contract by the mutual consent of the parties for sharing of profits and losses arising from a joint enterprise or venture.

This is a joint venture or investment partnership between two parties who both provide capital towards the financing of new or established projects. Both parties share the profits on a pre-agreed ratio, allowing managerial skills to be remunerated, with losses being shared on the basis of equity participation.

It is difficult to use *mudarabah* and *musharakah* instruments in every type of financing.

Murabaha may be used as a form of providing but should be restricted only to those cases where the *mudarabah* and *musharakah* are not practicable.

Murabaha

In traditional western finance a customer would borrow money from a bank in order to finance activity, say the purchase of an asset. However, under Sharia the bank cannot charge interest.

Murabaha is a form of trade credit for asset acquisition that avoids the payment of interest. The bank buys the asset and then sells it on to the customer on a deferred basis at a price that includes an agreed mark-up for profit. Payment can be made by instalments but the mark-up is fixed in advance and cannot be increased, even if there is a delay in payment.

Definition

Murabaha: Murabaha is a particular kind of sale where seller expressly mentions the cost he has incurred on the commodities to be sold and sells it to another person by adding some profit or mark-up thereon which is known to the buyer.

Thus, murabaha is a cost plus transaction where the seller expressly mentions the cost of a commodity sold and sells it to another person by adding mutually agreed profit thereon which can be either in lump-sum or through an agreed ratio of profit to be charged over the cost.

Compliance with Sharia

A loan transaction is not made *Shariah* compliant by simply changing the term ***interest*** in a contract to ***profi***t or ***mark-up***. A *murabaha* transaction must satisfy basic conditions as laid down in *Shariah*.

A Murabaha transaction is not valid under *Shariah* unless the subject of the transaction is:

- in existence; and
- owned by the seller; and
- in the physical or constructive possession of the seller.

The following conditions also apply:

- The sale must be prompt and absolute. Thus a sale attributed to a future date or a sale contingent on a future event is void.
- The subject matter of sale must be a property of value and must be specifically known and identified to the buyer.
- The subject matter of sale cannot be a thing which is forbidden (Haram) by *Shariah*.

There are further principles regarding deferred payment.

- A sale in which the parties agree that the payment of price is deferred is called a *Bai'mu'ajjal.*
- *Bai'mu'ajjal* is valid if the price and due date of payment is fixed in an unambiguous manner.
- The due time of payment can be fixed either with reference to a particular date, or by specifying a period of time, but it cannot be fixed with reference

to a future event, the exact date of which is unknown or is uncertain. If the time of payment is unknown or uncertain, the sale is void.

- If a particular period (e.g. one month) is fixed for payment, the period is deemed to start at the date of delivery unless the parties have agreed otherwise.
- A deferred price may be more than the cash price, but it must be fixed at the time of sale.

Further comment on the structure of a *Shariah* compliant transaction

A bank may purchase the commodity and keep it in its own possession prior to selling it or it could purchase the commodity through a third person appointed by it as an agent.

A bank is also allowed to appoint the customer in the *murabaha* transaction as its agent.

In this case the customer (who will eventually buy the commodity from the bank) first purchases the commodity and takes possession of it on behalf of the bank and then later buys it from the bank.

The following procedure can be used to accomplish a deal like the one above in a way that is compliant with *Shariah*:

- The client and the bank sign an agreement under which the bank promises to sell and the client promises to buy commodity up to a maximum amount of purchases at an agreed profit margin.
- The bank appoints the client as his agent for purchasing the commodity on its behalf.
- The client purchases the commodity on behalf of the bank and takes its possession as an agent of the bank.
- The client informs the bank that the commodity has been purchased for the bank and is in the client's possession. (The client is an agent of the bank thus the bank has constructive possession of the commodity).
- The client (at the same time) makes an offer to purchase the commodity from the bank at the agreed profit margin referred to above.
- The bank accepts the offer and raises an invoice for the sale. Ownership as well as the risk of the commodity is transferred to the client.

Standard Accounting Practice

IFAS 1 applies to *murabaha* transactions undertaken by a bank in historical cost financial statements.

Cost of inventories should comprise all costs of purchases and other costs incurred in bringing the inventories to their present location and condition.

Inventories remaining unsold with the bank at the reporting date are inventories of the bank and must be valued in accordance with IAS 2 and shown under ***other assets***.

The information required by IAS 2 should be disclosed.

Murabaha receivables must be recorded at the invoiced amounts.

Purchases and sales and the resulting profit are accounted for at the conclusion of a *Murabaha* transaction.

Profit on that portion of sales not due for payment should be deferred by debiting to ***unearned murabaha income*** and crediting ***deferred murabaha income*** which should be shown as a liability.

1.3 IFAS 2: Ijarah

Ijarah are leases that are *Shariah* compliant.

The objective of IFAS 2 is to prescribe the accounting treatment and required disclosures for lessees and lessors in respect of *ijarah*.

IFAS 2 does not apply to:

- lease agreements to explore for or use minerals, oil, natural gas and similar non-regenerative resources;
- licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights;
- lessors of investment property leased out under operating leases; and
- lessors of biological assets leased out under operating leases.

