# FREQUENTLY ASKED QUESTIONS IN

# IFRS

STEVEN COLLINGS

# Frequently Asked Questions in IFRS

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**Steven Collings**

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For my mother – a truly inspirational person.

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# About the Author

Steve Collings is the audit and technical director at Leavitt Walmsley Associates Ltd, a firm of Chartered Certified Accountants based in Manchester in the United Kingdom. Steve trained and qualified with the firm and specializes in financial reporting (UK GAAP and IFRS), auditing, and solicitors accounts rules. Steve qualified with the Association of Accounting Technicians (AAT) in 2001 and then qualified as an Associate Chartered Certified Accountant (ACCA) in 2005, becoming a Fellow Chartered Certified Accountant in 2010. Steve also holds the ACCA's Certificates in International Financial Reporting Standards and International Standards on Auditing, and has a Diploma in International Financial Reporting Standards, which he obtained in 2008.

Steve has been writing professionally for several years and is the author of several articles that have been published in the various accounting media, primarily AccountingWEB.co.uk. In addition, Steve is also the author of *Interpretation and Application of International Standards on Auditing* (Wiley, March 2011) and *IFRS For Dummies* (Wiley, April 2012), as well as the author of other publications on IFRS. Steve also lectures to professional accountants on areas of financial reporting, company law, auditing and solicitors accounts rules. Much of Steve's work can be seen on his personal website at www.stevecollings.co.uk.

In 2011, Steve was named Accounting Technician of the Year at the 2011 British Accountancy Awards.

Follow Steve on Twitter: @stecollings.

# Acknowledgements

Writing a book is a significant task – whether it be a work of fiction or a technical book such as this. Every author of a book therefore needs a strong and supportive team at the back of them to cope with the demands of such a project, so to put one name on the front cover feels quite fraudulent. I am extremely proud of the team that I have supporting me at Wiley and offer my heartfelt thanks and gratitude to Gemma Valler, the associate commissioning editor for all her support (and patience) during the production of this book. The road to publication was long, but we got there in the end!

Books do not print themselves and therefore I offer my thanks to all the production team at Wiley for their work in producing this book after the manuscript had been finalized. I also offer my sincere thanks to Wiley's marketing team in helping to get this book into the market.

Caroline Fox BA FCA, my technical reviewer, has once again applied deftness during her review of this book. Caroline's input into the structure, flow and technicality of this book has been, without a doubt, invaluable, and I am eternally grateful for her review of my manuscript and the suggestions she has offered (all of which were incorporated within the book). I am also extremely grateful to Caroline for writing the book's foreword. Her technical ability is outstanding and every author of an accountancy related book needs someone like Caroline on board!

I have to thank my family and friends (all of whom feature in the illustrative examples littered throughout this book) for their unwavering help and support over the years. In particular

I would like to thank Les Leavitt for his continued support – Les always shows an amazing amount of enthusiasm for my book projects and always asks how the writing is going! I would like to thank my friends Mark and Sue Breary for making sure my weekends were not completely filled up with writing!

Finally, I would like to thank you, the reader, for picking up this book. I sincerely hope you find it a useful reference to the murky world of IFRS and I hope that it answers some of your questions in a clear and concise manner. Make notes in the margin and keep it by your side as a companion to help you in your dealings with IFRS.

# Preface

Financial reporting has become more and more complex over the years. The ways in which many industries around the globe reported financial information, based on domestic Generally Accepted Accounting Practices (GAAP), differed significantly from one country to another because a set of accounting rules in one country may not be the same for a reporting entity operating in a similar industry but in another jurisdiction.

International Financial Reporting Standards (IFRSs) are primarily designed to enhance uniform financial reporting around the globe, promoting consistency, harmonization and comparability. The idea behind this uniform financial reporting is that it will give access to more capital markets because of the consistency in the way that financial information is both prepared and reported.

Mainstream IFRS are primarily designed for large entities that are listed on a recognized stock exchange (for example, the London Stock Exchange). As a consequence, mainstream IFRSs are extremely vast and significantly complex in many areas, and require a reporting entity that has adopted IFRS as its financial reporting framework to make extensive disclosures within its financial statements. This can result in a company's annual report running to hundreds of pages.

The introduction of the International Accounting Standards Board's (IASB's) IFRS for SMEs in July 2009 was a big step in promoting an international-based framework for those companies that mainstream IFRS would prove too costly and burdensome to adopt. IFRS for SMEs was designed by the IASB to be a less complex, less onerous and less burdensome

standard with a primary objective of enabling 'small-medium entities' (SMEs) to have access to more capital markets because it improved the quality of reporting compared with many existing national accounting standards. In addition to allowing SMEs the opportunity to access more capital markets, IFRS for SMEs also allows enhanced comparability for the users of the financial statements in, and across, borders. The target audience for IFRS for SMEs is essentially a company of any size, provided the company does not have 'public accountability' – a company has public accountability when its securities are traded or it is a financial institution. Such companies are beyond the scope of IFRS for SMEs and are mandated to use full IFRS as a financial reporting framework.

IFRS have been criticized by many countries as not being 'fit for purpose' or 'flawed' in many areas. This is largely due to the principles-based approach that IFRS is based upon (unlike US GAAP, which is largely rules-based). The turbulent economic difficulties that started in 2008 and are currently ongoing have been blamed, partly, on IFRS and the ways in which fair value accounting was essentially manipulated by the banking industry. IFRS has also been partly blamed for some large-scale corporate disasters that have occurred in the mid-2000s – however, many of these were mainly due to the ways in which management deliberately concealed or manipulated information to suit their own reporting requirements.

Notwithstanding the criticism that IFRS has been subjected to over recent years, it is the ambition of the International Accounting Standards Board (IASB) that the use of IFRS as a financial reporting framework will eventually be adopted throughout the globe to enhance consistency and comparability, and open up capital markets to promote a larger degree of trading. Many countries have adopted IFRS as their financial reporting framework, with many also considering the transition across to IFRS.

Steve Collings
March 2013

# Foreword

The development of IFRS is like an old friend to some of us. My own interest goes back to working for a New York investment bank, trying to consolidate results from our Italian, Spanish and other subsidiaries into the UK holding company accounts that were then to be explained, channelled and translated into results fit for our US parent to use.

As to the potential adoption of IFRS by the US, it is with some sadness that I write this in the week that SEC spokesman John Nestor has announced that 'the report [on IFRS] is nearing completion but staff have not established a timetable for completing a recommendation'.[1]

Notwithstanding, on a more optimistic note, more than 100 countries now use IFRS, including two-thirds of the Group of 20. I quote Sir David Tweedie: 'the gain to international investors, regulators and multinational companies of all speaking the same financial reporting language significantly outweighs the loss of national standards'.[2]

An exciting initiative has been the IFRS for SMEs, with scope for applicability to small and medium-sized enterprises, estimated as per the IFRS Foundation to account for nearly 95% of companies worldwide.[3]

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[1] *Accountancy Age*, 12 July 2012

[2] Chairman IASB, 2001–2011. Letter to the *Financial Times*, 29 March 2012

[3] IFRS.org website, July 2012

As to the need for this book, following Sir David's letter as quoted above, there followed a series of letters in the *Financial Times* – one reader even offering a prize – to anyone who could offer an explanation of certain terminology.

So for those of us using IFRS in Australia, Brazil, China or Dubai, to name but a few, read on – you will surely find answers to probably all of your frequently asked questions ahead.

Caroline Fox BA FCA
March 2013

# Frequently Asked Questions

1. What is the Conceptual Framework?
2. What are the qualitative characteristics of financial statements?
3. What are the elements of the financial statements?
4. Can you change accounting policies and, if so, how do you do it?
5. What are accounting estimates and how are these accounted for?
6. What is defined as current and non-current under IFRS?
7. What happens when an entity adopts IFRS for the first time?
8. What happens when one company acquires another company?
9. What are step acquisitions?
10. What are deemed disposals in business combinations?
11. Why are consolidated financial statements prepared and how do these differ from separate financial statements?
12. How is an associate defined under IFRS?
13. How do you account for an associate under IFRS?
14. What are joint arrangements and joint ventures?
15. How do you account for a joint venture under IFRS?
16. How does an entity deal with exchange rate differences?
17. How and when does an entity recognize a non-current tangible asset?
18. What is the accounting treatment for non-current assets held for sale?
19. Can internally generated goodwill be recognized on the statement of financial position?

20. What are intangible non-current assets, other than goodwill?
21. How does an entity deal with investment property in the statement of financial position?
22. What is an impairment test?
23. How does an entity account for borrowing costs (interest) incurred whilst constructing an asset?
24. What is the difference between a revaluation of property, plant and equipment, and the revaluation model for investment property?
25. What distinguishes whether an asset to be disposed of is classified as held for sale?
26. What are the accounting principles under IFRS for inventories?
27. If a company enters into construction contracts, how does it account for these?
28. What are the rules where leases are concerned?
29. Are there any changes planned for lease accounting?
30. When a company receives a government grant, how does it account for this?
31. What are the different categories of revenue under IFRS and how do they differ from gains?
32. How does a company recognize revenue in its income statement/statement of profit or loss?
33. What is the difference between current and deferred tax?
34. How do you work out deferred tax under IFRS?
35. How does an entity recognize a deferred tax asset?
36. What are the different types of share-based payment transactions?
37. How are share-based payments accounted for under IFRS?
38. What is the difference between a defined contribution pension plan and a defined benefit pension plan?
39. How are short-term employee benefits accounted for under IFRS?
40. What are operating segments?
41. What are the disclosure requirements for operating segments?

**42.** Why does a company have to report earnings per share and how are these calculated?
**43.** What are events after the reporting period and how do you differentiate between an adjusting and non-adjusting event?
**44.** What is the difference between a provision and a contingent liability?
**45.** How is a provision accounted for under IFRS?
**46.** What disclosures are needed for contingent liabilities?
**47.** Why is a statement of cash flows produced as part of the primary financial statements under IFRS?
**48.** What is the prescribed method for preparing a statement of cash flows?
**49.** How are agricultural and biological assets accounted for?
**50.** If a company operates in a hyperinflationary economy, how should the financial statements be prepared?
**51.** What is an audit of a company's financial statements and are there any ethical issues that affect auditors?
**52.** What are the basics with regards to financial instruments?
**53.** How are financial assets and financial liabilities accounted for?
**54.** What is the IFRS for SMEs and how is it structured?

# Introduction – What is IFRS?

# What exactly is IFRS?

International Financial Reporting Standards (IFRSs) are a set of accounting rules that have been produced by the International Accounting Standards Board (IASB). Many countries still prepare financial statements using their own national accounting standards (for example, the United States Generally Accepted Accounting Practice (US GAAP)), but many other countries have adopted the use of IFRS as an acceptable financial reporting framework.

Take, for example, countries in the European Union: the June 2002 European Commission Regulation requires that all EU-listed companies from 2005 must prepare their consolidated financial statements using IFRS as opposed to national GAAP. As a consequence, the preparation of consolidated financial statements of listed companies under IFRS is now well-established. This is particularly the case, for example, in the UK; however, not every entity in the UK adopted IFRS and very many remained on UK GAAP. The IFRS regime is permissible for entities that still report under UK GAAP, although very few do actually report under IFRS if they are not mandated to do so.

At the time of writing, there are 40 International Financial Reporting Standards (IFRSs) and International Accounting Standards (IASs) in issuance, which are detailed as below.

IFRS 1 First-time Adoption of International Financial Reporting Standards

IFRS 2 Share-based Payment

IFRS 3 Business Combinations

IFRS 4 Insurance Contracts

IFRS 5 Non-current Assets Held for Sale and Discontinued Operations

IFRS 6 Exploration for and Evaluation of Mineral Resource

IFRS 7 Financial Instruments: Disclosures

IFRS 8 Operating Segments

IFRS 9 Financial Instruments

IFRS 10 Consolidated Financial Statements

IFRS 11 Joint Arrangements

IFRS 12 Disclosure of Interests in Other Entities

IFRS 13 Fair Value Measurement

IAS 1 Presentation of Financial Statements

IAS 2 Inventories

IAS 7 Statement of Cash Flows

IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

IAS 10 Events After the Reporting Period

IAS 11 Construction Contracts

IAS 12 Income Taxes

IAS 17 Leases

IAS 18 Revenue

IAS 19 Employee Benefits

IAS 20 Accounting for Government Grants and Disclosure of Government Assistance

IAS 21 The Effects of Changes in Foreign Exchange Rates

IAS 23 Borrowing Costs

IAS 24 Related Party Disclosures

IAS 26 Accounting and Reporting by Retirement Benefit Plans

IAS 27 Consolidated and Separate Financial Statements

IAS 28 Investments in Associates

IAS 29 Financial Reporting in Hyperinflationary Economies

IAS 32 Financial Instruments: Presentation

IAS 33 Earnings per Share

IAS 34 Interim Financial Reporting

IAS 36 Impairment of Assets

IAS 37 Provisions, Contingent Liabilities and Contingent Assets

IAS 38 Intangible Assets

IAS 39 Financial Instruments: Recognition and Measurement

IAS 40 Investment Property

IAS 41 Agriculture

International Financial Reporting Interpretation Committee (IFRIC) and Standing Interpretation Committee (SIC) Interpretations (which are beyond the scope of this publication) can also be found on the IASB's website at www.ifrs.org.

In May 2011, the IASB issued the following IFRSs:

- IFRS 10 Consolidated Financial Statements;
- IFRS 11 Joint Arrangements;
- IFRS 12 Disclosure of Interests in Other Entities; and
- IFRS 13 Fair Value Measurement.

The IASB also went onto amend and rename the following standards:

- IAS 27 Consolidated and Separate Financial Statements became IAS 27 Separate Financial Statements;

- IAS 28 Investment in Associates became IAS 28 Investments in Associates and Joint Ventures; and
- IAS 31 Interests in Joint Ventures was superseded by IFRS 11 Joint Arrangements and IFRS 12 *Disclosure of Interests in Other Entities* for annual periods commencing on or after 1 January 2013.

Since 2007, the IASB has issued a separate document that outlines annual improvements to existing IFRSs. Such improvements are first issued as an exposure draft; if the exposure draft is approved, they are then issued as a separate standard that will then eventually be embedded into the standards that are subject to the relevant amendment (usually with an 'effective from' date of 1 January in the next year).

Traditionally, many of the IASs allowed more than one alternative method of accounting for certain transactions that were referred to as the benchmark treatment. Over the years there has been an increasing tendency of the IASB reducing the number of benchmark treatments contained within the standards. On the one hand, having a benchmark treatment is advantageous to a reporting entity, because it increases the acceptability of the relevant accounting standard; on the other hand, having alternative accounting treatments within the standards gives rise to a reduction in the comparability of financial statements – the ultimate aim of IFRS is to achieve comparability across the board.

IAS 23 Borrowing Costs and IAS 31 Interests in Joint Ventures were the last two standards that gave an entity a choice of following either a benchmark or alternative accounting treatments. IAS 23 was amended in 2007, which resulted in all borrowing costs relating to qualifying assets having to be capitalized on the statement of financial position (balance sheet) as opposed to having an option of writing these off to the statement of comprehensive income (income statement/profit and loss account). IAS 31 allowed a reporting entity that had an interest in a joint venture to account for its share of a joint

venture's income, expenses, assets and liabilities by way of the 'equity' method or the 'proportionate consolidation' method. IAS 31 was superseded by IFRS 11 Joint Arrangements and this standard does not permit the use of the proportionate method of consolidation.

Notwithstanding the fact that much of the work of the IASB has been to remove alternative accounting treatments, there are still accounting standards that offer reporting entities options to account for various items. For example, IAS 16 Property, Plant and Equipment permits a reporting entity to value its property, plant and equipment (non-current tangible assets) using either the cost model or the revaluation model. IFRS 3 Business Combinations permits non-controlling interests to be valued at either fair value or at the fair value of the identifiable assets and liabilities (resulting in 'full' goodwill or 'proportionate' goodwill on the part of the parent).

An important point to emphasize in the introduction section to Frequently Asked Questions in IFRS is the fact that IFRSs do not override local legislation governing the issue of financial statements in a particular jurisdiction. In addition, the IASB does not have the power to mandate the use of IFRS on any jurisdiction; regulators in different countries are left to decide whether or not to adopt IFRS as that particular country's financial reporting framework.

Notwithstanding the fact that the EU is the most notorious constituency to adopt the use of IFRS, there are also a number of other commercially developed countries that have already adopted IFRS as their financial reporting framework, or are in the process of adopting:

- Australia adopted IFRS with effect from 2005.
- Canada replaced Canadian GAAP for 'publicly accountable' entities for accounting periods commencing on or after 1 January 2011.

- Japan approved a roadmap for adoption of IFRS and a decision is still being deliberated.
- Banks in Russia, Ukraine, Kazakhstan and the United Arab Emirates.
- A convergence project is currently underway in Indonesia and a transition over to IFRS.
- From 2012, Mexico requires all listed companies to report under IFRS.

There are still many countries that do not permit IFRS at present, but many (if not all) countries are aware of its existence and its primary objective of allowing access to more capital markets.

The country that seems to hold the key to the vast majority of countries converging to IFRS is the United States. The US Securities and Exchange Commission (US SEC) is a prominent member of the International Organisation of Securities Commissions (IOSCO). The members of IOSCO are securities commissions and other stock exchange regulators. The global harmonization of financial reporting standards has been high on their agenda for quite some time. The US has been reluctant to adopt IFRS because of the major gaps between IFRS and US GAAP; however, the IASB and the US standard-setters (the Financial Accounting Standards Board (FASB)) are working together in an attempt to come to an agreement so that eventually the US may eventually adopt IFRS. This will be a huge step forward, and may prompt many other countries to adopt the use of IFRS.

## Chapter 1

# What is the Role of the International Accounting Standards Board (IASB)?

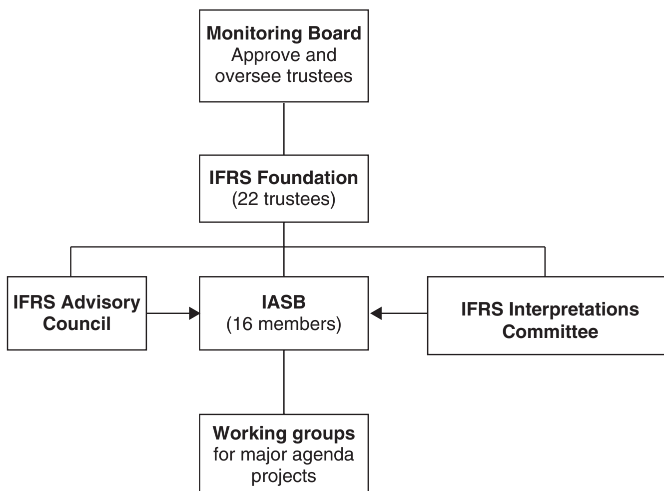
## What exactly does the IASB do and what are its objectives?

## Answer

The IASB was previously known as the International Accounting Standards Committee (IASC) until April 2001, when it became the IASB.

The IASC was originally set up in 1973 and was the sole body to have both responsibility and authority to issue international accounting standards. In 2001, when the IASB took over responsibility for international financial reporting, it took on all of the IASC's standards (which were all prefixed with 'IAS' – e.g. IAS 2 Inventories, IAS 10 Events After the Reporting Period). The IASB amended many of the standards, but then began to issue its own standards, which were known as International Financial Reporting Standards (IFRS). This is why you see standards prefixed with IAS (IASC standards) and IFRS (IASB standards). The term 'IFRS' has become a somewhat generic term that refers to all the standards (both IAS and IFRS).

The setup of the IASB is as follows:



**Monitoring Board**

The Monitoring Board has been subject to criticism over the years because of its lack of accountability and lack of responsiveness to the concerns of its constituent members. However, the responsibilities of the monitoring board are to oversee the IFRS Foundation trustees, participate in the trustee nomination process and approve appointments of new trustees.

It also has responsibility to review and provide advice to the trustees on the fulfilment of their responsibilities: there is an obligation for the trustees to report, on an annual basis, to the Monitoring Board. The Monitoring Board also has the authority to request meetings with the trustees, or separately with the chairs of the trustees and the IASB, to discuss any area of the trustees' or IASB's work.

**IFRS Foundation**

The 22 trustees within the IFRS Foundation act under the terms of the IFRS Foundation Constitution. It is a requirement of this constitution that in order to ensure a broad international basis, the Foundation must comprise of:

- six trustees that are appointed from Asia/Oceania regions;
- six trustees that are appointed from Europe;
- six trustees that are appointed from North America;
- one trustee that is appointed from Africa;
- one trustee that is appointed from South America; and
- two trustees that are appointed from any area, but this is subject to the Foundation maintaining an overall geographical balance.

The IFRS Foundation oversees the IASB, and in addition the trustees appoint members of the:

- IASB;
- IFRS Advisory Council; and
- Interpretations Committee.

Other responsibilities include monitoring the IASB's effectiveness, securing funding and approving the IASB's budgets.

**IASB**

The IASB comprises 16 members (of whom only three may be part-time) that are appointed for a term of three to five years. The IASB has overall responsibility for all technical matters, which include:

- preparing and issuing IFRSs;
- preparation, and issuance, of exposure drafts;
- setting up procedures for reviewing comments received on documents that have been published for comment; and
- issuing bases for conclusions.

It is expected that by July 2012, the IASB will comprise of the following:

- four members from Asia/Oceania;
- four members from Europe;
- four members from North America;
- one member from Africa;
- one member from South America; and
- two members appointed from any area (subject to the IASB retaining overall geographical balance).

Each member of the IASB has one vote and the approval of ten members is required for exposure drafts to be issued as discussion or as the final standard. If there are fewer than 16 members of the IASB, approval by at least nine members is required.

**IFRS Advisory Council**

There are approximately 40 members appointed to Council by the trustees for a renewable term of three years. Each member has a diverse geographic and functional background.

Council provides a forum for participation by organizations and those individuals that have an interest in international financial reporting. It meets at least three times a year and its primary responsibilities include:

- advising the board on agenda decisions and priorities;
- giving advice to the trustees and the board; and
- passing on the views of the council members on the major standard-setting projects.

Ultimately, IFRSs are the basis of international financial reporting and must be complied with in their entirety; in other words, financial statements can never be prepared using a mix of IFRSs and national accounting standards. There are several steps involved in the creation of an IFRS, which include:

1. Setting the agenda.
2. Planning the project.
3. Developing and publishing a discussion paper.
4. Developing and publishing an exposure draft.
5. Developing and publishing an IFRS.
6. Procedures after the IFRS is published.

Clearly, once a standard has been published, that is not necessarily the end of the line. There is often a need to amend a standard for a variety of reasons, and any necessary (but not urgent) changes are incorporated within the IASB's Annual Improvements Project. There are generally two types of amendments required to an IFRS/IAS:

- To clarify a standard due to ambiguous wording or because of unintentional gaps within the standard itself.
- To correct a minor (and unintended) consequence, conflict resolution, and to deal with any oversights. It is important to emphasize that the correction does not introduce, or change, the existing principles contained within the standard.

However, in situations when the amendment is considered priority, the IFRS interpretations committee will deal with such issues. IFRS interpretations committee does not issue standalone standards, but it is important to point out that IFRICs are authoritative. There are seven steps that IFRS interpretations committee must follow to achieve transparency and consistency:

1. Identify the issue(s).
2. Set an agenda.
3. Hold the IFRIC meeting and vote.
4. Draft an interpretation.
5. IASB release the draft interpretation.
6. Allow the comment period and deliberation process to take place.
7. IASB release the interpretation.

## Chapter 2

# Frequently Asked Questions

# 1. What is the Conceptual Framework?

Consistency and comparability are at the heart of preparing general purpose financial statements, and over the years many authorities have attempted to officially define the purpose of accounting. The provision of a 'coherent and consistent foundation for the development of accounting standards' was a study carried out in 1940 by Paton and Littleton, and the intention was to provide an accounting framework that would do just that.

## Answer

The truth of the matter is that financial reporting has evolved considerably – not necessarily from the position it was at, say, 100 years ago, but even in modern times. It is true to say that the information conveyed in financial statements is indeed more detailed than it was possibly even ten years ago, which is a legacy of today's globalization of business and the increased access to the global capital markets.

The definition of a *Conceptual Framework* is essentially a framework that contains a set of generally accepted theoretical principles that form the basis of new reporting practices (such as the introduction of a new IFRS) or evaluation of existing practices (such as when an IFRS is amended). The theoretical basis for a *Conceptual Framework* must keep in mind the overarching principle that the financial reporting process must be able to provide information to the user of the financial statements that allows them to make rational, informed and economic decisions.

It follows, therefore, that a *Conceptual Framework* – whilst being theoretical in nature – has a very practical objective in mind.

In 1989, the IASB's *Framework for the Preparation and Presentation of Financial Statements* was published. It was derived from the US Financial Accounting Standards Board (FASB) framework, which had been developed and published much earlier.

In September 2010, the IASB issued the *Conceptual Framework for Financial Reporting 2010* (referred to as the *Conceptual Framework*). This current version of the *Conceptual Framework* is still in the stages of being developed and at the time of writing currently comprised two chapters that were developed in the first phase of a project between the IASB and the FASB to develop an agreed framework. The 2010 *Conceptual Framework* will have four chapters, comprising:

- Chapter 1 – The objective of general purpose financial reporting.
- Chapter 2 – The reporting entity (this chapter was in the process of development at the time of writing – check www.ifrs.org for up-to-date details).
- Chapter 3 – Qualitative characteristics of useful financial information.
- Chapter 4 – The 1989 framework: the remaining text.

It is important to emphasize that while the *Conceptual Framework* is clearly the 'backbone' of IFRS, as it assists in the development and evaluation of IFRSs, the *Conceptual Framework* itself does not have the force of an accounting standard. Where conflicts arise between the *Conceptual Framework* and an accounting standard, the accounting standard will always prevail.

The overall purpose of the *Conceptual Framework* is to:

- assist the IASB in developing future IFRSs and evaluating (and amending) existing ones;
- assist the IASB to promote global harmonization of regulations, accounting standards and procedures in

attempts to provide a basis for the number of differing accounting treatments provided for in IFRS;
- assist national standard-setters in developing their own accounting standards;
- assist preparers of financial statements to apply IFRS and also deal with issues that are currently not covered by an IFRS;
- provide assistance to auditors to form an opinion as to whether the financial statements of a reporting entity comply with IFRS; and
- provide those who are interested in the work of the IASB with information as to the IASB's approach in the formulation of IFRSs.

It is important that preparers of financial statements are aware of the overall objective of financial reporting that is contained within Chapter 1 of the *Conceptual Framework*. Paragraph CF.OB2 defines the objective of general purpose financial reporting as being:

> '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.'
>
> [CF.OB2]

# 2. What are the qualitative characteristics of financial statements?

## Answer

The 'qualitative characteristics' of financial statements are contained within the IASB's *Conceptual Framework*, which recognizes that financial information must contain two 'fundamental qualitative characteristics' and four 'enhancing characteristics'.

The two fundamental qualitative characteristics are:

- relevance; and
- faithful representation.

These are supplemented by the enhancing characteristics, which are:

- comparability;
- verifiability;
- timeliness; and
- understandability.

**Relevance**
Financial information is relevant when it is capable of making a difference to the decisions made by the user(s) of the financial statements. The *Conceptual Framework* identifies that financial information is capable of making a difference in the decisions of users if it has 'predictive' or 'confirmatory' value, or both.

Financial information will have predictive value if it can be used as an input to processes employed by users that will predict future outcomes. This need not be a prediction or

forecast, but instead is a tool adopted by users to make their own predictions. Financial information has confirmatory value when it confirms, or changes, previous evaluations (for example by confirming a previously estimated outcome).

**Example**

Gabriella Garment Co. has seen the value of its revenue fall in the last three years and operates in an industry where it is forecast that the turbulent economic times will continue and inevitably see more companies in Gabriella's industry cease trading.

The declining revenue in the financial statements for the current and comparative year (together with industry speculation) can be used as a prediction that revenue will continue to fall. Should revenue continue to fall as predicted, then the financial statements will have confirmatory value.

As a consequence, it should be appreciated that both predictive and confirmatory value are very much interrelated.

**Materiality**

The *Conceptual Framework* also includes materiality as a 'subsection' of relevance. An item is *material* if its omission (or misstatement) may cause the user of the financial statements to arrive at an incorrect conclusion. The *Conceptual Framework* regards materiality as very much an 'entity-specific' matter of relevance that is to be based on the nature or magnitude (or both) of items to which the information relates to in an entity's financial statements. Due to materiality being an 'entity-specific' matter, it is impossible for the IASB to specify quantitative thresholds for materiality or pre-determine what could be material in a given situation.

**Faithful representation**

When financial statements are prepared they must be useful to the user of them. Faithful representation contains three characteristics, hence financial statements must be:

- complete;
- neutral; and
- free from error or bias.

The term 'free from error' does not imply that the financial statements are completely accurate in all respects. It implies that there are no errors or omissions in the description of the economic phenomenon being depicted or in the selection or application of the process used to produce the financial statements.

**Comparability**

Users of financial information need to be able to compare financial information so that they arrive at an informed decision as to whether to make, or sell, an investment. As a consequence, financial information is more useful if it can be compared with similar financial information about other entities, or about the same entity from one period to another.

**Verifiability**

Verifiability means that different, knowledgeable users of the financial statements could reach consensus, although the *Conceptual Framework* recognizes that such users may not reach complete agreement. It goes on to say that a range of possible amounts and related probabilities can also be verified [CF.QC26].

**Timeliness**

Financial statements prepared at a year or period end are often prepared some time after the year or period end. Timeliness means that information is available to users of financial

statements in time so that they can make their decisions. It is widely understood that the older the financial information, the less useful it is. Conversely, financial information may need to be timely long after the end of the reporting period, for example to assess trends.

**Understandability**

Information is made understandable when it is classified, characterized and presented in a clear and concise manner. Financial information should not be omitted from the financial statements just because it is too complex; when this information is complex, it might be the case that the user should seek specialist advice to assist them.

# 3. What are the elements of the financial statements?

## Answer

There are generally four sets of elements to a complete set of general purpose financial statements, which include:

- assets;
- liabilities;
- equity; and
- income and expenses.

The elements of the financial statements are all defined in the IASB's *Conceptual Framework* and the section of the *Conceptual Framework* that deals with the elements of a set of general-purpose financial statements are derived from the FASB equivalent.

**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.'
>
> [CF.4.4(a)]

While the definitions of the elements are derived from the FASB equivalent, it is important to note that the definition of an asset refers to resources that are 'controlled' by the entity. The FASB's definition of an asset refers to benefits that are 'obtained and controlled'.

Many individuals or entities regard an asset as something that an entity **owns**. However, nowhere in the definition will you find the word 'own' or 'ownership'. This is because the

principles work on the basis of control and from which future economic benefits are expected to flow to the enterprise. 'Future economic benefits' refer to items of property, near cash (such as debtors/receivables), or cash itself – in other words, that an asset will generate another asset for the reporting entity.

**Liabilities**

Liabilities are defined in the IASB's *Conceptual Framework* as:

> 'a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.'
>
> [CF.4.4(b)]

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* is built on the principle of a liability in that an entity can only recognize a provision within the financial statements if it essentially has a liability that meets specified criteria. This is to prevent reporting entities from inappropriately recognizing provisions or creating 'big bath provisions' to manipulate profits or losses.

Assets and liabilities are characterized as 'rights and obligations': in other words, 'rights' to receive future economic benefits and 'obligations' to transfer out economic benefits in the form of cash outflows.

**Equity**

The *Conceptual Framework* defines equity as 'the residual interest in the assets of the entity after deducting all its liabilities' [CF.4.4(c)].

The logic here is that a company takes all of its assets (non-current and current), and deducts all of its liabilities (non-current and current) – the result is the entity's equity.

**Income and expenses**

The *Conceptual Framework* defines income and assets with regard to changes in assets and liabilities as follows:

> 'Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
>
> 'Expenses 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.'
>
> [CF.4.25].

Income can represent revenue from sales of goods or services, interest, royalties and dividends. It is also worth pointing out that 'gains' are not the same as revenue. Gains are one-off transactions (such as the disposal of a building), but for the purposes of the *Conceptual Framework* they represent increases in economic benefits and as such are not different in nature from revenue, so they are not regarded as constituting a separate element in this *Conceptual Framework* [CF.4.30].

In terms of losses, the *Conceptual Framework* recognizes that these may or may not arise in the ordinary course of business. It acknowledges that losses may arise, for example, due to natural disaster, fire and flood, and also recognizes losses in the context of unrealized losses, for example those arising from the effects of increases in the rate of exchange for a foreign currency [CF.4.35]. The *Conceptual Framework* requires such losses to be displayed separately, because knowledge of them is useful for the purposes of decision making. In addition, the *Conceptual Framework* also requires losses to be reported net of related income [CF.4.35].

**Recognition and measurement**

The *Conceptual Framework* requires that an asset is recognized if 'it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably' [CF.4.38]. Conversely, a liability is recognized 'when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably' [CF.4.46].

Measurement is defined in the *Conceptual Framework* as:

> 'the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet and income statement. This involves the selection of the particular basis of measurement.'
>
> [CF.4.54]

This recognition and measurement criteria means that an item may meet part of the asset recognition test, but not necessarily be recognized. In such cases, disclosure will be necessary [CF.4.41].

# 4. Can you change accounting policies and, if so, how do you do it?

## Answer

Accounting policies are essentially the backbone for the preparation of an entity's financial statements. Accounting policies (and changes in estimates and error correction) are dealt with in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

The selection of appropriate accounting policies is a critical issue for reporting entities and, as such, entities must ensure that the accounting policies they select will enable the financial statements to present fairly the financial affairs of the reporting entity. ('Present fairly' is also known as 'give a true and fair view'.) IAS 8 does permit a reporting entity to change an accounting policy, but only in limited circumstances. A reporting entity can change an accounting policy if the change:

- is required by an IFRS; or
- results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows [IAS 8.14].

IAS 8 also addresses changes in an entity's accounting policy which arise from three sources:

- the initial application (including early application) of an IFRS containing specific transitional provisions;
- the initial application of an IFRS that does not contain specific transitional provisions; and
- voluntary changes in accounting policy.

When an entity changes an accounting policy, it does so retrospectively. In other words, it must apply that change to the

earliest period reported in the financial statements (usually the comparative year) so that the financial statements reflect the revised accounting policy as if that revised policy had always been in existence, so as to achieve consistency. The opening retained earnings figure must be restated and the comparative year should be clearly headed up 'as restated'.

**Example**

A company changes the way it values closing inventory for the year ending 31 December 2012 from a first-in, first-out basis to average cost. The company has calculated that the inventory for the year ended 31 December 2011 would have been C10,000 less had this policy been in operation during that year.

A change in the way a company values inventory is a change in accounting policy and therefore must be applied retrospectively. In order to do this, the previous year's comparative must be restated so as to reflect the revised policy, as if this revised policy had always been in operation. This is achieved as follows:

| | |
|---|---|
| Credit inventory | (C10,000) |
| Debit retained earnings | C10,000 |

Additional disclosures are also required to be made in the notes to the financial statements and the disclosures required depend on the nature of the change in accounting policy.

If the accounting policy has arisen because of initial application of an IFRS, the following disclosures must be made:

- the title of the IFRS;
- when applicable, that the change in accounting policy is made in accordance with its transitional provisions;
- the nature of the change in accounting policy;

- where applicable, a description of the transitional provisions;
- when applicable, the transitional provisions that might have an effect on future periods;
- for the current and each prior period presented, to the extent practicable, the amount of the adjustment:
  - for each financial statement line item affected; and
  - if IAS 33 *Earnings per Share* applies to the entity, for basic and diluted earnings per share;
- the amount of the adjustment relating to periods before those presented, to the extent practicable; and
- if retrospective application required by IAS 8 is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

When an entity voluntarily changes an accounting policy because the entity views the change to give more relevant and reliable financial information, the following disclosures should be made in the notes to the financial statements:

- the nature of the change in accounting policy;
- the reasons why applying the new accounting policy provides reliable and more relevant information;
- for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:
  - for each financial statement line item affected; and
  - if IAS 33 applies to the entity, for basic and diluted earnings per share;
- the amount of the adjustment relating to periods before those presented, to the extent practicable; and
- if retrospective application is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

# 5. What are accounting estimates and how are these accounted for?

## Answer

All financial statements will contain some degree of estimation; for example, inventory provisions and general bad debt provisions. Accounting estimates are a fundamental feature of financial reporting and they reflect the uncertainties inherent in business activities.

IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* is the accounting standard that governs accounting estimates and the standard contains various examples of what it classes as an accounting estimate:

- bad debts;
- inventory obsolescence;
- the fair value of financial assets or financial liabilities;
- the useful lives of, or expected pattern of consumption of the future economic benefits embodied in, depreciable assets; and
- warranty obligations [IAS 8.32–8.33].

The examples of accounting estimates cited in IAS 8 are not by any means exhaustive, and there would be other examples of accounting estimates that may be entity-specific; for example, post-retirement benefits.

Unlike a change in accounting policy, when an entity changes an accounting estimate it applies this change *prospectively*; in other words, going forward, and no retrospective application to previous periods is required.

**Example**

Breary Brick Co. has always depreciated its motor vehicles using a 25% reducing balance (also known as 'diminishing balance') method of depreciation. In 2012, the company decides that it is going to change the way it depreciates motor vehicles from 25% reducing balance to three years on a straight-line basis, as the directors feel this is more representative of the manner in which the company consumes the vehicles.

A change in depreciation method is a change in accounting estimate and, as such, Breary Brick Co. will apply this change from 2012 onwards. It will not go back and restate the 2011 comparative financial statements because it is not a change in accounting policy.

When a reporting entity changes an accounting estimate, IAS 8 requires disclosure of the nature and amount of the change in the accounting estimate, and an estimate of the effect the change has had in the current period or is expected to have an effect in future periods – except for the disclosure of the effect on future periods when it is impracticable to estimate that effect [IAS 8.39]. If the amount of the effect in future periods is not disclosed because estimating it is impracticable, the entity should disclose that fact [IAS 8.40].

IAS 8 also deals with the correction of prior period errors. Errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of the financial statements, and the standard itself addresses the issue that financial statements do not comply with IFRS if they contain errors that are:

- material; or
- immaterial, but are made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows [IAS 8.41].

When an error is discovered and the error is material, IAS 8 requires that it is corrected in the first set of financial statements prepared after its discovery [IAS 8.42]. The correction itself should be excluded from profit or loss for the period in which the error is discovered and the error is corrected by:

- restating the comparative amounts for the prior period(s) presented in which the error occurred; or
- if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented [IAS 8.42].

# 6. What is defined as current and non-current under IFRS?

## Answer

The distinction between 'current' and 'non-current' assets and liabilities is dealt with in IAS 1 *Presentation of Financial Statements*. This particular standard requires a reporting entity to make the distinction between current and non-current assets and liabilities.

The term 'current' is taken to mean that assets will be realized and liabilities will be settled within 12 months from the reporting date. 'Non-current' is taken to mean that assets will be realized and liabilities will be settled after more than 12 months from the reporting date.

Non-current assets will include items such as:

- tangible and intangible assets used in the business;
- investment property;
- long-term investments; and
- goodwill.

Current assets will include items such as:

- current asset investments;
- inventories;
- receivables; and
- cash and cash equivalents.

Non-current liabilities will include items such as:

- long-term element of loans/finance; and
- deferred tax liabilities.

Current liabilities will include items such as:

- trade and other payables;
- short-term provisions;
- short-term element of loans/finance; and
- income tax expense.

IAS 1 explains that the requirement to present current and non-current items separately by observing that when an entity supplies goods or services within a clearly identifiable operating cycle, separate classification of current and non-current assets and liabilities on the face of the balance sheet (statement of financial position) will distinguish the net assets that are continuously circulating as working capital from those used in long-term operations. IAS 1 also states that the 'operating cycle' of an entity is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. However, when the entity's normal operating cycle is not clearly identifiable, it is assumed to be 12 months [IAS 1.68, 70].