Compliance with Sharia (the *Shariah* essentials)

The following characteristics are necessary for a lease to be compliant with *Shariah*:

- In Ijara/leasing, the asset that is the subject of the lease remains in the ownership of the lessor and only its usufruct is transferred to the lessee.
- Only owned assets can be leased out except that a lessee can effect a sub-lease with the express permission of the lessor.
- Any asset that cannot be used without being consumed cannot be a leased asset (e.g money, edibles, fuel, etc.).
- Lease rentals do not become due and payable until the assets to be leased are delivered to the lessee.
- The lessor must retain title to the asset and bear all risks and rewards pertaining to ownership during the entire term of the lease. However, the lessee is responsible for any damage or loss caused to the leased asset due to the fault or negligence of the lessee or from non-customary use of the asset and is also responsible for all risks and consequences in relation to third party liability, arising from or incidental to operation or use of the leased assets.
- The insurance of the leased asset should be in the name of lessor and the cost of such insurance borne by him.

- A lease can be terminated before expiry of the term of the lease but only with the mutual consent of the parties.
- Either party can make a unilateral promise to buy/sell the assets upon expiry of the term of lease, or earlier at a price and at such terms and conditions as are agreed. However, the lease agreement cannot be conditional upon such a sale nor can the lease agreement contain a term agreeing to transfer of ownership at a future date.
- The amount of rental must be agreed in advance in an unambiguous manner either for the full term of the lease or for a specific period in absolute terms.
- A lease contract of is considered terminated if the leased asset ceases to give the service for which it was rented.

Definitions

Ijarah is a form of lease finance agreement where a bank buys an asset for a customer and then leases it to the customer over a specific period for agreed rentals which allow the bank to recover the capital cost of the asset and a profit margin.

Definition: Ijarah (Lease)

Ijarah is a contract whereby the owner of an asset, other than consumables, transfers its usufruct to another person for an agreed period for an agreed consideration.

Usufruct: The right to use an asset.

The term *ijarah* also includes a contract of sublease executed by the lessee with the express permission of the lessor (being the owner).

Whether a transaction is an *ijarah* or not depends on its substance rather than the form of the contract provided it complies with the *Shariah* essentials (as shown above).

An *ijarah* is an agreement that is cancellable only:

- upon the occurrence of some remote contingency such as force majeure;
- with the mutual consent of the *muj'ir* (lessor) and the *musta'jir* (lessee); or
- If the *musta'jir* (lessee) enters into a new *ijarah* for the same or an equivalent asset with the same *muj'ir* (lessor).

Definitions

Inception of the ijarah: The date the leased asset is put into musta'jir's (lessee's) possession pursuant to an ijarah contract.

The term of the ijarah: The period for which the musta'jir (lessee) has contracted to lease the asset together with any further terms for which the musta'jir (lessee) has the option to continue to lease the asset, with or without further payment, which option at the inception of the ijarah it is reasonably certain that the musta'jir (lessee) will exercise.

Ujrah (lease) payments: Payments over the ijarah term that the musta'jir is, contractually required to pay.

Economic life: Either the period over which an asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from the asset by one or more users.

Useful life: The estimated period, from the beginning of the ijarah term, without limitation by the ijarah term, over which the economic benefits embodied in the asset are expected to be consumed by the enterprise.

Ijarah in the financial statements of musta'jir (lessees)

Assets acquired for *ijarah* are recognised upon acquisition at historical cost which is the net purchasing price plus all expenditures necessary to bring the asset to its intended use, such as custom duties, taxes, freight, insurance, installation, testing, etc.

Ujrah payments under an *ijarah* should be recognised as an expense in the statement of profit or loss on a straight-line basis over the *ijarah* term unless another systematic basis is representative of the time pattern of the user's benefit.

Ujrah payments are recognised as an expense in the statement of profit or loss on a straight- line basis unless another systematic basis is representative of the time pattern of the user's benefit, even if the payments are not on that basis.

Musta'jir (Lessees) should make the following disclosures for *ijarah*, in addition to meeting the IFRS disclosure requirements in respect of financial instruments:

- the total of future *ujrah* payments under *ijarah*, for each of the following periods:
  - not later than one year;
  - later than one year and not later than five years;
  - later than five years;
- the total of future sub-*ijarah* payments expected to be received under sub-*ijarah* at the reporting date;
- *ijarah* and sub-*ijarah* payments recognised in income for the period, with separate amounts for *ijarah* payments and sub-*ijarah* payments;
- a general description of the *musta'jir*'s (lessee's) significant *ijarah* arrangements including, but not limited to restrictions imposed by *ijarah* arrangements, such as those concerning dividends, additional debt, and further *ijarah*.

Ijarah in the financial statements of muj'ir (lessors)

Muj'ir (lessors) should present assets subject to *ijarah* in their statement of financial position according to the nature of the asset, distinguished from the assets in own use.

Ijarah income from Ijarah should be recognised in income on accrual basis as and when the rental becomes due, unless another ~ systematic basis is more

representative of the time pattern in which benefit of use derived from the leased asset is diminished.

Costs, including depreciation, incurred in earning the *ijarah* income are recognised as an expense.

Ijarah income is recognised in income on accrual basis as and when the rental becomes due, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished.

Initial direct costs incurred specifically to earn revenues from an *ijarah* are either deferred and allocated to income over the *ijarah* term in proportion to the recognition of *ujrah*, or are recognised as an expense in the statement of profit or loss in the period in which they are incurred.

Assets leased out should be depreciated over the period of lease term using depreciation methods set out in IAS 16 However, in the event of an asset expected to be available for re-*ijarah* after its first term, depreciation should be charged over the economic life of such asset on the basis set out in IAS 16.

Muj'ir (Lessors) should make the following disclosures for *ijarah*, in addition to meeting the IFRS disclosure requirements in respect of financial instruments:

- the future *ijarah* payments in the aggregate and for each of the following periods:
  - not later than one year;
  - later than one year and not later than five years;
  - later than five years; and
- a general description of the *muj'ir* (lessor's) significant leasing arrangements.