Current and non-current items are displayed separately on the face of an entity's balance sheet (statement of financial position) and IAS 1 defines current assets and current liabilities, with the non-current category being the residual [IAS 1.66, 69].

However, there are some transactions that are not as straightforward; for example, where entities have the discretion to refinance, or roll over an obligation for 12 months after the reporting period under an existing loan agreement. In such cases, IAS 1 requires the entity to class such an obligation as non-current, even if it would otherwise fall due within a shorter period. Conversely, where such obligations are not at the discretion of the reporting entity, such an obligation would therefore be classified as current.

**Example**

Don's Dart Club has seen membership declining over recent years and is currently experiencing severe cash flow restrictions. It has a bank loan and the club has defaulted on the loan. The terms of the loan agreement state that if the conditions are breached, the loan will become immediately repayable. Don's Dart Club has a year end of 31 December 2012 and on 31 March 2013, the bank agreed not to demand immediate repayment. The financial statements were approved on 1 April 2013.

IAS 1 says that where a loan agreement has been breached and there is the potential for the lender to require immediate payment, the loan must be classified as current. This is because the reporting entity does not have an unconditional right to defer settlement for at least 12 months after the reporting period, regardless of the fact that the lender may agree not to demand immediate repayment after the end of the reporting period but before the financial statements are authorized for issue as a consequence of the breach [IAS 1.74].

**Example**

Lucas Lighting Co.

Balance sheet as at 31 December 2012

| | 2012<br>C | 2011<br>C |
|---|---|---|
| **ASSETS** | | |
| **Non-current assets** | X | X |
| Property, plant and equipment | X | X |
| Goodwill | X | X |
| Other intangible assets | X | X |

| | | |
|---|---|---|
| Investments in associates | X | X |
| Available-for-sale investments | X | X |
| | X | X |
| **Current assets** | | |
| Inventories | | |
| Trade receivables | | |
| Other current assets | | |
| Cash and cash equivalents | X | X |
| | X | X |
| **Total assets** | **X** | **X** |
| **EQUITY AND LIABILITIES** | | |
| **Equity attributable to owners of the parent** | | |
| Share capital | X | X |
| Retained earnings | X | X |
| Other reserves | X | X |
| | X | X |
| **Non-controlling interests** | X | X |
| **Total equity** | X | X |
| **Non-current liabilities** | | |
| Long-term borrowings | X | X |
| Deferred tax | X | X |
| Long-term provisions | X | X |
| **Total non-current liabilities** | X | X |
| **Current liabilities** | | |
| Trade and other payables | X | X |
| Short-term borrowings | X | X |
| Current portion of long-term borrowings | X | X |
| Current tax payable | X | X |
| Short-term provisions | X | X |
| **Total current liabilities** | X | X |
| **Total liabilities** | X | X |
| **Total equity and liabilities** | **X** | **X** |

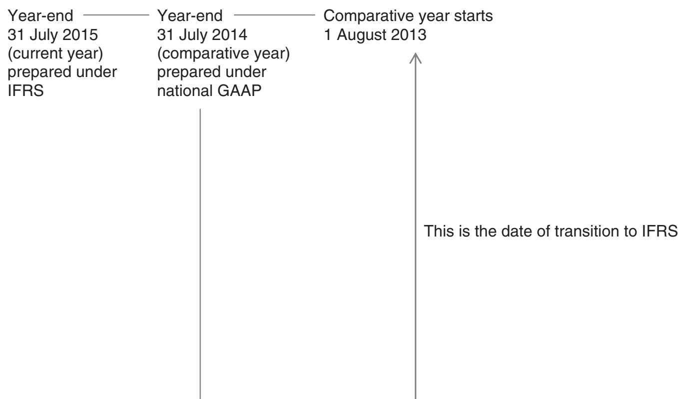
# 7. What happens when an entity adopts IFRS for the first time?

## Answer

First-time adoption of IFRS is dealt with in the aptly named IFRS 1 *First-time Adoption of International Financial Reporting Standards*. The principle aim of this standard is to ensure that a company adopting IFRS for the first time produces financial statements and interim financial statements that provide high-quality and transparent information, where the cost of producing this information does not outweigh the benefits.

**Determine the date of transition to IFRS**

The first thing to do is to identify the date of transition to IFRS. It is important to emphasize that the date of transition is *not* the first day of the accounting period in which the company switches to IFRS; the date of transition is the first day of the *earliest* period reported in the financial statements, which can be illustrated as follows:



From the diagram we can see that we need to go back to the *earliest* period reported in the financial statements (the 2014 comparative year) and restate those financial statements so the date of transition – and thus the trial balance, which will need to be restated to accord with IFRS – is the 1 August 2013 trial balance (the 2013 closing trial balance, essentially).

**Consider the accounting policies**

When an entity is planning to migrate to IFRS for the first time, it needs to consider the accounting policies it has chosen. This is because what is permissible in national accounting standards, may not be permissible under IFRS, as the following table shows:

| Accounting policy | Under some national GAAP | Under IFRS |
|---|---|---|
| Recognition of a defined benefit pension plan surplus or deficit | An entity cannot bring a defined benefit pension plan surplus or deficit onto the balance sheet (statement of financial position). | IAS 19 *Employee Benefits* requires that an entity recognizes such a surplus or deficit. |
| Recognition of deferred tax assets or liabilities | An entity does not recognize a deferred tax asset or liability, since this is not necessary under the 'timing difference' approach. | IAS 12 *Income Taxes* requires that an entity recognize deferred tax assets and liabilities. |
| Recognition of intangible non-current assets | An entity writes off the cost of intangible assets to the profit and loss account (income statement), for example where training costs are incurred – these are not recognized as an intangible non-current asset. | IAS 38 *Intangible Assets* requires that an entity recognize items of expenditure as an intangible non-current asset if it meets the recognition criteria. |

*(continued overleaf)*

| Accounting policy | Under some national GAAP | Under IFRS |
|---|---|---|
| Share-based payment transactions | An entity does not recognize the expense arising on a share-based payment transaction. | IFRS 2 *Share-based Payment* requires an entity dealing in share-based payments to reflect the effect of such payments in the profit and loss account (income statement). |
| Provisions for liabilities when a legal or constructive obligation exists | An entity does not recognize a 'constructive' obligation, only a legal obligation. | IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires an entity to recognize both legal and constructive obligations that fulfil the recognition criteria of a provision. |
| Assets and liabilities in respect of finance leases | An entity does not recognize finance leases and instead writes off all leasing payments to the profit and loss account (income statement). | IAS 17 *Leases* requires that an entity capitalizes an asset obtained under a finance lease and recognize a corresponding lease creditor in the balance sheet (statement of financial position). |
| Borrowing costs | An entity can choose not to capitalize borrowing costs on qualifying assets. | IAS 23 *Borrowing Costs* requires an entity to capitalize such costs. |
| Transaction costs of buying another company | An entity can include transaction costs such as legal fees and accountancy fees for due diligence in respect of buying another company in the cost of the transaction. | IFRS 3 *Business Combinations* requires an entity to expense such costs immediately. |

| Accounting policy | Under some national GAAP | Under IFRS |
|---|---|---|
| Statement of cash flows | An entity may be exempt from preparing and presenting a statement of cash flows in the primary financial statements. | IAS 1 *Presentation of Financial Statements* requires an entity to produce a statement of cash flows. |
| Valuation of inventories | An entity may adopt the use of the last-in, first-out (LIFO) cost methodology of valuing its inventories. | IAS 2 *Inventories* only permits the first-in, first-out (FIFO) method of valuation or average cost (AVCO). LIFO is strictly prohibited. |
| Goodwill | Goodwill is amortized under some national standards over its estimated useful economic life. | IFRS 3 requires goodwill in respect of a business combination to be tested annually for impairment. IFRS therefore prohibits the amortization of goodwill. |

**Recognize and derecognize assets and liabilities**

Once an entity has considered its accounting policies and revised where necessary, it should then recognize assets and liabilities permitted under IFRS and derecognize any previously recognized assets and liabilities that are not permitted to be recognized under IFRS. Such assets and liabilities are recognized or derecognized as appropriate in the opening IFRS balance sheet.

**Example**

Gabriella Gardening Co. prepared its previous year's financial statements to national accounting standards.

From 1 January 2012 it has decided to report under IFRS and will be producing year end financial statements to 31 December 2012.

National accounting standards permit the costs of staff training to be capitalized in an entity's balance sheet as an intangible non-current asset.

Gabriella Gardening Co. cannot capitalize such training costs under the provisions in IAS 38 *Intangible Assets* – instead they must be written off directly to profit or loss as they are incurred. IFRS 1 requires an entity to derecognize items as assets or liabilities if IFRS does not permit such recognition. In this instance, the company must derecognize and expense the training costs as follows:

- credit intangible assets; and
- debit retained earnings.

A first-time adopter should also recognize all assets and liabilities that are required to be recognized by IFRS, even if they were never recognized under its own national accounting standards, such as:

- Derivative financial assets and liabilities, which also include embedded derivatives.
- Recognition of a liability in respect of employee benefits to be paid in the future under IAS 19 *Employee Benefits*.
- Provisions for liabilities such as restructuring provisions, onerous contracts, decommissioning provisions and warranties.

**Reclassification**

A first-time adopter will also need to reclassify its previous GAAP opening balance sheet into appropriate IFRS classification. For example:

- Dividends declared, or proposed, after the reporting date cannot be recognized as a liability at the reporting date. If such a practice was permissible under national accounting standards, it would be reversed in the opening IFRS balance sheet.
- If national accounting standards had permitted treasury stock (where a company repurchases its own shares), and which had been reported as an asset, this would be reclassified as a component of equity in the opening IFRS balance sheet.
- If a first-time adopter had issued preference shares that contained a debt component and an equity component, and these shares had all been recognized within equity under national accounting standards, the entity would have to adopt the use of 'split accounting' and recognize the debt component in liabilities, while the equity component would be recognized within equity.
- Items previously reported as intangible assets due to a business combination, may have to be reclassified to goodwill because they may not meet the recognition criteria as an intangible asset under IAS 38 *Intangible Assets*.

**Comprehensive example**

Alicia Architraves Ltd is a company that is registered in the United Kingdom and has a reporting date of 30 June 2012. From 1 July 2011 it decided to report under IFRS. The opening balance sheet as at 1 July 2010 (the date of transition to IFRS), together with supporting information is as follows. Note the formats used are those laid down in the UK's Companies Act 2006 and, as such, do not accord with the layout prescribed in IAS 1 *Presentation of Financial Statements* – this example is to merely show the effect of transition to IFRS on an opening balance sheet (statement of financial position):

| | | £ |
|---|---|---|
| Fixed assets | | |
| Goodwill | Note 1 | 390,000 |
| Property, plant and equipment | Note 2 | 386,000 |
| | | 776,000 |

| | | |
|---|---|---|
| Current assets | | |
| Stock | Note 3 | 14,500 |
| Trade and other debtors | | 600,000 |
| Cash and cash equivalents | | 290,000 |
| | | 904,500 |
| Creditors: due within one year | | |
| Trade and other payables | | 425,000 |
| Net current assets | | 479,500 |
| Total assets less current liabilities | | 1,255,500 |
| Creditors: due in more than one year | | |
| Loans | | 116,000 |
| Provisions for Liabilities | | |
| Deferred tax | Note 4 | 20,000 |
| NET ASSETS | | 1,119,500 |
| Capital and reserves | | |
| Called up share capital | | 1000 |
| Profit and loss account | | 1,118,500 |
| | | 1,119,500 |

### Notes

1. Goodwill was recognized in respect of a purchase of a subsidiary and the directors have carried out an impairment test, which revealed the goodwill is only considered to have a recoverable amount of $130,000.
2. Property, plant and equipment includes a building that was revalued on 1 July 2010. The valuation of the building amounted to $200,000 and the directors wish to use this valuation as the building's deemed cost at the date of transition to IFRS.
3. The company has always valued its stock using the last-in, first-out (LIFO) method. Because this method is not permitted in IAS 2 *Inventories*, the directors have decided to

use average cost (AVCO), which has produced a stock valuation as at 1 July 2010 of $10,370.

4. The company's accounting policy in respect of deferred tax is to discount the deferred tax balances to present day values. If discounting had not been used, the deferred tax liability as at 1 July 2010 would have been $24,000. IAS 12 *Income Taxes* prohibits the discounting of deferred tax balances to present day values.

Part of the process of transition from UK GAAP to IFRS would involve closely scrutinizing the accounting policies and determining those that are permissible under IFRS and those that are not. In respect of Alicia Architraves Ltd, the issues in points 1–4 above would be dealt with as follows:

1. The recoverable amount of goodwill has been calculated as $130,000, and is currently carried in the opening balance sheet at $390,000. This means that the goodwill needs to be written down by an amount of $260,000 as follows:

| | |
|---|---|
| CR goodwill | $260,000 |
| DR retained earnings (reserves) | $260,000 |

2. In accordance with IFRS 1, a first-time adopter is permitted to use the revalued amount as deemed cost, so the building can be included in the opening IFRS balance sheet at $200,000.
3. As LIFO is not permitted as a cost valuation method under IAS 2, the directors must write down the value of its inventory in the opening balance sheet as follows:

| | |
|---|---|
| Inventory valuation under LIFO | $14,500 |
| Revised valuation under AVCO | ($10,370) |
| Inventory write-down | $4130 |

4. IAS 12 prohibits the discounting of deferred tax balances to present day values, so an adjustment to the deferred tax liability is required as follows:

| | |
|---|---|
| Deferred tax per UK GAAP | £20,000 |
| Effects of discounting | £4000 |
| Revised deferred tax balance | £24,000 |

Having revised the accounting policies to conform to the new standard, the following shows the effect that the transition to IFRS has had on the opening balance sheet of Alicia Architrave Ltd as at 1 July 2010:

**Alicia Architraves Ltd**
**Reconciliation of Opening Equity as at 1 July 2010**

| | **UK GAAP** £ | **Transitional Effect** £ | **IFRS** £ |
|---|---|---|---|
| **Fixed assets** | | | |
| Goodwill | 390,000 | (260,000) | 130,000 |
| Property, plant and equip. | 386,000 | | 386,000 |
| | 776,000 | (260,000) | 516,000 |
| **Current assets** | | | |
| Stock | 14,500 | (4130) | 10,370 |
| Trade/other debtors | 600,000 | | 600,000 |
| Cash/cash equivalents | 290,000 | | 290,000 |
| | 904,500 | (4130) | 900,370 |
| **Current liabilities** | | | |
| Trade/other creditors | 425,000 | | 425,000 |
| **Net current assets** | 479,500 | (4130) | 475,370 |
| **Total assets less current liabilities** | 1,255,500 | (264,130) | 991,370 |

| | | | |
|---|---|---|---|
| **Non-current liabilities** | | | |
| Loans | 116,000 | | 116,000 |
| **Provisions for Liabilities** | | | |
| Deferred tax | 20,000 | 4000 | 24,000 |
| | 136,000 | 4000 | 140,000 |
| **NET ASSETS** | **1,119,500** | **(268,130)** | **851,370** |
| **Capital and reserves** | | | |
| Called up share capital | 1000 | | 1000 |
| Profit and loss account | 1,118,500 | (268,130) | 850,370 |
| | **1,119,500** | **(268,130)** | **851,370** |

**Disclosures**

A first-time adopter is required to present the following:

- Reconciliations of its equity reported under previous GAAP to its equity under IFRSs at:
  - the date of transition to IFRSs; and
  - the end of the latest period presented in the entity's most recent annual financial statements under previous GAAP;
- A reconciliation to its total comprehensive income under IFRSs for the latest period in the entity's most recent annual financial statements. The starting point for that reconciliation should be total comprehensive income under previous GAAP for the same period or, if an entity did not report such a total, profit or loss under previous GAAP.
- An explanation of the material adjustments to the statement of cash flows, if it presented one under its previous GAAP.

**Other reporting aspects**

IAS 1 requires at least one year of comparative information be presented within a complete set of general purpose financial statements prepared under IFRS, and a first-time adopter's first financial statements prepared to IFRS will have to include at least:

- three balance sheets (statements of financial position);
- two statements of comprehensive income;
- two separate income statements (if presented);
- two statements of cash flows;
- two statements of changes in equity; and
- related notes, including comparative information.

# 8. What happens when one company acquires another company?

## Answer

When one company acquires another company, this is referred to as a 'business combination'. Business combinations are dealt with in IFRS 3 *Business Combinations*. Appendix A to IFRS 3 defines a business combination as a 'transaction or other event in which an acquirer obtains control of one or more businesses'.

It is worth emphasizing the changes to IFRSs relating to business combinations, and a summary is as follows:

- IFRS 10 *Consolidated Financial Statements* – this IFRS supersedes the requirements for consolidated financial statements in IAS 27 and is applicable for annual periods commencing on or after 1 January 2013. As a consequence of the issuance of IFRS 10, IAS 27 has been renamed *Separate Financial Statements*.
- IAS 28 *Investments in Associates* – this has been renamed *Investments in Associates and Joint Ventures*.
- IAS 31 *Interests in Joint Ventures* – this standard has been replaced by IFRS 11 *Joint Arrangements* and there are consequential changes to IAS 28 (above).
- IFRS 12 *Disclosure of Interests in Other Entities* – this IFRS replaces the disclosure requirements in the current versions of IAS 27, IAS 28 and IAS 31, and applies to annual periods commencing on or after 1 January 2013.

In 2008, IFRS 3 was significantly revised as follows:

- The scope was broadened to cover business combinations involving mutual entities and business combinations achieved by contract alone (i.e. without consideration).

- The definitions of a business and a business combination were amended and additional guidance was added for identifying when a group of assets constitutes a business.
- For each business combination, the acquirer may measure any non-controlling interest in the acquiree either at fair value or as the non-controlling interest's proportionate share of the acquiree's net identifiable assets. Previously, only the latter was permitted.
- The requirements for how the acquirer makes any classifications, designations or assessments for the identifiable assets acquired and liabilities assumed in a business combination were clarified.
- The period during which changes to deferred tax benefits acquired in a business combination can be adjusted against goodwill has been limited to the measurement period through a consequential amendment to IAS 12 *Income Taxes*.
- An acquirer is no longer permitted to recognize contingencies acquired in a business combination that do not meet the definition of a liability.
- Costs that the acquirer incurs in connection with the business combination must be accounted for separately from the business combination, which generally means that the costs will be written off to profit or loss as opposed to being recognized within goodwill.
- Consideration, including contingent consideration, transferred by the acquirer must be measured and recognized at fair value at the date of acquisition. Any subsequent changes in the fair value of contingent consideration that has been classified as a liability are recognized in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, or other IFRSs as applicable as opposed to adjusting goodwill.
- Application guidance was added to the revised IFRS 3 in relation to when the acquirer is obliged to replace the acquiree's share-based payment awards; measuring indemnification assets; rights sold previously that are reacquired in a business combination; operating leases; and

valuation allowances related to financial assets such as receivables and loans.
- For business combinations achieved in stages, having the acquisition date as the single measurement date was extended so as to include the measurement of goodwill. The consequence of this is that the acquirer must remeasure any equity interest it holds in the acquiree immediately before achieving control at its acquisition date fair value, and recognize the resulting gain or loss, where applicable, in profit or loss.

**Stages in a business combination**
The first stage is to identify a business combination. IFRS 3 defines a business combination as a 'transaction or other event in which an acquirer obtains control of one or more businesses'. There is a variety of ways in which an acquirer obtains control over a business, such as:

- transferring cash, cash equivalents or other assets to the acquiree;
- incurring liabilities;
- issuing equity interests;
- providing more than one type of consideration; or
- without transferring consideration – by contract alone.

Once a business combination has been identified, IFRS 3 requires the use of the 'acquisition method' of accounting for such combinations. This method of accounting has four stages to it:

- identify an acquirer;
- determine the date of acquisition;
- recognize and measure the identifiable assets acquired, liabilities assumed and any non-controlling interests in the acquiree; and
- recognize and measure goodwill, or a gain in a bargain purchase.

**Identifying an acquirer**

The acquirer in a business combination is the entity that obtains control of the acquiree. Control, in the context of IFRS, is 'the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities' [IFRS 3.7 Appendix A]. Usually control is obtained by the acquirer when the acquirer obtains more than 50% of the voting rights, or net assets, in an acquiree. However, this quantitative threshold is not absolute and control can be obtained by other measures, such as the acquirer's ability to direct the operating and financial policies of the business, or if the acquirer has the ability to appoint the majority of board members or control the decision making of an entity.

**Determine the date of acquisition**

The date of acquisition is the date on which the acquirer obtains control of the acquiree. This is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree (i.e. the 'completion date'). If a written agreement is in place that provides that the acquirer obtains control of the acquiree on a date before the date that the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquire, the date of acquisition may precede the completion date.

**Recognize and measure the identifiable assets acquired, liabilities assumed and any non-controlling interests in the acquiree**

Such assets and liabilities are recognized at the date of acquisition and are measured at fair values as at that date. Any non-controlling interests in the acquiree is recognized at the date of acquisition. Any non-controlling interests that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event that the entity is liquidated can be measured using one of two bases:

- at fair value; or
- at the non-controlling interest's proportionate share of the acquiree's net identifiable assets.

Any other components of non-controlling interests are measured at their acquisition date fair values, unless another basis is required under IFRS.

Assets acquired and liabilities assumed can only be recognized if it is:

- an asset or liability at the date of acquisition; and
- part of the acquiree rather than the result of a separate transaction.

In some cases it might the case that an acquirer can recognize some assets and liabilities that had not previously been recognized in the acquiree's financial statements; for example, internally generated brand names, patents or customer relationships.

**Recognize and measure goodwill**
The final stage in a business combination is to recognize and measure goodwill. The principles contained in IFRS 3 define goodwill in terms of its nature rather than its measurement. IFRS 3 defines goodwill as: '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 Appendix A].

The calculation of goodwill is fairly straightforward, as demonstrated below:

**(a)** The aggregate of:
  (i) the consideration transferred (measured at acquisition-date fair value);
  (ii) the amount of any non-controlling interest in the acquiree; and

(iii) the acquisition date fair value of the acquirer's previously held equity interest in the acquiree.

**(b)** The net of the acquisition date fair values of the identifiable assets acquired and liabilities assumed.

The excess of (a) and (b) is goodwill.

### Example

Charlotte Group acquires an 80% interest in the net assets of Leah Corp for C250 million. At the date of acquisition, the fair value of the net assets of Leah Corp amount to C250 million and the fair value of the non-controlling interests in Leah Corp amount to C50 million. Goodwill is calculated as follows:

| | **Cm** | **Cm** |
|---|---|---|
| Amount of Leah Corp identifiable net assets | | 250 |
| Less: | | |
| Fair value of the consideration transferred | 250 | |
| Fair value of non-controlling interests in Leah Corp | 50 | |
| | | 300 |
| Goodwill on acquisition | | 50 |

After initial recognition, goodwill is never amortized. Instead, the acquirer has to test it for impairment annually, or more frequently when events or changes in circumstances indicate that goodwill may be impaired. IAS 36 *Impairment of Assets* deals with the impairment aspects.

**Recognize and measure a gain in a bargain purchase**

Where the net assets acquired in a business combination are in excess of the consideration transferred (i.e. where (b) exceeds (a) above), this results in 'negative' goodwill.

Acquirers must not simply just recognize negative goodwill on the consolidated statement of financial position (balance

sheet); instead, acquirers must reassess all components of the goodwill calculation to ensure that measurements are all based on available information at the date of acquisition. This will entail ensuring that the acquirer has correctly identified all of the assets acquired and liabilities assumed, and does not have to recognize any additional assets or liabilities. Once this exercise is complete, the acquirer must then undertake a review of the procedures used to measure the following:

- the identifiable assets acquired and liabilities assumed;
- the non-controlling interest in the acquiree, if any;
- for a business combination achieved in stages, the acquirer's previously held equity interest in the acquiree; and
- the consideration transferred.

Following these exercises, should an excess of net assets acquired over consideration transferred still remain, the gain is recognized by the acquirer in profit or loss on the date of acquisition. All of the gain is attributed to the acquirer.

**Example**

Charlotte Group acquires an 80% interest in the net assets of Leah Corp for C250 million. At the date of acquisition, the fair value of the net assets of Leah Corp amount to C250 million and the fair value of the non-controlling interests in Leah Corp amount to C50 million. Goodwill is calculated as follows:

| | Cm | Cm |
|---|---|---|
| Amount of Leah Corp identifiable net assets | | 200 |
| Less: | | |
| Fair value of the consideration transferred | 150 | |
| Fair value of non-controlling interests in Aidan Corp | 40 | |
| | | 190 |
| Gain on bargain purchase of 80% interest in Leah Corp | | 10 |

# 9. What are step acquisitions?

## Answer

If a company acquires an interest in another company in several stages, rather than in one go, this is known as a 'step' acquisition. They are also referred to as 'piecemeal acquisitions' or 'acquired on the step'.

An investment is carried on the statement of financial position (balance sheet) at cost, or this cost may be replaced by a share of net assets in a subsidiary and goodwill. A parent/subsidiary relationship occurs when control is obtained by the parent over the subsidiary.

Following the revision of IFRS 3 *Business Combinations* in 2008, it is now a requirement that any previous shareholding during a step acquisition is remeasured to fair value at the date that the parent acquires either significant influence in an associate or control of a subsidiary; hence goodwill is only calculated once the parent obtains control.

There is no impact on profit or loss, or goodwill, when a parent obtains more shares in a subsidiary.

**Example**

The Breary Group PLC acquired 75% of Slevin Limited several years ago for C90,000 when the fair value of Slevin's net assets was C100,000. The fair value of the non-controlling interests at the date of acquisition was C28,000 and, since the initial date of acquisition, the fair value of Slevin's net assets has increased by C30,000. On 1 January 2012, the Breary Group acquired a further 15% of shares for C21,000.

There is no impact on profit or loss, or goodwill, because the Breary Group has simply obtained more of the

non-controlling interests in a previously recognized subsidiary. The initial goodwill is calculated as follows:

| | C |
|---|---|
| Fair value of consideration for 75% control | 90,000 |
| Non-controlling interests at fair value | 28,000 |
| Fair value of net assets of Slevin Ltd | (100,000) |
| Goodwill | 18,000 |

The impact on the non-controlling interests is as follows:

| | C |
|---|---|
| Previous non-controlling interests C28,000 + (C30,000 × 25%) | 35,500 |
| Transfer to the Breary Group PLC (15%/25% × C35,500) | (21,300) |
| Remaining non-controlling interests | 14,200 |

**Investment to subsidiary**

When an investment becomes a subsidiary through a step acquisition, the previous shareholding is treated as if it were disposed of and then reacquired at the acquisition date at fair value. Any resulting gain or loss on the remeasurement is included in profit or loss.

Any change in the value of the investment that had been previously reported within 'other comprehensive income' is not reported in profit or loss under IFRS 9 *Financial Instruments*.

**Illustration**

| 1 January 2000 → | 1 January 2009 → | 1 January 2013 |
|---|---|---|
| Entity A acquires a 15% holding in Entity B | Entity A acquires a further 60% holding in Entity B | Entity B becomes a wholly owned subsidiary of Entity A |

**Example**

Norah, Inc. (Norah) acquired 75% of Stella, Inc. (Stella) in two stages. Initially, 15% was acquired several years ago for C10,000; this investment was classified as 'fair value through other comprehensive income'. A fair value gain has been reported in other comprehensive income amounting to C2000. On 1 January 2012, Norah acquired a further 60% for C60,000 and on this date the net assets of Stella were C80,000. The Norah Group has a policy that all non-controlling interests are measured at their share of Stella's net assets, and on 1 January 2012 the fair value of the 15% holding was C12,500.

The accounting for this step acquisition is twofold: first, we need to consider the impact on 'other comprehensive income'; second, we have to consider the impact on goodwill.

**Other comprehensive income**

On acquisition, Norah will recognize a further gain of C500 (this is the increase in fair value from the previous valuation to the date of acquisition). The C2000 previously recognized in other comprehensive income will not be reclassified to profit or loss.

**Goodwill**

This is calculated as follows:

| | **C** |
|---|---|
| Fair value of 60% acquisition | 60,000 |
| Non-controlling interests (C80,000 × 25%) | 20,000 |
| Fair value of previously recognized 15% | 12,500 |
| Fair value of net assets of Stella | (80,000) |
| Goodwill | 12,500 |

**Associate to subsidiary**

Associates are accounted for under IAS 28 *Investments in Associates and Joint Ventures*. When the investor acquires further shares in the associate that take the associate into subsidiary status, it is presumed that the previous investment(s) was/were disposed of and then remeasured at acquisition date fair value. Where there is a difference between the previous carrying amount and the remeasured fair value, such differences are recognized within profit or loss at the date of acquisition. Goodwill is then calculated.

**Example**

Judith, Inc. (Judith) acquires 75% control of Graham, Inc. (Graham) in two stages. The first 40% was acquired several years ago for C50,000 when the fair value of Graham's net assets was C90,000. Since this shareholding was acquired, Judith has recognized C7000-worth of post-acquisition profit and C2000 of revaluation gain relating to a property. The carrying amount is therefore C59,000. On 1 January 2013, Judith obtained a further 35% in Graham for C65,000. At this date the net assets in Graham were C120,000 and the fair value of the non-controlling interests were C30,000. On 1 January 2013 the fair value of the 40% holding was C60,000.

On acquisition, Judith will recognize a gain of C1000 (being the difference between the carrying amount of C59,000 and the remeasured fair value of C60,000). The revaluation gain of C2000 is not reclassified because this gain would not be reclassified on disposal. Goodwill is calculated as follows:

| | C |
|---|---|
| Fair value of consideration for 35% | 65,000 |
| Non-controlling interest at fair value | 30,000 |
| Fair value of previous 40% holding | 60,000 |
| Fair value of the net assets in Graham | (120,000) |
| Goodwill | 35,000 |

The *key principle* underpinning this concept is the triggering of remeasurement of goodwill.

# 10. What are deemed disposals in business combinations?

## Answer

There are situations that arise when a group may reduce its percentage interest as a result of a 'deemed' disposal. This is when ownership interests reduce, but not because of a disposal in the traditional 'money changes hands' fashion. A deemed disposal may arise, *inter alia*, where:

- the group does not take up its full allocation of rights in a rights issue;
- the group does not take up its full share of a scrip dividend;
- another party exercises its options or warrants; or
- the subsidiary issues shares to other non-group parties.

Deemed disposals have the same effect as changes in ownership due to disposal, hence should be accounted for in the same way.

**Example**

The Whitaker Group owns 600,000 of the one million shares in Heaton Enterprises, hence a 60% holding. Heaton Enterprises' net assets in the consolidated financial statements of The Whitaker Group are C100 million. When The Whitaker Group acquired Heaton Enterprises, goodwill amounting to C12 million arose, which has not suffered any impairment. Heaton Enterprises issues a further 500,000 shares to a third party investor for C90 million, resulting in The Whitaker Group's share falling from 60% to (600,000 shares / 1.5 million shares) 40%. Because of this fall, Heaton Enterprises is no longer a subsidiary because The Whitaker Group's ownership is less than 51% but more than 20%:

therefore, Heaton Enterprises becomes an associate of The Whitaker Group. The reduction in ownership by 20% is essentially a deemed disposal and the resulting gain or loss can be calculated as follows:

| | **Cm** |
|---|---|
| The Whitaker Group's effective interest in Heaton Enterprises following the share issue* | 84 |
| Less The Whitaker Group's effective interest in Heaton before Heaton's share issue** | (72) |
| Gain in Whitaker Group's statement of comprehensive income | 12 |

*40% × (C100m net assets + C90m cash raised by the share issue) = C76m + C8m goodwill (C12m × 40 / 60) = C84m.
**60% × C100m original net assets = C60m + C12m goodwill = C72m.

There may be occasions when a deemed disposal occurs but the parent may still retain control – this is sometimes referred to as a 'deemed partial disposal'.

**Example**

Using the example above, The Whitaker Group owns 600,000 of the 1 million shares issued in Heaton Enterprises, resulting in a 60% interest. Heaton Enterprises then issues a further 90,909 shares to a third party for C17 million.

In this example, The Whitaker Group's interest in Heaton Enterprises is diluted from 60% to (600,000 / 1,090,909) 55%. The Whitaker Group therefore still controls Heaton Enterprises, because its holding is more than 50%; therefore, Heaton Enterprises is still a subsidiary of The Whitaker Group.

What The Whitaker Group will do is to account for this deemed disposal as a transaction between shareholders. The Whitaker Group will not recognize any gain or loss, and will not adjust any goodwill previously recognized on the acquisition of Heaton Enterprises. The journals will be:

| | **Debit Cm** | **Credit Cm** |
|---|---|---|
| Cash at bank | 17 | |
| Non-controlling interest* | | 12.65 |
| Equity | | 4.35 |

*Previously the non-controlling interests were 40%, so 40% × C100m = C40m. Non-controlling interests are now 45%, because The Whitaker Group's holding has reduced following the share issue, so:
45% × C117m (C100m net assets + C17m proceeds from the share issue) = C52.65m.
Therefore, C52.65m less C40m is an increase of C12.65m.

# 11. Why are consolidated financial statements prepared and how do these differ from separate financial statements?

## Answer

Consolidated financial statements are produced when there is a parent–subsidiary relationship. In other words, the consolidated financial statements will present the results of both parent and subsidiary as if the group was a single economic entity. The overall objective of consolidated financial statements, therefore, is to show the group (parent and subsidiary/subsidiaries) in line with its substance, which is that of a single economic entity.

The principles relating to consolidated financial statements are dealt with in IFRS 10 *Consolidated Financial Statements*. This was a new standard issued in 2011; previously, consolidation issues were dealt with in IAS 27 *Consolidated and Separate Financial Statements*, which was renamed IAS 27 *Separate Financial Statements* following the issuance of IFRS 10.

The separate financial statements of the parent will contain the investment in the subsidiary/subsidiaries, illustrated as follows:

**Example**

On 1 January 2013, Susan PLC (Susan) obtained an 80% shareholding in James PLC (James). On that date, the issued share capital of James was C100,000 ordinary C1 shares and retained earnings were C200,000. Susan paid C125,000 for the 80% holding.

In Susan's individual financial statements, the investment will be shown as follows:

**Susan PLC**

**Statement of financial position (extract) as at 31 December 2013**

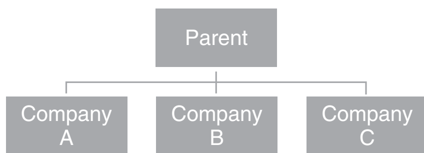
| | **2013** | **2012** |
|---|---|---|
| | **C** | **C** |
| **Non-current assets** | | |
| Investment in James | 125,000 | – |

It is clear from the example above that a parent–subsidiary relationship is triggered by the fact that Susan has obtained an 80% stake in James, because for control to be obtained, the investor must obtain a share of more than 50%. However, there are examples where a holding of less than 50% can still lead to control being triggered – hence a parent–subsidiary relationship, and hence consolidated financial statements. This may be because the parent has:

- the power over more than 50% of the voting rights by virtue of agreement with other investors;
- the power to govern the financial and operating policies of the entity under statute or agreement;
- the power to appoint or remove the majority of the members of the board of directors; or
- the power to cast the majority of the votes at the meetings of the board of directors.

**Intra-group trading**

As discussed above, the idea of consolidated financial statements is that they present the financial results of the group as if it were a single reporting entity. This can be illustrated as follows:




In this group structure the Parent will prepare its own financial statements, and so will Companies A, B and C. Assume for the purposes of this illustration that the Parent controls all three companies; then, consolidated financial statements will be prepared that combine the results of Companies A, B and C with those of its Parent.

There are many situations when members of a group will trade with each other. For example, in the above illustration, it may be that the Parent sells goods to Company A, and Company A may buy goods from Company C. An important principle that governs the way in which consolidated financial statements are prepared is the fact that consolidated financial statements must show the group as a *single* reporting entity – in other words, only the financial results due to trading with the outside world. For this reason, all intra-group trading (and the effects of intra-group trading) are eliminated during the consolidation process.

**Example**

The Josie Group of Companies is the parent of Josie's Jelly Tots, a children's nursery. It has two subsidiary companies, Byrne Ltd (Byrne) and Weaver Ltd (Weaver). The group's year end is 31 December 2012 and during the year the following intra-group transactions occurred:

- 14 March 2012: Josie's Jelly Tots provided services to Byrne for C20,000.
- 20 October 2012: Byrne sold goods to Weaver for C10,000.
- 31 December 2012: Josie's Jelly Tots bought goods from Weaver for C16,000 and paid for these on 12 January 2013.

The fact that each company has recorded a sale and a purchase in their individual books and records is correct at individual company level. However, for the purposes of consolidated financial statements, any intra-group sales and purchases are merely intra-group transfers and not, in substance, a genuine sale. Such sales only become a sale when they are sold on to unconnected third parties, i.e. the customers of the group. The above transactions are eliminated as follows:

**Transaction on 14 March 2012**

Josie's Jelly Tots will reduce revenue by C20,000 and Byrne will reduce purchases (cost of sales) by C20,000.

**Transaction on 20 October 2012**

Byrne will reduce revenue by C10,000 and Weaver will reduce purchases (cost of sales) by C10,000.

**Transaction on 31 December 2012**

This transaction is twofold. Not only has there been an intra-group sale and purchase, but the 'effects' of this transaction are also an intra-group receivable and an intra-group payable (because Josie's Jelly Tots did not pay for the goods until after the year end).

Firstly, Josie's Jelly Tots will reduce its purchases (cost of sales) by C16,000 and Weaver will reduce revenue by

C16,000. However, on consolidation, receivables must also be reduced by C16,000 (to reduce Weaver's receivables balance brought in from their individual financial statements) and similarly, payables must also be reduced by C16,000 (to reduce Josie's Jelly Tots' payables balance brought in from their individual financial statements).

The principles of consolidation show the group's financial results from its trading with the outside world, not trading with other group members. If intra-group trading (and the effects thereof) were not eliminated from the consolidated financial statements, the consolidated financial statements would report higher revenues and expenses, as well as higher receivables and higher payables – which would mislead the user of the consolidated financial statements.

**Unrealized profit in inventory**

It is widely known that when members of a group trade with each other, the selling member will clearly 'sell' goods to the purchasing member at a profit. For example, the parent company will sell goods that cost C10 to a subsidiary company for, say, C20. If these goods (or part of these goods) remain in the purchasing member's inventory at the year or period end, this element of 'unrealized' profit must also be eliminated so as to accord with the principles in IAS 2 *Inventories*, which state that inventory must be valued at the lower of cost or net realizable value. To accord with such principles, unrealized profits in inventory are eliminated to bring inventory back down to cost to the group.

**Example**

Diane PLC (Diane) is the parent of a group with a year end of 31 December 2012. On 1 December 2012, Diane sold goods to Stewart Ltd (Stewart) that cost C15,000 for

C25,000. On 31 December 2012, all of these goods remained unsold by Stewart and were included in Stewart's inventory.

For individual financial statements purposes, it is perfectly acceptable for Stewart to include the unsold inventory at a value of C25,000 because that is what it cost Stewart. However, for consolidation purposes, if the value of this unsold inventory were included at a value of C25,000, this would include the element of unrealized profit. As a consequence, the unrealized profit on the sale of the goods must be eliminated as follows:

| | | |
|---|---|---|
| CR | Inventory in the consolidated statement of financial position | C10,000 |
| DR | Inventory in the consolidated statement of profit or loss | C10,000 |

This entry will bring the inventory valuation back down to cost to the group.

If, on the other hand, only half of the goods sold by Diane to Stewart were included in Stewart's inventory at the year end, then clearly the unrealized profit would only be C5000 because the other half of the goods will have been sold to customers outside of the group structure.