In addition, the requirements on disclosure under *IAS 16: Property, plant and equipment*, *IAS 36: Impairment of assets*, *IAS 38: Intangible assets* and *IAS 40: Investment property*, apply to assets leased out under *ijarah*.

Sale and leaseback transactions

A sale and leaseback transaction involves the sale of an asset by the vendor and the leasing of the same asset back to the vendor.

When an asset is sold with an intention to enter into an *ijarah* arrangement, any profit or loss based on the asset's fair value should be recognised immediately.

If the sale price is below fair value, any profit or loss should be recognised immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used.

If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

1.4 IFAS on profit and loss sharing deposits

Financial institutions establish and manage funds for investment. Investors contribute to the funds and share in the profit or loss of the fund. This is the return on the investments made using the assets of the fund less the financial institutions management fee.

Each investor owns a share of the fund determined by his investment. The financial institution must keep records comprising individual accounts for each investor which shows the balance on the account that belongs to the investor (investment account holder).

Some funds are set up with limitations on the type of investments that can be made by the financial institution on behalf of the investors. Other funds are set up without such limitations. These funds are said to be unrestricted.

This standard provides guidance on accounting principles to be followed by Institutions offering Islamic Financial Services (IIFS). The guidance covers recognition, measurement, presentation and disclosure in respect of transactions relating to equity (funds) of unrestricted investment / (Profit/Loss Sharing) PLS deposit account holders and their equivalents (unrestricted funds) in which the IIFS is acting as *mudarib*.

The standard only deals with funds which in effect are *mudaraba* or *musharaka* contracts. These definitions are repeated here for your convenience.

Definitions

Mudaraba

Mudaraba is a partnership in profit whereby one party provides capital (rab al maal) and the other party provides labour (mudarib). (Mudarib may also contribute capital with the consent of the rab al maal).

Musharaka

Relationship established under a contract by the mutual consent of the parties for sharing of profits and losses arising from a joint enterprise or venture.

The standard does not address the following:

- The funds received by the IIFS on a basis other than *mudaraba* or *musharaka* contracts.
- Bases of calculation of Zakat on funds within the scope of the standard.

The standard addresses two issues:

- The accounting principles relating to funds received by the IIFS for investment in its capacity as a mudarib at the IIFS's discretion, in whatever manner the IIFS deems appropriate (unrestricted funds); and
- the disclosure of bases for profit allocation between owners' equity and that of unrestricted funds.

Definitions

Definition

Unrestricted investment accounts / PLS deposit accounts (unrestricted funds)

Accounts where the investment account holder authorises the IIFS to invest the account holder's funds on the basis of Mudaraba or Musharaka contract in a manner which the IIFS deems appropriate without laying down any restrictions as to where, how and for what purpose the funds should be invested.

The IIFS might also use other funds which it has the right to use with the permission of Investment account holders.

The investment account holder authorises the IIFS to invest the account holder's funds on the basis of *mudaraba* or *musharaka* contract as IIFS deems appropriate without laying down any restrictions as to where, how and for what purpose the funds should be invested.

The IIFS can commingle the investment account holder's funds with its own equity or with other funds that it has the right to use with the permission of Investment account holders.

Holders of investment accounts appoint IIFS to invest their funds on the basis of an agency contract in return for a specified fee and perhaps a specified share of the profit if the realised profit exceeds a certain level.

Profits (calculated after the IIFS has received its share of profits as a *mudarib*) are allocated between investment account holders and the IIFS according to relative amount of funds invested and a pre-agreed profit sharing formula.

Losses are allocated between the investment account holders and the IIFS based on the relative amount of funds invested by each.

Accounting treatment in respect of unrestricted investment account holders / PLS deposit account holders

Definition

Funds of unrestricted investment/PLS deposit account holders

The balance, at the reporting date, from the funds originally received by the IIFS from the account holders plus (minus) their share in the profits (losses) and decreased by withdrawals or transfers to other types of accounts.

Funds of the account holders are initially measured as the amount invested and the subsequently measured as follows at each reporting date:

Illustration:

Balance of investment account at the beginning of the period	X
Add: Any further deposits	X
Less: Any withdrawals	(X)
Add: Any share of profits allocated and reinvested	X
Less: Any share of losses allocated	(X)
Add / less: Any other necessary adjustment.	X/(X)
	X

Profits of investments jointly financed by the investment account holders and the IIFS are allocated between them according to the mutually agreed terms.

Profits which have been allocated but have not yet been repaid or reinvested must be recognised and disclosed as a liability by the IIFS.

Any loss resulting from transactions in a jointly financed investment is accounted as follows:

- as a deduction from any unallocated profits; then
- any loss remaining should be deducted from provisions for investment losses set aside for this purpose; then
- any remaining loss should be deducted from the respective equity shares in the joint investment account holders and the IIFS according to each party's investment for the period.

A loss due to negligence or similar on the part of the IIFS is deducted from its share of the profits of the jointly financed investment. Any such loss in excess of the IIFS's share of profits is deducted from its equity share in the joint investment.

Presentation and disclosure in financial statements

Funds of account holders must be accounted for as redeemable capital.

The financial statement must disclose the following in its note on significant accounting policies:

- the bases applied to allocate profits between owners' equity and the account holders;
- the bases applied by the IIFS for charging expenses to unrestricted account holders;
- the bases applied by the IIFS for charging provisions, such as provision for non performing accounts, provisions on impairment etc and the parties to whom they revert once they are no longer required.