**Goodwill**

As discussed earlier, the individual financial statements of the parent will include the investment in the subsidiary/subsidiaries. On consolidation, this investment is eliminated from the parent's statement of financial position and is replaced by goodwill. IFRS 3 *Business Combinations* allows two permissible methods of calculating goodwill:

- the 'full' method of goodwill (also referred to as the 'gross' method); or
- the 'proportionate' method.

Under the full method, we include the fair value of the non-controlling interests in the goodwill calculation, as follows:

| | C |
|---|---|
| Fair value of consideration transferred | X |
| Fair value of non-controlling interest | X |
| Fair value of net assets at the date of acquisition | (X) |
| Goodwill on acquisition | X |

Under the proportionate method, we only recognize our share of the goodwill as follows:

| | |
|---|---|
| Cost of investment* | X |
| Less parent share of net assets acquired | (X) |
| Goodwill on acquisition | X |

*This is the cost of the investment figure that would appear in the parent's individual financial statements.

**Example**

Smyth Ltd acquired an 80% holding in Beele Ltd for a consideration of C100,000 on 31 December 2011. On that date, the fair value of the non-controlling interests was C20,000 and the fair value of the net assets of Beele was C90,000. At the year end of 31 December 2012, the net assets of Beele were C120,000.

Under the full method, goodwill is calculated as follows:

| | C |
|---|---|
| Cost of investment | 100,000 |
| Fair value of non-controlling interests | 20,000 |
| | 120,000 |
| Fair value of net assets acquired | (90,000) |
| Gross goodwill | 30,000 |

The non-controlling interests at the year end is calculated by updating the fair value of the non-controlling interests at the date of acquisition by giving them their share of the post-acquisition profit (in other words, their share of the profit for the year ended 31 December 2012). These post-acquisition profits are the rise in net assets of Beele Ltd since the date of acquisition, calculated as follows:

| | C |
|---|---|
| On acquisition (31 December 2011) | 90,000 |
| Post acquisition (31 December 2012) | 120,000 |
| Profit for the year ended 31 December 2012 | 30,000 |

The non-controlling interests share of post acquisition profit is calculated as:

| | C |
|---|---|
| Fair value of non-controlling interest at acquisition | 20,000 |
| Plus share of post-acquisition profit (20% × C30,000) | 6000 |
| | 26,000 |

Under the proportionate method, the calculation for goodwill is:

| | C |
|---|---|
| Cost of investment | 100,000 |
| Net assets acquired (80% × C90,000) | (72,000) |
| Goodwill | 28,000 |

The non-controlling interests at the year end of 31 December 2012 is simply the non-controlling interests share of the year end net assets calculated as 20% × C120,000 = C24,000.

You can compare the effect of both the ‘full’ and ‘proportionate’ method as follows:

| | Goodwill | Non-controlling interest | Difference |
|---|---|---|---|
| Full method | C30,000 | C26,000 | C4000 |
| Proportionate method | C28,000 | C24,000 | C4000 |

It's no coincidence that the difference in the goodwill and non-controlling interests under both the new and the old method is C4000. This difference is simply the goodwill that belongs to the non-controlling interests and to put it in numerical terms:

| | |
|---|---|
| Fair value of the non-controlling interests of Beele Ltd at the date of acquisition (per scenario) | 20,000 |
| Non-controlling interests holding | × 20% |
| Goodwill attributable to the non-controlling interests | C4000 |

# 12. How is an associate defined under IFRS?

## Answer

Associates are dealt with in IAS 28 *Investments in Associates and Joint Ventures*, which was revised in 2011. The revised version is effective for accounting periods commencing on or after 1 January 2013. The previous version of IAS 28 was titled *Investments in Associates*.

An entity that makes an investment in an investee and obtains 20–50% of the voting rights in the investee is said to have obtained 'significant influence'. It is important to emphasize that 'control' is not obtained in such situations; hence there is no parent–subsidiary relationship. Significant influence is defined in IAS 28 at paragraph 3 as 'the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies'.

Therefore, it is clear from the definition of significant influence that control cannot be achieved through significant influence. However, bear in mind that there are situations when it can be clearly demonstrated that control has been obtained by the parent, despite the fact that the parent holds less than 51% of the voting rights (see Question 11).

It follows, therefore, that an entity has an associate when it has significant influence over the associate – but how is significant influence usually evidenced? Paragraph 6 of IAS 28 outlines five ways in which such influence can be evidenced:

- representation on the board of directors or equivalent governing body of the investee;
- participation in the policy-making process, including participation in decisions about dividends or other distributions;

- material transactions between the entity and the investee;
- interchange of managerial personnel; or
- provision of essential technical information.

**Example**

The Hill Corporation has issued share capital of 100,000 ordinary C1 shares. On 1 January 2013, the Bury Corporation agreed to purchase 40% of the share capital in exchange for a consideration of C40,000.

In the absence of any other information that would clearly demonstrate that control has been obtained by the Bury Corporation, the Hill Corporation would become an associate of the Bury Corporation because the Bury Corporation holds 20–50% of its share capital, thus giving the Bury Corporation significant influence over the Hill Corporation.

# 13. How do you account for an associate under IFRS?

## Answer

IAS 28 *Investments in Associates and Joint Ventures* is the standard that governs the way in which associates are accounted. As discussed in the previous chapter, an investor gains an associate when the investor has 'significant influence' over the investee. Significant influence is generally achieved with a holding of 20–50% of the net assets of the investee.

Once it has been determined that significant influence has been achieved, the basic principle of accounting for an associate is by way of the 'equity' method of accounting. Under this method, on initial recognition the investment is recognized at cost. The carrying amount of that investment is then subsequently increased or decreased to recognize the investor's share of the profit or loss of the investee after the date of acquisition. The investor's share of the investee's profit or loss is recognized in the investor's profit or loss.

An example of initial recognition and accounting for the investor's share in the investee's profit is shown below:

**Example**

On 31 December 2010, Indigo Investments invests a sum of C10,000 in Alicia Associates in return for a 25% holding in the voting rights of Alicia. On 31 December 2011, the resulting profit of Alicia Associates was C7000.

On 31 December 2010, Indigo Investments accounting entries will be:

| | |
|---|---|
| Credit cash at bank | C10,000 |
| Debit investment in associate | C10,000 |

This represents the initial investment in Alicia Associates.

Indigo Investments then needs to reflect its share of Alicia Associates' profit in its income statement (profit and loss account), so the entries in Indigo Investments' books will be:

| | |
|---|---|
| Debit investment in associate (25% × C7000) | C1750 |
| Credit income statement (profit and loss account) | C1750 |

**Dividends**

If the associate pays dividends to the investor – note that dividends are sometimes referred to as 'distributions' – then such dividends will reduce the carrying amount of the investment. Why? Well, dividends are essentially a return on investment; therefore, dividends from an associate are a return on the investor's initial investment. An example is as follows:

**Example**

Business Angels LLP obtains a 35% holding in Aspinall Associates at a cost of C80,000 on 31 December 2010. On 31 December 2011, the profit of Aspinall Associates was C70,000 and it had proposed a dividend (prior to the year end) amounting to C10,000.

The dividend is the return on Business Angels' investment. The investment of C80,000 is increased for Business Angels' share of the profit of C24,500 (C70,000 × 35%). The investment is then reduced by the value of the dividend paid by Aspinall Associates to Business Angels of C3500

(C10,000 × 35%) because this dividend represents a return on this investment, hence it decreases the investment's carrying value in Business Angels statement of financial position (balance sheet). Therefore, the carrying value of the investment in Business Angels' statement of financial position (balance sheet) as at 31 December 2011 is as follows:

| | C |
|---|---|
| Initial cost of investment in Aspinall Associates | 80,000 |
| Share of Business Angels' profit | 24,500 |
| Dividend received | (3500) |
| | 101,000 |

**Consolidated financial statements**
In the consolidated statement of financial position, the investor will:

- account for dividends payable/receivable fully in the individual financial statements; and
- include a receivable representing dividends owed to the investor from the associate(s)

However, the investor *will not* cancel inter-company balances for dividends because the associate is not part of the group – the associate is only an associate, not a subsidiary!

In the consolidated statement of profit or loss, the investor *does not* include dividends from the associate. It will include the parent's share of the associate's after tax profit under equity accounting as 'income from associate'.

**Loss-making associates**
If an associate makes a loss, the investor will recognize all losses until its share of the losses equals, or exceeds, its

interest in the associate, at which point the investor no longer recognizes its share of further losses.

**Example**

Alpine Investments invests C5 million in exchange for a 30% share of the equity of Alpha Associates on 1 April 2012. In addition, Alpine Investments also makes a loan to Alpha Associates of C9 million, which is unsecured, and Alpine Investments has not committed itself to any further funding. The financial statements of Alpha Associates Ltd as at 31 March 2013 show a loss of C20 million.

Alpine Investments' share of the C20 million loss is C6 million (C20m × 30%). If the loan to Alpha Associates is considered to be part of the investment in Alpha Associates, then the carrying amount of the associate will be reduced by C6 million from C14 million (C5m investment + C9m loan) to C8 million. (The ownership interest is reduced to nil and the loan is reduced to C8m.) However, if the loan is not considered to be part of the investment in Alpha Associates, Alpine Investments accounts for the loss as follows:

- The interest in Alpha Associates is reduced from C5 million to nil.
- A loss of C1 million (C5m less C6m) remains unrecognized because Alpine Investments did not provide any commitments to further funding.
- Because the associate is loss-making, this loss is an indicator of impairment. Alpine Investments should test the loan for impairment in accordance with IAS 36 *Impairment of Assets*.

**Goodwill**

In consolidated financial statements for a subsidiary, goodwill is always shown separately on the face of the consolidated

statement of financial position (balance sheet). However, when accounting for an associate, you don't show any goodwill separately, but instead it is included in the carrying amount of the investment, therefore:

> Carrying value = share of net assets at acquisition PLUS goodwill PLUS share of post-acquisition profit or loss

**Transactions between investor and associate**
Intra-group trading between investor and associate are *not* cancelled because associates are not subsidiaries and are therefore not consolidated. Also, in the consolidated statement of financial position (balance sheet), you *must* show balances with associates separately from other receivables (debtors) and payables (creditors). The associate is *not* part of the group, so you do not need to show amounts owed to the group by the associate as assets and amounts owed to the associate by the group as liabilities.

If the investor sells goods to the associate (downstream) and the associate still has these goods in inventory at the year end, the associate's carrying value of this inventory will include the profit element of the sale by the investor. This element of profit is *unrealized profit* and the investor must eliminate unrealized profits to the extent of the investor's interest in the associate.

A similar situation will arise if the associate makes a sale of goods to the investor (upstream). The investor has to eliminate unrealized profit on consolidation to avoid double-counting when equity accounting the associate.

Eliminating unrealized profit on unsold inventory is achieved by deducting the profit from the associate's pre-tax profit and retained earnings, regardless of whether the sale is from investor to associate or vice versa.

**Example**

Investors R Us owns a 40% share in Adams Associates. Investors R Us sold goods to Adams Associates for C200 that originally cost C150. All the goods remain in the inventory of Adams Associates at the year end.

The unrealized profit of C50 is eliminated by deducting C50 from the associate's pre-tax profit in the statement of profit or loss. The other side of the entry goes to retained earnings in the statement of financial position (balance sheet). The share of the net assets and post-acquisition profit is C20 (C50 × 40%) lower under equity accounting.

# 14. What are joint arrangements and joint ventures?

## Answer

IAS 28 *Investments in Associates and Joint Ventures* defines 'joint arrangements' and 'joint ventures' in paragraph 3 as follows:

**Joint arrangement**
An arrangement of which two or more parties have joint control.

**Joint venture**
A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

It is also worth pointing out that IAS 28.3 also defines:

- joint control; and
- joint venturer.

**Joint control**
The contractually agreed sharing of control of an arrangement that exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

**Joint venturer**
A party to a joint venture that has joint control of that joint venture.

IFRS 11 *Joint Arrangements*, which is effective for annual periods commencing on or after 1 January 2013, also contains the same definitions as above in Appendix A. IFRS 11 superseded SIC-13 *Jointly Controlled Entities – Non-Monetary Contributions by Venturers* and the core principles of this IFRS is to require

a party to a joint arrangement to determine the type of joint arrangement in which it is involved. The party does this by assessing its rights and obligations and accounts for those rights and obligations in accordance with the substance of the arrangement.

In addition to the definitions above, IFRS 11 also defines the following:

- joint operation;
- party to a joint arrangement; and
- separate vehicle.

**Joint operation**
A joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets and obligations for the liabilities relating to the arrangement.

**Party to a joint arrangement**
An entity that participates in a joint arrangement, regardless of whether that entity has joint control of the arrangement.

**Separate vehicle**
A separately identifiable financial structure, including separate legal entities or entities recognized by statute, regardless of whether those entities have a legal personality.

# 15. How do you account for a joint venture under IFRS?

## Answer

Under the revised IAS 28, an investor can only use the equity method of accounting for its investments in joint ventures. (The proportionate consolidation is outlawed in the revised IAS 28 effective for annual periods commencing on or after 1 January 2013.) Proportionate consolidation is therefore outside the scope of this publication.

The equity method of accounting for joint ventures is the same as that applied in equity accounting for associates. However, it is important to emphasize that IFRS 11 *Joint Arrangements* deals with the issue of accounting for joint ventures, and that this standard is effective for annual periods beginning on or after 1 January 2013.

IFRS 11 distinguishes between a joint operation and a joint venture. 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 [IFRS 11.15].

A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. Those parties are called joint venturers [IFRS 11.16].

**Example**

Liza and Johnny set up a joint venture (L&J Ventures). On 31 December 2011, Liza invests in 50% of L&J Ventures at a

cost of C100. In the statement of financial position in Liza's books, the accounting entries will be:

| | |
|---|---|
| CR cash | C100 |
| DR investments | C100 |

On 31 December 2012, the profit of L&J Ventures amounted to C60. Liza's share will be C30 (50% × C60); hence Liza will (a) debit the investment in the statement of financial position, and (b) credit 'share of profit of joint venture' in the statement of profit or loss with C30. The financial statements extracts will show:

| | |
|---|---|
| Statement of financial position (extract) at 31 December 2012 | |
| Investments (being initial investment of C100 plus share of profit of C30) | C130 |
| Statement of profit or loss at 31 December 2012 | |
| Share of profit of joint venture | C30 |

**Financial statements of parties involved in a joint arrangement**

*Joint operations* Where a joint operation is concerned, IFRS 11 requires a joint operator to recognize its interests in the joint operation by recognizing:

- 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 [IFRS 11.20].

***Joint ventures*** A joint venturer will recognize its interest in a joint venture as an investment and shall account for such an investment under the equity method as defined in IAS 28 *Investments in Associates and Joint Ventures* [IFRS 11.24].

In situations where the party participates in but does not have joint control of a joint venture, the investment is accounted for in accordance with IFRS 9 *Financial Instruments* unless it has significant influence over the joint venture. In such cases the joint venturer will account for the joint venture under IAS 28.

In the separate financial statements, a joint operator or joint venturer will account for its interest in a joint operation in accordance with paragraphs 20–22 of IFRS 11 and will account for a joint venture in accordance with paragraph 10 of IAS 27 *Separate Financial Statements* [IFRS 11.26].

If the entity is a party that participates in but does not have joint control of a joint arrangement, the entity will account for its interest in:

- a joint operation in accordance with paragraph 23 of IFRS 11; or
- a joint venture in accordance with IFRS 9 – unless the entity has significant influence over the joint venture, in which case it will apply the provisions in IAS 27 at paragraph 10.

# 16. How does an entity deal with exchange rate differences?

## Answer

Lots of companies will deal with fluctuations in exchange rates. For example, a company may purchase goods from a supplier that is located in a different country, or conversely a company may sell goods to customers that are located overseas. Whatever the situation a company faces, the accounting standard that deals with foreign exchange differences is IAS 21 *The Effects of Changes in Foreign Exchange Rates.* This standard deals with two issues:

- how to account for foreign currency transactions and operations in a set of financial statements; and
- translating financial statements into a presentation currency.

The history of IAS 21 dates back to the mid-1970s and has been amended a few times during its lifespan. There are some important definitions contained within the standard that need to be understood before discussing its main technical content; these are outlined in paragraph eight of IAS 21 as follows:

- **Functional currency:** The currency of the primary economic environment in which the entity operates.
- **Presentation currency:** The currency in which financial statements are presented.
- **Exchange difference:** The difference resulting from translating a given number of units of one currency into another currency at different exchange rates.
- **Foreign operation:** A subsidiary, associate, joint venture or branch whose activities are based in a country or currency other than that of the reporting entity.

When companies enter into foreign currency transactions, the transaction should be recorded initially at the rate of exchange on the date that the transaction took place. An

average exchange rate can be used under IAS 21, provided that it results in a reasonable approximation of the actual result.

At each subsequent reporting date:

- foreign currency monetary amounts should be reported using the closing rate (the rate at the date of the financial statements);
- non-monetary items carried at historical cost should be reported using the exchange rate at the date of the transaction; and
- non-monetary items carried at fair value should be reported at the rate that existed when the fair values were determined.

Exchange differences that arise when monetary items are settled, or where monetary items are translated at different rates from those at which they were translated on initial recognition, or in previous financial statements, must be reported in profit or loss in the period.

There is an exception to this basic principle that exchange differences are reported in profit or loss in the period they arise. The difference relates to a reporting entity's net investment in a foreign operation. Exchange differences that arise on monetary items that form part of the reporting entity's net investment in a foreign operation are recognized (in the consolidated financial statements that include the foreign operation) in other comprehensive income. Exchange differences are only recognized in profit or loss on disposal of the net investment.

**Translating functional currency into presentation currency**
Paragraph 39 of IAS 21 outlines the following procedures to translate functional currency into presentation currency:

- Assets and liabilities for each statement of financial position presented (including comparatives) are translated at the closing rate at the date of that statement of financial position. This would include any goodwill arising on the

acquisition of a foreign operation. Any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation are treated as part of the assets and liabilities of the foreign operation [IAS 21.47].
- Income and expenses for each statement of profit or loss (including comparatives) are translated at exchange rates at the dates of the transactions.
- All resulting exchange differences are recognized in other comprehensive income.

**Example**

Cahill Kayaks buys and sells kayaks and water sports equipment to the general public and outdoor sports companies. The company's major supplier is located overseas and invoices the company in euros. The company's year end is 31 December 2012 and on 30 September 2012 it placed an order with its supplier for the supply of ten canoes. The goods were delivered on 15 October 2012 and the invoice for €10,000 was received on 23 October 2012. The exchange rate on 23 October 2012 for €1 into C1 was 1.187.

The invoice is entered onto Cahill Kayak's purchase ledger at a value of (€10,000 / 1.187) C8424.60, because this is the exchange rate that was prevailing at the date of the transaction.

The year end of Cahill Kayak's is 31 December 2012 and if it is assumed that on this date the exchange rate was 1.180, this 'closing' rate is used to translate the closing payable. Hence in the statement of financial position, the supplier's purchase ledger balance will be translated to (€10,000 / 1.180) C8474.58. This will mean that there is a loss on exchange, which will be recognized in profit or loss, amounting to (C8424.60 – C8474.58) C49.98.

# 17. How and when does an entity recognize a non-current tangible asset?

## Answer

Non-current tangible assets are those assets within a company that have a physical substance; in other words, you can physically touch them. They can comprise of all kinds of assets, such as buildings, motor vehicles, computer equipment, and plant and machinery.

In the *Conceptual Framework*, the IASB defines an asset 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'. The main thrust of this definition does not imply ownership of an asset; instead, it implies that an asset is something that a company can exercise 'control' over and that future economic benefits must be expected.

An organization must be able to exercise control over an asset; in other words, it must be able to restrict the use of an asset, for example by storing inventories in a locked warehouse. The ability to control the asset is key in recognizing an asset in the financial statements. The costs of hiring employees cannot, for example, be recognized on the statement of financial position (balance sheet), because the organization cannot control those employees; they could leave at any time.

The accounting standard that governs the ways in which a tangible non-current asset is recognized in the statement of financial position (balance sheet) is IAS 16 *Property, Plant and Equipment*. IAS 16 specifies the recognition criteria of an item of property, plant and equipment; in order to recognize an item of property, plant and equipment as a tangible non-current asset, it must be probable that:

- future economic benefits associated with the asset will flow to the entity; and
- the cost of the asset can be measured reliably.

**Future economic benefits**

'Future economic benefits' essentially mean that the company will incur other assets such as cash, or near-cash items such as debtors. In other words, in the context of property, plant and equipment, 'future economic benefits' means that the tangible non-current asset will generate assets for the company.

**Example**

Lockland Chemical Co. is a manufacturer of fine chemicals for use in the chemical industry. It has a significant level of plant and machinery in its factory and the directors have just secured a large contract to supply fine chemicals to a company located in Europe. Demand for these products is going to be significantly high and in their present form, the current items of plant will not be able to produce the levels of output that will be required to meet the demands of the contract.

The directors have been in negotiations with one of the company's suppliers, which has managed to source an item of machinery that can produce significantly high levels of output in a much quicker period of time. This item of machinery will cost C20,000 and the directors anticipate that this machine will vastly improve production – not just for the new contract that it has just been awarded, but for existing customers as well.

Clearly this new item of plant will meet the recognition criteria of an asset under IAS 16. As such, the company will include this item of plant within the property, plant and equipment section of its statement of financial position

(balance sheet) at cost because it is clear that future economic benefits associated with ownership of this new item of plant will flow to the entity.

**Cost**

IAS 16 specifies the components of cost. Cost is not necessarily simply the purchase price of an asset – it includes other components, as follows:

- any irrecoverable taxes (such as import duty);
- any costs directly attributable to bringing the asset to its present location and condition (including professional costs); and
- present obligations for future costs (such as future costs to dismantle and restore a site).

**Example**

Concrete Creations overhauls patios and driveways by digging up and disposing of existing patios and driveways, laying new concrete, and finally putting a pattern on them as instructed by their customers, which involves the use of heavy duty machinery. The year end is 30 September 2012. Concrete Creations invested in a machine 15 years ago that dug up the original concrete, but this machine recently broke down beyond repair and the directors sourced a new and even better machine from a reputable distributor based in Spain. The supplier's invoice has been received dated 20 September 2012 and shows the following information:

| | |
|---|---|
| Cost of machine | €10,000 |
| Freight cost | €2000 |
| Import duty (not recoverable) | €1000 |

Management has also estimated that the annual maintenance costs amount to €200.

The cost of the machine is permissible for capitalization, as are the freight costs because (as per IAS 16) these are *directly attributable* to bringing the asset to its present location and condition. The import duty is not recoverable and IAS 16 permits the capitalization of such costs.

The maintenance charges are only estimates at €200 per annum. In addition, maintenance costs, by definition, are routine repairs and servicing costs, which IAS 16 specifically does not permit to be capitalized. These costs are written off to the statement of profit or loss as and when they are incurred. In addition, it is only ever an 'intention' by management to incur expenditure on servicing and maintenance, as opposed to an 'obligation'.

There are occasions when a company may incur small levels of expenditure on property, plant and equipment that would meet the recognition criteria, but fall below a company's monetary policy for recognition on the statement of financial position.

**Example**

A garage has several items of tools that it uses in its day-today work repairing and maintaining domestic and commercial vehicles. On 2 May 2012, it purchased a spanner for C15 for use in the garage. The company's accounting policy is not to capitalize any item that costs less than C300.

Clearly, this purchase is significantly under the capitalization threshold of the company, and it would make economic sense to write off the whole of the cost to profit or loss.

However, companies that make this sort of purchase may need to consider aggregating such small items and capitalizing them all in totality under one line item in the non-current assets register, because smaller items may become much more significant when they are all aggregated.

**Depreciation**

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. The depreciable amount of an asset is calculated as the cost of the asset, 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.

**Example**

Whitaker Enterprises purchases an item of machinery for C10,000 on 1 January 2012. The machine's estimated useful life is five years and the directors estimate that at the end of this useful life, the machine will have a residual value of C1000. Whitaker Enterprises' accounting policy for depreciating plant and machinery is a straight-line basis over the machine's useful economic life.

The depreciable amount is calculated as follows:

| | |
|---|---|
| Cost of the asset | C10,000 |
| Less estimated residual value | (C1000) |
| Depreciable amount | C9000 |

The annual depreciation charges are calculated as follows:

| | |
|---|---|
| Depreciable amount | C9000 ÷ |
| Useful economic life | 5 years |
| Annual depreciation charge | C1800 |

There is another well-known method of calculating depreciation called the 'reducing balance' method (sometimes referred to as the 'diminishing balance' method). This works on the basis that an item of property, plant and equipment will require less routine maintenance and servicing in the earlier years, while recognizing that more routine maintenance and servicing will be needed in later years. This is particularly the case with motor vehicles.

**Example**

Heaton Enterprises purchases a new motor vehicle for use in the business on 1 January 2012 for C18,000. The directors have estimated that this vehicle will have a zero residual value at the end of its useful economic life and Heaton Enterprises' accounting policy for depreciating motor vehicles is at a rate of 25% on the reducing balance method.

The depreciation charges in years one, two and three are calculated as follows:

| | |
|---|---|
| Year 1 | |
| Cost of vehicle | C18,000 |
| | × 25% |
| Depreciation charge – year 1 | C4500 |
| Net book value at end of year 1 | C13,500 |
| Year 2 | |
| Cost b/f | C13,500 |
| | × 25% |
| Depreciation charge – year 2 | C3375 |
| Net book value at end of year 2 | C10,125 |
| Year 3 | |
| Cost b/f | C10,125 |
| | × 25% |
| Depreciation charge – year 3 | C2531 |
| Net book value at end of year 3 | C7594 |

You can see, therefore, that using the reducing balance method means that more depreciation is charged in the earlier years than is charged in the later years. This reduction represents the fact that the company will have incurred more charges in the statement of profit or loss (profit and loss account) in respect of servicing and maintenance in the later years.

**Subsequent measurement**
An entity is required to measure its property, plant and equipment at cost. Cost, in the context of IAS 16, comprises:

- purchase price;
- import duties;
- non-refundable purchase taxes;
- costs directly attributable in bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended; and
- initial estimate of the costs of dismantling and removing the item, and restoring the site on which the asset is located (for example, in onerous contracts).

After initial recognition, an entity can choose between the 'cost model' and the 'revaluation model' for its subsequent accounting.

*Cost model* This is the most common and is illustrated in the examples above. After initial recognition, the asset is simply carried at its original cost less accumulated depreciation and less any amounts recognized in respect of impairment.

*Revaluation model* After initial recognition, the asset is carried at its fair value (sometimes referred to as 'market value'), with any increases or decreases in the fair value being recognized in other comprehensive income and accumulated in equity under the heading of 'revaluation surplus'. Any increases in fair value

shall only be recognized in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognized in profit or loss.

Where an entity adopts the revaluation model, it must apply this model to all assets in the same class.

**Example**

Westhead Trading purchases a building on 1 January 2010 for C100,000. It decides to carry this building using the revaluation model and its depreciation policy is to depreciate the building on a straight-line basis over 50 years (or 2% straight-line). The financial statements for the year ended 31 December 2012 are being prepared and the valuation agency have carried out a valuation on that date showing that the building has a market value of C105,000.

The net book value of the building as at 31 December 2011 would be:

| | |
|---|---|
| Cost at 1 January 2010 | C100,000 |
| Depreciation charge – 31 December 2010 | (C2000) |
| Depreciation charge – 31 December 2011 | (C2000) |
| Net book value at 31 December 2011 | C96,000 |

However, the valuation agency have said that the building is worth C105,000, so Westhead Trading's statement of financial position must show the value of the building at that carrying amount. Here are the entries that will need to be recorded in the books of Westhead Trading as at 31 December 2012:

| | |
|---|---|
| Debit building – cost | C5000 |
| Credit revaluation surplus | C5000 |
| *Being uplift of initial cost to valuation* | |
| Debit accumulated depreciation | C4000 |

| | |
|---|---|
| Credit revaluation surplus | C4000 |
| *Being reversal of accumulated depreciation* | |
| Credit depreciation charge | C2234 |
| Debit depreciation charge expense | C2234 |
| *Being depreciation charge for the year end 31 December 2012 (based on revalued amount over 47 years)* | |

The depreciation charge going forward will be based on the building's revalued amount, but the clock does not start again in relation to the building's useful economic life. At the end of 31 December 2012, it will still only have 47 years left to run.

# 18. What is the accounting treatment for non-current assets held for sale?

## Answer

In Question 17 I examined the principle of recognizing a tangible non-current asset on the statement of financial position (balance sheet) and how an entity subsequently accounts for such. There are many occasions when an entity will decide to sell an asset or a group of assets (referred to as a 'disposal group'). It is not, in fact, IAS 16 *Property, Plant and Equipment* that deals with such issues; it is covered by a separate IFRS, IFRS 5 *Non-Current Assets Held for Sale and Discontinued Operation.*

The objective of IFRS 5 is to specify how assets that qualify for and are treated as 'held for sale' should be presented and disclosed within a set of general purpose financial statements. The standard also deals with discontinued operations.

A non-current asset (or disposal group) that is held for sale must be up for sale in its present condition and the sale must be highly probable. In order for the sale to be classified as 'highly probable', there must be certain characteristics present:

- management must be committed to a plan to sell the asset;
- there must be an active programme of seeking a buyer;
- the asset (or disposal group) must be available for immediate sale;
- the sale is highly probable; and
- the sale is expected to complete within one year of the asset being classified as held for sale.

**Accounting treatment**

Where an asset (or disposal group) is classified as 'held for sale', depreciation of such asset(s) or disposal group(s) must cease as soon as classification as held for sale is met. The asset (or disposal group) must be carried in the statement of financial position (balance sheet) at the *lower* of the carrying amount in the statement of financial position and fair value less costs to sell. 'Fair value' is essentially how much could be received by knowledgeable and willing persons in exchange for the asset in an arm's length transaction.

**Discontinued operations**

A discontinued operation is a part of an entity that has either been disposed of or is classified as held for sale (for example, a division of a manufacturing plant). A discontinued operation has to meet certain criteria, in other words it must:

- represent a separate major line of business or geographical area of operations;
- be part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations; or
- be a subsidiary acquired exclusively with a view to resale.

**Accounting treatment**

Where an entity has a discontinued operation, that component of the entity's operations and cash flows must be clearly distinguished, both operationally and for financial reporting purposes, from the rest of the entity.

For financial reporting purposes, the revenue, expenses, pretax profit or loss, and the income tax expense of the discontinued operation should be separately presented on the face of the statement of profit or loss, or in the notes to the financial statements.

# 19. Can internally generated goodwill be recognized on the statement of financial position?

## Answer

The short answer to this is no! While purchased goodwill is dealt with in the provisions contained in IFRS 3 *Business Combinations*, IAS 38 *Intangible Assets* deals with intangible assets; because internally generated goodwill is 'intangible', the provisions in IAS 38 apply.

Internally developed intangible assets can only be capitalized if they have a readily ascertainable market value; this applies to internally generated goodwill as well. The reality is that in practice, hardly any intangible assets have a readily ascertainable market value, and those that do are unlikely to have been developed internally.

Readily ascertainable market values will only be available from 'active markets'. An 'active market' is one where:

- the items traded in the market are homogenous;
- willing buyers and sellers can normally be found at any time; and
- prices are available to the public.

IAS 38 acknowledges that active markets are likely to be rare for intangible assets, but examples of where they may exist are in relation to:

- production quotas;
- fishing licences; and
- taxi licences.

### Accounting treatment

Paragraph 48 of IAS 38 is extremely specific on the issue of internally-generated goodwill – it must be charged to expenses when incurred.

# 20. What are intangible non-current assets, other than goodwill?

## Answer

An intangible non-current asset is an asset that does not have physical substance; in other words, it is the direct opposite to a 'tangible' non-current asset. IAS 38 *Intangible Assets* is the accounting standard that prescribes the accounting and disclosure requirements needed in a set of general purpose financial statements for intangible non-current assets. Paragraph 8 of the standard defines an intangible asset as 'an identifiable non-monetary asset without physical substance'.

Paragraph 21 of IAS 38 says that an intangible asset must be recognized on the statement of financial position (balance sheet) if, and only if:

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

Examples of possible intangible non-current assets are as follows:

- computer software;
- patents;
- copyrights;
- motion picture films;
- customer lists;
- mortgage servicing rights;
- licences;
- import quotas;
- franchises;
- customer and supplier relationships; and
- marketing rights.

**Research and development**

Companies that are involved in research and development may have lots of intangible non-current assets on their statements of financial position. For the purposes of IAS 38, research and development are split into two distinct areas:

- *Research expenditure* – any expenditure incurred during the research phase of a project must be recognized as an expense as and when it is incurred.
- *Development expenditure* – once the research phase has been completed and the development phase commences, any costs incurred during the development phase must be capitalized if, and only if, an entity can demonstrate the following:
  - the technical feasibility of completing the intangible asset so it will be available for use or sale;
  - its intention to complete the intangible asset to either use it or sell it;
  - the entity's ability to sell the intangible asset;
  - the entity can demonstrate how it will generate probable future economic benefits;
  - the availability of resources in order to complete the intangible asset (resources include those of a technical and financial nature, as well as other applicable resources to complete the intangible asset); and
  - the entity's ability to measure the cost reliably.

**Accounting issues**

An intangible non-current asset can only be recognized on the statement of financial position (balance sheet) if, and only if, the following criteria are met:

- it is probable that future economic benefits will flow to the entity; and
- the cost of the asset can be measured reliably.

The accounting issues in IAS 38 do not pose a problem for 'purchased' intangible assets (such as those acquired in a business

combination) because there is a presumption within IAS 38 that the probability criterion is always met, as well as the fact that information is available to measure the cost of such intangible assets separately from goodwill. Such assets are:

- customer lists;
- research and development projects that are in progress;
- employment contracts that are below market rate; and
- order or production backlogs.

Where the above are concerned, these should be recognized separately from goodwill in the statement of financial position (balance sheet) and amortized over their useful economic lives. Where the entity deems such assets to have an indefinite useful economic life (hence no amortization), the entity must subject such assets to annual impairment reviews.

An entity may revalue an intangible non-current asset, provided an active market for such assets exists. In real life, this is likely to be very rare because an active market is one in which the intangible assets are frequently traded.

An important point to bear in mind is that internally generated goodwill cannot be recognized on an entity's statement of financial position (balance sheet) because such goodwill does not have a reliable cost; nor does it have a probable future economic benefit. The same stance is also taken for internally generated intangible assets such as brands, mastheads, publishing titles, customer lists and similar items. IAS 38 strictly prohibits the recognition of such items on the statement of financial position.

A final point to also note is that when a company decides to launch a new product or service and incurs costs in launching it (for example, advertising), the standard is very prohibitive on the recognition of such costs. An entity is not permitted to recognize them on the statement of financial position (balance sheet); instead, they are written off to profit or loss immediately.

# 21. How does an entity deal with investment property in the statement of financial position?

## Answer

Where investment properties are concerned, the first important issue to address is whether or not the property can be classified as an investment property. IAS 40 *Investment Property* is fairly wide in its overall scope and includes property that is held for capital appreciation purposes, or property from which rentals are earned. The scope of IAS 40 also includes property that is leased out by the entity under an operating lease – but be careful here! IAS 40 does not deal with other aspects of leased property, which are dealt with under IAS 17 *Leases*.

Paragraph 5 of IAS 40 defines investment property as land or a building – or part of a building (or both) – held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

- use in the production or supply of goods or services or for administrative purposes; or
- sale in the ordinary course of business.

In terms of investment property that is subject to a lease, a property interest held by a lessee under an operating lease can be treated as investment property if, and only if:

- it can meet the rest of the definition of investment property;
- the lessee uses the fair value model in IAS 40;
- the initial cost of a property interest held under an operating lease and classified as an investment property should be treated as for a finance lease – in other words, the asset should be recognized at the *lower* of the fair value of the

property and the present value of the minimum lease payments.

**Example**

The Gabriella Group owns a portfolio of properties, one of which is a converted mill that it leases out (as lessor) to a manufacturer of curtains and soft furnishings under an operating lease. The mill itself is built on land that is leased by the government to the Gabriella Group (as lessee) for a period of 999 years. Title to the land on which the mill is built does not pass to the Gabriella Group at the end of the lease and the mill's useful life is expected to be 50 years. The terms of the lease do not require the land to be returned with the building intact at the end of the 999-year lease term.

In this scenario, the land element should be accounted for as an operating lease under the provisions in IAS 17 and can be recognized as investment property only if it meets the definition of such and the Gabriella Group has chosen the fair value model for the investment property. The converted mill does meet the definition of an investment property and should be accounted for such under the provisions in IAS 40. A building is recognized as an investment property if the lease of the land extends beyond the building's expected useful life and there are no provisions in the lease to return the land with the building intact.

**Examples of investment property**

IAS 40 cites several examples of what *is* and what *is not* investment property. Examples of investment property as per paragraph 8 of IAS 40 include:

- land held for long-term appreciation in value, rather than for short-term sale in the ordinary course of business;

- land whose future use has not yet been determined – if the future use has not yet been determined, land is assumed to be held for capital appreciation;
- a building owned or held under a finance lease and leased out under an operating lease;
- a building that is vacant, but held to be leased out under an operating lease; and
- investment property being redeveloped for continued use as investment property.

Paragraph 9 of IAS 40 then goes on to say what investment property does not include:

- property intended for sale in the ordinary course of business or for redevelopment and resale;
- property under construction for third parties;
- owner-occupied property, including property held for such use or for redevelopment prior to such use;
- property occupied by employees;
- owner-occupied property awaiting disposal; and
- property that is leased to another entity under a finance lease.

It is important to ensure that you are familiar with what is and what is not investment property in the real world, because the accounting requirements differ greatly. Getting the classification incorrect can be both costly and misleading to the users of the financial statements.

**Initial recognition in the financial statements**

Investment property should be recognized as an asset within the financial statements when it is probable that future economic benefits that are associated with the property will flow to the entity, and the cost of the property can be reliably measured.

Once management is satisfied that a property meets the definition and recognition criteria of investment property, the

initial recognition in the financial statements is exactly the same as the initial recognition for other property, plant and equipment – at cost. Cost includes:

- the initial purchase price; and
- directly attributable costs (see below).

IAS 40 recognizes that start-up costs, abnormal waste or initial operating losses incurred before the investment property achieves the planned level of occupancy should not be recognized.

Paragraph 17 of IAS 16 outlines examples of directly attributable costs as follows:

- the cost of employee benefits as defined in IAS 19 *Employee Benefits* that arise directly from the construction or acquisition of the item;
- the costs of site preparation;
- initial delivery and handling costs;
- installation and assembly costs;
- professional fees;
- costs of testing whether the asset is working properly (commissioning costs), after deducting the net proceeds of sale of any items produced while bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

**Subsequent measurement**

IAS 40 permits the reporting entity to adopt either the fair value model or the cost model as its accounting policy for investment property.

Under the fair value model, the investment property is revalued to fair value. 'Fair value' is defined as the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. 'Knowledgeable parties' in the context of IAS 40 means that both the buyer

and the seller are reasonably informed about the nature and characteristics of the property, its actual and potential uses, and the state of the market at the reporting date. A 'willing buyer' is one who is motivated, but not forced to buy; nor is such a buyer over-eager or determined to buy at any price.

Under the cost model, an entity will carry an investment property at cost less accumulated depreciation and any accumulated impairment losses. This treatment is consistent with the requirements in IAS 16. However, when an entity adopts the use of the cost model, they must still obtain fair values because IAS 40 requires the disclosure of such fair values within the financial statements, so the benefits of using the cost model are not evident when fair values still have to be obtained.

An important point to flag up is the situation that may occur when management wishes to switch from measuring investment property at fair value to measuring investment property under the cost model. The following example illustrates a problem in switching from the fair value model to the cost model.

**Example**

Lucas Property Company (Lucas) has two properties, both of which meet the definition of investment property under IAS 40. Management previously declared that Lucas will carry the investment property under the fair value model, but has now expressed a desire to carry the properties under the cost model.

Where the entity has adopted the fair value model, the IASB considers that it should not then subsequently change to the cost model. This is because the provisions in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* allows a change of accounting policy only if the revised policy will provide reliable and more relevant

information about the effects of transactions, other events or conditions. The IASB has concluded that it is highly unlikely that a switch from the fair value model to the cost model will result in more reliable and more relevant information.

**Changes in fair value**

Changes in the fair values of investment property are recognized within profit or loss for the period in which they arise. The standard itself requires disclosure of net gains or losses arising from fair value adjustments, but it does not specify where such gains and losses on revaluation should be shown within the statement of profit or loss (income statement). They should, however, be shown separately from rental income and direct operating expenses, which IAS 40 requires to be disclosed separately.

**Illustration**

**Entity A, Inc.**

**Statement of profit or loss (extract)**

| | **2012 C000** | **2011 C000** |
|---|---|---|
| **Profit before taxation** | **X** | **X** |
| Analyzed as: | | |
| Underlying profit before taxation | X | X |
| Profit on disposal of properties | X | – |
| Changes in fair value of investment property | X | X |

The IASB revised IAS 1 *Presentation of Financial Statements* as part of its *Improvements Project* in 2003. Following this project, IAS 1 no longer requires the disclosure of a line item for the results of operating activities. In the *Basis for Conclusions*

section of IAS 1 (specifically IAS 1 paragraph BC13), the IASB has said that if an entity voluntarily discloses a line item for the results of operating activities, it should ensure that the amount disclosed is representative of activities that would normally be considered to be 'operating'. Revaluation gains and losses would form part of the operating results and should, therefore, be disclosed in arriving at operating profit, should such a line item be disclosed. When an entity does not disclose such a line item, it is generally considered that gains and losses on revaluation should be shown in the line item before 'finance costs'. The general consensus here is that finance costs are generally not part of operating profit, unless the entity carries on a finance-related business.

**Disclosures**

Under IAS 40, an entity is required to make extensive disclosures within the financial statements relating to all investment property, whether carried at fair value or at cost less depreciation and impairment losses. The disclosure requirements are as follows:

- Whether the entity uses the cost model or the fair value model.
- If the entity applies the fair value model, whether and in what circumstances it classifies and accounts for property interests held under an operating lease as investment property.
- Basis of distinguishing investment property from owner-occupied property and property held for sale in the ordinary course of business, where classification is difficult.
- Methods and significant assumptions for determining fair value, including a statement as to whether fair value was supported by market evidence or was more heavily based on other factors (which the entity should disclose) because the nature of the property and lack of comparable market data.
- Extent of involvement of independent professional valuers with recent experience in the location and category of investment property being valued (in determining fair value

for measurement or disclosure purposes) or, if there has been no independent valuation, disclosure of that fact.
- Amounts included in profit or loss for rental income and direct operating expenses relating to investment property (such as repairs and maintenance), giving amounts separately in the latter case for property that generated rental income and property that did not.
- The cumulative change in fair value recognized in profit or loss on a sale of investment property from a pool of assets in which the cost model is used into a pool in which the fair value model is used.
- Details of the existence and amount of restrictions on the realizability of investment property or on remittance of income and proceeds of disposal.
- Contractual obligations to purchase, construct or develop investment property or for repairs, maintenance or enhancements.

When the entity adopts the use of the fair value model, it needs to disclose a reconciliation of the carrying amount at the beginning and end of the period showing:

- additions from acquisitions;
- additions from subsequent expenditure recognized in the carrying amount of an asset;
- additions from business combinations;
- assets classified as held for sale, or included in a disposal group classified as held for sale in accordance with IFRS 5 *Non-Current Assets Held for Sale and Discontinued Operations*, and other disposals;
- net gains or losses from fair value adjustments;
- net exchange differences arising from retranslation of the reporting entity's financial statements into a different presentation currency (where applicable) and from retranslation of a foreign operation (for example, an overseas subsidiary) into the reporting entity's presentation currency;

- transfer to and from inventory and owner-occupied property; and
- other changes.

Comparative amounts are also required for the above disclosures.

When an entity carries investment property under the cost model, it should make the following additional disclosures (including disclosure of the fair value of the investment property):

- the depreciation methods used;
- the useful lives or depreciation rates used;
- the gross carrying amount and the accumulated depreciation (combined with accumulated impairment losses) at the beginning and end of the period;
- a reconciliation of the carrying amount of investment property at the beginning and end of the period showing:
  - additions from acquisitions;
  - additions from subsequent expenditure recognized as an asset;
  - additions from business combinations;
  - assets classified as held for sale or included in a disposal group classified as held for sale in accordance with IFRS 5;
  - depreciation;
  - the amount of impairment losses recognized and the amount of impairment losses reversed during the period under IAS 36 *Impairment of Assets*;
  - net exchange differences arising from retranslation of the reporting entity's financial statements into a different presentation currency (where applicable) and from retranslation of a foreign operation (for example, an overseas subsidiary) into the reporting entity's presentation currency;
  - transfers to or from inventory and owner-occupied property; and
  - other changes.

If in exceptional circumstances the entity cannot reliably determine the fair value of an investment property, it should disclose:

- a description of the property;
- an explanation as to why fair value cannot be reliably determined; and
- if possible, the range of estimates of fair value within which the fair value of the property is highly likely to lie.

# 22. What is an impairment test?

## Answer

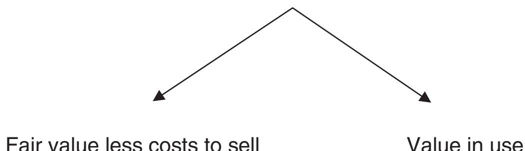
An important principle that governs financial reporting is that assets cannot be carried in the statement of financial position (balance sheet) at any more than their recoverable amount. The term 'recoverable amount' essentially means the price that an asset can be recovered for in an arm's length transaction. When it is clear that the carrying amount of an asset is higher than what could realistically be received in exchange for that asset, there is evidence of impairment and the asset(s) in question must be written down to its (their) recoverable amount.

IAS 36 *Impairment of Assets* is the standard that prescribes the requirement for a reporting entity to ensure that its assets are carried at no more than recoverable amount.

There are some definitions that need to be understood where impairment tests are concerned:

- *Fair value less costs to sell* is the amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs involved in the disposal.
- *Value in use* is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.
- A *cash-generating unit* is 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.

Where the recoverable amount of an asset(s) is concerned, this is sub-divided into two sub-components – fair value less costs to sell and value in use.




It is an important point to emphasize that intangible assets such as goodwill, intangible assets with indefinite useful lives and those intangible assets that are not yet available for use must be tested annually for impairment.

**Accounting for an impairment loss**

Impairment losses for individual or groups of assets are recognized as operating expenses as either depreciation or a separate line item in the statement of profit or loss (income statement), hence the entries are:

- credit asset (statement of financial position); and
- debit statement of profit or loss (additional depreciation or separate line item).

**Example**

Joyce Enterprises has a manufacturing division that manufactures roller-shutter doors and associated components that are sold on to contractors. The manufacturing division consists of a large group of heavy industrial machines that manufacture the curtains, bottom-rails, guides, angles, barrels and canopies. The reporting date of the entity is 31 December 2012 and, at that date, these machines have a book value of C140,000. The directors of the entity consider that this group of machines constitutes a cash-generating unit under IAS 36 provisions.

The directors have undertaken an exercise relating to the expected cash inflows and outflows, which have been based on reduced productivity levels due to the age and condition of the machinery. The analysis is shown below:

| Year | Revenues C | Costs C |
|---|---|---|
| 2013 | 70,000 | 27,000 |
| 2014 | 75,000 | 45,000 |
| 2015 | 85,000 | 65,000 |
| 2016 | 30,000 | 20,000 |

The original manufacturer of the plant has been approached to give a reliable estimate of the net realizable value of the machinery in the cash-generating unit. The manufacturer has informed the directors that the net selling price that an informed, unconnected third party should expect to pay for the equipment is C82,150.

The directors have based their value in use calculations having reference to the above cash flows and have discounted the above cash flows at a rate of 5%, which is the entity's cost of capital. Using this discount rate produces a present value of C93,656, which is calculated as follows:

| Year | Cash flows C | PV factor | Present value C |
|---|---|---|---|
| 2013 | 43,000 | 0.952 | 40,936 |
| 2014 | 30,000 | 0.907 | 27,210 |
| 2015 | 20,000 | 0.864 | 17,280 |
| 2016 | 10,000 | 0.823 | 8230 |
| **Value in use** | | | **93,656** |

As value in use exceeds the manufacturer's net selling price, value in use is selected to represent the recoverable amount. This is lower than the current carrying value of the group of assets as at 31 December 2012; therefore, an impairment loss of (C140,000 less C93,656) C46,344 is recognized.

The impairment loss is recognized as an operating expense as either depreciation or a separate heading in the statement of profit or loss.

There is a specific order in which an impairment loss for a cash-generating unit is recognized in the financial statements as per IAS 36 provisions. Impairment losses are recognized:

- first, to goodwill in the group; and
- second, to the other assets of the unit on the basis of the carrying amount of each asset in the unit on a pro rata basis according to their carrying value.

**Example**

Barry Enterprises has the following net assets in its statement of financial position (balance sheet) as at 31 December 2012:

| *Non-current assets* | |
|---|---|
| | C |
| Property | 60 |
| Plant | 90 |
| Goodwill | 30 |
| | 180 |

In the board meeting, the directors decided that the recoverable amount of the above net assets was C135.

The impairment amounts to (C180 less C135) C45 and must be allocated to goodwill, then to the rest of the assets in the cash-generating unit on a pro rata basis.

C30 of the impairment loss is allocated to goodwill, reducing the carrying value of goodwill to C0. C6 is allocated to the property and the remaining C9 being allocated to the plant.

Following the impairment allocation, Barry Enterprises' statement of financial position (balance sheet) extract will look like this:

| *Non-current assets* | |
|---|---|
| | C |
| Property | 54 |
| Plant | 81 |
| Goodwill | – |
| | 135 |

**Disclosures**
The disclosures required by IAS 36 are split between those required for impairment losses or reversals, and those of material impairments.

*Impairment losses or reversals* For each class of asset, paragraph 126 of IAS 36 requires an entity to disclose:

- the amount of impairment losses recognized in profit or loss during the period, and the line item(s) in profit or loss in which those impairment losses are included;

- the amount of reversals of impairment losses recognized in profit or loss during the period, and the line item(s) in profit or loss in which those impairment losses are reversed;
- the amount of impairment losses on revalued assets recognized directly in other comprehensive income during the period; and
- the amount of reversals of impairment losses on revalued assets recognized directly in other comprehensive income during the period.

***Material impairments*** In respect of material impairments, the following disclosures are required:

- the events and circumstances that led to the recognition or reversal of the impairment loss;
- the amount of the impairment loss recognized or reversed;
- for an individual asset:
  - the nature of the asset; and
  - if the entity reports segmental information in accordance with IFRS 8 *Operating Segments*, the reportable segment to which the asset belongs.
- for a cash-generating unit:
  - a description of the cash-generating unit (such as whether it is a product line, a plant, a business operation, a geographical area, or a reportable segment defined in IFRS 8);
  - the amount of the impairment loss recognized or reversed by class of assets and if the entity reports segmental information in accordance with IFRS 8, by reportable segment; and
  - if the aggregation of assets for identifying the cash-generating unit has changed since the previous estimate of the cash-generating unit's recoverable amount (if any), a description of the current and former way of aggregating assets and the reasons for changing the way the cash-generating unit is identified.

- whether the recoverable amount of the asset or cash-generating unit is its fair value less costs to sell or its value in use;
- if recoverable amount is fair value less costs to sell, the basis used to determine fair value less costs to sell (such as whether fair value less costs to sell was determined by reference to an active market); and
- if recoverable amount is value in use, the discount rates used in the current estimate and previous estimate (if any) of value in use.

# 23. How does an entity account for borrowing costs (interest) incurred whilst constructing an asset?

## Answer

When an entity incurs borrowing costs on assets that it is self-constructing, IAS 23 *Borrowing Costs* outlines the accounting treatment for such costs. The objective of IAS 23 is to prescribe the treatment that a reporting entity should follow in dealing with borrowing costs associated with the acquisition, construction or production of a qualifying asset; the fundamental aspect to this standard is determining what a qualifying asset is.

A 'qualifying asset' is an asset that takes a substantial period of time to get ready for its intended use or sale. The term 'substantial period' is fundamental to this standard and is taken to mean that the asset will take longer than one year to construct.

Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds to construct an asset.

IAS 23 requires a reporting entity to capitalize borrowing costs – that is, to recognize such costs within the cost of the asset – that are attributable to the acquisition, construction or production of a qualifying asset. Examples of qualifying assets are:

- manufacturing plant;
- investment properties; and
- intangible assets.

**Capitalization rate**

The capitalization rate is the weighted average of the borrowing costs applicable to the borrowing of the entity that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs that an entity capitalizes in a period must not exceed the amount of borrowing costs it incurred in the accounting period.

The capitalization of borrowing costs commences when the entity:

- incurs expenditure for the asset;
- incurs borrowing costs; and
- undertakes activities that are necessary to prepare the asset for its intended use or sale.

When an entity suspends active development of a qualifying asset, it must suspend capitalization of borrowings.

### Example

Byrne Group has three sources of borrowings in an accounting period:

| | **Outstanding liability C000** | **Interest charge C000** |
|---|---|---|
| Five-year bank loan | 9000 | 1500 |
| 30-year loan | 14,000 | 2000 |
| Bank overdraft | 6000 | 750 |

If all of the above borrowings are used to finance the production of a qualifying asset, the capitalization rate is calculated as follows:

$$\frac{1{,}500{,}000 + 2{,}000{,}000 + 750{,}000}{9{,}000{,}000 + 14{,}000{,}000 + 6{,}000{,}000} \times 100 = 14.66\%$$

If the five-year loan is used to finance a specific qualifying asset, the capitalization rate is calculated as follows:

$$\frac{2{,}000{,}000 + 750{,}000}{14{,}000{,}000 + 6{,}000{,}000} \times 100 = 13.75\%$$

# 24. What is the difference between a revaluation of property, plant and equipment, and the revaluation model for investment property?

## Answer

Revaluations of property, plant and equipment are permitted in the provisions of IAS 16 *Property, Plant and Equipment*. Once assets in the same class have been subjected to the revaluation model contained in IAS 16, then every asset in that class must be subjected to revaluation – in other words, assets in a same asset class cannot be subjected to the revaluation model and the depreciated cost model in IAS 16.

The requirements in IAS 16 say that after initial recognition at cost, an item of property, plant and equipment subsequently measured under the revaluation model is carried at its fair value – fair value being market value between market participants. Any increases or decreases in the fair value of items accounted for under IAS 16 are recognized in other comprehensive income and accumulated in equity under the heading of 'Revaluation surplus'. Any increases in fair value are only recognized in profit or loss to the extent that they reverse back a revaluation decrease of the same asset previously recognized in profit or loss. Preparers of IFRS financial statements are required to apply the principles contained in IFRS 13 *Fair Value Measurement* where fair values are concerned. IFRS 13 provides a single IFRS framework for measuring fair value. In addition, IFRS 13 also requires certain disclosures about fair value measurement.

For investment property, the accounting requirements are covered in IAS 40 *Investment Property*, not IAS 16. IAS 40 says

that after initial recognition, an investment property can be measured using the fair value model, with any increases or decreases in the investment property's value being recognized directly in profit or loss in the period the fluctuation in value occurs. There is no concept of a 'revaluation surplus' within equity.

# 25. What distinguishes whether an asset to be disposed of is classified as held for sale?

## Answer

When a company decides it is going to sell a non-current asset, the provisions within IFRS 5 *Non-Current Assets Held for Sale and Discontinued Operations* apply. The objective of IFRS 5 is to specify how assets that both qualify for and are treated as 'held for sale' should be presented and disclosed within an entity's financial statements. IFRS 5 also deals with discontinued operations.

A non-current asset (or group of assets, known as a 'disposal group') that is held for sale must be up for sale in its present condition and the sale must be highly probable. In order for the sale to be classed as 'highly probable', there must be certain characteristics present:

- management must be committed to a plan to sell the asset;
- there must be an active programme of seeking a buyer;
- the asset (or disposal group) must be available for immediate sale;
- the sale must be highly probable; and
- the sale is expected to complete within one year of the asset being classified as held for sale.

Once an asset or a disposal group meets the classification above and is deemed as held for sale, depreciation must cease. The asset (or disposal group) should be carried in the statement of financial position (balance sheet) at the *lower* of the carrying amount and fair value less costs to sell. 'Fair value' is essentially how much could be received by knowledgeable and willing persons in an arm's length transaction.

**Discontinued operations**

A discontinued operation is a part of an entity that has either been disposed of, or is classified as held for sale; for example, a division of a manufacturing plant. A discontinued operation should:

- represent a separate major line of business or geographical area of operations;
- be part of a single coordinated plan to dispose of a separate major line of business or geographical area of operation; or
- be a subsidiary acquired exclusively with a view to resale.

Where an entity has a discontinued operation, that component of the entity's operations and cash flows must be clearly distinguished, both operationally and for financial reporting purposes, from the rest of the entity.

The revenue, expense, pre-tax profit or loss, and the income tax expense of the discontinued operation should be separately presented on the face of the statement of profit or loss, or within the notes to the financial statements.

# 26. What are the accounting principles under IFRS for inventories?

## Answer

Inventories are dealt with in the provisions of IAS 2 *Inventories*. IAS 2 prescribes the methods for determining cost of inventories and for recognizing the associated expense in the statement of profit or loss. In addition, IAS 2 provides guidance regarding any write-downs of inventory to net realizable value and on the cost formulas that are used to assign costs to inventories.

According to paragraphs 2 and 3, IAS 2 does not include:

- work in progress arising under construction contracts (these are dealt with in IAS 11 *Construction Contracts*);
- financial instruments (IAS 32 *Financial Instruments: Presentation* and IFRS 9 *Financial Instruments*);
- biological assets related to agricultural activity and agricultural produce at the point of harvest (such assets are dealt with in IAS 41 *Agriculture*);
- producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products to the extent that they are measured at net realizable value in accordance with established practices within those types of industries; and
- commodity brokers and dealers who measure their inventories at fair value less costs to sell.

The basic approach in IAS 2 is that an entity's inventories are to be valued at the *lower* of cost or net realizable value.

Cost comprises:

- the costs of purchase (for example, the cost of raw materials);
- the costs of conversion (for example converting raw materials to finished goods); and
- other costs.

'Other costs' relate to costs incurred in bringing the inventories to their present location and condition.

Costs that must not be recognized as per IAS 2 at paragraphs 16 and 18 are:

- abnormal waste;
- storage costs;
- administrative overheads which are unrelated to production;
- selling costs;
- foreign exchange differences arising directly on the recent acquisition of inventories invoiced in a foreign currency; and
- interest cost when inventories are purchased under deferred settlement terms.

**Cost formulas**

IAS 2 prescribes two possible cost formulas for inventories that are interchangeable. An entity can use either the 'first-in, first-out' (FIFO) basis or the weighted average basis (sometimes called the 'average cost', or AVCO). An important point to emphasize is that the use of the last-in, first-out basis (LIFO) is not permitted in IAS 2.

Standard cost and retail methods can also be used as a cost formula, provided that the results approximate actual cost.

**Net realizable value**

Net realizable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and estimated costs necessary to make the sale.

### Example

Robinson Co. (Robinson) imports chemical products from overseas and the reporting date is 31 December 2012. At that date, Robinson undertakes an inventory count where inventory has been valued at the lower of cost or net realizable value in accordance with IAS 2 provisions. It has extracted details of the following chemical products:

| Product | Cost C | NRV C | Valuation C |
|---|---|---|---|
| 556-009 | 200.00 | 450.00 | 270.00[1] |
| 556-010 | 150.00 | 340.00 | 150.00[2] |
| 556-011 | 200.00 | 120.00 | 200.00[3] |

[1] The first product valuation includes an element of administrative salaries because this product is highly valuable and involves a lot of extra administration work.
[2] There are no issues with this product. The valuation appears to be fairly stated.
[3] This product is obsolete and management deem the net realizable value to be nil.

Based on the above three issues, the revised inventory valuation should be as follows:

| Product | Cost C | NRV C | Valuation C |
|---|---|---|---|
| 556-009 | 200.00 | 450.00 | 200.00[1] |
| 556-010 | 150.00 | 340.00 | 150.00 |
| 556-011 | 200.00 | nil | nil[2] |

[1]The administrative salary is deducted because IAS 2 specifically states that general administrative overheads should be excluded from the costs of inventory.

[2]Management's assessment is that the saleable value of this product is nil and this product needs to be written down to nil in order to accord with IAS 2 *lower of cost or net realizable value* principles.

# 27. If a company enters into construction contracts, how does it account for these?

## Answer

Many companies operate in the construction industry and the general principle of revenue recognition (being 'recognize when realized') is not generally applicable to such companies, because construction contracts can span more than one (in some cases, several) accounting periods.

IAS 11 *Construction Contracts* outlines the accounting treatment associated with revenue and cost recognition associated with construction contracts. A separate standard was needed in this area because of the nature of construction contracts. Consider the following illustration:

**Illustration**

Clasper Construction Co. (Clasper) has just won a bid to build a stadium that will be used by a major football club. Work on the new stadium will commence on 1 January 2012 and it is anticipated that the stadium will be completed on 31 December 2015.

Under 'traditional' revenue recognition principles, the normal sales of goods and services are recognized in the financial statements when contractual obligations have been fulfilled. If Clasper did not recognize revenue and profit until the end of the contract, it can be argued that recognizing the revenue associated with the new stadium would not faithfully present the circumstances of the contract, simply because revenue will have been earned over

the three-year duration of the contract and not just when the stadium was completed. This argument is accentuated further by the fact that if Clasper was to delay recognizing revenue and profit until the stadium was completed, the bedrock accruals concept contained in the IASB's *Conceptual Framework* will not have been complied with.

Construction contracts pose particular problems where the financial statements are concerned, because in reality the main problem is determining at what point revenue and costs should be recognized – which is where IAS 11 is needed. IAS 11 defines a construction contract as:

> 'a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology, and function for their ultimate purpose or use.'
>
> [IAS 11 paragraph 3]

**Contract revenue**
IAS 11 also requires contract revenue to be measured at the fair value of the consideration received or receivable.

**Contract costs**
Contract costs must comprise:

- costs that relate directly to specific contracts;
- costs that are attributable to contract activity in general and can be allocated to the contract; and
- such other costs as are specifically chargeable to the customer under the terms of the contract.

**Contracts expected to be profit-making**
As mentioned earlier, the accruals concept is bedrock in the preparation of financial statements and IAS 11 exercises this concept where the outcome of a project can be reasonably

foreseen, because IAS 11 then recognizes profit on contracts in progress in proportion to the percentage of completion, which is applied to the total contract profit. There are two ways in which the stage of completion can be calculated:

The **work certified method** is calculated as follows:

$$\frac{\text{Work certified to date}}{\text{Contract price}}$$

The **cost method** is calculated as follows:

$$\frac{\text{Costs incurred to date}}{\text{Total contract costs}}$$

IAS 11 does not specify a particular method to be adopted by reporting entity

**Contracts expected to be loss-making**

Conversely, if a contract is expected to be loss-making, IAS 11 then exercises the prudence concept by saying that expected losses on contracts must be recognized immediately.

As a summary, the way that revenue and costs are recognized in an entity's financial statements for construction contracts is as follows:

| Scenario | Revenue recognition | Costs measured |
|---|---|---|
| Contract is profitable | By reference to the stage of completion (percentage of completion method). | Costs incurred in reaching the stage of completion are included within cost of sales. This is arrived at by applying the percentage of completion to the total costs that are expected to occur over the contract's life. |
| Contract is loss-making | By reference to the stage of completion (percentage of completion method). | As a balancing figure to interact with the revenue that has been recognized in order to generate the required loss. |
| The outcome of the contract is uncertain | To equal the cost figure. | The costs incurred in the period are expensed. |

**Example – profit-making contract**

The Holmes Group (Holmes) is in the construction industry and constructs commercial buildings. The company's year end is 31 December 2012 and during this current financial year, the company entered into a contract that is expected to span more than one accounting period. A summary of the contract is as follows:

| | **C000** |
|---|---|
| Progress payments from the contractor | 1700 |
| Contract price | 3842 |
| Work certified as complete | 1921 |
| Contract costs incurred to 31 December 2012 | 2070 |
| Estimated total costs to 31 December 2012 | 2740 |

The company uses the 'work certified complete' method as their accounting policy.

**Step 1**

Determine whether the contract is profit- or loss-making as follows:

| | |
|---|---|
| Contract price | 3842 |
| Total costs | 2740 |
| Expected profit | 1102 |

**Step 2**

Calculate how much profit should be shown in this year from the contract.

The accounting policy is the 'work certified complete' method which is calculated as follows:

| | |
|---|---|
| Work certified to date / Contract price | 1921 / 3842 = 50% |
| Therefore C1102 × 50% = profit to be recognized of | C551 |

**Step 3**

Work out the asset or liability to be recognized in the statement of financial position (balance sheet):

| | |
|---|---|
| Costs incurred to date | 2070 |
| Profit recognized to date (C1102 × 50%) | 551 |
| Less: progress payment received | (1700) |
| | 921 |

**Financial statement extracts**:

**Statement of profit or loss – 31 December 2012**

| | |
|---|---|
| Revenue (work certified) | 1921 |
| Cost of sales (balancing figure) | 1370 |
| Gross profit (step 2) | 551 |

**Statement of financial position as at 31 December 2012**

| | |
|---|---|
| Current assets | |
| Asset on construction contract (step 3) | 921 |

# 28. What are the rules where leases are concerned?

## Answer

Accounting for lease transactions are covered in IAS 17 *Leases*. The actual accounting for lease transactions involves a number of complexities, which derive partly from the range of alternative structures that are available to the parties involved in the leasing transaction. For example, in many cases, leases can be configured to allow manipulation of tax benefits, with other features such as lease term and implied interest rate adjusted to achieve the intended overall economics of the arrangement.

The IASB's *Conceptual Framework* refers to 'substance over form' and IAS 17 is probably *the* standard where application of this principle is most prevalent. When we refer to 'substance over form' we are talking about the commercial reality of the transaction, rather than what it says on paper. In other words, we need to look at the characteristics of the transaction. If the lessor essentially transfers all the risks and rewards of ownership of the asset to the lessee, then the asset is recognized on the statement of financial position with a corresponding liability.

If the lessor retains the risks and rewards of ownership, the rentals are simply charged to profit or loss as and when they arise. IAS 17 recognizes two types of lease:

- finance lease; and
- operating lease.

A finance lease is a lease where the risks and rewards of ownership have been transferred to the lessee. An operating lease is where the lessor retains the risks and rewards of ownership.

### Examples

**Example 1**

Company A enters into a leasing arrangement with a finance company to lease six vans. The lease agreement contains provisions stating that the finance company will maintain the vehicles and ownership of the vehicles will remain with the finance company, and that Company A will return the vehicles at the end of the hire period with no transfer to ownership.

Company A has acquired six vans that, on the face of it, may come across as a capital transaction, i.e. where the vehicles would be capitalized in the statement of financial position and raise a corresponding creditor. We look to the 'substance over form' concept and we can see quite clearly that the finance company owns those vans. The finance company has not transferred the risks and rewards over to Company A. In addition, the finance company is maintaining the vans on behalf of Company A; this means that the finance company retains the risks and rewards, which is indicative of an operating lease – hence the rentals will simply be charged to profit or loss as and when they arise.

**Example 2**

Company A enters into a leasing arrangement with a finance company to lease an item of plant. Company A is responsible for maintenance of the machine and title to the machine will pass to Company A at the end of the lease term.

In this example, the finance company have transferred the risks and rewards of ownership of the item of plant to Company A and Company A will also own the asset at the end of the lease term. As a consequence, Company A will recognize an asset and raise a corresponding creditor.

The above two examples are rudimentary, but they demonstrate how a leasing transaction can be manipulated in order to achieve a desired outcome. The act of 'off balance sheet finance' (where liabilities were conveniently 'missed off' the statement of financial position) was a huge problem before IAS 17 was issued.

IAS 17 stipulates that substantially all the risks and rewards of ownership are deemed to have been transferred if *any one* of the following five criteria are met:

- The lease transfers ownership to the lessee by the end of the lease term.
- The lease contains a bargain purchase option (an option to purchase the leased asset at a price that is expected to be substantially lower than the fair value at the date the option becomes exercisable) and it is reasonably certain that the option will be exercisable.
- The lease term is for the major part of the economic life of the leased asset; title may, or may not, eventually pass to the lessee.
- The present value at the inception of the lease of the minimum lease payments is at least equal to substantially all of the fair value of the leased asset, net of grants and tax credits to the lessor at that time; title may, or may not, pass to the lessee.
- The leased assets are of a specialized nature such that only the lessee can use them without major modifications being made.

There are a further three indicators that may suggest a lease may be properly considered to be a finance lease:

- If the lessee can cancel the lease, the lessor's losses associated with the cancellation are to be borne by the lessee.
- Gains or losses resulting from the fluctuation in the fair value of the asset will accrue to the lessee.

- The lessee has the ability to continue the lease for a supplemental term at a rent that is substantially lower than market rent (i.e. there is a bargain renewal option).

The first five criteria are essentially determinative in nature, with the final three being more suggestive in nature.

**Example – accounting issues**

Lucas Lighting Ltd enters into a lease for a machine on 1 January 2013. The machine has an expected useful life of three years, at which time it will be returned to the lessor. The market value of the machine is C135,000 and three payments to the lessor of C50,000 are due to the lessor starting on 31 December 2013. The residual value of the machine is estimated to be C10,000.

In this example the lease term is three years, which is equivalent to 100% of the expected useful life of the asset. The present value of C1 due in three years at 10% (as per present value tables) is 0.7513. The present value of an ordinary annuity of C1 for three years at 10% is 2.4869.

The present value of the guaranteed residual value is (C10,000 × 0.7513) = C7,513 + (C50,000 × 2.4869) C124,345 = C131,858.

The market value of the machine is C135,000 and the present value of the residual value and the annual lease payments is C131,858, which equates to 97.7% of the market value. As the present value at the inception of the lease of the minimum lease payments is at least equal to substantially all of the fair value of the leased asset, this is indicative of a finance lease.

The machine will be recognized as an asset with a corresponding lease creditor.

Reference is made to the term *substantially all* – but what determines what 'substantially all' is?

IFRS does not actually state a threshold quantitative amount. There is room for debate on whether *substantially all* implies a lower threshold than 90%, or even a higher threshold, but it is generally accepted that 90% is the basis figure.

For the purposes of determining this calculation, the minimum lease payments are considered to be the payments that the lessee is obligated to make, or can be required to make, excluding contingent rent and executory costs (i.e. costs such as insurance, maintenance, etc.). The minimum lease payments generally include the minimal rental payments, and the present value is computed using the incremental borrowing rate of the lessee – unless it is practicable for the lessee to determine the implicit rate computed by the lessor, in which case this is used.

**Operating leases**
Operating leases are much simpler than finance leases. The rentals are simply charged to profit or loss as and when they arise, in other words:

- CR cash at bank; and
- DR profit or loss (operating leases).

**Lessor accounting: operating leases**
The payments received by the lessor are to be recorded as rental income in the period in which the payment is received, or becomes receivable. As with the lessee, if the rentals vary from a straight-line basis, or if the lease agreement contains a scheduled rent increase over the lease term, the revenue is nonetheless to be recognized on a straight-line basis unless an alternative basis of systematic and rational allocation is more representative of the time pattern of the earning process contained in the lease.

The lessor must report the leased property on the statement of financial position under the caption 'Investment in leased

property' under non-current assets and depreciation should be determined in the same manner as for the rest of the lessor's owned property, plant and equipment.

**Lessor accounting: finance leases**
The lessor should record a trade receivable using the net investment method. The net investment in the lease is the difference between the lessor's gross investment in the lease and the unearned finance income.

The gross investment (lease receivable) of the lessor is equal to the sum of the minimum lease payments (excluding ancillary costs) from the standpoint of the lessor, plus the non-guaranteed residual value accruing to the lessor. The difference between the gross investment and the present value of the two component of gross investment (i.e. the minimum lease payments and non-guaranteed residual value) is recorded as unearned finance income. This is also referred to as 'unearned interest revenue'.

In terms of unearned finance income, IAS 17 states that this is to be amortized into income using the effective rate (or yield) interest methods, which will result in a constant periodic rate of return on the lessor's net investment. The effective rate is now the only acceptable method of income recognition.

# 29. Are there any changes planned for lease accounting?

## Answer

At the time of writing, there are substantial changes planned for the area of lease accounting!

Back in 2010, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) issued an exposure draft, '2010 *Leases*', which caused an element of outcry among those that report under IFRS. Indeed, the proposals contained in the exposure draft were of such a radical nature that if they were implemented, other countries reporting under national accounting standards that converge to IFRS could also jump on the bandwagon and change the area of lease accounting to run in conjunction with IFRS.

However, at a meeting in London on 13 June 2012, the IASB and FASB both agreed on a revised method of accounting for leasing arrangements that would include two types of lease transaction, essentially based on the length of time a lease is taken out in comparison to the value of the leased asset.

**Current accounting rules**

Lease accounting has always been somewhat controversial because of the ability to manipulate lease transactions to achieve a desired outcome (often referred to as 'off balance sheet finance'). Critics have said that the ways in which lease transactions are currently accounted for mean that many leases do not appear on balance sheets, which misleads users. This has been a problem that has been around ever since the introduction of accounting standards governing the ways in which leases are accounted for.

Many entities around the world believe that if they enter into a leasing arrangement with a lessor, there is no requirement to put the asset subjected to the lease on the balance sheet because they have not, in effect, taken out a loan to finance the lease. The problem with this interpretation is that such entities are looking to the asset's legal form as opposed to the substance of the arrangement. In a finance lease, the substance of the arrangement is such that an asset has been acquired by the lessee and the lessee has used a leasing arrangement as a means of financing the asset's acquisition.

The principles contained in IAS 17 (and also the new UK GAAP) are based on the risks and rewards of ownership of an asset. If the risks and rewards associated with ownership of a leased asset remain with the lessor, then this lease falls to be treated as an operating lease; whereas if the risks and rewards are passed to the lessee, the lease is treated as a finance lease – hence the asset is capitalized on the balance sheet with an associated lease creditor representing the capital element of the future lease obligations payable to the lessor.

**Proposals**

The original proposals contained in the 2010 exposure draft introduced a 'right of use' model that was considered to be a significant change. Essentially, the 2010 exposure draft suggested that all leases – regardless of whether risks and rewards remain with the lessor or pass to the lessee – should be treated as a finance lease, therefore eradicating the operating lease classification.

These proposals came in for a substantial amount of criticism from those entities that use genuine operating leases as a means of financing assets. Indeed, many professional accountants and analysts said that the use of such a model would seriously distort the financial statements, particularly EBITDA.

Had the proposals been given the go-ahead and been enshrined into IFRS, a company would have had to apply the 'effective

interest rate method' on the liability owed to the lessor. This means that a company would have an interest charge based on its outstanding liability, so the financial statements would reflect a higher charge in the earlier years. A lower rate of interest would be recognized in the later years, so the expense profile of a lease transaction would essentially be front-loaded in the earlier years of a client's leasing arrangement.

Other entities were also concerned as to the effect that the proposals would have on them if they were to be passed by the IASB and FASB, because the revised accounting treatment would result in lower asset turnover ratios, lower return on capital and a detrimental impact on gearing ratios. For clients that have loan covenants imposed on them by financiers, the proposals were quite worrying, as they could have meant that covenants may well have been breached.

The IASB and FASB tentatively agreed that all leases should be recorded on the balance sheet, but acknowledged the need to consider the ways in which the classification and pattern of expense should be recognized within the income statement (profit and loss account).

**Revised approach**

On 13 June 2012, the IASB and FASB agreed on an approach for lease accounting in respect of the expense that would be recognized within the income statement. This would affect companies that report under IFRS (and US GAAP), and the IASB and FASB are planning to issue a joint exposure draft in the first quarter of 2013 – readers should check www.iasb.org for updates on this – with a planned version of the revised accounting standard being issued in mid-2013 and a potential implementation date in 2015/2016 (although this has yet to be confirmed).

Under the 'compromise', the two boards agreed that some lease contracts would be accounted for under a similar approach to the treatment outlined in the 2010 exposure

draft – hence all such leases will be reported on the balance sheet. This treatment would apply to the vast majority of lease transactions that are entered into for periods of more than one year.

There are some leases that would be accounted for in a similar way to an operating lease – in other words, by way of a straight-line expense into the P&L account (income statement) – and this treatment would apply to those leases that represent a relatively small percentage of the life (or value) of the leased asset. So if a lease transaction is not significant over the life of the asset, the treatment is the same as that of an operating lease.

Expensing leasing payments on a straight-line basis to the P&L account (income statement) for those leases that represent a relatively small percentage of the life/value of the leased asset would eliminate an 'uneven spread'; otherwise, if such short leases were put on balance sheet, this would result in depreciation charges *and* interest charge on the liability – hence there would be a higher expense reported in the profit and loss account (income statement) in the early part of a lease transaction.

# 30. When a company receives a government grant, how does it account for this?

## Answer

Many companies receive grants for various things; for example, when a company wants to expand and set up in a deprived area, the company may receive a grant from the government to entice it to create employment opportunities. Similarly, a company could receive a government grant towards the cost of an item of machinery, or the reimbursement of previously incurred expenditure.

Whatever the reason for receiving the grant, a company that does so accounts for the grant in accordance with IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. The objective of IAS 20 is to prescribe the accounting treatment and the disclosure requirements of an entity that has received government grants and/or government assistance.

A government grant is assistance by a government in the form of transfers of resources (usually in the form of economic benefits) to an entity in return for past, or future, compliance with stipulated terms relating to the operating activities of the entity. Government assistance is action by the government designed to provide an economic benefit specific to an entity, or range of entities, qualifying under certain criteria.

**Recognition in the financial statements**

Government grants must not be recognized within an entity's financial statements until there is reasonable assurance that:

- the entity will comply with the terms and conditions attached to the grant(s); and
- the grant will be received by the entity.

If the reporting entity does not comply with the conditions of the grant's term, the grant-awarding body will more than likely have the right to recover all, or part, of the grant. To accord with the prudence concept, this does not mean that just because there is a possibility that a grant *may* have to be repaid at some point in the future, this means indefinite deferral from profit or loss. The concept requires entities to consider if there is a likelihood that any breach of the grant's terms will occur (or already has occurred) and – if this is the case, or is likely to be the case – then provision should be made for the liability.

**Types of grant**

There are generally two forms of grant that need accounting consideration:

- revenue-based grants; and
- capital-based grants.

The principles within IFRS require grants to be recognized within profit or loss so as to match them with the expenditure that they are intended to contribute towards. For revenue-based grants, these will be written off to profit or loss as and when the relevant expenditure has been incurred. In terms of capital-based grants, these are generally recognized in profit or loss over the life of the asset(s) to which the grant(s) relate – in other words, matched with the relevant depreciation charges.

**Accounting treatment**

When a grant relates to an item of property, plant and equipment (non-current assets), IAS 20 recognizes that there are two potential accounting treatments available to reporting entities:

**(a)** to treat the amount of the grant as deferred income that is credited to profit or loss by instalments over the expected useful economic life of the related asset on a basis consistent with the entity's depreciation policy; or
**(b)** to deduct the amount of the grant from the purchase price or production cost of the related asset.

If a company opts for treatment (b), the grant will be recognized in profit or loss by way of reduced depreciation charges because the annual depreciation charge will be based on a reduced cost.