The IIFS should disclose significant category of accounts and of the percentage which the IIFS has agreed to invest in order to produce returns for them.

Disclosure should be made of the aggregate balances of all unrestricted funds (and their equivalent) classified as to type and also in terms of local and foreign currency.

The following disclosures should be made either in the notes to the financial statements or a separate statement:

- the total administrative expenses charged in respect of unrestricted funds with a brief description of their major components;
- details of profit allocation between owner's equity investment account holders applied in the current financial period;
- the percentage of profit charged by the IIFS as a *mudarib* during the financial period;
- where the IIFS is unable to utilise all funds available for investment how the investments made relates to the IIFS and investment account holders.

The following disclosures should alos be made:

- the bases and the aggregate amounts (if applicable) for determining incentive profits which IIFS receives from the profits of unrestricted funds and incentive profits which IIFS pays from its profits to investment account holders;
- concentration of sources of investment accounts;
- maturity profile of the unrestricted investment funds.

Disclosure should be made of sources of financing of material classes of assets showing separately those:

- exclusively financed by investment account holders;
- exclusively financed by IIFS; and
- jointly financed by IIFS and investment account holders.

The rights, conditions and obligations of each class of investment account holders shown in the statement of financial position should be disclosed.

Separate disclosures must be made of all material items of revenues, expenses, gains and losses classified under the headings appropriate to the IIFS distinguishing those attributable to investment accounts, IIFS, and IIFS and investment account holders jointly.

CHAPTER 36

Ethical issues in financial reporting

Contents

INTRODUCTION

Objective

To develop an in-depth understanding of, and the ability to apply the requirements of international pronouncements, the Companies Ordinance, 1984, and other applicable regulatory requirements in respect of financial reporting and the presentation of financial statements.

Learning outcomes

LO 3 **Exercise professional judgment and act in an ethical manner (that is in the best interest of society and the profession).**

FINANCIAL REPORTING AND ETHICS

Ethics

B (b) 1 Professional misconduct under the Chartered Accountants Ordinance 1961

B (b) 2 Code of Ethics issued by the Institute of Chartered Accountants of Pakistan

1 ICAP CODE OF ETHICS

Section overview

- Introduction
- Revised code of ethics
- Structure of the revised code of ethics

1.1 Introduction

Illustration: Quotation from the Revised Code of Ethics for Chartered Accountants

Chartered Accountants are expected to demonstrate the highest standards of professional conduct and to take into consideration the public interest. Ethical behaviour by Chartered Accountants plays a vital role in ensuring public trust in financial reporting and business practices and upholding the reputation of the accountancy profession.

The Code of Ethics helps members of the Institute meet these obligations by providing them with ethical guidance. The Code applies to all members, students, affiliates, employees of member firms and, where applicable, member firms, in all of their professional and business activities, whether remunerated or voluntary.

Meaning of ethics

Ethics can be difficult to define but it is principally concerned with human character and conduct. Ethical behaviour is more than obeying laws, rules and regulations. It is about doing 'the right thing'. The accountancy profession is committed to acting ethically and in the public interest.

Most people are honest and have integrity and will always try to behave in the right way in a given set of circumstances. However, accountants might face situations where it is not easy to see the most ethical course of action. One of the main roles of the ICAP code is to provide guidance in these situations.

Professional accountants may find themselves in situations where values are in conflict with one another due to responsibilities to employers, clients and the public.

ICAP has a code of conduct which members and student members must follow. The code provides guidance in situations where ethical issues arise.

1.2 Revised code of ethics

The International Ethics Standards Board for Accountants (IESBA) of IFAC issues a Code of Ethics every year.

ICAP's Auditing Standards Committee has made an exhaustive study of the IESBA Codes and recommended the latest IESBA Code for adoption as ICAP's code subject to few changes. The changes are not in conflict with the requirements of IESBA Code. They principally arise out of the requirements of

the Chartered Accountants Ordinance, 1961 and result in making the code more stringent than the original.

ICAP's has adopted the revised ICAP Code of Ethics to be effective from July 01, 2015.

Any violation of the provisions of the Code will fall under Part 4 of Schedule 1 of the Chartered Accountants Ordinance, 1961.

If any conflict arises between the guidance in the Code and the content of CAO, Chartered Accountants bye-laws, or any specific directive issued by the Council, the provisions of CAO, Chartered Accountants bye-laws, and the specific directive must prevail in that order respectively.

1.3 Structure of the revised code of ethics

The Code contains three parts.

- Part A establishes the fundamental principles of professional ethics for chartered accountants and provides a conceptual framework that chartered accountants must apply to:
  - identify threats to compliance with the fundamental principles;
  - evaluate the significance of the threats identified; and
  - apply safeguards, when necessary, to eliminate the threats or reduce them to an acceptable level.
- Parts B (applying to chartered accountants in public practice) and C (applying to chartered accountants in business):
  - describe how the conceptual framework applies in certain situations;
  - provide examples of safeguards that may be appropriate to address threats to compliance with the fundamental principles; and
  - describe situations which must be avoided because safeguards are not available to address the threats.

Illustration: Quotation from the Revised Code of Ethics for Chartered Accountants

A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. Therefore, a chartered accountant's responsibility is not exclusively to satisfy the needs of an individual client or employer. In acting in the public interest, a chartered accountant must observe and comply with this Code.

This chapter explains ethical issues surrounding the preparation of financial statements and other financial information.