It is important to emphasize that there are some jurisdictions that prohibit option (b) from being applied, which is illustrated as follows, using a company based in the UK reporting under IFRS.

**Example**

Cahill Corp Ltd (Cahill) is a company based in the UK that reports under IFRS. Cahill purchased an item of machinery for £60,000 cash and received a government grant towards the cost of this asset for £20,000. The useful economic life of this item of machinery is ten years with zero residual value at the end of this useful economic life. The directors have said that for simplicity they are going to offset the grant against the cost of the machine. The proposed entries in the books of Cahill are as follows:

On initial recognition

| | |
|---|---|
| DR non-current assets | £60,000 |
| CR cash at bank | £60,000 |

*Being initial recognition of the new machine*

Grant receipt

| | |
|---|---|
| DR cash at bank | £20,000 |
| CR non-current assets | £20,000 |

*Being receipt of grant*

Annual depreciation

(£60,000 minus £20,000) / 10 years = £4000 per annum

Under this option, the grant is recognized in the profit and loss account by way of reduced depreciation charges.

In the UK, the Companies Act 2006 prohibits offsetting because the statutory definitions of 'purchase price' and 'production costs' do not make any provision for any deduction from that amount in respect of a grant. As a result, companies (incorporated entities) must recognize any unamortized grant(s) as a liability within the statement of financial position (balance sheet) as 'deferred income', as follows:

| On initial recognition | |
| --- | --- |
| DR non-current assets | £60,000 |
| CR cash at bank | £60,000 |
| *Being initial recognition of the new machine* | |
| Grant receipt | |
| DR cash at bank | £20,000 |
| CR deferred income | £20,000 |
| *Being receipt of grant* | |
| Depreciation | |
| DR depreciation charges | £6000 |
| CR accumulated depreciation | £6000 |
| *Being depreciation charge for one year* | |
| Grant release over life of the asset | |
| DR deferred income | £2000 |
| CR grant income | £2000 |
| *Being one year's worth of grant income* | |

While IAS 20 permits the creation of a deferred income account or the offsetting of the grant against the purchase price or production cost of the asset to which the grant relates, reporting entities must be extremely careful to ensure their accounting treatment does not breach the requirements of legislation (as in the UK).

**Revenue-based grants**

Revenue-based grants are recognized in profit or loss in the same period as the expenditure to which the grant relates. If the grant relates to a reimbursement of costs that have been previously incurred, without any conditions attached, or a requirement to incur further costs, the grant should be recognized in profit or loss in the period in which the company is paid. If the grant does not specify a specific accounting period, the grant should be recognized in profit or loss in the period in which the grant becomes receivable.

# 31. What are the different categories of revenue under IFRS and how do they differ from gains?

## Answer

The accounting standard that deals with revenue is IAS 18 *Revenue*. IAS 18 explains that its objective is to prescribe the accounting treatment of revenue arising from the following types of transactions and events:

- the sale of goods;
- the rendering of services; and
- the use by others of entity assets yielding interest, royalties and dividends.

It is important that the different categories of revenue are differentiated correctly. The term 'goods' relates to goods produced by an entity for the purpose of sale and goods that are purchased for resale; for example, clothing purchased by a manufacturer in a retail shop, or land or other property held for resale.

The rendering of services will typically involve the performance by an entity of a contractually agreed task over an agreed period of time. An 'agreed period of time' may be as short as six months, or it could cover more than one accounting period. What is important to emphasize where the rendering of services are concerned is that the rendering of services that are directly related to construction contracts are not dealt with under the provisions in IAS 18, but are instead dealt with in IAS 11 *Construction Contracts*.

Paragraph 5 of IAS 18 says that the use by others of entity assets gives rise to revenue in the form of:

- interest – charges for the use of cash or cash equivalents or amounts due to the entity;
- royalties – charges for the use of long-term assets of the entity (for example, patents, trademarks, copyrights and computer software); and
- dividends – distributions of profits to holders of equity investments in proportion to their holdings of a particular class of capital [IAS 18.5].

Paragraph 6 of IAS 18 outlines those matters that are expressly not dealt with in IAS 18, which are as follows:

- lease agreements (IAS 17) – it is to be noted that IAS 17 itself does not apply to licensing agreements in relation to motion picture films, video recordings, plays, manuscripts, patents and copyrights;
- dividends arising from investments that are accounted for under the equity method;
- insurance contracts within the scope of IFRS 4 *Insurance Contracts*;
- the changes in the fair value of financial assets and financial liabilities or their disposal;
- the changes in the value of other current assets;
- revenue arising from the initial recognition and from changes in the fair value of biological assets related to agricultural activity;
- the initial recognition of agricultural produce; and
- the extraction of mineral ores.

One final point to emphasize where revenue is concerned is that the IASB's *Conceptual Framework* distinguishes between 'revenue' and 'gains'. Gains are not the same as revenue. The *Conceptual Framework* recognizes that revenue arises in the course of the ordinary activities of an entity, whereas gains represent other items that meet the definition of income and may, or may not, arise in the ordinary course of business. Among other things, gains often include profits arising on the disposal of non-current assets.

**Example**

Joyce Joinery Co. (Joyce Joinery) is a nationwide firm of joiners with branches across the country and has a year end date of 31 December 2012. During the year to 31 December 2012, Joyce Joinery sold three of its branches to unconnected third parties and the profit on disposal of these three properties amounted to C54,000. Joyce Joinery has included this profit within revenue for the year-ended 31 December 2012.

The business that Joyce Joinery is in (joinery) does not include the buying and selling of property (i.e. the sale of property is not in the ordinary course of Joyce Joinery's business). As a result, the profit on disposal of C54,000 must be shown within profit on disposal of non-current assets within the statement of profit or loss.

# 32. How does a company recognize revenue in its income statement/statement of profit or loss?

## Answer

Question 31 outlined the different types of revenue that falls under the scope of IAS 18 *Revenue*, namely:

- sales of goods;
- rendering of services; and
- the use by others of entity assets yielding interest, royalties and dividends.

**Measurement of revenue**

In terms of revenue recognition, an entity is required (under paragraph 9 of IAS 18) to measure revenue at the fair value of the consideration received or receivable. The standard also recognizes that the actual amount of revenue that arises in a transaction is usually determined by agreement between the entity and the buyer or user of the asset. The phrase 'at the fair value of the consideration received or receivable' means taking into consideration any trade discounts or volume rebates that the entity allows, while 'fair value' is defined as 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction'.

Generally, the amount of revenue to be recognized is fairly straightforward because it will essentially be the amount of cash that a customer is obliged to pay the entity for the sale of goods, rendering of services or use of entity assets. However, problems can arise when the inflow of economic benefits from a sale transaction is deferred, because the fair value of the consideration will be less than the nominal amount of

cash received or receivable. In recognition of these types of transactions, IAS 18 has a discounting requirement embedded within the standard. This discounting requirement works by discounting all future receipts using an imputed interest rate. Paragraph 11 of IAS 18 says that the imputed rate of interest is the more clearly determinable of either:

- the prevailing rate for a similar instrument of an issuer with a similar credit rating; or
- a rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services.

**Example**

The Ward Group has sold goods to one of its customers on deferred credit terms and is preparing financial statements for the year ended 31 December 2012. It has worked out that the fair value of the consideration receivable from its customer is C100,000. The nominal value of the consideration is C120,000.

The difference between the fair value and the nominal value of the consideration is recognized as interest revenue using the effective interest method as set out in paragraph 9 of IAS 39 *Financial Instruments: Recognition and Measurement* and AG5 to AG8.

**Revenue recognition**

The term 'revenue recognition' has been in the headlines quite a lot over recent years. This is due to the fact that revenue lends itself to a whole host of manipulation; for example, it has been known for companies to delay recognizing revenue in their financial statements to reduce the levels of taxation. Conversely, it has also been known for companies to accelerate revenue disproportionately to boost profitability in order to secure additional financing or attract additional investors. The

overarching objective of IAS 18 is to outline the exact timing as to when a reporting entity should recognize revenue. The measurement criteria in IAS 18 (see above) has the objective of ensuring that reporting entities recognize the correct amount of revenue in the financial statements.

*Sale of goods* There are five criteria that have to be met in paragraph 14 of IAS 18 where sales of goods are concerned. If any of the five criteria cannot be met, then no revenue can be recognized. The five criteria are as follows:

- the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
- the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
- the amount of revenue can be measured reliably;
- it is probable that the economic benefits associated with the transaction will flow to the entity; and
- the costs incurred or to be incurred in respect of the transaction can be measured reliably.

**Example**

Bart Baling Equipment has a year end of 31 December 2012. On 1 November 2012 it sold a batch of baling equipment to a customer located in an overseas country for C100,000. The terms of the agreement are that Bart Baling Equipment will supply the equipment and attend the customer's premises overseas to install it, and ensure that it is in full working capacity prior to the customer signing to say they are satisfied. Bart Baling Equipment is to fly over to the customer's premises on 4 January 2013 to install the machinery but is planning to recognize the sale in the financial statements as at 31 December 2012.

> Bart Baling Equipment cannot recognize the C100,000 sale in the 2012 financial statements because it still has an obligation to its customer to go to the customer's premises, install the machinery and ensure that it is working to full capacity. Revenue from this sale can only be recognized in the financial statements once the customer has signed to say they are satisfied that the equipment has been installed correctly and is working to its full capacity.

If a reporting entity is not able to reliably measure the costs incurred (or to be incurred), IAS 18 requires that 'any consideration already received for the sale of goods is recognized as a liability' [IAS 18.19].

A notable phrase in the five criteria above is the passing of 'significant risks and rewards of ownership of the goods'. This is an absolutely crucial aspect of revenue recognition and must be dealt with correctly. The standard gives the following four examples of situations in which an entity may **retain** the significant risks and rewards of ownership:

- when the entity retains an obligation for unsatisfactory performance not covered by normal warranty provisions;
- when the receipt of the revenue from a particular sale is contingent on the derivation of revenue by the buyer from its sale of the goods;
- when the goods are shipped subject to installation and the installation is a significant part of the contract that has not yet been completed by the entity; and
- when the buyer has the right to rescind the purchase for a reason specified in the sales contract and the entity is uncertain about the probability of return.

*Rendering of services* IAS 18 requires that when the outcome of a transaction involving the rendering of services can be estimated reliably, the amount of revenue to be recognized

is calculated 'by reference to the stage of completion of the transaction at the end of the reporting period' [IAS 18.20]. The 'stage of completion' is also referred to as 'the percentage of completion method'.

**Example**

IT Solutions R Us has been commissioned by one of its customers to develop a bespoke accounting software programme. It is anticipated that it will take nine months from 1 October 2012 to complete the work. IT Solutions R Us has a year end of 31 December 2012 and the contractual terms of the work are as follows:

- 30% of the price to be paid when the contract is 40% complete
- 25% of the price to be paid when the contract is 70% complete
- 25% of the price to be paid when the contract is 85% complete
- 20% of the price to be paid when the work is complete

The project cost is C150,000 and on 31 December 2012, 30% of the project was complete therefore a sales invoice was raised for C45,000 (30% × C150,000). The total costs incurred in the project have been calculated at C100,000.

As the contract is 30% completed on 31 December 2012, IT Solutions R Us will recognize 30% of the total revenue in its financial statements (C45,000), but will also recognize 30% of the project costs, so in total it will recognize profit on the project at 31 December 2012 as follows:

| | |
|---|---|
| Revenue | C45,000 |
| Costs (30% × C100,000) | C30,000 |
| Profit | C15,000 |

IAS 18 says that the outcome of a transaction can be estimated reliably when all the following conditions are satisfied:

- the amount of revenue can be measured reliably;
- it is probable that the economic benefits associated with the transaction will flow to the entity;
- the stage of completion of the transaction at the end of the reporting period can be measured reliably; and
- the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

**Example**

James Joinery Co. (James Joinery) is undertaking a large project for one of its customers that is expected to span two accounting periods. James Joinery has a year end date of 31 October 2012. On 31 October 2012, the company assessed the project, but was unable to conclude the stage of completion; hence was not able to reliably estimate the outcome of the transaction at the year end.

Paragraph 26 of IAS 18 says that when the outcome cannot be estimated reliably, revenue is recognized only to the extent of the expenses recognized that are recoverable.

In situations when a company cannot reliably estimate the outcome of a transaction and it is not probable that the costs incurred will be recovered, revenue is not recognized and the costs incurred are recognized as an expense. When the uncertainties that originally prevented the outcome of the transaction being reliably estimated are extinguished, then revenue is recognized by reference to the stage of completion.

Paragraph 23 to IAS 18 suggests that an entity is generally able to make reliable estimates after it has agreed the following with the other parties to the transaction:

- each party's enforceable rights regarding the service to be provided and received by the parties;
- the consideration to be exchanged; and
- the manner and terms of settlement.

*Interest, royalties and dividends* IAS 18 says that when it is probable that the economic benefits associated with the transaction will flow to the entity, and the amount of revenue can be measured reliably, revenue in respect of the use by others of entity assets yielding interest, royalties and dividends should be recognized as follows:

- *Interest*: using the effective interest method as set out in IAS 39, paragraphs 9 and AG5-AG8.
- *Royalties*: on an accrual basis in accordance with the substance of the relevant agreement.
- *Dividends*: when the shareholder's right to receive payment is established.

*Exchanges of goods and services* It may be the case that an entity exchanges goods and/or services for goods or services that are of a similar nature and value. In such cases, the exchange is not regarded as one that generates revenue. However, in situations when goods are sold or services are rendered in exchange for dissimilar goods or services, then the exchange is regarded as one that will generate revenue. Revenue is measured at the fair value of the goods or services received and adjusted by the amount of any cash, or cash equivalents, that are transferred. If an entity is not able to reliably measure the fair value of goods or services, the revenue is measured at the fair value of the goods or services given up, and adjusted by the amount of any cash or cash equivalents transferred.

# 33. What is the difference between current and deferred tax?

## Answer

Accounting for taxes is dealt with in IAS 12 *Income Taxes*. The objective is:

> 'to prescribe the accounting treatment for income taxes. The principal issue in accounting for income taxes is how to account for the current and future tax consequences of:
>
> - the future recovery (settlement) of the carrying amount of assets (liabilities) that are recognized in an entity's statement of financial position; and
> - transactions and other events of the current period that are recognized in an entity's financial statements.'

Deferred tax is covered in Question 34.

**Current tax**
Current tax is the amount of income tax payable or recoverable in respect of the taxable profit (or taxable loss) for an accounting period.

Current tax is calculated based on tax, not accounting, profit. In arriving at accounting pre-tax profit, certain items may be recognized in the financial statements as income or expense, but may not be permissible under tax legislation.

**Example**

The pre-tax profit for Leah Lighting at 31 December 2012 is C100,000. In arriving at that profit, Leah Lighting has charged C20,000 worth of depreciation that is not permitted

as a deduction in Leah's country, as the tax authority grants capital allowances (sometimes known as 'tax-allowable depreciation'). The items that have been charged C20,000 depreciation have been identified and the associated capital allowances amount to C25,000. Leah Lighting taxable profit can be calculated as follows:

| | C |
|---|---|
| Profit as per financial statements | 100,000 |
| Addback depreciation | 20,000 |
| | 120,000 |
| Less capital allowances (tax allowable depreciation) | (25,000) |
| Profit for taxation purposes | 95,000 |

Assume that Leah Lighting pays tax at 25% then the current tax expense for the year ended 31 December 2012 will be:

C95,000 × 25% = C23,750

This liability will be recognized in Leah Lighting financial statements by way of the following journal:

| | |
|---|---|
| DR income tax expense (statement of profit or loss) | C23,750 |
| CR income tax liability (statement of financial position – current liability) | C23,750 |

**Deferred tax**

Deferred tax is inherently more complicated than current tax! The most crucial point to understand is that deferred tax is merely an accounting adjustment; it is not a tax that is actually paid over to the tax authorities. The objective of deferred tax is to make an accounting adjustment to deal with the future tax consequences on *current period* transactions with the

intention of smoothing out distortions relating to tax timings from the post-tax profit figure. IAS 12 deals with deferred tax and contains some of the following definitions that should be understood in order to move on to the calculation of deferred tax:

- *Accounting profit* is the profit before income tax expense (pre-tax profit) that is shown in the statement of profit or loss.
- *Tax base* is the amount of an asset that is deductible for tax purposes against any taxable economic benefits (for example, sales) generated by that asset. If the economic benefits are not taxable, the asset's tax base (the value for tax purposes) is equal to its carrying amount in the financial statements.
- *Temporary differences* are the differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. A temporary difference can be *deductible*, which means that the difference can be deducted in the future to determine taxable profit or loss. A temporary difference can also be *taxable*, which means that the difference gives rise to an amount you can use to determine future taxable profit or loss.

As you saw in the example above (Leah Lighting), pre-tax accounting profit is often, if not always, different to taxable profit. This difference is due to various transactions that make up accounting profit that are not allowed for the purposes of taxation, hence get added back to arrive at a taxable profit. In addition, events in the current year can have a tax consequence in future years and there are many occurrences that can give rise to deferred tax. The most frequent example of a transaction that is recorded in the current accounting period but has a future tax consequence is the acquisition of a new non-current asset.

**Example**

Robinson Renovator Co. (Robinson) is located in a country whose tax authority allows 100% capital allowances (tax allowable depreciation) on qualifying items of non-current assets. The company has a year end of 31 December 2012. On 1 November 2012, Robinson purchased an item of machinery for C50,000, which qualified for 100% capital allowances. The accounting policy of the company is to depreciate such machinery on a straight-line method over its expected useful life and the expected useful economic life of this particular item of machinery is five years.

In year 1, the item of machinery will have a depreciation charge of (C50,000 / 5 years) C10,000. However, the tax authority will grant 100% capital allowances against the cost of the machine, so its tax base following the capital allowances will be nil because the tax authority have written off the cost of the machine in year 1; in other words, Robinson has received tax relief for years two to five early. This is only a temporary difference because in years 2–5 there will be no capital allowances available on the machine hence there will be additional tax to pay. This is because the temporary differences in years 2–5 are reversing and therefore the temporary differences can be said to be taxable temporary differences. For more on taxation issues, refer to Questions 34 and 35.

# 34. How do you work out deferred tax under IFRS?

## Answer

As discussed in the previous chapter, the overarching objective of IAS 12 *Income Taxes* is to deal with how an entity accounts for income taxes, both current and deferred. It is widely accepted throughout the world of financial reporting that accounting standards such as IFRS will permit a particular accounting treatment, while tax legislation will dictate an alternative treatment. This is particularly the case with transactions such as depreciation, which are a necessity for financial reporting purposes but are not permitted for the purposes of tax legislation (as illustrated in the previous FAQ).

In light of this, the generally accepted view is that it is necessary to seek some sort of reconciliation between these two treatments; this 'treatment' is therefore known as 'deferred tax'. The main thrust of deferred tax, therefore, is to recognize the tax effects of transactions in the financial statements in the same period as the transactions themselves.

**Timing and temporary differences**
IAS 12 works on the 'temporary difference' approach. Broadly speaking, this approach calculates the tax that would be paid if the net assets of the reporting entity were sold at book value. A temporary difference is the difference between the carrying amount of an asset or a liability and its 'tax base'. The 'tax base' is basically the amount at which an item is recognized for the purposes of tax.

Some accountants may have come across the 'timing difference' approach (which is the way the UK's FRS 19 *Deferred Tax* works). Timing differences represent items of income or

expenditure that are taxable or tax-deductible, but in periods different from those in which they are dealt with in the financial statements. They therefore arise when items of income and expenditure enter into the measurement of profit for both accounting and tax purposes, but in different accounting periods. The essential difference between the 'timing' and 'temporary' difference approach is that the timing difference approach focuses on the statement of comprehensive income, whereas the temporary difference approach focuses on the statement of financial position.

**Example**

Gabriella has an item of plant with a carrying amount in the financial statements amounting to C10,000. The same item of plant has a tax base (a tax written down value) of C5000. This results in a temporary difference of C5000. Gabriella pays tax at 30%, so the deferred tax liability that should be recognized by Gabriella amounts to (C5000 × 30%) = C1500. To recognize this liability, Gabriella should record these as follows:

| | |
|---|---|
| DR income tax expense | C1500 |
| Credit deferred tax liability | C1500 |

Deferred tax is always shown as a non-current liability in the statement of financial position.

Because the tax authority is essentially 'consuming' the asset at a faster rate than Gabriella (net book value vs. tax base), then the tax effects (usually because of accelerated tax allowable depreciation) will be felt in the financial statements in future periods. If you assume that Gabriella already had a deferred tax provision brought forward amounting to C500, then from the perspective of the statement of financial position, the difference is taken to the income statement as follows:

| | |
|---|---|
| Opening balance brought forward | C500 |
| Movement in the period | C1000 |
| Closing balance carried forward | C1500 |

It is only the movement between the opening and closing provision for deferred tax that gets charged or (credited) to the income statement.

**Temporary differences**
Debit balances in the financial statements compared to the tax written down values give rise to deferred tax liabilities and are known as taxable temporary differences.

Credit balances in the financial statements compared to the tax written down values give rise to deferred tax assets that are known as deductible temporary differences.

Temporary differences can also arise in the following situations:

- Revenue recognized for financial reporting purposes before being recognized for tax purposes. Such instances are taxable temporary differences, which give rise to deferred tax liabilities.
- Expenses that are deductible for tax purposes prior to recognition in the financial statements. An example of this is where the tax authority will grant tax allowable depreciation, which is higher than the depreciation charged in the financial statements and these differences will give rise to deferred tax liabilities.
- Expenses that are accounted for in the financial statements prior to becoming deductible for tax purposes. An example of these expenses is warranty costs – these are deductible temporary differences which give rise to deferred tax assets.
- Revenue recognized for tax purposes prior to recognition in the financial statements. A typical example of this would be prepaid rental income that would give rise to deductible temporary differences and a deferred tax asset.

### Example

Aidan purchase a machine on 1 January 2012 for C48,000 that is estimated to have a useful economic life of seven years with a residual value at the end of this useful life of C6000. Depreciation will therefore be (C48,000 – C6000) / 7 = C6000 per annum. For the purposes of this illustration, assume Aidan pays tax at 30%. Aidan's tax authority grants tax allowable depreciation (sometimes referred to as 'capital allowances') at a rate of 25% on a reducing balance basis (rounded up to the nearest thousand). Aidan's profit for each year (before taxation) amounts to C80,000.

Aidan would determine its deferred tax by first calculating the temporary differences as follows (all figures are in C).

| *Financial Statements* | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|
| Net book value b/fwd | 48,000 | 42,000 | 36,000 | 30,000 | 24,000 | 18,000 | 12,000 |
| Depreciation | 6000 | 6000 | 6000 | 6000 | 6000 | 6000 | 6000 |
| Net book value c/fwd | **42,000** | **36,000** | **30,000** | **24,000** | **18,000** | **12,000** | **6000** |
| *Tax Computation* | | | | | | | |
| Tax base b/f | 48,000 | 36,000 | 27,000 | 20,000 | 15,000 | 11,000 | 8000 |
| Tax depreciation | 12,000 | 9000 | 7000 | 5000 | 4000 | 3000 | 2000 |
| Tax base c/f | **36,000** | **27,000** | **20,000** | **15,000** | **11,000** | **8000** | **6000** |
| *Temporary difference arising* | | | | | | | |
| Net book value | 42,000 | 36,000 | 30,000 | 24,000 | 18,000 | 12,000 | 6000 |
| Tax base | 36,000 | 27,000 | 20,000 | 15,000 | 11,000 | 8000 | 6000 |
| Temporary difference | **6000** | **9000** | **10,000** | **9000** | **7000** | **4000** | **0** |
| *Deferred tax provision* | | | | | | | |
| Temporary difference above × 30% | **1800** | **2700** | **3000** | **2700** | **2100** | **1200** | **0** |

Aidan's financial statements will show the following:

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|
| Profit before taxation | 80,000 | 80,000 | 80,000 | 80,000 | 80,000 | 80,000 | 80,000 |
| Current tax at 30% | 22,200 | 23,100 | 23,700 | 24,300 | 24,600 | 24,900 | 25,200 |
| Deferred tax* | 1800 | 900 | 300 | (300) | (600) | (900) | (1200) |
| Profit after taxation | 56,000 | 56,000 | 56,000 | 56,000 | 56,000 | 56,000 | 56,000 |

*The deferred tax charge/(credit) in the income statement is only the movement in the deferred tax provision from one period to the next.

**Deferred tax in business combinations**

The above illustrations show a fairly simplistic example of how deferred tax issues arise. However, there are many situations that give rise to deferred tax and the consideration of deferred tax may extend to more complex scenarios, such as deferred tax in a business combination.

IAS 12 requires the tax effects of the tax-book basis differences of all assets and liabilities to be presented as deferred tax assets and deferred tax liabilities at the date of acquisition. Consider the following example:

**Example**

Lucas is involved in the acquisition of Charlotte. The following information is relevant:

- Lucas pays tax at the rate of 40%.
- The cost of acquiring Charlotte was C500,000.
- The fair value of Charlotte's net assets acquired are C750,000.
- The tax base of the assets acquired are C600,000.
- The tax base of the liabilities acquired are C250,000.
- The difference between the tax and fair values of the assets acquired are C150,000, which are made up as follows:

- Taxable temporary differences of C200,000.
- Deductible temporary differences of C50,000.
- The directors have given their assurances that the deductible temporary differences are recoverable.

Show how the purchase price will be allocated in the above scenario.

Essentially all you are doing here is to show how the purchase proceeds Lucas paid of C500,000 to acquire Charlotte are going to be split. This can be demonstrated as follows:

| | C | C |
|---|---|---|
| Consideration | | 500,000 |
| Allocation to identifiable assets/liabilities | | |
| Assets (excluding the goodwill/deferred tax asset) | 750,000 | |
| Deferred tax asset (C50,000 × 40%) | 20,000 | |
| Liabilities (excluding deferred tax liability) | (250,000) | |
| Deferred tax liability (C200,000 × 40%) | (80,000) | |
| | | 440,000 |
| Difference goes to goodwill | | 60,000 |

If the goodwill is tax deductible in Lucas's jurisdiction, the amortization period will cause the carrying amount for tax purposes to differ from that of the financial statements. Under IFRS 3 *Business Combinations*, goodwill is not amortized over its expected useful life, hence a temporary difference will develop with book values being greater than the tax base. If impairment charges are taken into consideration, then the carrying amounts may be lower than the corresponding tax basis.

When you encounter negative goodwill, IFRS 3 states that the acquirer should reassess the values placed on the net assets and liabilities. If this does not lead to the elimination of the

negative goodwill, that amount is then reported as income in the current period. This will more than likely result in a difference between the tax and carrying values for the negative goodwill, which is also a timing difference to be considered in computing the deferred tax balance for the reporting entity.

In the scenario above, Lucas's directors are confident that the deferred tax assets are deemed probable of being realized. However there are circumstances when there is substantial doubt about the ability to recover deferred tax assets, hence it is *not* probable that such an asset will be recovered. Under IAS 12, the deferred tax asset would not be recognized at the date of acquisition; therefore, if the directors of Lucas were *not* confident that the deferred tax asset would be recovered, the allocation of the purchase price would have to reflect that fact and more of the purchase cost would be allocated to goodwill than would have otherwise been the case above.

**Change in circumstances**

### Example

On 1 January 2005, Lucas was involved in a business combination. At the date of acquisition, the deferred tax asset was calculated at C100,000 and on that date the directors considered that the realization of the deferred tax asset was *not* probable.

The unrecognized deferred tax asset is allocated to goodwill during the purchase price assignment process.

On 1 January 2006, circumstances change and the directors reassess the likelihood of realizing the original deferred tax asset when it becomes probable that the deferred tax asset *will* be recovered. On 1 January 2006, the entries are:

| | |
|---|---|
| Debit deferred tax asset | C100,000 |
| Credit goodwill | C100,000 |

# 35. How does an entity recognize a deferred tax asset?

## Answer

An important point to emphasize at the outset is that there is a significant difference between deferred tax liabilities and deferred tax assets. An entity's deferred tax liabilities will crystallize if the entity recovers its existing net assets at their carrying amount in the financial statements. A significant aspect of IAS 12 *Income Taxes* is that the standard prohibits the recognition of deferred tax assets to the extent that it is probable that taxable profit will be available against the underlying deductible temporary differences. An important principle contained within IAS 12 is that the existence of unused tax losses give rise to strong evidence that taxable profits (other than those represented by deferred tax liabilities) may not be available. For reporting entities that have a history of recent losses, a deferred tax asset arising from unused tax losses (or tax credits) should only be recognized to the extent that:

- it has sufficient taxable temporary differences; or
- there is other convincing evidence that sufficient taxable profit will be available against which the unused tax credits can be utilized by the reporting entity.

In times of economic difficulty it is fairly common for companies to sustain losses. One of the most frequent occurrences of deferred tax assets are unutilized taxable losses that are available to be carried forward and go to reducing the next accounting period's tax liability, as the losses can be offset against taxable profits. However, it has to be probable that the entity will make profits in order to offset these unused losses. If it is not probable, then a deferred tax asset must not be recognized in the financial statements.

**Example**

The Alicia Group is in the construction industry. Over recent years the industry has been suffering a decline due to economic recession and the Alicia Group's financial statements at 31 December 2011 showed a pre-tax loss of C30,000. The financial statements for the Group as at 31 December 2012 are also expected to show a further loss of around the same figure, and the accountant has recognized deferred tax assets in respect of the unused tax losses that will be available to be offset against future taxable profits.

On 1 February 2013, the Alicia Group won a contract to build 120 luxury three- and four-bedroomed houses in a vibrant part of the country. This contract is very profitable and will be in operation for at least three years.

In this example, it is clear that the Alicia Group will be able to recognize a deferred tax asset because there is going to be suitable future taxable profits available in order to offset taxable losses.

Where an entity recognizes deferred tax assets, the standard requires re-assessment of deferred tax assets (both recognized and unrecognized) at each reporting date.

**Previously recognized deferred tax assets**
An entity must reduce the carrying amount of deferred tax assets to the extent that it is no longer probable that sufficient taxable profit will be available to allow the deferred tax asset to be recovered. Conversely, any such reduction should be reversed if it subsequently becomes apparent that such taxable profit will be available.

**Previously unrecognized deferred tax assets**
The reporting entity must recognize a deferred tax asset to the extent that it has become probable that sufficient taxable profit will be available to enable the asset to be recovered.

# 36. What are the different types of share-based payment transactions?

## Answer

A share-based payment transaction is an agreement between a reporting entity and a third party that entitles the third party to receive equity instruments of the company, or cash or other assets for amounts based on the price or value of the equity instruments of the entity making the offer, providing certain conditions are met.

Share-based payment transactions are dealt with under IFRS 2 *Share-based Payment* and a standard was needed in this particular area because traditional methods of accounting did not recognize an expense for a share-based payment arrangement, since there was no associated cash flow. IFRS 2 is one of the most controversial standards that the IASB issued and requires an expense to be recognized only for awards that (are considered to) vest.

The overarching objective of IFRS 2 is to show the effects of share-based payments in the reporting entity's statement of profit or loss and statement of financial position. IFRS 2 specifies when to recognize the charge for share-based payment transactions and how much to recognize in the financial statements.

There are three types of share-based payment transaction that IFRS 2 deals with:

- **Equity-settled share-based payment:** The company receives goods or services as consideration for equity instruments in the company.
- **Cash-settled share-based payment:** The company acquires goods or services by incurring liabilities to a third party. The

amount of the liability is based on the price, or value, of the company's shares or other equity instruments.

- **Transactions involving a choice of cash or shares:** The company acquires or receives goods or services and the terms of the arrangement are such that the reporting entity has a choice of whether to settle the transaction in cash or shares.

# 37. How are share-based payments accounted for under IFRS?

## Answer

IFRS 2 *Share-based Payment* prescribes the accounting treatment for share-based payment transactions. When a reporting entity enters into share-based payment arrangements, the employees that are party to the arrangement are essentially benefiting from a form of remuneration and the reporting entity is benefiting from their labour. In real life, share-based payment transactions can be extremely complicated because the bigger the company, the more share options tend to be granted.

Many companies offer share options that contain a condition that says the shares will only vest if the share price reaches a certain price. An important point to emphasize is that for the purposes of IFRS 2, you must ignore any increases in the market price of a company's shares for the purposes of calculating the value of share options to be included in the annual financial statements of a reporting entity.

**Example**

Lucas grants 2000 share options to each of its three directors on 1 January 2011. The terms of the option are that the directors must still be employed by the company on 31 December 2013 when the options vest. The fair value of each option as at 1 January 2011 is C10 and all the options are expected to vest. The options vest only if Lucas share price reaches C16 per share. As at 31 December 2011, the share price was only C7 per share and this share price is not expected to rise in the next two years. Further, the

company expects that only two directors will be in the employment of Lucas as at 31 December 2013.

The increase in the share price for the purposes of calculating the value of the share options at 31 December 2011 must be ignored. However, the fact that it is only expected that two directors will be employed by the company at 31 December 2013 must be taken into consideration. The calculation, therefore, is as follows:

2000 options × 2 directors × C10 × 1 year / 3 years = C13,333

The entries in the financial statements of the company as at 31 December 2011 are:

| | |
|---|---|
| DR statement of profit or loss | C13,333 |
| CR equity | C13,333 |
| (statement of financial position) | |

This is a fairly simplistic example and in real life there are many more complex share-based payment scenarios that will need to be dealt with.

Share-based payment transactions start to become complicated when employees leave a company where they are involved with a share-based payment arrangement. It is an inherent fact that just because an employee may have share options, this does not preclude the employee(s) from staying with the company until the options vest. Management will have to make an informed estimate of how many employees may leave during the period until the share options vest. Clearly, these estimates are a bit 'hit and miss', but sometimes management can make very accurate estimates.

**Example**

Lucas grants 120 share options to each of its 400 employees. The terms of the grant are that each employee must stay in the employment of the entity over the next three years. The fair value of each share option is C11 and Lucas has estimated that 25% of employees will leave during the three-year period, and in doing so will forfeit their rights to the share options. The estimates on how many employees would leave turn out to be correct.

This is how Lucas will calculate the expense to be recognized in the financial statements over the three-year period:

| Year | Calculation | Remuneration expense for the year (C) | Cumulative remuneration expense (C) |
|---|---|---|---|
| 1 | 48,000 options × 75% × C11 × 1 / 3 years | 132,000 | 132,000 |
| 2 | (48,000 options × 75% × C11 × 2 / 3 years) – C132,000 | 132,000 | 264,000 |
| 3 | (48,000 options × 75% × C11 × 3 / 3 years) – C264,000 | 132,000 | 396,000 |

In the above example, it was assumed that management's estimate of leavers during the three-year period was accurate. The reality is that management often have no idea as to the levels of leavers during a period.

**Example**

Same facts as in the Lucas example above, but consider that:

- In year 1, 25 employees leave and Lucas revises its estimate of total leavers over the three-year vesting period from 25% (100 employees) to 20% (80 employees).
- In year 2, another 23 employees leave. Lucas revises its estimate of total leavers over the three-year vesting period from 20% to 15% (60 employees).
- In year 3, another 13 employees leave.

The calculation of the remuneration expense is as follows:

| Year | Calculation | Remuneration expense for the year (C) | Cumulative remuneration expense (C) |
|---|---|---|---|
| 1 | 48,000 options × 80% × C11 × 1 / 3 years | 140,800 | 140,800 |
| 2 | (48,000 options × 85% × C11 × 2 / 3 years) – 140,800 | 158,400 | 299,200 |
| 3 | (40,680 options × C11) – C299,200 | 148,280 | 447,480 |

In this example, a total of 61 employees (25 + 23 + 13) forfeited their rights to the share options during the three-year vesting period. As a result, when the share options vested, a total of 339 employees (400 – 61) received 120 share options, which resulted in 40,680 share options vesting in year 3 at C11 per share.

**Deferred tax issues**

Some jurisdictions grant tax relief for share-based payment transactions; however, it is unlikely that the amount of the tax relief will be the same as the amount charged to the statement of profit or loss. This difference in amounts is because the tax relief is often based on the share options' intrinsic value. The intrinsic value is the difference between the fair value of the shares and the exercise price. This will often give rise to a deferred tax asset to recognize the difference between the tax base of the employee services and the carrying amount, which is normally zero.

### Example

Gabriella Garments operates in a country where the tax authority grants an allowance equal to the intrinsic value of share options at the date they are exercised. Gabriella Garments grants share options to its employees with a fair value of C1.5 million at the date of the grant. The tax authority gives a tax allowance for the intrinsic value that is C1.9 million. Gabriella pays tax at 26% and the share options will vest in two years' time.

The deferred tax asset is calculated as follows:

C1.9 million × 26% × 1 year / 2 years = C247,000.

This deferred tax asset will need to be split between the portion to be recognized in the statement of profit or loss and the portion that is to be recognized within equity. This is completed as follows:

- If the estimated (or actual) tax deduction is less than or equal to the cumulative expense recognized, credit the deferred tax asset to the statement of profit or loss.

- If the estimated (or actual) tax deduction exceeds the cumulative expense recognized, recognize the excess tax benefits directly in a separate component of equity.

In the Gabriella Garments example above, the deferred tax asset will need to be apportioned between the amount that goes as a credit into the statement of profit or loss and the portion that is reported in the statement of changes in equity. Gabriella Garments will recognize the C1.5 million expense in profit or loss and because the intrinsic value of the share options of C1.9 million exceeds the cumulative expense that has been charged (C1.5 million), Gabriella Garments will charge part of the deferred tax asset to equity (as per the second bullet above). If, in the future, the expense exceeds the intrinsic value, Gabriella Garments will take the amount recorded to equity to income.

The split of the C247,000 deferred tax asset between the element charged to profit or loss and the element reported in the statement of changes in equity is as follows:

C1.5 million × 26% × 1 year / 2 years = C195,000 (this is credited to profit or loss)

(C247,000 less C195,000) = C52,000 (this is taken to the statement of changes in equity)

# 38. What is the difference between a defined contribution pension plan and a defined benefit pension plan?

## Answer

Accounting for pension plans falls under the scope of IAS 19 *Employee Benefits,* which recognizes two types of pension plan: a defined *contribution* pension plan and a defined *benefit* pension plan. There are fundamental differences between the two that need to be fully understood in order to account for the pension plans correctly.

**Defined contribution plans**

Defined contribution plans are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund). The entity will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets in order to pay all employee benefits relating to employee service in the current and prior periods.

**Defined benefit plans**

IAS 19 simply says that defined benefit pension plans are post-employment benefit plans other than defined contributions plans [IAS 19.7].

The most fundamental difference between the two types of pension plan is that, under a defined benefit pension plan, both actuarial risk and investment risk fall on the employer. The consequence here is that if actuarial or investment risk is worse than expected, the employer's obligation is increased and additional amounts will therefore more than likely need to be paid into the fund by the employer in an attempt to reduce the overall deficit. Conversely, under a defined contribution plan, the benefits received by the employee are determined by

the amount of contributions paid (either by the employer, or both the employer and employee) together with investment returns, and therefore it follows that actuarial and investment risk are borne by the employee.

# 39. How are short-term employee benefits accounted for under IFRS?

The accounting standard that deals with short-term employee benefits is IAS 19 *Employee Benefits*. The first thing to understand where this standard is concerned is what constitutes 'employee benefits' and what gives rise to 'short-term employee benefits'. The standard defines these terms as follows:

- *Employee benefits* are all forms of consideration given by an entity in exchange for service rendered by employees, or for the termination of employment.
- *Short-term employee benefits* are employee benefits (other than termination benefits) that are expected to be settled within 12 months after the end of the period in which the employees render the related service.