References to chartered accountants in the following pages should be taken to include student members of ICAP.

2 GENERAL APPLICATION OF THE CODE

Section overview

- The fundamental principles
- Threats to the fundamental principles
- Safeguards
- Resolving ethical conflicts

2.1 The fundamental principles

ICAP's Code of Ethics expresses its guidance in terms of five fundamental principles which a chartered accountant must comply with. . These are:

- integrity;
- objectivity;
- professional competence and due care;
- confidentiality; and
- professional behaviour

Integrity

Members should be straightforward and honest in all professional and business relationships. Integrity implies not just honesty but also fair dealing and truthfulness.

A chartered accountant should not be associated with reports, returns, communications or other information where they believe that the information:

- Contains a materially false or misleading statement;
- Contains statements or information furnished recklessly; or
- Omits or obscures information required to be included where such omission or obscurity would be misleading.

Objectivity

Members should not allow bias, conflicts of interest or undue influence of others to override their professional or business judgements.

A chartered accountant may be exposed to situations that may impair objectivity. It is impracticable to define and prescribe all such situations.

Relationships that bias or unduly influence the professional judgment of the chartered accountant should be avoided.

Professional competence and due care

Practising as a chartered accountant involves a commitment to learning over one's entire working life.

Members have a duty to maintain their professional knowledge and skill at such a level that a client or employer receives a competent service, based on current

developments in practice, legislation and techniques. Members should act diligently and in accordance with applicable technical and professional standards.

Continuing professional development develops and maintains the capabilities that enable a chartered accountant to perform competently within the professional environments.

Confidentiality

Members must respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose such information to third parties without authority or unless there is a legal or professional right or duty to disclose.

Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of members or third parties.

Professional behaviour

Members must comply with relevant laws and regulations and should avoid any action which discredits the profession. They should behave with courtesy and consideration towards all with whom they come into contact in a professional capacity.

2.2 Threats to the fundamental principles

The circumstances in which chartered accountants operate may create specific threats to compliance with the fundamental principles. It is impossible to define every situation that creates threats to compliance with the fundamental principles and specify the appropriate action.

Therefore, the Code establishes a conceptual framework that requires a chartered accountant to identify, evaluate, and address threats to compliance with the fundamental principles.

Compliance with the fundamental principles may potentially be threatened by a broad range of circumstances. Many threats fall into the following categories:

- self-interest;
- self-review;
- advocacy;
- familiarity; and
- intimidation.

Threats could compromise, or could be perceived to compromise, a chartered accountant's compliance with the fundamental principles.

Members must identify, evaluate and respond to such threats. Unless any threat is clearly insignificant, members must implement safeguards to eliminate the threats or reduce them to an acceptable level so that compliance with the fundamental principles is not compromised.

Self- interest threats

This is the threat that a financial or other interest will inappropriately influence the chartered accountant's judgment or behaviour

Self-interest threats may occur as a result of the financial or other interests of members or their immediate or close family members.

Such financial interests might cause members to be reluctant to take actions that would be against their own interests.

Examples of circumstances that may create self-interest threats include, but are not limited to:

- Incentive compensation arrangements.
- Concern over employment security.
- Commercial pressure from outside the employing organization.

Example:

Ibrahim is member of ICAP working as a unit accountant.

He is a member of a bonus scheme under which, staff receive a bonus of 10% of their annual salary if profit for the year exceeds a trigger level.

Ibrahim has been reviewing working papers prepared to support this year's financial statements. He has found a logic error in a spreadsheet used as a measurement tool for provisions.

Correction of this error would lead to an increase in provisions. This would decrease profit below the trigger level for the bonus.

Analysis:

Ibrahim faces a self-interest threat which might distort his objectivity.

Self-review threats

Self-review threats occur when a previous judgement needs to be re-evaluated by members responsible for that judgement. For example, where a member has been involved in maintaining the accounting records of a client he may be unwilling to find fault with the financial statements derived from those records. Again, this would threaten the fundamental principle of objectivity.

Circumstances that may create self-review threats include, but are not limited to, business decisions or data being subject to review and justification by the same chartered accountant in business responsible for making those decisions or preparing that data.

Advocacy threats

A chartered accountant in business may often need to promote an organisation's position by providing financial information to the point that the chartered accountant's objectivity is compromised. As long as information provided is neither false nor misleading such actions would not create an advocacy threat.

Familiarity threats

Familiarity threats occur when, because of a close relationship, members become too sympathetic to the interests of others. Examples of circumstances that may create familiarity threats include:

- A chartered accountant in business in a position to influence financial or non-financial reporting or business decisions having an immediate or close family member who is in a position to benefit from that influence.
- Long association with business contacts influencing business decisions.
- Acceptance of a gift or preferential treatment, unless the value is clearly insignificant.

Intimidation threats

Intimidation threats occur when a member's conduct is influenced by fear or threats (for example, when he encounters an aggressive and dominating individual at a client or at his employer).

Examples of circumstances that may create intimidation threats include:

- Threat of dismissal or replacement over a disagreement about the application of an accounting principle or the way in which financial information is to be reported.
- A dominant personality attempting to influence decisions of the chartered accountant.

2.3 Safeguards

Safeguards are actions or other measures that may eliminate threats or reduce them to an acceptable level.

When a chartered accountant identifies threats to compliance with the fundamental principles chartered accountant must then determine whether or not that they are at an acceptable level.

If they are not at an acceptable level, the chartered accountant must determine whether appropriate safeguards are available that, if applied, would eliminate the threats or reduce them to an acceptable level.

Safeguards fall into two broad categories:

- safeguards created by the profession, for example:
  - educational, training and experience requirements for entry into the profession;
  - continuing professional development requirements;
  - corporate governance regulations;
  - professional standards; and
  - professional or regulatory monitoring and disciplinary procedures.
- safeguards in the work environment.

2.4 Resolving ethical conflicts

The following factors might be relevant to a when resolving a conflict in complying with the fundamental principles.

- relevant facts;
- ethical issues involved;
- fundamental principles related to the matter in question;
- established internal procedures; and
- alternative courses of action.

After considering the relevant a chartered accountant must decide on an appropriate course of action.

If a matter remains unresolved, the chartered accountant could consult with other appropriate persons within the firm or employing organisation.

If a significant conflict cannot be resolved, a chartered accountant may consider obtaining professional advice from the relevant professional body or from legal advisors. This would not breach confidentiality if the matter is discussed with:

- the relevant professional body on an anonymous basis; or
- a legal advisor under the protection of legal privilege.

If an ethical conflict remains unresolved all relevant possibilities have been exhausted a chartered accountant must refuse to remain associated with the matter creating the conflict.

3 ACCOUNTANTS IN PUBLIC PRACTICE

Section overview

- Introduction
- Questionable issues associated with the client
- Provision of non-audit services

3.1 Introduction

This is a large section of Code. The following explanations focus on those areas that might form the basis of an ethical conflict in the context of financial reporting.

A chartered accountant in public practice must not knowingly act in a way that conflicts with the fundamental principles.

A chartered accountant must not accept a new client if that would create threats to compliance with the fundamental principles. Such threats might include:

- questionable issues associated with the client; and
- conflicts of interest.

3.2 Questionable issues associated with the client

Replacing an existing auditor

A chartered accountant who is asked to replace another chartered accountant must determine whether there are any reasons for not accepting the engagement. Such reasons might include the existence of circumstances that create threats to compliance with the fundamental principles that cannot be eliminated or reduced to an acceptable level by the application of safeguards. For example, there may be a threat to professional competence and due care if a chartered accountant accepts the engagement before knowing all the pertinent facts. It could be that the firm is not competent or has insufficient resource to undertake the necessary work.

This also applies to chartered accountant who is considering tendering for an engagement currently held by another chartered accountant.

Work of a complimentary nature

A chartered accountant may be asked to undertake work that is complementary or additional to the work of the existing accountant. Such circumstances may create threats to professional competence and due care resulting from, for example, a lack of or incomplete information.

A possible safeguard in such a case might be the notification of the existing accountant of the proposed work, which giving him the opportunity to provide any relevant information needed for the proper conduct of the work.

Second Opinions

A chartered accountant might be asked to provide a second opinion on a financial reporting issue by a company that is not an existing client. This may

threaten compliance with the fundamental principles. For example, there may be a threat to professional competence and due care in circumstances where the second opinion is not based on the same set of facts that were made available to the existing accountant or is based on inadequate evidence.

A possible safeguard in such a case might include seeking client permission to contact the existing accountant, describing the limitations surrounding any opinion in communications with the client and providing the existing accountant with a copy of the opinion.

If the company seeking the opinion will not allow communication with the existing accountant, it might not be appropriate to provide the opinion sought.

Conflicts of interest

A chartered accountant may be faced with a conflict of interest when performing a professional service.

A conflict of interest creates a threat to objectivity and may create threats to the other fundamental principles.

Examples of situations in which conflicts of interest may arise include:

- Providing a transaction advisory service to a client seeking to acquire an audit client of the firm, where the firm has obtained confidential information during the course of the audit that may be relevant to the transaction.
- Advising two clients at the same time who are competing to acquire the same company where the advice might be relevant to the parties' competitive positions.
- Providing services to both a vendor and a purchaser in relation to the same transaction.

ICAP members or firms should not accept or continue an engagement where there is a conflict of interest between the member or firm and its client. The test is whether or not a "reasonable and informed third party" would consider the conflict of interest as likely to affect the judgement of the member or the firm.

3.3 Provision of non-audit services

It is common for audit firms of all sizes to provide non-audit services.

Most auditors recognise the potential threat to their independence and they try to deal with the problem through their internal organisational structure.

- Larger firms will operate in a number of separate departments, each with its own partners and members of staff. By dividing the work of the audit firm into different functions, employees involved in audit work will not be the same as those involved in providing, say, consultancy advice to the same client.
- A similar approach is often taken by smaller audit firms. Although these firms may not be large enough to be organised in separate departments, efforts are usually made to ensure that different members of staff and partners are responsible for different services provided to clients.

Preparing accounting records and financial statements

Preparing accounting records and financial statements and then auditing them creates a significant self-review threat. This may also apply where an assurance engagement involves reviewing subject matter (such as forecasts) prepared by the firm itself.

In providing such assistance, firms must not make management decisions such as:

- deciding on or changing journal entries without the client's approval;
- authorising or approving transactions; or
- preparing source documents or originating data (including decisions on valuation assumptions).

The provision of advice on accounting principles and presentation in the financial statements given during the course of an audit will not generally threaten the firm's independence. Such advice is considered to be part of the normal audit process.

For non-listed clients, accounting or book-keeping services, including payroll services, of a routine or mechanical nature may be provided with appropriate safeguards such as:

- the service not being performed by a member of the audit team;
- the firm having policies and procedures such that an individual is prevented from making any management decision on behalf of the client;
- requiring the source data for accounting entries to be originated by the client;
- requiring the underlying assumptions to be originated and approved by the client; or
- obtaining the client's approval for any changes to the financial statements.