Examples of short-term employee benefits are as follows:

- wages, salaries and social security contributions;
- short-term compensated absences (paid annual leave and paid sick leave), where the absences are expected to occur within 12 months after the end of the period in which the employees render the related employee service;
- profit-sharing and bonuses that fall due to be paid within 12 months after the end of the period in which the employees render the related service; and
- non-monetary benefits such as medical care, housing, cars and free or subsidized goods or services for current employees.

The accounting for these types of employee benefits is fairly straightforward. When an employee has rendered service to the reporting entity during an accounting period, the entity

should recognize the amount of short-term employee benefits expected to be paid in exchange for that service as follows:

- as a liability, net of any deductions in respect of amounts already paid; and
- as an expense (provided that another IFRS requires or permits the inclusion of the short-term employee benefit in the cost of an asset).

# 40. What are operating segments?

## Answer

Operating segments are dealt with in the provisions of IFRS 8 *Operating Segments*. This standard was a very controversial standard that became mandatory for accounting periods commencing on or after 1 January 2009 and earlier adoption was permissible.

Appendix A to IFRS 8 defines an operating segment as:

> 'a component of an entity:
>
> - that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components or the same entity);
> - whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segments and assess its performance; and
> - for which discrete financial information is available.'

**Example**

Susan's Supermarkets sells a range of products and services as follows:

- clothing;
- domestic appliances;
- grocery; and
- provisions of loans and finance.

Each of the above departments has its own revenue streams and incurs its own expenses, and each departmental manager must report its results daily to the financial director.

In this example, the operating segments are each of the four different departments, because each is essentially 'a company within a company'. The operations, revenues and expenses can each be identified separately from the main company, and each department reports results to the financial director as an identifiable component of the company.

# 41. What are the disclosure requirements for operating segments?

## Answer

Companies that are required to apply IFRS 8 *Operating Segments* in their financial statements must comply with extensive disclosure requirements and reconciliations in order that the financial statements will allow users to evaluate the nature and financial effects of the types of business activities in which the reporting entity engages and the economic environments in which it operates.

A reporting entity applying IFRS 8 is required to disclose the following information for each period for which a statement of comprehensive income, or separate statement of profit or loss, is presented:

- general information on segments identified for reporting;
- reported segment profit or loss, including information about specified revenues and expenses included in reported segment profit or loss, segment assets, and segment liabilities (if reported to the chief operating decision maker), and the basis of measurement; and
- reconciliations of the totals of segment revenues, reported segment profit or loss, segment assets, segment liabilities, and other material segment items to the corresponding entity amounts in the financial statements.

In addition, reconciliations of amounts in the statement of financial position are required at each reporting date for which a statement of financial position is presented.

**General information on segments identified for reporting**
A reporting entity is required to disclose the factors used to identify reportable segments and must also include an

explanation of the entity's basis of organization (for example whether management has chosen to organize the entity by product, service or geographical dispersion, or a combination of such factors). Management should also disclose whether operating segments have been aggregated. The general information would also include a description of the types of products and services from which each reportable segment generates its revenue. When a reporting entity has operating segments classified as 'all other segments', the reporting entity must also include a description of the sources of 'all other segments' revenue.

**Segmental profit or loss, assets, and liabilities**
IFRS 8 requires an entity to disclose a measure of profit or loss for each segment and disclose a measure of total assets and total liabilities for each reportable segment. It is important to emphasize that reporting entities need only disclose a measure of total assets and total liabilities if such amounts are regularly provided to the chief operating decision maker together with the basis of measurement.

**Disclosure of the elements of revenue, income and expense**
Paragraph 23 to IFRS 8 requires the following items to be disclosed concerning each reportable segment where the specified amounts are included in the measure of segment profit or loss and are reviewed by the chief operating decision maker or regularly provided to the chief operating decision maker (regardless of whether or not they are included in the measure of segment profit or loss):

- revenues from external customers;
- revenues from transactions with other operating segments of the same entity;
- interest revenue;
- interest expense;
- depreciation and amortization;
- material items of income and expense disclosed in accordance with IAS 1 *Presentation of Financial Statements*;

- 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; and
- material non-cash items other than depreciation and amortization.

**Example**

**Disclosure by product**

| **Product** | **2012 C** | **2011 C** |
|---|---|---|
| Fridge freezers | 217,930 | 235,200 |
| Cookers | 235,820 | 232,830 |
| Televisions | 158,780 | 160,680 |
| Audio | 102,580 | 102,400 |
| Washing machines | 99,340 | 98,160 |
| Repairs and maintenance | 53,240 | 50,520 |
| **Total revenue** | **867,690** | **879,790** |

**Disclosure by geographical location**

| **Geographical location** | **2012 C** | **2011 C** |
|---|---|---|
| Europe | 46,100 | 27,800 |
| United States | 10,102 | – |
| Asia | 9283 | 17,820 |
| China | 7145 | 9185 |
| Japan | 15,240 | 7580 |
| **Total revenue** | **87,870** | **62,385** |

**Reconciliations**

IFRS 8 requires a reporting entity to disclose reconciliations of total reportable segments revenues, total profit or loss, total assets, total liabilities, and any other amounts. Paragraph 28 of IFRS 8 stipulates the required reconciliations. Reconciliations are required of all of the following:

- the total of revenue from reportable segments to the entity's revenue;
- the total profit or loss for reportable segments to the entity's profit or loss before income taxes and discontinued operations – where items such as income taxes have been allocated to arrive at segment profit or loss, the reconciliation can be made to the entity's profit or loss after those items;
- if segment assets are reported, the total of the reportable segments' assets to the entity's assets;
- if segment liabilities are reported, the total of reportable segments' liabilities to the entity's liabilities; and
- for every other material item of information the entity chooses to give in its segment information, the total of each item from all reportable segments to the corresponding amount for the entity.

**Example of segmental reconciliation**

| | C |
|---|---|
| ***Revenue reconciliation*** | |
| Total revenues for reportable segments | 94,000 |
| Sundry revenue | 2500 |
| Inter-segment revenue eliminated | (9000) |
| Company revenue | 87,500 |
| ***Profit or loss*** | |
| Total profit or loss for reportable segments | 9800 |
| Inter-segment profit eliminated | (600) |
| Other expenses | (1000) |
| Consolidation adjustment to pension expense | (500) |
| Company profit before income tax expense | 7700 |

| | |
|---|---|
| ***Assets*** | |
| Total assets for reportable segments | 190,000 |
| Other assets | 5000 |
| Inter-segment receivable eliminated | (2000) |
| Company's assets | 193,000 |
| ***Liabilities*** | |
| Total liabilities for reportable segments | 105,000 |
| Unallocated defined benefit pension plan liability | 60,000 |
| Company's liabilities | 165,000 |
| ***All other material items*** | |

Also included in the reconciliation to the Group's consolidated totals for depreciation and amortization for the years 2012 and 2011 are depreciation and amortization of Subsidiary Co., Inc. activities of C1222 and C2140 respectively.

# 42. Why does a company have to report earnings per share and how are these calculated?

## Answer

'Earnings per share' is possibly one of the most important ratios used by financial analysts, investors and other interested parties. The idea of earnings per share is that it gives the user an idea as to the profitability of a reporting entity as well as being used as a basis of placing a value on an entity's shares. Earnings per share is dealt with in IAS 33 *Earnings per Share*.

Shareholders are particularly interested in the earnings per share figure, because this figure represents how much retained profit the entity has generated that is eligible for distribution to the shareholders.

**Basic earnings per share**
The calculation of 'basic' earnings per share is actually quite simple; it is simply earnings divided by the number of issued shares. However, for the purposes of IAS 33, 'earnings' is the profit after tax, less non-controlling interests – in other words, it is the profit figure that is distributable to the shareholders after all other interested stakeholders (for example, the tax authority) have had their share of the profit.

**Example**

Alicia Corporation has 100,000 ordinary C1 shares in issue. Alicia Corporation's earnings for the purposes of calculating earnings per share is C75,000.

Basic earnings per share is calculated as:

| Earnings | 75,000 |
|---|---|
| Shares | 100,000 = 0.75 per share |

A key point to remember is that the shares figure is the 'ordinary' shares figure – if a reporting entity has any preference shares shown in equity, these are ignored for the purposes of the earnings per share calculation.

**Group situations**
When a reporting entity is the parent of a group of companies and the subsidiaries in which the parent has an interest does not wholly own those subsidiaries (the parent may own, say, 80% of the voting rights in the subsidiaries), the profit figure used for the earnings per share calculation is the profit for the period that is only attributable to the parent entity's ordinary shareholders.

### Example

Heaton Enterprises Ltd owns 75% of the voting rights in Westhead Enterprises Ltd. The post-tax profit for the year of Westhead Enterprises was C2 million.

The consolidated statement of profit or loss of Heaton Enterprises shows the following as at 31 December 2012:

| | **C000** |
|---|---|
| Profit before taxation | 15,000 |
| Taxation | 3900 |
| Profit after taxation | 11,100 |

| | |
|---|---:|
| Attributable to: | |
| Equity holders of the parent | 10,600 |
| Non-controlling interests * | 500 |
| | 11,100 |

*Heaton Enterprises owns 75% of Westhead Enterprises, hence non-controlling interests own the remaining 25%. Post-tax profit was C2 million, therefore C2 million × 25% = C500,000.

Heaton Enterprises has 12 million ordinary C1 shares in issue and three million C1 preference shares.

The calculation of the earnings per share figure is therefore:

$$\frac{\text{Earnings}}{\text{Shares}} \quad \frac{10{,}600{,}000}{12{,}000{,}000} = 88.3 \text{ per share}$$

**Issuing additional shares**

Many companies will issue additional shares, primarily to raise finance. It may also be the case that the company wishes to raise finance through a bank loan, but the bank may wish to meet the shareholders halfway and require them to invest more money in additional shares in the company to show their commitment to its future viability.

In situations when an entity issues more shares in the year, complications arise where the earnings per share calculation is concerned because a weighted average number of shares has to be calculated for the purposes of the earnings per share figure. In many smaller companies, the number of issued shares remains constant throughout the lifetime of the company; however, in much larger companies, the capital structure of the entity may change on a very frequent basis.

**Example**

Benjamin Building Co. has a year end of 31 December 2012. On 1 January 2012 it had 10,000 shares in issue. On 30 June 2012, the company issued a further 7000 shares at market value. For the purposes of the earnings per share calculation, the weighted average number of shares outstanding in the period will be calculated as follows:

| Date | Number of shares issued / length of time in issue | Total |
|---|---|---|
| 1.1.12 | 10,000 × 6 months / 12 months | 5000 |
| 30.6.12 | 17,000* × 6 months / 12 months | 8500 |
| **Weighted average number of shares outstanding in the period** | | **13,500****|
| *Original number of shares in issue | | 10,000 |
| Further shares issued in the year | | 7000 |
| | | 17,000 |

**This is the number that will be used for the number of shares in issue in the period for the purposes of the earnings per share calculation.

**Rights issue**

There are some pieces of terminology in use where rights issues are concerned that need to be understood. *Actual cumulative (cum) rights price* is the price of a share with rights attached immediately *before* the rights issue takes place; the *theoretical ex-rights price* is the expected price immediately *after* the rights issue.

A rights issue is a way of raising finance by selling additional shares to existing shareholders in proportion to their current shareholding. As an incentive to the existing shareholders, the

price at which the shares are offered is usually set at a discount to the current share price (the market value). However, rights issues can be offered to existing shareholders at market value if an entity wishes to do so. An inherent disadvantage to shareholders where rights issues are concerned is that if a shareholders takes up a rights issue, their shareholding becomes diluted.

When ordinary shares are issued during an accounting period at a discount to the market price, the weighting calculation must reflect that the discount is essentially a bonus issue (see below). It is only the discount element of the share that is classed as a bonus, because essentially what has happened in a rights issue is that an element of the share (the discounted element) is given to the shareholder at no cost to them.

The notional capitalization issue reflects the bonus element inherent in the rights issue and is measured by using the following fraction:

$$\frac{\text{Fair value per share immediately before the exercise of rights}}{\text{Theoretical ex-rights fair value per share}}$$

The fair value per share immediately before the exercise of rights is the closing value at which the shares are quoted on the last date inclusive of the right to subscribe for the new shares (i.e. the ‘cum rights’ price). The ex-rights price is the theoretical price at which the shares would trade after the exercise of the rights in an ideal world (in other words a world with no external influences). The fraction above must be used to adjust the number of shares in issue before the rights issue in order to make an adjustment for the bonus element inherent within the rights issue.

It is also important to emphasize that the adjustment for the bonus element inherent within the rights issue needs to be applied for both the current reporting period prior to the rights issue and the previous accounting period.

**Example**

The financial statement of Breary Brick Co. (Breary) shows the following distributable net profit attributable to shareholders:

| | |
|---|---|
| 31 December 2011 | C2,100,000 |
| 31 December 2012 | C3,500,000 |

On 1 January 2012, the company had 800,000 C1 ordinary shares in issue. On 1 April 2012 it offered its existing shareholders a rights issue in proportion of one share for every five shares already held at a price of C6 per share. On that date, the actual fair value of Breary shares was C10 per share.

The theoretical ex-rights value per share is therefore calculated as follows:

$$\frac{(800{,}000 \times C10) + 160{,}000^{*} \times C6}{960{,}000} = C9.33$$

* The rights issue is one share for every five held, therefore 800,000 shares already in issue × one share / five shares = 160,000.

The market value of the shares is C10; however, Breary is offering them to shareholders at a discounted price of C6 – hence an element of the shares are being 'given' to the existing shareholders at no cost, which is the bonus element of the shares. A calculation has to be undertaken to calculate the adjustment factor using the fraction above to determine this bonus element as follows:

$$\frac{\text{Fair value per share immediately prior to the exercise of rights}}{\text{Theoretical ex-rights fair value per share}} = \frac{C10}{9.33} = C1.07$$

The earnings per share calculation can be calculated as follows:

| | | |
|---|---|---|
| 2012 | C3.5m / (800,000 × 3/12 × 1.07) + (960,000 × 9/12) | C3.75 |
| 2011 | C2.1m / 800,000 × 1.07 | C2.45 |

A key point to emphasize is that for the bonus element of the shares issued in a rights issue, it is always assumed that they have always been in issue and therefore the comparative year must also be adjusted – hence why the prior year in the above example was adjusted accordingly.

**Bonus issues**

Bonus issues are another common method of changing an entity's capital structure. However, an important distinction between a bonus issue and a rights issue is that a bonus issue is given for free.

Bonus issues are sometimes referred to as 'scrip issues' or 'capitalization issues', and a bonus issue takes place by issuing further shares to the shareholders in proportion to their existing shareholding (for example, by issuing a shareholder with one share for every five shares currently held).

A bonus issue has a distinct advantage in that shareholders receive additional shares at no extra cost to them and are usually undertaken as an alternative to paying dividends to existing shareholders. This will help the entity by preserving cash and is also very advantageous to companies that are under-capitalized, because paying dividends to existing shareholders in an under-capitalized entity will be much higher. A further advantage to a bonus issue is that they have minimal costs attached to them.

When an entity makes a bonus issue to existing shareholders, it is assumed that the shares within the bonus issue have always been in issue and therefore the prior year comparative Earnings per Share figure will be adjusted accordingly.

**Example**

Sue's Salons, Inc. has 100,000 C1 ordinary shares in issue on 1 January 2012. On 30 September 2012, the entity made a bonus issue of one ordinary share for every five held at that date to its existing shareholders. Post-tax profit attributable to the equity holders of the company was C85,000.

The bonus issue will not have any effect on the earnings figure, but it does cause a dilution to the earnings per share figure because more shares have been issued, so pre-bonus the earnings per share figure will have been:

C85,000 / 100,000 = 0.85 per share

The bonus issue will cause a dilution in earnings per share, which can be illustrated as follows:

$$0.85 \times \frac{\text{100,000 shares (pre bonus issue)}}{\text{120,000 shares post issue *}} = 0.71 \text{ per share}$$

| | |
|---|---|
| * Shares in issue pre bonus: | 100,000 |
| Bonus issue: (100,000 × 1 share / 5 shares) | 20,000 |
| New number of shares: | 120,000 |

If the entity ignored the impact of the dilution, the earnings per share figure would be disproportionately higher and mislead the users of the financial statements.

**Diluted earnings per share**
IAS 33 requires disclosure of both the basic and diluted earnings per share figures. Basic earnings per share is discussed at the start of this question.

Many companies may have the potential to issue ordinary shares in the future to, say, current creditors. The most frequent transaction that gives rise to the potential to issue future ordinary shares is when a company has 'convertible debt'.

The term 'convertible debt' relates to a loan that the company has taken out and where the terms of the loan provide an option for the loan provider to convert the capital element of the loan into shares at a later date, if they so wish. This is not necessarily the only eventuality of what may give rise to the potential for the issuance of future shares, but is a fairly common occurrence.

The objective of IAS 33 and the requirement to disclose diluted earnings per share is to alert current shareholders to the future impact on the earnings per share figure that exists at the current time.

**Calculating diluted earnings per share**
To calculate diluted earnings per share, take the profit or loss that is attributable to the parent entity's ordinary shareholders and then adjust this figure for the after-tax effect of:

- dividends or other items relating to dilutive potential ordinary shares that have been used in arriving at profit attributable to ordinary shareholders, such as dividends on dilutive ordinary preference shares;
- interest recognized in the period on dilutive potential ordinary shares, such as interest on dilutive convertible debt; and

- any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares.

## Example

Byrne Enterprises has a C50,000 4% debenture in place, with each debenture having a nominal value of C1. The terms of the debentures are that the holders can convert them into shares at any time until 2019. The directors of Byrne Enterprises receive a bonus based on 1% of profit before taxation, and at 31 December 2012 the results showed a pre-tax profit of C90,000 and a post-tax profit of C63,000. The company pays tax at a rate of 30%.

Earnings for the purposes of diluted earnings per share is calculated as follows:

| | C |
|---|---|
| Profit after taxation | 63,000 |
| Plus reduction in interest cost (C50,000 × 4%) | 2000 |
| Less tax relief that would have been granted on interest cost (C2000 × 30%) | (600) |
| Less increase in management bonus (C2000 × 1%) | (20) |
| Add tax benefit (C20 × 30%) | 6 |
| **Earnings for the purpose of diluted earnings per share** | **64,386** |

It is worth mentioning that this example has been included to illustrate the calculation of diluted earnings per share. It does not take into consideration the requirements of IAS 32 *Financial Instruments: Presentation* regarding the classification of convertible debentures as liabilities and equity.

**Presentation of earnings per share**

A reporting entity must present both basic and diluted earnings per share on the face of the statement of comprehensive income, or – if the company presents the components of profit or loss in a separate statement of profit or loss – present both basic and diluted earnings per share on the face of the statement of profit or loss.

In respect of any operations that have been discontinued during the accounting period, IAS 33 requires disclosure on the face of the statement of comprehensive income, or the separate statement of profit or loss where this is presented, of the basic and diluted earnings per share figure for discontinued operations. A reporting entity can also make such disclosure of basic and diluted earnings per share within the notes to the financial statements.

**Disclosure requirements in IAS 33**

The most common disclosures required by IAS 33 are:

- basic and diluted earnings per share for profit or loss for the period attributable to the ordinary shareholders of the parent company;
- basic and diluted earnings per share for the discontinued operation(s) on the face of the statement of comprehensive income or separate statement of profit or loss, or in the notes to the financial statements; and
- any events that change the earnings per share calculations.

It is also worth noting that reporting entities must also present basic and diluted earnings per share even if the amounts disclosed are negative (losses per share).

**Example**

| | 2012 | 2011 |
|---|---|---|
| **Earnings per share**: | | |
| Profit from continuing operations | X | X |
| Profit from discontinued operations | X | X |
| **Profit for the period** | **X** | **X** |
| **Diluted earnings per share**: | | |
| Profit from continuing operations | X | X |
| Profit from discontinued operations | X | X |
| **Profit for the period** | **X** | **X** |

# 43. What are events after the reporting period and how do you differentiate between an adjusting and non-adjusting event?

## Answer

It is widely understood that many companies finalize their year or period end financial statements after a period of time has elapsed between the year or period end date and the date on which the financial statements are approved. During this interim period, transactions or events could occur that may require the financial statements at the reporting date to be adjusted ('adjusting events') or require disclosure of such transactions or events without the need to change the amounts recognized in the financial statements ('non-adjusting events').

IAS 10 *Events after the Reporting Period* is the accounting standard that deals with such issues. The standard defines 'events after the reporting period' as 'those events, favourable and unfavourable, that occur between the end of the reporting period and the date on which the financial statements are authorised for issue'. The description includes all events that existed at the end of the reporting period and the principle issue in applying IAS 10 is to determine which events after the reporting period are to be reflected in the financial statements 'adjusting events'.

**Adjusting events**

An *adjusting event* occurs between the reporting date and the date on which the financial statements are approved and authorized for issue. It provides evidence of conditions that

existed at the reporting date. Paragraph 9 of IAS 10 contains examples of adjusting events as follows:

- The settlement after the reporting period of a court case that confirms that the entity had a present obligation at the end of the reporting period. In this situation, an entity adjusts any previously recognized provision related to this court case as required under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, or recognizes a new provision.
- The recognition of information after the reporting period indicating that an asset was impaired at the end of the reporting period, or that the amount of a previously recognized impairment loss for that asset needs to be adjusted. For example:
  - the bankruptcy of a customer that occurs after the reporting period usually confirms that a loss existed at the end of the reporting period and that the entity should write-down the amount of trade receivables to recoverable amount;
  - the sale of inventories after the reporting period may give evidence about their net realizable value at the end of the reporting period, which may result in a write-down of inventories to net realizable value at the end of the reporting period.
- The determination after the reporting period of the cost of assets purchased, or the proceeds from assets sold, before the end of the reporting period.
- The determination after the reporting period of the amount of profit-sharing or bonus payments, if the entity had a present, legal or constructive obligation at the end of the reporting period to make such payments as a result of events before that date.
- The discovery of fraud or errors that show the financial statements are incorrect.

Often, accounting standards will interact with one another and an example of this is where IAS 33 *Earnings per Share* comes

into the equation. IAS 33 requires consequential amendment to earnings per share in the case of bonus issues, share splits or share consolidations, regardless of the fact that such transactions themselves are non-adjusting events.

**Non-adjusting events**

A non-adjusting event is defined as 'those that are indicative of conditions that arose after the reporting period' [IAS 10.3(b)].

Likewise with adjusting events, IAS 10 offers examples of non-adjusting events and gives the following examples in paragraphs 11, 12 and 22:

- major business combinations;
- announcing a plan to discontinue an operation;
- a major purchase of assets, classification of assets as held for sale in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, other disposal of assets, or expropriation of major assets by government;
- the destruction of a major production plant by a fire;
- announcing, or commencing the implementation of, a major restructuring;
- a major ordinary share transaction or potential ordinary share transactions;
- an abnormally large change in asset prices or foreign exchange rates;
- a change in tax rates or the enactment or announcement of tax laws that significantly affect current and deferred tax assets and liabilities;
- entry into significant commitments or contingent liabilities, for example by issuing significant guarantees;
- start of major litigation arising solely out of events that occurred after the reporting period;
- a decline in market value of investments; and
- a declaration of dividends to holders of equity instruments as defined in IAS 32 *Financial Instruments: Presentation*.

### Accounting treatment

*Adjusting events* IAS 10 requires adjusting events to be reflected within the financial statements themselves. A common instance of such is the bankruptcy of a customer shortly after the end of the reporting period. It is widely understood that assets cannot be carried in the statement of financial position at any more than their recoverable amount, so it would be inappropriate to continue to recognize a trade receivable (debtor) within assets if that customer has ceased trading. As a result, the trade receivables figure should be written down to recoverable amount (by the amount of the bad debt) and recognized in profit or loss.

*Non-adjusting events* Non-adjusting events, by definition, are not recognized within the financial statements as at the reporting date; instead, the reporting entity must make disclosure of such non-adjusting events within the financial statements themselves. The disclosures should include:

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

### Going concern

One of the fundamental characteristics in financial reporting is the concept of 'going concern': a company must not prepare its financial statements on a going concern basis when management intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. This is an exception to the standard's general rule for non-adjusting events because rebutting the use of the going concern presumption is treated as an adjusting event.

When management determines that the going concern presumption is not appropriate, the standard recognizes that the effect of this is so pervasive that it results in a fundamental change in the basis of accounting, as opposed to merely

adjusting the amounts recognized in the financial statements. Because IFRS does not contain any guidance on this fundamental change in the basis of accounting, reporting entities will need to carefully consider their individual situations in order to arrive at an appropriate basis for preparing the financial statements.

IAS 10 refers to the requirements in IAS 1 *Presentation of Financial Statements* relating to going concern:

- when the financial statements are not prepared on a going concern basis, that fact should be disclosed, together with the basis on which the financial statements have been prepared and the reason why the entity is not regarded as a going concern; or
- when management is aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, a disclosure of those uncertainties should be made.

**Approval of the financial statements**

The final stage of the financial statement process is the approval of the financial statements, which IAS 10 does cover. One of the main aims of IAS 10 is that it requires management to consider all events, both favourable and unfavourable, before approval of the financial statements takes place.

The date on which the financial statements are authorized for issue is a critical matter during the approval process. IAS 10 recognizes two particular instances that give rise to differences in the meaning of *authorized for issue*:

- An organization may be required to submit its financial statements to its shareholders for approval after the financial statements have been issued. In such cases, the financial statements are considered authorized for issue on the *date of issue*. This is not the date when the shareholders approve the financial statements.

- The management of an organization may be required to issue its financial statements to a supervisory board (made up solely of non-executive directors) for approval. Under the principles in IAS 10, such financial statements are considered authorized for issue when management *authorizes them for issue to the supervisory board.*

Where a reporting entity re-issues the financial statements because of errors, or because of events that occurred after the financial statements were originally authorized for issue, this will give rise to a new date of authorization for issue. The financial statements must then properly reflect all adjusting and non-adjusting events, which also include those that occurred during the interim period between the original date and the new date of authorization.

# 44. What is the difference between a provision and a contingent liability?

## Answer

Provisions and contingencies are dealt with in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Prior to the issuance of IAS 37, there were no international accounting standards that dealt with the definition, recognition, measurement, use and presentation of provisions, and hence reporting entities were frequently exploiting this loophole by creating provisions in one accounting period, only to release them in the next accounting period. In other words, prior to the issuance of IAS 37, reporting entities would be driven by the profit figure and this profit figure would be manipulated by the creation, or reversal, of a provision depending on the level of profit.

Profit manipulation was fairly common prior to IAS 37. In years when profits were high, management would create a provision to reduce profit to an acceptable level, as invariably shareholders expect profits to go in an upward direction, i.e. if profit was high in one year, shareholders would expect a higher profit in the next year, hence putting pressure on management. Conversely, when profitability came in lower than shareholder expectation, management would simply reverse prior year provisions to enable profits to be increased.

The creation and reversal of artificial provisions were coined 'big bath provisions' or 'big bath accounting', and it was this practice that led to the issuance of IAS 37 several years ago. It outlawed any provisions being recognized in a reporting entity's financial statements if such a provision did not meet the recognition criteria laid down in the standard.

IAS 37 distinguishes between a 'provision' and a 'contingent liability'; because a provision is a present obligation, whereas a

contingent liability is only a possible obligation, or a present obligation that cannot be measured with sufficient reliability. Essentially, however, a provision is also a contingency, because provisions are uncertain in timing or amount.

**Provisions**

Under the concept of IAS 37, a provision is defined as follows:

> '*Provisions* are liabilities of uncertain timing or amount. The *Conceptual Framework* defines a liability as 'a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits'.'
>
> [IAS 37 paragraph 10]

In order for a provision to be recognized in the financial statements, there must be an *obligating event*. An obligating event is an event that creates a *legal* or *constructive* obligation that results in a reporting entity having no realistic alternative to settling that obligation.

A *legal* obligation is one that is derived from a contract, legislation or other operation of law, while a *constructive* obligation is an obligation that derives from an entity's actions where:

- by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
- as a result the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

**Example**

Bury Corporation has been in existence for more than 30 years, and buys and sells retail merchandise aimed

at adults. The company has always enjoyed market domination and has been rapidly expanding, quite successfully, over recent years. A few years after the company commenced trading, the directors offered a bonus incentive to its management. Where pre-tax profit is over a certain benchmark figure, the company will pay a 1% bonus to the management and staff for profits in excess of the benchmark. Each year the company is over the benchmark and the management accounts for the year ended 28 February 2013 currently show that profitability is over the benchmark. The last meeting of the management team occurred on 31 January 2013, where it was announced that profitability would be over the benchmark threshold. The reporting accountant is therefore proposing to recognize a provision for a bonus in the 2013 year-end financial statements.

The fact that the company has always paid bonuses, based on a pre-determined formula, and that the announcement that the company is already over the benchmark figure in the meeting held on 31 January 2013, creates an expectation in the minds of the management team that they will be receiving a bonus. The creation of this expectation in the minds of the management team gives rise to a constructive obligation, and – provided the provision can be estimated reliably and there will be an outflow of economic benefits required to settle the provision – the company can recognize a bonus provision in the financial statements for the year ended 28 February 2013.

**Contingent liability**

A contingent liability is only a 'potential' obligation. IAS 37 says:

> 'A contingent liability is
>
> - a possible obligation that arises from past events and whose existence will be confirmed only on the occurrence or

non-occurrence of one or more uncertain future events that are not wholly within the control of the entity; or
- a present obligation that arises from past events but is not recognised because:
  - it is not probable that an outflow of benefits embodying economic benefits will be required to settle the obligation; or
  - the amount of the obligation cannot be measured with sufficient reliability.'

Because the recognition criteria in IAS 37 is not met, a contingent liability is never provided for within the entity's financial statements; instead, the user is informed of the potential liability by way of a disclosure note within the financial statements.

**Example**

Hill Haulage Co. manufactures chemicals and is currently involved in a legal claim that was brought against the company on 3 October 2012. The company has a year-end of 31 December and is not scheduled to be heard by the courts until 2013. The claim has been brought against the company by one of its employees, who is claiming damages for a chemical spillage that brought on a severe skin reaction. Hill Haulage's legal advisers have said that the company is unlikely to be successful in its defence, but the legal advisers have not been able to reliably estimate the amount of damages that the company will face if they are unsuccessful.

While the legal advisers have intimated that the company is likely to be unsuccessful in their defence, they are not able to estimate a monetary amount that the company will be required to pay out. As a consequence, the recognition criteria in IAS 37 is not met and hence disclosure should be made in the company's financial statements.

A summary of the way in which contingencies are accounted for under the provisions in IAS 37 are as follows:

| Estimate of outcome | Accounting treatment (contingent liability) | Accounting treatment (contingent asset) |
|---|---|---|
| Virtually certain | Not a contingent liability, so a provision is recognized | Not a contingent asset, therefore an asset is recognized |
| Probable | Not a contingent liability, so a provision is recognized | Disclosure |
| Possible, though not probable | Disclosure | No disclosure permitted |
| Remote | No disclosure required | No disclosure permitted |

An issue with IAS 37 is that it does not include a numerical measure of 'probable' or 'virtually certain', and therefore the author is of the opinion that the following percentiles be applied:

- Virtually certain = 95% probable.
- Probable = 50–95% probable.
- Possible but not probable = 5–50% probable.
- Remote = less than 5% probable.

The above benchmarks are merely the author's opinion and are not definitive – and, in any event, it is usually possible to assess the probability of the outcome of a particular event only approximately.

# 45. How is a provision accounted for under IFRS?

## Answer

Paragraph 36 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires a best estimate of the likely levels of expenditure required to settle the present obligation at the end of a reporting period. The measure is always estimated before taxation because the tax effects of such a provision are dealt with in IAS 12 *Income Taxes*.

In terms of defining a 'best estimate', the standard itself says that it is 'the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time'. The responsibility of arriving at a best estimate for a provision lies with management of the entity and is based on similar transactions that have occurred in the past. In some cases it may be the case that an expert is needed to arrive at a best estimate, particularly where there are inherent uncertainties.

Some companies, particularly companies that operate in the retail sector, need to make provisions in their financial statements for defective products and returns. In arriving at a best estimate, such entities will calculate expected values based on previous history, as can be illustrated in the following example:

**Example**

Scanlon Electricals sells electrical products such as dishwashers, washing machines, televisions and audio equipment. It sells goods to the general public with a warranty that covers customers for the costs of repairs

that occur during the first six months from the date that the customer purchases the equipment. The company is preparing its financial statements for the year ended 31 December 2012 and it has calculated that if all the products sold contained minor defects, the costs of repair would be C1 million. If major defects occurred in all the products, the costs of repair would be C4 million.

Management of Scanlon Electricals has concluded that past experience, and future expectations, suggest that for the coming year, 75% of the goods sold will contain no defects, 20% will contain minor defects and 5% will have major defects.

The expected value of the repair costs is calculated as:

(75% × Cnil) + (20% × C1 million) + (5% × C4 million) = C400,000

In certain situations, the time value of money may become a material issue to the reporting entity, and paragraph 45 of IAS 37 requires the provision to be the present value of the expenditures expected to be required in order to settle the obligation. Where the time value of money is material, the discount rate (or rates) used in discounting the obligation to present-day values must be the pre-tax rate (or rates). These situations are fairly infrequent, and in many cases no discounting will be required because the cash flows associated with the provision will not be sufficiently far into the future for discounting to have a material impact.

**Disclosures**

IAS 37 requires additional disclosures to be made within the financial statements where provisions are concerned. For each class of provision, an entity should provide a reconciliation of

the carrying amount of the provision at the beginning and end of the accounting period showing:

- additional provisions made in the period, including increases to existing provisions;
- amounts used during the period;
- unused amounts reversed during the period; and
- the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

The standard also requires disclosure of the following:

- a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
- an indication of the uncertainties about the amount or timing of those outflows; and
- the amount of any expected reimbursement, stating the amount of any asset that has been recognized for that expected reimbursement.

# 46. What disclosures are needed for contingent liabilities?

## Answer

Contingencies are never accounted for under the provisions in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* because the recognition criteria are not met. Users of general purpose financial statements are made aware of the potential liability by way of a disclosure note within the financial statements. The disclosure issues relating to provisions have been discussed in the previous section.

IAS 37 requires disclosure for each class of contingent liability to include a brief description of the nature of the contingent liability and, where practicable:

- an estimate of its financial effect;
- an indication of the uncertainties relating to the amount or timing of any outflow; and
- the possibility of any reimbursement.

In situations where it is not practicable to disclose the above information, that fact should be disclosed to comply with paragraph 91 of IAS 37.

# 47. Why is a statement of cash flows produced as part of the primary financial statements under IFRS?

## Answer

Reporting entities that use IFRS must produce a statement of cash flows as part of their primary financial statements. The prescribed method in which such a statement of cash flows is prepared is dealt with in the provisions in IAS 7 *Statement of Cash Flows*. IFRS acknowledges that such a statement provides useful information to users about the activities of a reporting entity, because it enables users to understand how the company has generated and spent cash from one accounting period to the next. In addition, such information is useful in assessing factors that affect an entity's liquidity, financial position and risk.

The statement of profit or loss and the statement of financial position are both prepared on an accruals basis; that is, that transactions and events are accounted for on an arising basis, as opposed to when they are paid or settled. The statement of cash flows is prepared on a cash basis and can often tell the user a great deal – that the statement of profit or loss and the statement of financial position may not.

**Example**

A reporting entity has suffered from a decline in sales during the year to 31 December 2012 due to the economic recession and cash flow has been extremely tight. The company had to enter into a payment arrangement with the tax authority to pay its tax liability over a period of time

and, as at 31 December 2012, the company was still paying this liability off. Despite a difficult year, the reporting entity made a small profit on which tax is payable.

The statement of profit or loss will show the tax charge on the profit for the year; the statement of financial position will show the total liability due to the tax authority, and the statement of cash flows will show the total amount of tax paid to the tax authority. From this information, the user can establish that the company is in arrears with its tax affairs. Without the statement of cash flows, it could be inherently difficult for a user to gain a clear understanding of the entity's financial position at the year end.

In the United Kingdom, there are some fundamental differences between the requirements of IAS 7 and the UK's counterpart, FRS 1 *Cash Flow Statement*. Firstly, the layout of the cash flow statement under FRS 1 is significantly different and small companies that are eligible to apply the Financial Reporting Standard for Smaller Entities do not have to prepare such a statement. IAS 7 mandates the preparation of the statement of cash flows for reporting entities that apply IFRS, so unfortunately there is no option to prepare such a primary statement as part of the financial statements.

# 48. What is the prescribed method for preparing a statement of cash flows?

## Answer

IAS 7 *Statement of Cash Flows* prescribes the layout that the statement must comply with. It is important that the following definitions (as found in paragraph 6) are understood prior to preparing a statement of cash flows under IAS 7:

- *Cash* comprises cash on hand and on demand deposits.
- *Cash equivalents* are short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value.
- *Cash flows* are inflows and outflows of cash and cash equivalents.
- *Operating activities* are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.
- *Investing activities* are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.
- *Financing activities* are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

IAS 7 requires cash inflows and cash outflows to be classified under:

- operating activities;
- investing activities; and
- financing activities.

**Operating activities**
The definitions contained in IAS 7 say that 'operating activities' are 'the principal revenue-producing activities of the entity and

other activities that are not investing or financing activities' [IAS 7.6]. Essentially, therefore, any cash inflow or outflow that is neither an investing nor financing activity is included within operating activities (operating activities being the 'default' category). The standard says that cash flows from operating activities are as a result of transactions and other events that enter into the determination of profit or loss, and it goes on to include some examples of operating activities:

- cash receipts from the sale of goods and the rendering of services;
- cash receipts from royalties, fees, commissions and other revenue;
- cash payments to suppliers for goods and services;
- cash payments to and on behalf of employees;
- cash receipts and cash payments of an insurance entity for premiums and claims, annuities, and other policy benefits;
- cash payments or refunds of income taxes, unless they can be specifically identified with financing and investing activities; and
- cash receipts and payments from contracts held for dealing or trading purposes.

**Investing activities**

These are activities that involve the acquisition and disposal of long-term assets such as payments for non-current assets and investing in other companies, as well as the proceeds from the disposal of non-current assets. However, the proceeds from disposal of non-current assets are not always considered to be investing activities. It could be the case that an entity disposes of a non-current asset routinely (for example, vehicle hire companies), where the business model is to purchase vehicles and hold on to them for a while for rental purposes with the intention of then selling them. In such cases, the proceeds from such assets will not be classified as investing activities, but will instead be reported as cash flows from operating activities.

**Financing activities**
These are activities that change the equity and borrowing composition of the company; for example, if a company was to issue shares in the year to raise cash or take out a loan from a bank or other financier. In preparing the statement of cash flows, IAS 7 allows two approaches:

- the direct method; and
- the indirect method.