4 ACCOUNTANTS IN BUSINESS

Section overview

- Introduction
- Section 320 of the ICAP Code of Ethics
- Potential conflicts

4.1 Introduction

Accountants in business are often responsible for the preparation of accounting information.

Accountants in business need to ensure that they do not prepare financial information in a way that is misleading or that does not show a true and fair view of the entity's operations.

Accountants who are responsible for the preparation of financial information must ensure that the information they prepare is technically correct, reports the substance of the transaction and is adequately disclosed.

There is a danger of influence from senior managers to present figures that inflate profit or assets or understate liabilities. This puts the accountant in a difficult position. On one hand, they wish to prepare proper information and on the other hand, there is a possibility they might lose their job if they do not comply with their managers wishes.

In this case, ethics starts with the individual preparing the information. They have a difficult decision to make; whether to keep quiet or take the matter further. If they keep quiet, they will certainly be aware that they are not complying with the ethics of the accounting body they belong to. If they speak out, they may be bullied at work into changing the information or sacked.

4.2 Section 320 of the ICAP Code of Ethics

Chartered accountants in business are often involved in the preparation and reporting of information that may either be made public or used by others inside or outside the employing organisation. Such information may include financial or management information, for example:

- forecasts and budgets;
- financial statements;
- management discussion and analysis; and
- the management letter of representation provided to the auditors as part of an audit of financial statements.

Information must be prepared and presented fairly, honestly and in accordance with relevant professional standards. In particular financial statements must be prepared and presented in accordance with the applicable financial reporting standards.

A chartered accountant in business must maintain information for which he is responsible in a manner that:

- describes clearly the true nature of business transactions, assets or liabilities;
- classifies and records information in a timely and proper manner; and
- represents the facts accurately and completely in all material respects.

Threats to compliance with the fundamental principles, for example self-interest or intimidation threats to objectivity or professional competence and due care, may be created where a chartered accountant in business may be pressured (either externally or by the possibility of personal gain) to become associated with misleading information or to become associated with misleading information through the actions of others.

The significance of such threats will depend on factors such as the source of the pressure and the degree to which the information is, or may be, misleading.

The significance of the threats should be evaluated and unless they are clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. Such safeguards may include consultation with superiors within the employing organization, for example, the audit committee or other body responsible for governance, or with a relevant professional body.

Where it is not possible to reduce the threat to an acceptable level, a chartered accountant should refuse to remain associated with information they consider is or may be misleading.

If the chartered accountant is aware that the issuance of misleading information is either significant or persistent, he should consider informing appropriate authorities in line with the guidance in this code. The chartered accountant in business may also wish to seek legal advice or resign.

4.3 Potential conflicts

There may be times when the responsibilities of a chartered accountant to an employing organisation come into conflict with their professional obligations to comply with the fundamental principles in the Code. Where compliance with the fundamental principles is threatened, a chartered accountant in business must consider a response to the circumstances.

Responsibilities to an employer may put a chartered accountant under pressure to act or behave in ways that could directly or indirectly threaten compliance with the fundamental principles. Such pressure may be explicit or implicit; it may come from a supervisor, manager, director or another individual within the employing organization.

A chartered accountant in business may face pressure to:

- Act contrary to law or regulation.
- Act contrary to technical or professional standards.

- Lie to, or otherwise intentionally mislead (including misleading by remaining silent) others, in particular:
  - the auditors of the employing organization; or
  - regulators.
- Issue, or otherwise be associated with, a financial or non-financial report that materially misrepresents the facts, including statements in connection with, for example:
  - the financial statements;
  - tax compliance;
  - legal compliance; or
  - reports required by securities regulators.

The significance of threats must be evaluated and unless they are clearly insignificant, safeguards should be considered and applied to eliminate them or reduce them to an acceptable level.

Such safeguards may include:

- Obtaining advice where appropriate from within the employing organisation, or an independent professional advisor or a relevant professional body.
- The existence of a formal dispute resolution process within the employing organization.
- Seeking legal advice.

Example:

Ibrahim is member of ICAP working as a unit accountant.

He is a member of a bonus scheme under which, staff receive a bonus of 10% of their annual salary if profit for the year exceeds a trigger level.

Ibrahim has been reviewing working papers prepared to support this year's financial statements. He has found a logic error in a spreadsheet used as a measurement tool for provisions.

Correction of this error would lead to an increase in provisions. This would decrease profit below the trigger level for the bonus.

Analysis:

Ibrahim faces a self-interest threat which might distort his objectivity.

Ibrahim has a professional responsibility to ensure that financial information is prepared and presented fairly, honestly and in accordance with relevant professional standards. He has further obligations to ensure that financial information is prepared in accordance with applicable accounting standards and that records maintained represent the facts accurately and completely in all material respects.

Ibrahim must make the necessary adjustment even though it would lead to a loss to himself.

Example:

Ali is a chartered accountant recruited on a short-term contract to assist the finance director, Bashir (who is not a chartered accountant) in finalising the draft financial statements.

The decision on whether to employ Ali on a permanent basis rests with Bashir.

Ali has been instructed to prepare information on leases to be included in the financial statements. He has identified a number of large leases which are being accounted for as operating leases even though the terms of the contract contain clear indicators that the risks and benefits have passed to the company. Changing the accounting treatment for the leases would have a material impact on asset and liability figures.

Ali has explained this to Bashir. Bashir responded that Ali should ignore this information as the company need to maintain a certain ratio between the assets and liabilities in the statement of financial position.

Analysis

Ali faces a self-interest threat which might distort his objectivity.

The current accounting treatment is incorrect.

Ali has a professional responsibility to ensure that financial information is prepared and presented fairly, honestly and in accordance with relevant professional standards. He has further obligations to ensure that financial information is prepared in accordance with applicable accounting standards and that records maintained represent the facts accurately and completely in all material respects.

Possible course of action

Ali must explain his professional obligations to Bashir in particular that he cannot be party to the preparation and presentation of knowingly misleading information.

Ali should refuse to remain associated with information that is misleading.

If Bashir refuses to allow the necessary changes to the information Ali should report the matter to the audit committee or the other directors.

As a last resort if the company refuses to change the information Ali should resign from his post.

Ali may need to consider informing the appropriate authorities in line with the ICAP guidance on confidentiality.

Example:

Etishad is a chartered accountant who works in a team that reports to Fahad, the finance director of Kohat Holdings.

Fahad Is also a chartered accountant. He has a domineering personality.

Kohat Holdings revalues commercial properties as allowed by IAS 16. Valuation information received last year showed that the fair value of the property portfolio was 2% less than the carrying amount of the properties (with no single property being more than 4% different). A downward revaluation was not recognised on the grounds that the carrying amount was not materially different from the fair value.

This year's valuation shows a continued decline in the fair value of the property portfolio. It is now 5% less than the carrying amount of the properties with some properties now being 15% below the carrying amount.

Etishad submitted workings to Fahad in which he had recognised the downward revaluations in accordance with IAS 16.

Fahad has sent him an email in response in which he wrote "Stop bothering me with this rubbish. There is no need to write the properties down. The fair value of the portfolio is only 5% different from its carrying amount. Restate the numbers immediately".

Analysis

Etishad faces an intimidation threat which might distort his objectivity.

The current accounting treatment might be incorrect. The value of the properties as a group is irrelevant in applying IAS 16's revalution model. IAS 16 allows the use of a revalution model but requires that the carrying amount of a property should not be materially different from its fair value. This applies to individual properties not the whole class taken together.

(It could be that Fahad is correct because there is insufficient information to judge materiality in this circumstance. However, a 15% discrepancy does sound significant).

Etishad has a professional responsibility to ensure that financial information is prepared and presented fairly, honestly and in accordance with relevant professional standards. He has further obligations to ensure that financial information is prepared in accordance with applicable accounting standards and that records maintained represent the facts accurately and completely in all material respects.

Example continued

Possible course of action

Etishad should arrange a meeting with Fahad to try to explain Fahad's misapplication of the IAS 16 guidance and to try to persuade Fahad that a change might be necessary.

Fahad should be reminded that he too is bound by the same guidance that applies to Etishad. Indeed he has a greater responsibility as the more senior person to show leadership in this area.

Etishad cannot be party to the preparation and presentation of knowingly misleading information. He should explain that he cannot remain associated with information that is misleading. If Fahad refuses to allow the necessary changes to the information, Etishad should report the matter to the audit committee or the other directors.

As a last resort if the company refuses to change the information, Etishad should resign from his post.

Etishad may need to consider informing the appropriate authorities in line with the ICAP guidance on confidentiality.

Index

a

b

c

d

e

f

g

h

i

j

l

m

n

o

p

q

r

s

t

u

v

w

Head Office-Karachi: Chartered Accountants Avenue, Clifton, Karachi-75600
Phone: (92-21) 99251636-39, UAN: 111-000-422, Fax: (92-21) 99251626, e-mail: info@icap.org.pk

Regional Office-Lahore: 155-156, West Wood Colony, Thokar Niaz Baig, Raiwind Road, Lahore
Phone: (92-42) 37515910-12, UAN: 111-000-422, e-mail: lahore@icap.org.pk

Islamabad Office: Sector G-10/4, Mauve Area, Islamabad
UAN: 111-000-422, Fax: (92-51) 9106095, e-mail: islamabad@icap.org.pk

Faisalabad Office: P- 3/33 East Canal road, Muhammadi Colony, Near Govt. College of Commerce Abdullahpur, Opposite Nusrat Fateh Ali Khan under pass, Faisalabad
Phone: (92-41) 8531028, Fax: (92-41) 8503227, e-mail: faisalabad@icap.org.pk

Multan Office: 3rd Floor, Parklane Tower, Officers' Colony, Near Eid Gaah Chowk, Khanewal Road, Multan.
Phone: (92-61) 6510511-6510611, Fax: (92-61) 6510411, e-mail: multan@icap.org.pk

Peshawar Office: House No. 30, Old Jamrud Road, University Town, Peshawar
Phone: (92-91) 5851648, Fax: (92-91) 5851649, e-mail: peshawar@icap.org.pk

Gujranwala Office: 2nd Floor, Gujranwala Business Center, Opp. Chamber of Commerce, Main G.T. Road, Gujranwala.
Phone: (92-55) 3252710, e-mail: gujranwala@icap.org.pk

Sukkur Office: Admin Block Sukkur IBA, Airport Road, Sukkur
Phone: (92-71) 5806109, e-mail: sukkur@icap.org.pk

Quetta Office: Civic Business Center, Hali Road, Quetta Cantt
Phone: (92-81) 2865533, e-mail: quetta@icap.org.pk

Mirpur AJK Office: Basic Health Unit (BHU) Building Sector D, New City Mirpur, Azad Jammu and Kashmir
e-mail: mirpur@icap.org.pk

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