*The direct method* Under the direct method, major classes of gross cash receipts and gross cash payments are disclosed and this is the method that IAS 7 encourages. A typical layout is as follows:

| | 2012<br>C | 2011<br>C |
|---|---|---|
| **Operating activities** | | |
| Collections from clients | X | X |
| Payments to suppliers | (X) | (X) |
| Payments to employees | (X) | (X) |
| Payments relating to income taxes | (X) | (X) |
| Payments relating to post-retirement benefits | (X) | (X) |
| Cash flows from operating activities from continuing operations | X | X |
| Cash flows from operating activities from discontinued operations | X | X |
| **Cash flow from operating activities** | **X** | **X** |

*The indirect method* The indirect method is the method most commonly used and is an alternative option in IAS 7. The indirect method arrives at the same value for cash flow from operating activities as the direct method, but this method works

back from the amounts that are reported in the statement of profit or loss. A typical layout is as follows:

| | 2012<br>C | 2011<br>C |
|---|---|---|
| Profit from operations | X | X |
| Adjustments for: | | |
| Depreciation | X | X |
| Loss on disposal of non-current assets | X | X |
| Gain on disposal of non-current assets | (X) | (X) |
| **Operating cash flows before movements in working capital** | **X** | **X** |
| (Increase) decrease in inventories | X | (X) |
| (Increase) decrease in trade receivables | (X) | X |
| Increase (decrease) in trade payables | X | (X) |
| **Cash generated by operations** | **X** | **X** |
| Income taxes paid | (X) | (X) |
| Interest paid | (X) | (X) |
| **Net cash from operating activities** | **X** | **X** |

### Example

The financial statements of Byrne Enterprises are being prepared for the year ended 31 December 2012 and the statement of profit or loss for the year ended 31 December 2012 and the statements of financial position as at 31 December 2012 and 2011 are as follows:

| Statement of profit or loss | C000 |
|---|---|
| Revenue | 31,461 |
| Cost of sales (including depreciation of C2172) | 16,304 |
| Gross profit | 15,157 |

| | | |
|---|---|---|
| Loss on disposal of non-current assets | 183 | |
| Distribution costs | 5663 | |
| Administrative expenses | 3681 | |
| Profit from operations | 5630 | |
| Finance costs | 800 | |
| Profit before tax | 4830 | |
| Income tax expense | 919 | |
| Profit after tax | 3911 | |

| **Statement of financial position** | **2012 C000** | **2011 C000** |
|---|---|---|
| **ASSETS** | | |
| **Non-current assets** | | |
| Property, plant and equipment | 29,882 | 19,100 |
| **Current assets** | | |
| Inventories | 4837 | 4502 |
| Trade receivables | 5244 | 4978 |
| Cash at bank | 64 | 587 |
| **Total assets** | 40,027 | 29,167 |
| **EQUITY AND LIABILITIES** | | |
| **Equity** | | |
| Share capital | 8000 | 5000 |
| Share premium | 2500 | 1000 |
| Retained earnings | 15,570 | 12,359 |
| **Total equity** | 26,070 | 18,359 |
| **Non-current liabilities** | | |
| Bank loan | 10,000 | 7000 |
| **Current liabilities** | | |
| Trade payables | 3038 | 2954 |
| Tax | 919 | 854 |
| | 3957 | 3808 |
| **Total liabilities** | 13,957 | 10,808 |
| **Total equity and liabilities** | 40,027 | 29,167 |

The statement of cash flows required under IAS 7 will be prepared as follows:

| | C000 | C000 |
|---|---|---|
| Profit from operations | | 5630 |
| Adjustments for: | | |
| Depreciation | 2172 | |
| Loss on disposal of non-current assets | 183 | 2355 |
| **Operating cash flows before movements in working capital** | | **7985** |
| Increase in inventories | (335) | |
| Increase in trade receivables | (266) | |
| Increase in trade payables | 84 | (517) |
| **Cash generated by operations** | | **7468** |
| Income taxes paid (W1) | (854) | |
| Interest paid | (800) | (1654) |
| **Net cash from operating activities** | | **5814** |
| **Investing activities** | | |
| Proceeds from disposal of non-current assets (W2) | 509 | |
| Purchases of property, plant and equipment (W3) | (13,646) | |
| **Net cash used in investing activities** | | **(13,137)** |
| | | (7323) |
| **Financing activities** | | |
| New bank loan | 3000 | |
| Proceeds from share issue (W4) | 4500 | |
| Dividend paid | (700) | |
| **Net cash (used in)/from financing activities** | | **6800** |
| Net increase (decrease) in cash and cash equivalents | | (523) |

| | | |
|---|---|---|
| **Cash and cash equivalents at beginning of year** | | **587** |
| **Cash and cash equivalents at end of year** | | **64** |
| **Workings** | | |
| W1 – income taxes paid | | |
| Tax liability brought forward | (854) | |
| Tax charge per statement of profit or loss | (919) | |
| Tax liability carried forward | 919 | |
| Balancing figure = tax paid | 854 | |
| W2 – Proceeds from disposal of non-current assets | | |
| Book value of assets sold | 692 | |
| Loss on sale per statement of profit or loss | (183) | |
| Balancing figure = proceeds | 509 | |
| W3 – Purchases of property, plant and equipment | | |

Opening balance C19,100 less depreciation (C2172) less net book value of assets sold (W2) (C692) plus additions (?) = closing balance of C29,882, therefore (?) = C13,646.

| | |
|---|---|
| W4 – proceeds from share issue | |
| Share capital brought forward | (5000) |
| Share premium brought forward | (1000) |
| Share capital carried forward | 8000 |
| Share premium carried forward | 2500 |
| Balancing figure = proceeds | 4500 |

# 49. How are agricultural and biological assets accounted For?

## Answer

The standard that prescribes the accounting treatment for agricultural and biological assets is that of IAS 41 *Agriculture*. The term 'agricultural activity' refers to the management by an entity of the biological transformation of biological assets for sale into agricultural produce or additional biological assets. A 'biological asset' is a living animal or plant and the following table illustrates how these terms interrelate:

| **Biological asset** | **Agricultural produce** | **Harvested product** |
|---|---|---|
| Cattle | Milk | Cheese |
| Bushes | Leaves | Tea, tobacco |
| Vines | Grapes | Wine |
| Plants | Cotton | Thread, clothing |
| Sheep | Wool | Yarn |

Paragraph 10 of IAS 41 says that an entity will recognize a biological asset, or agricultural produce, when, and only when:

- it controls the asset as a result of past events;
- it is probable that future economic benefits associated with the asset will flow to the entity; and
- the fair value or cost of the asset can be measured reliably.

A biological asset shall be measured on initial recognition and at the end of each reporting period at its fair value less costs to sell, unless fair value cannot be measured reliably. In cases where the reporting entity is unable to measure the fair value reliably, the entity must then measure the biological asset at

historic cost less accumulated depreciation and any accumulated impairment losses.

Agricultural produce that has been harvested from an entity's biological assets should be measured at its fair value less costs to sell at the point of harvest. The standard prohibits historical cost being used because it assumes that a reporting entity will always be able to determine fair value less costs to sell at the point of harvest.

The term 'costs to sell' refer to the incremental costs directly attributable to the disposal of an asset excluding finance costs and income taxes. Such costs include all costs that are necessary for a sale to occur but would otherwise not arise. Costs to sell include:

- commissions to brokers/dealers;
- levies by regulatory bodies; and
- transfer taxes/duties.

It is important to emphasize that costs to sell do not include costs such as transport or other such costs needed to get the asset to market.

Under the fair value hierarchy, there are three rules that determine the fair value of a biological asset or agricultural produce:

- An active market exists: the quoted price in the market is the appropriate basis for determining the fair value of that asset.
- No active market exists: if an active market does not exist, an entity should use one or more of the following market-determined prices or values to estimate fair value:
  - the most recent market transaction price, provided the economic circumstances have not significantly changed;
  - market prices for similar assets with adjustment to reflect differences; and
  - sector benchmarks.

- No active market and no market-based information is available: if an active market does not exist and there is no market-based information available on which to base an estimate of fair value, an entity estimates fair value using a discounted cash flows method. Cost as an approximation of fair value can only be used in limited circumstances [IAS 41.24].

### Example

On 1 January 2012, a farmer held a herd of ten two-year old animals. He purchased an animal aged 2.5 years on 1 July 2012 for C108 and one animal was born on 1 July 2012. No animals were disposed or disposed of during the period. Per-united fair values, less estimated costs to sell, are as follows:

| | C |
|---|---|
| Two-year old animal at 1 January 2012 | 100 |
| Newborn animal at 1 July 2012 | 70 |
| Two and a half-year old animal at 1 July 2012 | 108 |
| Newborn animal at 31 December 2012 | 72 |
| Half a year old animal at 31 December 2012 | 80 |
| Two-year old animal at 31 December 2012 | 105 |
| Two and a half-year old animal at 31 December 2012 | 111 |
| Three-year old animal at 31 December 2012 | 120 |

This is how the herd will be calculated for the purposes of the financial statements:

| **Fair value less estimated costs to sell of herd**: | |
|---|---|
| At 1 January 2012 (10 × C100) | 1000 |
| Purchase 1 July 2012 (1 × C108) | 108 |

| | | |
|---|---|---|
| **Increase in fair value less estimated costs to sell due to price charges** | | |
| 10 × (C105 – C100) | 50 | |
| 1 × (C111 – C108) | 3 | |
| 1 × (C72 – C70) | 2 | 55 |
| **Increase in fair value less estimated costs to sell due to physical change** | | |
| 10 × (C120 – C105) | 150 | |
| 1 × (C120 – C111) | 9 | |
| 1 × (C80 – C72) | 8 | |
| 1 × C70 | 70 | 237 |
| **Fair value less costs to sell at 31 December 2012** | | |
| 11 × C120 | 1320 | |
| 1 × C80 | 80 | |
| | | **1400** |

# 50. If a company operates in a hyperinflationary economy, how should the financial statements be prepared?

## Answer

The standard that deals with the accounting requirements for those entities whose functional currency is the currency of a hyperinflationary economy is IAS 29 *Financial Reporting in Hyperinflationary Economies*.

Hyperinflation is inflation that is out of control. The financial statements of an entity whose functional currency is the currency of a hyperinflationary economy must be stated in terms of the measuring unit current at the end of the reporting period. If the financial statements are not restated and are reported in a hyperinflationary economy they will clearly be unreliable.

Financial statements need to be restated with the use of a general price index that reflects changes in general purchasing power.

Restatement of the financial statements should be as follows:

- Non-monetary items carried at cost or cost less depreciation (also known as 'depreciated historic cost') should be restated by applying the change in general price index from the date of acquisition to the reporting date to the historical cost and accumulated depreciation.
- Non-monetary items carried at revaluation should be restated by applying the change in general price index to their revalued amount from the date of revaluation to the reporting date.

- Monetary items do not need to be restated because, by definition, they are already expressed in the monetary unit current at the reporting date.

When an economy ceases to be hyperinflationary and an entity ceases to use the provisions in IAS 29, the entity must treat the amounts expressed in the measuring unit current at the end of the previous reporting period as the basis for the carrying amount in the subsequent financial statements.

# 51. What is an audit of a company's financial statements and are there any ethical issues that affect auditors?

## Answer

In order to appreciate the role of the auditor, one needs to first set the historical context of audit.

Auditing has been a worldwide profession for hundreds of years. Historically, auditing was concerned with accounting for government activities and reviewing the work done by tax collectors. In the early years of auditing, the keeping and maintaining of accounting records was done primarily to detect fraudulent activity. The Industrial Revolution from the mid-1700s to the mid-1800s was responsible for increased demand in auditors, because this period saw an increase in responsibility being passed from owners to managers. This led to an increased requirement for auditors who were independent of management and who were engaged not only to be alert for errors within the financial records, but also errors within the records. In simple terms, deliberate errors in order to achieve personal financial gain were deemed to be fraudulent activity (as is still the case today), while an 'error' was (and still is) unintentional.

During the early 1700s, the concept of 'sampling' was introduced. Sampling is where auditors select a sample of items that make up various balances and was used where it is not economically viable to physically examine all the transactions that have taken place. This practice is still pivotal today.

During the 1940s, it was clear that the auditor's role had developed into that of providing an opinion on the financial statements, and that the detection of fraud and error had taken

a very much subordinate role in the objective of an audit. It developed that management were responsible for the prevention and detection of fraud, and that the auditor's work should not be concerned primarily with detecting fraud, but should be planned in such a way that they will detect a material fraud. This view was formalized much earlier in the UK than the 1940s: Lord Justice Lopez, in the case of Kingston Cotton Mills (1896), said that the auditor's role in an entity should be that of a 'watchdog' rather than a 'bloodhound'. He said:

> 'It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably careful, cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said to approach his work with suspicion, or with a foregone conclusion that there is something wrong. He is a watchdog not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest and rely upon their representations, provided he takes reasonable care.'

The view here was that the auditor should act with such reasonable care and skill in order that their work will have a reasonable chance of detecting a material fraud and other errors. This view is the same today, with auditing standards requiring auditors to adopt and maintain a degree of professional scepticism by assuming that the financial statements will contain a material misstatement due to fraud.

**Risk-based auditing**

Since the early 1980s, audit fees have increased to reflect the fact that audits need to be undertaken effectively and efficiently. Audit firms have developed a technique known as 'risk-based auditing', which involves the auditor determining the nature, timing and extent of various audit procedures. This method of auditing is based on the auditor's assessment of

the risk that the financial statements of an entity contain a material misstatement.

**Regulation**
In the vast majority of countries that practise audit, the auditing profession is regulated under legislation. For example, in the UK, auditing is a regulated profession under the Companies Act 2006. It is for this reason that not all professional accountants can practise audit-related work unless they have obtained senior statutory auditor status.

The objective of the audit exercise is to enable the auditor to express an opinion on whether the financial statements present fairly in all material respects (or give a true and fair view), and whether they have been properly prepared in accordance with the applicable financial reporting framework.

**Internal versus external audit**
Auditing predominantly takes two forms: internal and external audit. An internal audit function is usually a department that is set up within an entity that is staffed by employees of that entity who will provide internal audit services that benefit the entity as a whole. In many cases the role of internal audit is often outsourced. Internal audit departments will have their roles dictated by the management of that organization. Internal auditors will comply with their own set of auditing standards, which are largely independent of International Standards on Auditing (ISAs). Internal auditing functions by, among other things, examining, evaluating and reporting to management on the adequacy and effectiveness of components of the accounting and internal control systems. In other words, internal auditing exists to add value and improve an organization's operations.

External audit is usually a statutory requirement imposed on an entity. For example, in the UK, companies are required by legislation to have their financial statements audited if, under the Companies Act 2006, any one of the auditing thresholds

in the table below are breached. Where reference to 'net' and 'gross' are made in the table, this relates to intra-group trading. 'Gross' means intra-group trading has not been eliminated, whereas 'net' means all intra-group trading has been eliminated in accordance with IFRS 10 *Consolidated Financial Statements*.

| | **Turnover** | **Statement of financial position (gross assets)** | **Number of employees** |
|---|---|---|---|
| Small company | £6.5 million | £3.26 million | 50 |
| Small group | £6.5 million net and £7.8 million gross | £3.26 million net and £3.9 million gross | 50 |
| Medium-sized company | £25.9 million | £12.9 million | 250 |
| Medium-sized group | £25.9 million net and £31.1 million gross | £12.9 million net and £15.5 million gross | 250 |

In the UK, the government has announced changes to the Companies Act 2006 to allow more companies to take advantage of audit exemption. The government has announced that for accounting periods ending on or after 1 October 2012, two out of the above three criteria will need to be breached in order to trigger the audit requirement. This change is in line with the Companies Act 2006 threshold for determining whether a company meets the 'small company' criteria.

Other jurisdictions may have their own eligibility criteria for audit and audit exemption. The auditor's opinion on the financial statements is not an opinion of absolute correctness because of the inherent limitations associated with an audit. There is often a concept of perception gap because some third parties often assume that an audited set of financial

statements can give absolute assurance. It is for this very reason that reference to *reasonable assurance* is made within the auditor's report.

It could also be the case that an entity is required to have a statutory audit because the members chose to have an audit when the company was first incorporated. This is often the case when a company has such a condition in their Articles of Association.

External stakeholders, such as banks and financiers, can also impose a requirement for audit on an entity, even if they are not required by statute to have an audit undertaken on their financial statements. In an increasing number of cases, financiers do require a certain level of assurance.

**Features of an audit**

In general terms, an audit will involve the examination of an entity's financial statements and of the disclosures contained therein. As a rule, the auditor is not responsible for preparing the financial statements, even though in some cases the auditors may be involved (provided adequate safeguards have been implemented to maintain independence). The end result of the audit is the auditor's opinion on the financial statements as to whether the financial statements give a true and fair view, or present fairly in all material respects, the state of the entity's affairs.

In order to arrive at their opinion, the auditor must be seen to be *independent* of the entity that is being subject to audit. For the purposes of audit, 'independent' means not having any significant personal interest in the entity. Ensuring the auditor is independent also guarantees that the objective of the audit is achieved and a professional and unbiased view is taken.

Because it is highly unlikely that two audit assignments will be identical, it is important that audit assignments are undertaken

in a logical and structured manner. The objective of the audit is to ensure that the financial statements of an entity give a true and fair view, or present fairly in all material respects, the state of the company's affairs at its reporting date. It would therefore be irresponsible for the auditor to undertake an audit in a sporadic and unplanned manner.

Before any detailed audit work takes places on an audit assignment, the auditor is required to undertake a thorough programme of planning. Planning is a significant area impacted by the redrafting process of the International Auditing and Assurance Board's *Clarity Project*. Without sufficient planning, the auditor is unable to document that they have gained a sufficient understanding of the entity in order to enable an efficient audit to take place. The planning will take various forms and includes the following programme of documentation:

- the entity's background and history;
- its policies and procedures;
- key management and staff;
- significant accounting policies;
- the environment in which the entity operates;
- accounting systems;
- any problems encountered in previous audits;
- a timetable for key events;
- the audit budget;
- the audit strategy and plan;
- meetings held with the client prior to the audit; and
- meetings of the audit team prior to the audit.

A full risk assessment is also required at the planning stage and the audit strategy is then developed as a result of this risk assessment to ensure that the audit procedures adopted during the course of the audit are responsive to the risks identified at the planning stage.

A review of the entire audit process is as follows:

| | New audit | Recurring audit |
|---|---|---|
| Legal and ethical matters | Consider | Review |
| Acceptance and letter of engagement | Prepare and issue | Review/update where necessary |
| Obtain an understanding of the entity and its environment | Obtain and prepare | Review/update where necessary |

The auditor will document their understanding of the accounting and internal control systems present at the audit client. This will also involve the auditor undertaking a risk assessment in order that the procedures the auditor adopts during the course of the detailed audit work are responsive to those risks.

The next step is for the auditor to consider the various ways in which they will generate sufficient and appropriate audit evidence. Audit evidence can be obtained from a variety of means, but usually from tests of control or substantive procedures, or a mix of both. In determining whether the evidence can be gathered from tests of control (and, therefore, reducing detailed substantive procedures), the auditor must assess whether the internal controls operate effectively; in other words, ensuring that the controls will prevent, detect and correct a material misstatement within the accounting system in a timely manner. Tests of controls are also referred to as 'compliance tests'. Any significant deficiencies in internal controls must be notified to those charged with governance

in accordance with the provisions in ISA 265 *Communicating Deficiencies in Internal Control to those Charged with Governance*.

The above summary highlights the primary objective of the external audit. The objective of the audit looks at the primary needs of external stakeholders of the entity, as opposed to the requirements of an entity's management. External stakeholders usually include, among others, an entity's bankers, trade payables and receivables, employees, and potential investors. The audit is therefore aimed at ensuring the general purpose financial statements are objective, free from bias and manipulation, and relevant to the needs of the users of those financial statements.

**Independence**

Auditors are expected to be independent of the reporting entity. The *Conceptual Framework Approach to Independence* identifies two aspects of independence:

- independence of mind; and
- independence in appearance.

### Independence of mind

> 'Independence of mind enables the auditor to form an opinion without being affected by influences that would compromise the auditor's professional judgement. Independence of mind will allow the auditor to act with integrity and exercise objectivity at all times during the course of the audit. Independence of mind will also allow the auditor to act with professional scepticism.'
>
> [IESBA Code]

### Independence in appearance

> 'Independence in appearance is achieved when the auditor avoids facts and circumstances that are so significant that a

> reasonable and informed third party would conclude that the auditor's integrity, objectivity and professional scepticism has been compromised.'
>
> [IESBA Code]

**Threats to independence**

Any threats to the auditor's independence must be eradicated in totality or mitigated to an acceptable level. The auditor also has an obligation to ensure that, where they identify threats to independence, adequate safeguards are applied. Where the auditor concludes that adequate safeguards cannot be applied to eradicate the threat in totality or mitigate it to an acceptable level, the auditor must resign from the audit engagement or decline the audit engagement. Threats to independence can arise in the following situations:

- The auditor's personal interest: the auditor may fear losing the audit fee.
- Intimidation: the auditor may be intimidated by dominant or aggressive management.
- Long association: if the auditor has had a long association with the audit client, they may be too sympathetic to the client.
- Performing non-audit work and subsequently auditing that work (referred to as a 'self-review' threat).

# 52. What are the basics with regards to financial instruments?

## Answer

Financial instruments are, possibly, the most complex area. This complexity has evolved considerably over the years given that it is such a broad topic and there are many contracts that companies can enter into. The new IFRS 9 *Financial Instruments* aims to be less cumbersome than the current IAS 39 *Financial Instruments: Recognition and Measurement* in that there are a reduced number of classifications and the focus of IFRS 9 is more concentrated on fair value accounting as opposed other methods prescribed in IAS 39. There are currently four accounting standards that deal with financial instruments as follows:

- IAS 32 Financial Instruments: Presentation;
- IAS 39 Financial Instruments: Recognition and Measurement;
- IFRS 7 Financial Instruments: Disclosures; and
- IFRS 9 Financial Instruments.

There is also a number of interpretations that have been issued in order to address various complexities inherent in the accounting standards governing financial instruments:

- IFRIC 2 Members' Shares in Co-operative Entities and Similar Instruments;
- IFRC 10 Interim Financial Reporting and Impairment;
- IFRIC 16 Hedges of a Net Investment in a Foreign Operation; and
- IFRIC 19 Extinguishing Financial Liabilities with Equity Instruments.

At the time of writing, the International Accounting Standards Board (IASB) was in the process of developing IFRS 9, which

will ultimately replace IAS 39. The first phase of IFRS 9 was published in two parts in November 2009 and October 2010. These parts will tentatively take effect for accounting periods commencing on or after 1 January 2015. The intention is to fully replace IAS 39, but currently IFRS 9 only deals with the classification of, and accounting requirements for, financial assets and financial liabilities, recognition and derecognition of such items and guidance on measuring fair value.

**Financial instruments**

IAS 32 defines a financial instrument as follows:

> 'A *financial instrument* is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.
>
> A *financial asset* is any asset that is:
>
> - 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 under conditions that are potentially favourable to the entity; or
> - a contract that will or may be settled in the entity's own equity instruments, and is:
>   - a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
>   - a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

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; or
- a contract that will or may be settled in the entity's own equity instruments and is:
  - a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
  - a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.'

[IAS 32.11]

A simple way of understanding what gives rise to a financial instrument is to consider that when a company needs to raise finance, a third party has to provide that finance, so for financial assets this could include:

- cash;
- contractual rights to cash or shares;
- deposits in other companies;
- investments in bonds;
- loans to other companies; and
- receivables.

For financial liabilities, these could include:

- bank loans and overdrafts;
- leasing;
- sundry loans; and
- trade payables.

# 53. How are financial assets and financial liabilities accounted for?

## Answer

**Financial assets**
Once an entity has concluded that a financial asset exists, the recognition and measurement criteria is laid down in IAS 39 *Financial Instruments: Recognition and Measurement*. Under IAS 39, four possible classifications of financial instruments exist within a set of financial statements. These are described below.

*Available-for-sale financial assets* These are non-derivative financial assets that are not classified as financial assets at fair value through profit or loss, held-to-maturity investments, or loans and receivables. This is essentially the 'default' category for those financial instruments that cannot be classified as fair value through profit or loss, held-to-maturity investments, or loans and receivables.

*Financial assets at fair value through profit or loss* These are carried at fair value with any changes in the instrument's fair value being recognized in profit or loss. In order to be able to recognize a financial asset at fair value through profit or loss, it has to meet one of the following conditions:

- the financial asset is classed as held-for-trading (in other words, the entity plans to sell it within a short period of time – usually within one year); and
- upon initial recognition, the financial asset was designated at fair value through profit or loss.

*Held-to-maturity investments* These are non-derivative fixed-term investments that the company intends to hold on to until they

mature and must be quoted in an active market. Strict 'tainting' rules in IAS 39 say that if a company sells or reclassifies a 'significant' amount of held-to-maturity investments, it must reclassify the entire portfolio of held-to-maturity investments to the available-for-sale category.

*Loans and receivables* These are non-derivative financial assets that have fixed or determinable payments, are not quoted in an active market, are not held-for-trading, and upon initial recognition have not been recognized as assets at fair value through profit or loss. A good example of these is a loan to another company or a sale to a customer on credit terms.

A summary of the accounting for financial assets in the financial statements is as follows:

| Financial asset | Statement of financial position | Gains or losses recognized in |
|---|---|---|
| Fair value through profit or loss | Fair value | Statement of comprehensive income |
| Available-for-sale | Fair value | In equity until derecognition, then recycled through the statement of comprehensive income |
| Held-to-maturity | At amortized cost | Not applicable |
| Loans and receivables | At amortized cost | Not applicable |

In the new IFRS 9 *Financial Instruments*, there is no classification of held-to-maturity or available-for-sale financial assets.

**Financial liabilities**

Financial instrument liabilities can be extremely complicated to deal with. In essence, however, when an entity wishes to raise finance, it may do so from a varying degree of sources such as a share issue or a loan. Under the provisions in IAS 32, there are generally two options to accounting for financial liabilities:

- recognize the financial liability as debt; or
- recognize the financial liability as equity.

Financial liabilities can be classified as:

- financial liabilities at fair value through profit or loss; or
- other financial liabilities measured at amortized cost using the effective interest method.

IAS 32 looks at the substance of the transaction where financial liabilities are concerned and in particular looks at whether (or not) the financial instrument entitles the holder to receive cash, or if the financial liability contains any sort of redemption feature. If the financial instrument does not entitle the holder to receive cash, or does not contain any form of redemption feature, then the financial instrument is classed as equity. If, on the other hand, the financial instrument entitles the holder to receive cash, or if the instrument contains a redemption feature, then the instrument is classed as debt.

**Compound financial instruments**

Compound financial instruments are financial instruments that contain a mixture of both debt and equity. The most common instrument that is classed as a compound financial instrument is a loan whereby the loan note holders have an option when the loan notes mature to either convert the capital amount into shares of the entity, or receive cash in settlement. In these situations part of the instrument will be recognized as debt, with the other part being recognized as equity.

### Example

On 1 April 2012, an 8% convertible loan note with a nominal value of C600,000 was issued at par. It is redeemable on 31 March 2016 also at par. Alternatively it may be converted into equity shares of the entity on the basis of 100 new shares for each C200 of loan note.

An equivalent loan note without the conversion option would carry interest at 10%. Interest of C48,000 has already been paid to the loan note holders and has been included as a finance cost in the statement of profit or loss.

Present value rates are as follows:

| End of year | Present value 8% | 10% |
|---|---|---|
| 1 | 0.93 | 0.91 |
| 2 | 0.86 | 0.83 |
| 3 | 0.79 | 0.75 |
| 4 | 0.73 | 0.68 |

As there is an option to convert the shares into equity (i.e. the loan note holders do not have to accept equity shares; they could demand repayment in the form of cash), there is clearly an obligation to transfer economic benefits. There is the issue of both 'debt' and 'equity', and there is an obligation to pay cash (the interest at 8% per annum) and a redemption amount, which is the 'debt' component of the instrument. The 'equity' part of the instrument is the loan note holder's option to convert.

The way to calculate the debt and equity component is to discount the cash flows to present day values and the difference between the discounted cash flows and the proceeds received is the equity component of the instrument.

| | **8% interest (C600,000 × 8%)** | **Factor at a rate of 10%** | **Present value** |
|---|---|---|---|
| Year 1 – 2013 | 48,000 | 0.91 | 43,600 |
| Year 2 – 2014 | 48,000 | 0.83 | 39,800 |
| Year 3 – 2015 | 48,000 | 0.75 | 36,000 |
| | | | 119,400 |
| Year 4 – 2016 | 648,000 | 0.68 | 440,600 |
| Amount recognized as a liability | | | 560,000 |
| Initial proceeds | | | (600,000) |
| Amount recognized as equity | | | 40,000 |

The next step is to consider the interest charge that has been recognized as a finance cost. The scenario shows that C48,000 has already been paid to the loan note holders, which has been debited to finance costs in the statement of profit or loss. This represents 8% of the loan. However, we have to recognize the fact that an equivalent loan without the option to convert the capital element into shares would carry interest at a rate of 10% and therefore it is necessary to reflect this.

The present value of the debt component is C560,000 and therefore this would be charged interest of (C560,000 × 10%) C56,000. C48,000 has already been charged to the

> statement of profit or loss so the difference of (C56,000 less C48,000) C8000 is also charged to finance costs, as this is essentially the 'rolled up' interest in the loan.

**Derivative financial instruments**
A derivative financial instrument is a financial instrument:

- whose value changes in response to a change in underlying variables, for example interest rates;
- that requires no initial investment, or one that is smaller than would be required for a contract with a similar response to changes in market factors; and
- is settled at a future date.

Examples of derivative financial instruments are:

- forward contracts;
- swaps;
- forward rate agreements;
- options; and
- caps and floors.

An 'embedded derivative' is a feature within a contract. It acts as a component part of a 'hybrid' financial instrument that also includes a non-derivative host contract with the effect that some of the cash flows of the hybrid instrument vary in a similar way to a standalone derivative. A 'hybrid' instrument is a combination of both the host contract and the embedded derivative.

Embedded derivatives can arise from deliberate financial engineering (for example, making a low interest rate debt more attractive by including an equity-linked return). This situation is not absolute and they can arise through market prices

and other contractual arrangements (for example lease and insurance contracts).

> **Example**
>
> An entity has a loan that pays interest based on changes in the FTSE index.
>
> The component of the contract that is to repay the principal amount is the 'host' contract. This is the 'base state' with a predetermined term and predetermined cash flows.
>
> The component that is to pay interest based on the FTSE index is the embedded derivative. This component causes some (or all) of the cash flows of the host contract.

### Derecognizing financial instruments

*Financial liabilities* A financial liability should be removed from the statement of financial position when, and only when, the obligation specified within the contract is discharged, cancelled or expired. A gain or loss on the derecognition of a financial liability is recognized in the statement of profit or loss.

*Financial assets* Financial assets require a bit more analysis. An entity needs to consider whether the asset under consideration is:

- an asset in its entirety;
- specifically identified cash flows from an asset;
- a fully proportionate share of the cash flows from an asset; or
- a fully proportionate share of specifically identified cash flows from a financial asset.

Once this analysis has been undertaken, consideration is then given to whether the asset has been transferred, and, if so, whether the transfer of the asset is eligible for derecognition. An asset is transferred if either the entity has transferred the contractual rights to receive cash flows, or the entity has retained the contractual rights to receive the cash flows from the asset, but has assumed a contractual obligation to pass those cash flows on under an arrangement that meets three conditions:

- the entity does not pay the amounts over until it collects an equivalent amount on the original asset;
- the entity is prohibited from selling or pledging the original asset other than to the recipient; and
- the entity has an obligation to remit those funds to the recipient without delay.

The key factor is to look at whether all the risks and rewards have also been transferred. If, substantially, all of the risks and rewards of ownership have been passed, the entity can derecognize the financial asset. If, substantially, all of the risks and rewards have not been passed over, the entity is prohibited from derecognizing the financial asset.

**Hedge accounting**

Many businesses will use hedge accounting to 'hedge' their exposure to risks such as interest rate risk, foreign exchange rate risk and suchlike.

In order to qualify for hedge accounting at the inception of a hedge and at each reporting date, the changes in the fair value or cash flows of the hedged item attributable to the hedged risk must be expected to be highly effective in offsetting the changes in the fair value or the cash flows of the hedging instrument on a prospective basis, and on a retrospective basis where the actual results are within a range of 80% to 125% when offset by an opposite gain or loss.

There are three types of hedge:

- fair value hedge;
- cash flow hedge; and
- hedge of a net investment in a foreign operation.

For hedge accounting to be applied, certain criteria must be met:

- there must be formal documentation put in place at the inception of the hedge;
- the designation between the item that is hedged and the hedging instrument itself is formally documented;
- hedge effectiveness can be measured;
- where cash flow hedges are concerned, the transaction must be highly probable (in other words, more likely than not); and
- assessment takes place on an ongoing basis and is effective throughout the period.

**Fair value hedge** A fair value hedge is a hedge of the exposure to changes in the fair value of a recognized asset or liability, or a firm commitment that is attributable to a particular risk that could affect profit or loss.

The gain or loss from remeasuring the hedging instrument at fair value (for a derivative hedging instrument) or foreign currency component measured in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates* is recognized in profit or loss.

The gain or loss on the hedged item attributable to the hedged risk will adjust the carrying amount of the hedged item and should be recognized in profit or loss even if the hedged item is measured at cost. Recognition in profit or loss also applies if the hedged item is an available-for-sale financial asset.

*Cash flow hedge* A cash flow hedge is a hedge against the exposure to variability in cash flows associated with a recognized asset or liability that could affect profit or loss.

The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognized in other comprehensive income. The ineffective portion of the gain or loss on the hedging instrument is recognized in profit or loss.

*Hedge of a net investment in a foreign operation* This is linked to IAS 21 and is a foreign operation (in other words, a foreign subsidiary). The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognized in other comprehensive income.

The ineffective portion is recognized in profit or loss.

**Example**

An entity has a C1000 debt at a 10% fixed rate with a two-year term. Interest payments are made annually and in order to hedge against future changes in interest rates, the entity enters into a two-year C1000 notional interest rate swap requiring interest payments at one year LIBOR in exchange for the receipt of fixed interest at 10%. At inception LIBOR is expected to be 10% for the following two years, but at the end of year one it is expected to be 5% for the second year.

At the end of year 1, the retrospective test is:

| | |
|---|---|
| *Hedged item* | |
| Fair value at inception | 1000 |
| *Fair value at the end of year 1* | |
| C1000 × 1.10 / 1.05 | 1048 |
| Change in fair value | (48) |

| *Hedging instrument* | |
|---|---|
| Fair value at inception | 0 |
| Fair value at end of year one (C50* / 1.05) | 48 |
| Change in fair value | 48 |

*This represents the difference in anticipated swap cash flows (C1000 × (10% – 5%))

The offset test at the end of year one is calculated as the change in fair value of the hedging instrument / change in fair value of the hedged item, hence:

48 / 48 = 1

The hedge is currently 100% effective.

If there had been a contractual difference or a delay in the timing of the cash flows (either on the debt instrument or the swap), or if hedge effectiveness is tested at a date other than the swap repricing date, then there would be some hedge ineffectiveness. In addition, credit risk in the swap also has the potential of introducing some hedge ineffectiveness.

A key point to emphasize is that where fair values are not easily available – for example, if they are not traded – then the principles-based approach of IFRS will mean that management must use their judgement in ascertaining a fair value.

# 54. What is the IFRS for SMEs and how is it structured?

## Answer

The objective of the International Accounting Standards Board (IASB) is to produce accounting standards that result in financial statements giving relevant, reliable and useful information that is high-quality and understandable.

In July 2009, the IASB issued the *International Financial Reporting Standard for Small and Medium-sized Entities* (IFRS for SMEs). Entities that fall under the scope of 'small and medium' can adopt these standards as their financial reporting framework. Offering reduced disclosure requirements from the mainstream IFRS, IFRS for SMEs provides an alternative framework that eligible entities can apply.

IFRS for SMEs is a standalone standard and was developed by incorporating the existing principles in full IFRS. However, due to its target audience, there are a number of accounting standards and practices that are not covered by the IFRS for SMEs, such as:

- IAS 33 Earnings per Share;
- IAS 34 Interim Financial Reporting;
- IFRS 8 Segment Reporting;
- IFRS 4 Insurance Contracts; and
- IFRS 5 Assets Held for Sale.

**Small-medium enterprise**
There is currently no definition in IFRS as to what constitutes a 'small-medium enterprise', and the decision as to who qualifies as an SME currently lies with national regulatory authorities and standard-setters. Currently such regulatory authorities and standard-setters usually set eligibility criteria, such as

turnover tests, statement of financial position (balance sheet) tests and employee numbers. IFRS for SMEs states that small and medium-sized entities are those who:

**(a)** *do not have public accountability* [IFRS for SMEs paragraph 1.2 (a))], and
**(b)** *publish general purpose financial statements for external users* [IFRS for SMEs paragraph 1.2 (b)].

In contrast, the IFRS for SMEs describes the circumstances when an entity does have public accountability, and is therefore not eligible to adopt IFRS for SMEs. Paragraph 1.3 (a) and (b) of IFRS for SMEs states:

> '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 for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets), or
> **(b)** it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. This is typically the case for banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks.'

Currently users of IFRS are primarily the capital markets. By definition, full IFRS would not necessarily be appropriate to small-medium entities, simply because of the overwhelming disclosures that IFRS compels users to make in their financial statements.

In developing the IFRS for SMEs, the IASB considered the needs of small-medium entities, having particular regard to the users of their financial statements. It followed, therefore, that IFRS for SMEs, whilst based on the principles contained within full IFRS, should be simplified in order to encourage those who fall within its scope to adopt IFRS for SMEs. If an entity adopts IFRS

for SMEs, it must follow the standard in its entirety. In other words, an entity cannot 'mix and match' full IFRS with IFRS for SMEs, hence IFRS for SMEs being a standalone standard.

IFRS for SMEs prohibits the use of the revaluation model for property, plant and equipment, as well as for intangible assets. In addition, IFRS for SMEs prohibits the use of proportionate consolidation for investments in jointly controlled entities. Where financial instruments are concerned, entities that adopt the use of IAS 39 *Financial Instruments: Recognition and Measurement* should classify their financial instruments between:

- available-for-sale;
- held-to-maturity;
- financial assets/liabilities at fair value through profit or loss; and
- loans and receivables.

IFRS for SMEs eliminates the 'available-for-sale' and 'held-to-maturity' classifications.

Such simplifications were adopted by the IASB in view of the undue cost burden of financial reporting for SMEs under full IFRS. The IASB is currently encouraging all jurisdictions to adopt IFRS as its financial reporting framework in order to achieve global consistency.

**Fall back to full IFRS**

In jurisdictions such as the United Kingdom, entities that are classed as 'small' entities can adopt the Financial Reporting Standard for Smaller Entities (the FRSSE), which offers significantly reduced disclosure and simplified standards for those entities who qualify for its use. Where the FRSSE does not deal with a transaction or event, the user is required to default to the full accounting standards to decipher the correct accounting treatment. If the full UK accounting standards do

not deal with such a transaction or event, then another GAAP is required to be consulted (for example, IFRS).

IFRS for SMEs is significantly different in its approach to dealing with such circumstances. IFRS for SMEs is a standalone standard; therefore, where a transaction or event is not dealt with, the user is not required to default to mainstream IFRS. Instead, the user is required to develop an accounting policy for the specific transaction or event in line with the principles laid down in the IASB's *Conceptual Framework for Financial Reporting*.

**Compliance with IFRS for SMEs**

Entities that adopt IFRS for SMEs can only make a 'one-way' switch. In other words, an entity cannot adopt IFRS for SMEs in one reporting period and then decide to switch back to domestic standards.

Where financial statements are prepared using IFRS for SMEs, the basis of presentation note in the financial statements and the auditor's report must refer to compliance with IFRS for SMEs.

In developing the IFRS for SMEs, the IASB did not set an 'effective from' date because whether or not a specific jurisdiction adopts the standard as its financial reporting framework for SMEs is a matter for each jurisdiction to decide. However, an entity that chooses IFRS for SMEs as its financial reporting framework must prepare an opening statement of financial position (balance sheet) as at the date of transition to IFRS. The 'transition date' is the start of the earliest period for which comparative information is provided.

**Example**

Alex, Inc. has a year end of 31 December 2012 and has decided to report under IFRS.

> The transition date is the start of the earliest period for which comparative information is provided. Therefore, because 2011 is the comparative year, the start of this period is 1 January 2011 (i.e. the closing 2010 trial balance).

In preparing its opening statement of financial position (balance sheet), a reporting entity adopting IFRS for SMEs must also:

- recognize all IFRS for SME assets and liabilities;
- not recognize assets and liabilities not permitted by IFRS for SMEs;
- classify assets and liabilities by IFRS for SMEs; and
- apply IFRS for SMEs in measuring all recognized assets and liabilities.

Paragraph 35.12 of IFRS for SMEs requires an entity to explain how the transition from its previous financial reporting framework to IFRS for SMEs has affected its reported financial position, financial performance and cash flows.

It should be noted that if a new IFRS is not yet mandatory, but early adoption is permitted, an entity that adopts IFRS for SMEs is permitted (but not required) to apply that IFRS in its first IFRS financial statements.

Paragraph 35.13 then goes on to state:

> 'To comply with paragraph 35.12, an entity's first financial statements prepared under this IFRS shall include:
>
> **(a)** a description of the nature of each change in accounting policy
>
> **(b)** reconciliations of its equity determined in accordance with its previous financial reporting framework to its equity determined in accordance with this IFRS for both of the following dates:

(i) the date of transition to this IFRS, and
(ii) the end of the latest period presented in the entity's most recent annual financial statements determined in accordance with its previous financial reporting framework

**(c)** a reconciliation of the profit or loss determined in accordance with its previous financial reporting framework for the latest period in the entity's most recent annual financial statements to its profit or loss determined in accordance with this IFRS for the same period.'

**Exceptions to the retrospective application of other IFRSs**
IFRS for SMEs allows all of the exemptions in IFRS 1 *First-Time Adoption of International Financial Reporting Standards*. IFRS 1 was amended on 23 July 2009 and the amendments took effect from 1 January 2010; further amendments are also planned. The five exceptions, which are listed for completeness and not all necessarily applicable to SMEs, are as follows:

***IAS 39 Financial Instruments: Recognition and Measurement – Derecognition of Financial Instruments*** A first-time adopter shall apply the derecognition requirements in IAS 39 prospectively for transactions occurring on or after 1 January 2004. However, the entity may apply the derecognition requirements retrospectively, provided that the needed information was obtained at the time of initially accounting for those transactions [IFRS1.B2-3].

***IAS 39 Financial Instruments: Recognition and Measurement – Hedge Accounting*** The general rule is that the entity shall not reflect in its opening IFRS statement of financial position (balance sheet) a hedging relationship of a type that does not qualify for hedge accounting in accordance with IAS 39. However, if an entity designated a net position as a hedged item in accordance with previous GAAP, it may designate an individual item within that net position as a hedged item in accordance with IFRS, provided that it does so no later than the date of transition to IFRSs [IFRS 1.B5].

***IAS 27 Consolidated and Separate Financial Statements—Non-Controlling Interest*** IFRS1.B7 lists specific requirements and is only applicable for first-time adopters that apply IAS 27R in their first IFRS reporting period. IFRS 1.B7 is applied for annual periods beginning on or after 1 July 2009 (IFRS 1.37), which is the same as the 2008 revisions to IAS 27R. Therefore:

- an entity whose annual reporting period begins on 1 July applies IAS 27R and IFRS 1.B7 for the annual period ending 30 June 2010; and
- an entity whose annual reporting period begins on 1 January applies IAS 27R and IFRS 1.B7 for the annual period ending 31 December 2010.

IFRS 1.B7 and IAS 27R can be adopted earlier; however, where the revisions are adopted earlier, the provisions in IFRS 3R must then be applied at the same time. IFRS 3R and IAS 27R cannot be applied prior to the beginning of an annual period beginning on or after 30 June 2007. It follows, therefore, that an entity whose annual reporting period begins on 1 January may early adopt for the year beginning on 1 January 2008, but not the year beginning 1 January 2007.

The exceptions are:

- The amendment in paragraph 28 of IAS 27R requiring attribution of total comprehensive income to the owners of the parent and to the non-controlling interest, even if this results in the non-controlling interests having a deficit balance.
- The requirement on accounting for changes in the parent's ownership interests in a subsidiary after control is obtained.
- The requirements on accounting for a loss of control of a subsidiary and the related requirements of IFRS 5.8A (to classify assets and liabilities of that subsidiary as held for sale when the criteria are met regardless of whether the first-time adopter will retain a non-controlling interest after the sale).

**Full-cost oil and gas assets**
Entities using the full-cost method may elect exemption from retrospective application of IFRSs for oil and gas assets. Entities electing this exemption will use the carrying amount under its old GAAP as the deemed cost of its oil and gas assets at the date of first-time adoption of IFRSs.

***Determining whether an arrangement contains a lease*** IFRIC 4 *Determining Whether an Arrangement Contains a Lease* is exempt from application where a first-time adopter with a leasing contract made the same type of determination of whether an arrangement contained a lease in accordance with its previous GAAP, albeit at a date other than that required by IFRIC 4.

***Optional exemptions from the basic measurement principles in IFRS 1*** IFRS 1 contains further optional exemptions to the general restatement and measurement principles that relate to:

- business combinations;
- share-based payment transactions;
- insurance contracts;
- fair value or revaluation as deemed cost;
- leases;
- employee benefits;
- cumulative translation differences;
- investments in subsidiaries, jointly controlled entities, associates and joint ventures;
- assets and liabilities of subsidiaries, associates and joint ventures;
- compound financial instruments;
- designation of previously recognized financial instruments;
- fair value measurement of financial assets or financial liabilities at initial recognition;
- decommissioning liabilities included in the cost of property, plant and equipment;

- financial assets or intangible assets accounted for in accordance with IFRC 12 *Service Concession Arrangements*; and
- borrowing costs.

Detailed analysis of the above exceptions is outside the scope of this publication and users are encouraged to consult the mainstream IFRS 1 for details of the above exceptions.

**Structure**

The IFRS for SMEs is structured in 'sections' as opposed to standards, and the current structure is as follows:

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The *Basis for Conclusions* and *Illustrative Financial Statements and Presentation and Disclosure Checklist* are included in separate booklets.

**Planned changes**

Readers need to be made aware of the IASB's Comprehensive Review 2012–14 in respect of IFRS for SMEs. The objective of this review is to assess the first two years' experiences of users and how they have implemented IFRS for SMEs, and to consider whether there are any changes that need to be made to IFRS For SMEs.

On 26 June 2012, the IASB issued a Request for Information as an initial step in their Comprehensive Review. The comment period was open until 30 November 2012 and the target date for effective implementation of revisions is in 2015. Readers and those who are affected by IFRS for SMEs are advised to pay close attention to the IASB's website for press releases relating to the Comprehensive Review of IFRS for SMEs.

# Chapter 3

# Test Your Knowledge

Having worked through the FAQs, you are asked to answer whether the following statements are true or false.

1. The accounting standard that deals with lease accounting is IAS 17.
2. Lease transactions are accounted for by looking at their legal form as opposed to their substance.
3. The determination of whether a lease is classed as a financing lease or an operating lease is based on whether the risks and rewards of ownership have passed over to the lessee.
4. The payments in respect of finance leases are written off directly to profit or loss.
5. 'Off balance sheet financing' is permissible under IFRS.
6. If an asset subject to a leasing arrangement is of such a specialized nature that only the lessee can use them without major modifications being made, the lease will be classified as an operating lease.
7. If gains or losses arising from the fluctuation in the fair value of a leased asset accrue to the lessee, this is indicative of a finance lease.
8. If the minimum lease payments is equal to substantially all of the fair value of the leased assets, the lease is a finance lease.
9. The minimum lease payments must equal 95% or more of the fair value of the leased asset in order for the lease to qualify as a finance lease.
10. In calculating the minimum lease payments, contingent rents and executory costs must be included in the calculation.
11. To calculate the present value of the minimum lease payments, the incremental borrowing rate of the lessee is used.
12. Payments received by the lessor in respect of leased assets are recorded as receivable in the period in which they become receivable.
13. Lessors cannot recognize an alternative basis of rental revenue other than that of the straight-line method.

14. Lessors record their interest in leased investment property within land and buildings on the statement of financial position.
15. Assets held under leases that are capitalized in the statement of financial position are not subjected to depreciation.
16. The net investment method for recording finance leases in the lessor's books is the difference between the lessor's gross investment lease and the unearned finance income.
17. Unearned finance income is calculated as the difference between the gross investment and the minimum lease payments plus non-guaranteed residual value.
18. The effective rate of interest method is now the only acceptable method of recognizing unearned finance income within the income statement.
19. If a significant portion of the lessor's business comprises that of operating leases, the lessor should disclose the amount of assets by each major class of asset plus accumulated depreciation at each reporting date.
20. If legal title of a lease that has been capitalized on the statement of financial position does not pass to the lessee at the end of the lease term, the lease payments must automatically be charged to profit or loss.

# Chapter 4

# Answers

1. True. IAS 17 Leases deals with accounting for lease transactions.
2. False. Transactions, including lease transactions, are accounted for by looking at their substance (i.e. their commercial reality) as opposed to their legal form.
3. True. If risks and rewards of ownership have passed to the lessee, the lease is a finance lease. If risks and rewards remain with the lessor, the lease is an operating lease.
4. False. Finance leases are capitalized on the statement of financial position with a corresponding lease creditor. The payments are then split between those of capital (which are debited to the lease obligations liability) and interest is debited to finance costs in profit or loss.
5. False. Off balance sheet financing is not permissible under any Generally Accepted Accounting Practice.
6. False. Assets of such a specialized nature that only the lessee can use without major modification are indicators of a finance lease.
7. True. Gains or losses resulting from the fluctuation in the fair value of the leased asset are indicators that the lease is a finance lease.
8. True. If the minimum leased payments amount to substantially all of the fair value of the leased asset, the lease is a finance lease.
9. False. There is no benchmark quantitative figure in IAS 17 that determines lease classification. Only the terminology 'substantially all' is used.
10. False. Contingent rents and executory costs are always excluded.
11. True. The incremental borrowing rate of the lessee is used, but if it is not practicable to use this rate, the interest rate implicit in the lease is used as an alternative.
12. True. Payments received by the lessor in respect of leased assets are recorded as received or as a receivable in the period in which they become receivable.
13. False. Lessors can recognize revenue arising from lease transactions on any basis other than straight-line, provided

the method is systematic and is more representative of the time pattern of the earning process contained in the lease.

**14.** False. Lessors must report leased property on the statement of financial position under the caption 'Investment in leased property'.

**15.** False. All finance leases capitalized in the statement of financial position must be depreciated in accordance with IAS 16 Property, Plant and Equipment.

**16.** True. The net investment in the lease is the difference between the lessor's gross investment in the lease and the unearned finance income.

**17.** True. Unearned finance income (also known as 'unearned interest revenue') is the difference between the gross investment and the minimum lease payments plus non-guaranteed residual value.

**18.** True. The effective rate of interest method is now the only permissible method of income recognition.

**19.** True. Where the lessor is involved in leasing out assets under operating leases, the lessor must separate each asset into the major classes of assets reported in their financial statements, with the associated depreciation at each reporting date.

**20.** False. The substance of the arrangement is reported, not the arrangement's legal form; therefore, if legal title does not pass at the end of the lease term, but the lease term is for the major part of the economic life of the leased, this would be indicative of a finance lease. As such, recognition on the statement of financial position would be appropriate.

## Chapter 5

# Additional Recommended Reading

It is very important that professional accountants keep up to date with the most recent developments in the world of financial reporting. International Financial Reporting Standards (IFRS) change very frequently and if accountants are not kept up to date with the most recent changes (or aware of planned changes), this could result in errors when preparing general purpose financial statements under IFRS.

This publication has not covered every single eventuality in the world of IFRS. By definition, this publication has only touched on the most commonly asked questions and therefore additional reading is recommended for those who deal with IFRS on a regular basis.

## IFRS for Dummies

*IFRS for Dummies*, written by me and published by John Wiley & Sons in April 2012 is an introduction into the world of IFRS. The book looks at all the IFRSs and IASs, and illustrates the concepts by using real-world examples.

From the back cover:

> If you're an accountant, student, or trainee looking for a quick fix on IFRS, this plain-English guide has you covered. *IFRS for Dummies* provides all the facts you need to understand the complex world of international financial reporting, along with plenty of practical, real-world examples.
>
> - **Learn the who, what and why** – get the lowdown on why the standards were created and which countries use them, as well as the advantages of IFRS.
> - **Master IFRS financial statements** – get up and running with the basics of how to prepare financial statements under IFRS, and how some of the key standards work.
> - **Prepare statements with confidence** – get to grips with some of the more complicated aspects of financial reporting,

including how to prepare consolidated financial statements for subsidiaries and joint ventures.
- **Know what to disclose** – find out what you should disclose in addition to the usual primary financial statements, and understand the importance of disclosure notes.
- **Avoid reporting mistakes** – be aware of common pitfalls when preparing financial statements under IFRS and IAS and know how to avoid them.
- **Fix reporting problems** – take in expert advice and guidance on how to resolve an array of complex financial reporting problems.

## Interpretation and Application of International Standards on Auditing

Also written by me and published by Wiley, this book is for the accountancy and auditing profession, and contains a comprehensive interpretation of all the clarified International Standards on Auditing (ISAs) that are effective for audits of accounting periods commencing on or after 15 December 2010. It gives readers lots of real-life practical examples on how to apply ISAs, as well as a summary of the main technical content of the various IFRSs and IASs, together with examples of how to apply them, audit tests and illustrative sets of financial statements.

From the back cover:

> In recent years auditing has undergone significant changes, due in large part to well-publicised corporate disasters such as Enron and Parmalat, which have shaken the profession. In response, many countries have replaced pre-existing domestic standards with International Standards on Auditing (ISAs) in an attempt to ensure that auditors throughout the world apply the same level of standards during all audit assignments, and that audit quality remains consistent on a global basis.

International Standards on Auditing are frequently updated to improve and clarify their application throughout the audit and accounting profession. They can be extremely complex and difficult to apply in real life situations. It is essential to apply the standards with sufficient rigour to enable an efficient audit to take place, to satisfy the regulators and to ensure that the client receives an audit which is beneficial, cost effective, and which conforms to the prescribed framework; however, auditors are often criticised for failing to do so.

Recognising that auditing is not always an exact science, and that in many cases an auditor is called upon to make a judgment in situations open to differing opinions, this book takes a practical and pragmatic approach to following International Standards on Auditing. Steve Collings looks at the full ISAs in their final form, as reissued following the IAASB 'Clarity Project', and gives auditors guidance on how to interpret and apply them in real life situations. Each redrafted or rewritten ISA is dealt with in a separate chapter, containing case studies and illustrative examples. The book also covers the regulatory framework of auditing and gives a summary of the five ethical standards applicable to auditors, as mapped by the IAASB. Detailed appendices provide an overview of IFRS and IAS, illustrative audit tests and illustrative financial statements.

## International GAAP 2012

Written by the International Financial Reporting Group of Ernst & Young, this publication is a 'must have' for any experienced professional dealing with IFRSs and IASs. With detailed and comprehensive examples, each IFRS, IAS and IFRIC interpretation is examined in significant amounts of intricate detail, offering guidance and interpretations where necessary.

From the back cover:

***International GAAP® 2012*** goes much further than explanation. It interprets IFRSs, sets them in a relevant business context and provides insights into how complex practical issues

should be resolved in the real world of global financial reporting. This book is an essential tool for anyone applying, auditing, interpreting, regulating, studying or teaching international financial reporting.

Written by financial reporting professionals from the International Financial Reporting Group of Ernst & Young, this book provides a truly global perspective on the real-world interpretation and practical application of IFRSs. Complex technical accounting issues are explained clearly in jargon-free terms, and IFRSs are set in a practical context with numerous worked examples and hundreds of illustrations from the published financial reports of major listed companies from around the world.

This 2012 edition of **International GAAP**® has been revised and updated in order to:

- Deal with all new and amended authoritative pronouncements, including the new standards on Consolidated Financial Statements (IFRS 10), Joint Arrangements (IFRS 11), Disclosure of Interests in Other Entities (IFRS 12) and Fair Value Measurement (IFRS 13) and revisions to standards including Financial Instruments (IFRS 9), Presentation of Financial Statements (IAS 1), Income Taxes (IAS 12), Employee Benefits (IAS 19), Separate Financial Statements (IAS 27) and Investments in Associates and Joint Ventures (IAS 28).
- Explain the many initiatives that are currently being pursued by the IASB and IFRS Interpretations Committee and that will lead to changes in accounting requirements. In particular, projects on Revenue Recognition, Leases, Financial Statement Presentation, Financial Instruments and Insurance Contracts may all significantly change current accounting practices.
- Provide insight and guidance on the interpretation and practical application of IFRS from a truly global perspective, based on the experience of the book's authors in dealing with recent day-to-day practical issues.

# Appendix

# The Differences Between Full IFRS and IFRS for SMEs

There are some extremely notable differences between full International Financial Reporting Standards (IFRS) and the IFRS for Small-Medium Enterprises (IFRSSME). These are set out in the following table in the following order of *Issue*:

- application of IFRSSME;
- statement of cash flows;
- accounting policies, changes in accounting estimates and errors;
- events after the reporting period;
- related party disclosures;
- business combinations and goodwill;
- consolidated and separate financial statements;
- investments (interests) in joint ventures;
- investments in associates;
- property, plant and equipment;
- intangible assets (other than goodwill);
- leases;
- impairment of assets;
- income taxes;
- liabilities and equity in relation to financial instruments;
- basic financial instruments, other financial instrument issues and recognition and measurement;
- share-based payment;
- employee benefits;
- specialized activities – agriculture;
- specialized activities – extractive industries;
- foreign currency translation;
- borrowing costs; and
- government grants and disclosure of government assistance.

| Issue | IFRSSME treatment | IFRS treatment |
|---|---|---|
| Application of IFRSSME | The scope for IFRSSME is for entities that meet the definition of an SME. An SME is defined as an entity that:<br>• does not have public accountability; and<br>• publishes general purpose financial statements for external users. | An entity that is required to apply full IFRS is required to apply IAS 1 when preparing and presenting financial statements. |
| **IAS 7/Section 7 *Statement of Cash Flows*** | | |
| Components of cash and cash equivalent | An entity is required to disclose the components of cash and cash equivalents, and reconcile these amounts in the statement of cash flows to the equivalent items in the statement of financial position. No reconciliation is required if cash and cash equivalents are presented as a single (similarly described) item in the statement of financial position. | An entity is required to disclose the components of cash and cash equivalents and reconcile the amounts in the cash flow to the equivalent items in the statement of financial position. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| Cash equivalents | Cash equivalents are short-term, highly liquid investments held to meet short-term cash commitments rather than for investment or other purposes.<br>Bank overdrafts may be included when repayable on demand and are an integral part of the entity's cash management. | Cash equivalents are held for meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent, it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value.<br>Overdrafts that are repayable on demand and form an integral part of an entity's cash management are included as a component of cash and cash equivalents. |
| Cash flows from investing and financing activities | Major classes of gross cash receipts and cash payments must be disclosed.<br>The aggregate cash flows on the acquisition or disposal of a business must be disclosed separately. | Major classes of gross cash receipts and cash payments must be disclosed, other than when a net basis of presentation is permitted. IAS 7 provides the situations where a net basis of presentation would be acceptable. |

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| | | The aggregate cash flows on the acquisition or disposal of a business must be disclosed separately. |
| **IAS 8/Section 10** ***Accounting Policies*, *Changes in Accounting Estimates and Errors*** | | |
| Selecting accounting policies | Where transactions, events and conditions are specifically dealt with, the standard must be applied.<br>In the absence of a relevant section that applies, management are to use their judgement in developing a policy that is relevant and reliable. In developing this policy, reference is made to:<br>• sections of IFRSSME that deal with similar or related issues; and<br>• the definitions, recognition and measurement concepts in section 2. | Where transactions, events and conditions are specifically dealt with in IFRS, the relevant standard must be applied.<br>In the absence of a standard that applies, judgement is used to develop a policy that is relevant and reliable. In developing this policy, reference is made to:<br>• IFRSs that deal with similar, or related issues; and<br>• the definitions, recognition and measurement concepts in the *Conceptual Framework* . |

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| Issue | IFRSSME treatment | IFRS treatment |
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| Correcting prior period errors | Errors are corrected, to the extent practicable, on a retrospective basis by restating the comparative amounts for prior periods presented when the error occurred. If the error occurred before the earliest period presented, opening balances of affected assets, liabilities and equity items are restated.<br>Where it is impracticable to determine the period-specific effects of an error, the entity restates the opening balance of assets, liabilities and equity for the earliest period that is practicable. | Errors are corrected, to the extent practicable, on a retrospective basis by restating the comparative amounts for prior periods presented when the error occurred. If the error occurred before the earliest period presented, opening balances of the affected assets, liabilities and equity items are restated.<br><br>Where it is impracticable to determine the period-specific effects of an error, the entity will restate the opening balances of assets, liabilities and equity for the earliest period that is practicable. When it is impracticable to determine the cumulative effect, the entity will restate the comparative information prospectively from the date that it is practicable. |

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| **IAS 10/Section 32** ***Events After the Reporting Period*** | | |
| Dividends | If an entity declares dividends to holders of its equity instruments after the end of the reporting period, the entity must not recognize those dividends as a liability at the end of the reporting period. However, the amount may be presented as a segregated component of retained earnings. | If an entity declares dividends to holders of equity instruments after the reporting period, the entity must not recognize those dividends as a liability at the end of the reporting period. |
| **IAS 24/Section 33** ***Related Party Disclosures*** | | |
| Key management personnel compensation | An entity must disclose key management personnel compensation in total. | An entity must disclose key management personnel compensation in total and for each of the following categories:<br>• short-term employee benefits;<br>• post-employment benefits;<br>• other long-term benefits;<br>• termination benefits; and<br>• share-based payment. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| Disclosures | At a minimum, entities must disclose the following regarding related party transactions:<br>• the amount of the transactions;<br>• the amount of outstanding balances including their terms and conditions, and details of any guarantees;<br>• provisions for uncollectible receivables; and<br>• the expense recognized in the period for bad or doubtful debts. | At a minimum, entities must disclose the following regarding related party transactions:<br>• the amount of the transactions;<br>• the amount of outstanding balances including their terms and conditions, and details of any guarantees;<br>• provisions for uncollectible receivables; and<br>• the expense recognized in the period for bad or doubtful debts. |
| | The above disclosures must be made separately for each of the following categories:<br>• entities with control, joint control or significant influence over the entity; | The above disclosures must be made separately for each of the following categories:<br>• the parent;<br>• entities with joint control or significant influence over the entity; |

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| | • entities over which the entity has control, joint control or significant influence;<br>• key management personnel; and<br>• other related parties. | • subsidiaries;<br>• associates;<br>• joint ventures in which the entity is a venture;<br>• key management personnel; and<br>• other related parties. |
| Exemptions from disclosure requirements | An entity is exempt from the disclosure requirements required above in relation to:<br>• a state that has control, joint control or significant influence over the entity;<br>• another entity that is a related party because the state has control, joint control or significant influence over both parties. | IAS 24 provides a-similar exemption for state controlled entities. Although the above disclosures are required, the following must also be disclosed:<br>• the name of the government and the nature of its relationship with the reporting entity; and<br>• the following in sufficient detail to allow users to understand the effect of the transactions:<br>∘ the nature and amount of each individually significant transaction; and<br>∘ for other transactions that are collectively significant, a qualitative or quantitative indication of their extent. |

| Issue | IFRSSME treatment | IFRS treatment |
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| **IFRS 3/Section 19** ***Business Combinations and Goodwill*** | | |
| | This section applies to all business combinations, as defined in the section. Furthermore, the section also addresses the accounting for goodwill at the time of the business combination, and subsequently. | The standard applies to all transactions or other events that meet the definition of a business combination, as defined in the standard. While not specifically mentioned in the scope of the standard, it also addresses the accounting for goodwill. |
| | This section specifically excludes combinations of entities or businesses under common control, the formation of joint ventures, and the acquisition of a group of assets that does not constitute a business. | The standard specifically excludes combinations of entities or businesses under common control, the formation of joint ventures and the acquisition of an asset or group of assets that does not constitute a business. The scope of IFRS 3 specifically excludes acquisitions of single assets. However, such assets would generally not meet the definition of a business in IFRSSME and therefore their acquisition would not constitute a business combination. |

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| Definitions | A business combination is the bringing together of separate entities or businesses into one reporting entity.<br>A business is an integrated set of activities and assets conducted and managed for the purpose of providing a return to investors or lower costs or other economic benefits directly and proportionately to policy holders or participants. Furthermore, a business generally consists of inputs, processes applied to those inputs and resulting outputs that are or will be used to generate revenues. If goodwill is present in a transferred set of activities or assets, the transferred asset is presumed to be a business. | A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses. The definition also includes transactions sometimes referred to as 'true mergers' or 'mergers of equals'.<br>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. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| Method of accounting | All business combinations are accounted for using the purchase method.<br>This method involves identifying the acquirer, measuring the cost of the combination and allocating that cost to the net assets acquired and liabilities, and provisions for contingent liabilities assumed. | All business combinations are accounted for using the acquisition method.<br>This method involves identifying the acquirer, determining the acquisition date, recognizing and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree, and measuring goodwill or a gain from a bargain purchase. |
| Identifying the acquirer | The acquirer is the combining entity that obtains control of the other combining entities or businesses. | The acquirer is the entity that obtains control of the acquiree. |

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| Cost of the business combination | The cost of a business is the aggregate of:<br>• the fair values of the assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer; and<br>• any costs directly attributable to the business combination. | The cost of a business combination is not separately defined. However, a component of the measurement of any goodwill or gain from a bargain purchase is the consideration transferred, which is calculated as the sum of the fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree and the equity interests issued by the acquirer. |
| Contingent consideration | When a business combination agreement provides for an adjustment to the cost of the business combination, contingent on future events, the acquirer includes the estimated amount of the adjustment in the cost of the combination at the acquisition date if the adjustment is probable and can be reliably measured. | The acquirer recognizes the acquisition-date fair value of any contingent consideration as part of the consideration transferred in exchange for the acquiree. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| | If the potential adjustment is not recognized at the acquisition date, but subsequently becomes probable and can be measured reliably, the additional consideration is treated as an adjustment to the cost of the combination. | The classification of a contingent consideration obligation as either a liability or equity is based on the definitions of an equity instrument and financial liability in IAS 32 *Financial Instruments: Presentation* or other applicable accounting standards.<br>After initial recognition, changes in the fair value of contingent consideration arising from events after the acquisition date are accounted for as follows:<br>• Contingent consideration classified as equity is not subsequently remeasured. Its subsequent settlement is accounted for within equity.<br>• Contingent consideration classified as a liability that is: |

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| | | ◦ a financial instrument and within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* is remeasured at fair value, with any resulting gain or loss recognized either in profit or loss; or<br>◦ in other comprehensive income in accordance with IAS 39; and<br>◦ not within the scope of IAS 39 and is accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, or other standards as appropriate. |
| Allocating the cost of a business | The acquiree's identifiable assets and liabilities and any contingent liabilities that can be measured reliably are recognized at their acquisition date fair values. | The identifiable assets acquired and liabilities assumed of the acquiree are recognized as of the acquisition date, separately from goodwill and measured at fair value as at that date. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| | Any difference between the cost of the business combination and the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities must be accounted for as goodwill, or negative goodwill. | |
| Recognition of assets and liabilities | The following criteria must be met for the acquirer to recognize the acquiree's identifiable assets and liabilities, and any provisions for contingent liabilities at the acquisition date:<br>• Assets other than an intangible asset: the future economic benefits must be probable and the fair value can be measured reliably. | To qualify for recognition, an item acquired or assumed must be:<br>• an asset or liability at the acquisition date, and meet the definitions of such in the *Conceptual Framework;* and<br>• part of the business acquired (the acquiree) rather than the result of a separate transaction. |

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| | • Liability other than a provision for a contingent liability: the outflow of resources must be probable and the fair value can be measured reliably.<br>• Intangible asset or provision for contingent liability: the fair value can be measured reliably. | |
| Retrospective adjustments | Retrospective adjustments to provisional amounts recognized in initial accounting for a business combination may be made up to 12 months after acquisition date.<br>This time limit does not apply to adjustments to the cost of a combination contingent on future events that become probable and can be reliably measured subsequent to the acquisition date. | Retrospective adjustments to provisional amounts recognized in initial accounting for a business combination may be made during the measurement period, which is a period up to a maximum of 12 months after the acquisition date, where new information is obtained regarding facts and circumstances that existed at the acquisition date. The measurement period ends as soon as the acquirer receives the information it was seeking or learns that further information is not available. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| Non-controlling interests | Where the acquirer obtains less than a 100% interest in the acquiree, a non-controlling interest (NCI) in the acquiree is recognized as the NCI's proportion of the identifiable assets, liabilities and provisions for contingent liabilities of the acquiree at their attributed fair values at the date of acquisition; no amount is included for any goodwill relating to the NCI. | IFRS 3 requires any NCI in an acquiree to be recognized, but provides a choice of two methods of measuring NCI arising in a business combination:<br>• to measure the NCI at its acquisition date fair value; and<br>• to measure the NCI interest at the proportionate share of the value of net identifiable assets acquired.<br>The choice of method is made for each business combination on a transaction-by-transaction basis, rather than being a policy choice. |
| Goodwill definition | Goodwill is defined as 'future economic benefits arising from other assets that are not capable of being individually identified and separately recognized'. | Goodwill is defined as 'an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized'. |

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| Measurement of goodwill | Goodwill is initially measured at cost, being the excess of the cost of the business combination over the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities recognized.<br>After initial recognition, goodwill is measured at cost less accumulated amortization and accumulated impairment losses. | The measurement of goodwill at the acquisition date is computed as the excess of (a) over (b) as follows:<br>(a) The aggregate of:<br>• the consideration transferred (usually measured at acquisition-date fair values);<br>• the amount of any non-controlling interest in the acquire; and<br>• the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.<br>(b) The net of the acquisition-date fair values (or other amounts recognized in accordance with the requirements of the standard) of the identifiable assets acquired and liabilities assumed. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| | Goodwill is amortized in accordance with the principles of intangible assets amortization in section 18 of IFRSSME. If a reliable estimate of the useful life of goodwill cannot be made, then the life is presumed to be ten years. Detailed requirements in relation to impairment testing of goodwill are contained in Section 27 of IFRSSME. This includes the requirement that the acquirer tests it for impairment where there is an indication that it may be impaired. | Goodwill acquired in a business combination is not amortized. The acquirer measures goodwill acquired in a business combination at the amount recognized at the acquisition date less any accumulated impairment losses. Detailed requirements in relation to the subsequent accounting for goodwill are dealt with in IAS 36 *Impairment of Assets*. This includes the requirement that the acquirer has to test it for impairment annually, or more frequently, if events or changes in circumstances indicate that it might be impaired. |

| Bargain purchases | An excess arises where the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and provisions for contingent liabilities exceeds the cost of the combination. The standard recognizes that this is sometimes termed 'negative goodwill'.<br>Where such an excess arises, the acquirer must:<br>• reassess the identification and measurement of the acquiree's assets, liabilities and provisions for contingent liabilities, and the measurement of the cost of the combination; and<br>• recognize immediately in profit or loss any excess remaining after that assessment. | A bargain purchase arises when the net fair value of the identifiable assets and liabilities exceeds the cost of the combination.<br>Before recognizing a gain on a bargain purchase, the acquirer should reassess whether it has correctly identified all of the assets acquired and all of the liabilities that are identified in that review. The acquirer then reviews the procedures used to measure the amounts recognized at the acquisition date for all of the following:<br>• the identifiable assets acquired and liabilities assumed;<br>• the non-controlling interest in the acquiree (where appropriate);<br>• for a business combination in stages, the acquirer's previously held equity interest in the acquire; and<br>• the consideration transferred. |
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| Issue | IFRSSME treatment | IFRS treatment |
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| | | The objective of the review is to ensure that the measurements appropriately reflect the consideration of all available information as at the acquisition date.<br>Having undertaken the review (and made any necessary revisions), if any excess remains, a gain is recognized in profit or loss on the acquisition date. |
| **IAS 27/IFRS 10/(SIC 12)/Section 9** ***Consolidated and Separate Financial Statements (Consolidation – Special Purpose Entities)*** | | |
| Exemption from preparing consolidated financial statements | A parent need not present consolidated financial statements if both of the following conditions are met:<br>• the parent is itself a subsidiary; and | A parent need not present consolidated financial statements if, and only if:<br>• the parent is itself a wholly owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements; |

- its ultimate parent (or any intermediate parent) produces consolidated general purpose financial statements that comply with full IFRS or IFRSSME;
- or it has no subsidiaries other than one that was acquired with the intention of selling or disposing of it within one year; a parent accounts for such a subsidiary:
  - at fair value with changes in fair value recognized in profit or loss, if the fair value of the shares can be reliably measured; or
  - otherwise at cost less impairment.

- the parent's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets);
- the parent did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market; or
- the ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use that comply with IFRS.

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| Issue | IFRSSME treatment | IFRS treatment |
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| Special purpose entities | An entity may be created to accomplish a narrow objective (e.g. to effect a lease, undertake research and development activities or securitize financial assets). Such a special purpose entity (SPE) may take the form of a corporation, trust, partnership or unincorporated entity. Often SPEs are created with legal arrangements that impose strict requirements over the operations of the SPE. | An SPE must be consolidated when the substance of the relationship between an entity and the SPE indicates that the SPE is controlled by that entity.<br>In addition to the situations described in IAS 27.13, the following circumstances may indicate a relationship in which an entity controls an SPE and consequently should consolidate the SPE (the list is not exhaustive):<br>• In substance, the activities of the SPE are being conducted on behalf of the entity according to its specific business needs so that the entity obtains benefits from the SPEs operation.<br>• In substance, the entity has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an 'autopilot' mechanism, the entity has delegated these decision-making powers. |

An entity must prepare consolidated financial statements that include the entity and any SPEs that are controlled by that entity. In addition to the circumstances described in paragraph 9.5 of IFRSSME, the following circumstances may indicate that an entity controls an SPE (this list is not exhaustive):

- The activities of the SPE are being conducted on behalf of the entity according to its specific business needs.
- The entity has the ultimate decision-making powers over the activities of the SPE, even if the day-to-day decisions have been delegated.

- In substance, the entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incidental to the activities of the SPE.
- In substance, the entity retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

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| Issue | IFRSSME treatment | IFRS treatment |
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| | • The entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incidental to the activities of the SPE.<br>• The entity retains the majority of the residual or ownership risks to the SPE or its assets. | |
| Disposal of subsidiaries | The difference between the disposal proceeds of the subsidiary and its carrying amount as at the date of disposal, excluding the cumulative amount of any exchange differences that relate to a foreign subsidiary recognized in equity, in accordance with Section 30 | If a parent loses control of a subsidiary it:<br>• derecognizes the assets (including any goodwill) and liabilities of the subsidiary at their carrying amounts at the date when control is lost;<br>• derecognizes the carrying amount of any non-controlling interest in the former subsidiary at the date when control is lost (including any components of other comprehensive income attributable to them); |

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| | *Foreign Currency Translation*, is recognized in the consolidated statement of comprehensive income (or the income statement, if presented) as the gain or loss on the disposal of the subsidiary.<br>If the parent continues to hold an investment in the entity, it is accounted for as a financial asset, associate or jointly controlled entity depending on the nature of the investment. The carrying amount of the investment at the date it ceases to be a subsidiary is the cost on initial measurement as a financial asset, associate or jointly controlled entity. | • recognizes the fair value of the consideration received, if any, from the transaction, event or circumstances that resulted in the loss of control;<br>• recognizes if the transaction that resulted in the loss of control involves a distribution of shares of the subsidiary to owners in their capacity as owners, that distribution;<br>• recognizes any investment retained in the former subsidiary at its fair value at the date when control is lost;<br>• reclassifies to profit or loss, or transfers directly to retained earnings if required in accordance with other IFRSs, the amounts identified in paragraph 35;<br>and<br>• recognizes any resulting difference as a gain or loss in profit or loss attributable to the parent. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| | | If a parent loses control of a subsidiary, the parent must account for all amounts recognized in other comprehensive income in relation to that subsidiary on the same basis as would be required if the parent had directly disposed of the related assets or liabilities. Therefore, if a gain or loss previously recognized in other comprehensive income would be reclassified to profit or loss on the disposal of the related assets or liabilities, the parent reclassifies the gain or loss from equity to profit or loss (as a reclassification adjustment) when it loses control of the subsidiary. |

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| Separate financial statements | If separate financial statements are prepared, a parent, an investor in an associate or a venturer with an interest in a jointly controlled entity must account for its investments in subsidiaries, associates and jointly controlled entities either:<br>• at cost less impairment; or<br>• at fair value, with changes in fair value recognized in profit or loss.<br>The entity must apply the same accounting policy for all investments in a single class (subsidiaries, associates or jointly controlled entities), but it can elect different policies for different classes. | If separate financial statements are prepared, a parent, an investor in an associate or a venturer with an interest in a jointly controlled entity must account for its investments in subsidiaries, associates and jointly-controlled entities either:<br>• at cost; or<br>• in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.<br>The entity must apply the same accounting policy for each category of investments.<br>There are additional requirements in relation to investments accounted for at cost that are classified as held-for-sale. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| Investments in joint ventures – scope | Section 15 of IFRSSME applies to accounting for all joint ventures in consolidated financial statements and in the financial statements of an investor that is not a parent but has an interest in one or more joint ventures.<br>Accounting for interests in joint ventures in a venturer's separate financial statements is covered in Section 9 to IFRSSME. | The standard applies in accounting for all interests in joint ventures, regardless of the structures or forms under which the joint venture activities take place. However, the scope excludes interests in jointly controlled entities held by venture capital organizations or mutual funds, unit trusts and similar entities that on initial recognition are designated at fair value through profit or loss or classified as held-for-trading in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. |

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| **Section 15/IAS 30** ***Investments (Interest) in Joint Ventures*** | | |
| Measurement of jointly controlled entities | A venturer must account for all of its interests in jointly controlled entities using one of the following:<br>• The cost model, where investment is measured at cost less any accumulated impairment losses. This model may not be used for investments for which there is a published price quotation, in which case the fair value model should be used.<br>• The equity method, where investments are measured using the method as applied to associates and outlined in Section 14. | A venturer must account for all of its interests in jointly controlled entities using one of the following:<br>• The equity method, where the investment is measured using the method applied to associates as outlined in IAS 28 *Investments in Associates and Joint Ventures.*<br>• Interests in jointly controlled entities that are classified as held-for-sale are accounted for in accordance with IFRS 5 *Non-Current Assets Held for Sale and Discontinued Operations.* |

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| Issue | IFRSSME treatment | IFRS treatment |
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| | • The fair value model, where investments are initially measured at transaction price and subsequently remeasured to fair value at each reporting date, with changes in fair value recognized in profit or loss. The cost model may be applied to investments for which it is impracticable to measure fair value without undue cost or effort. | |

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| Transactions between a venturer and a joint venture | When a venturer contributes or sells assets to a joint venture, IFRSSME requires that the recognition of any gains or loss should reflect the substance of the transaction. While the assets are retained by the joint venture, and provided that the venturer has transferred the significant risks and rewards of ownership, the venturer should recognize only that portion of the gain or loss that is attributable to the interests of the other venturers. However, the venturer should recognize the full amount of any loss when the contribution or sale provides evidence of an impairment loss. | When a venturer contributes or sells assets to a joint venture, full IFRS requires that the recognition of any gain or loss should reflect the substance of the transaction. While the assets are retained by the joint venture, and provided that the venturer has transferred the significant risks and rewards of ownership, the venturer should recognize only that portion of the gain or loss that is attributable to the interests of the other venturers. However, the venturer should recognize the full amount of any loss when the contribution or sale provides evidence of a reduction in the net realizable value of current assets or an impairment loss. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| | When a venturer purchases assets from a joint venture, the venturer must not recognize its share of the profits of the joint venture from the transaction until it resells the assets to an unrelated third party. A venturer recognizes its share of the losses resulting from these transactions in the same way as profits, except that losses should be recognized immediately when they represent an impairment loss. | When a venturer purchases assets from a joint venture, the venturer must not recognize its share of the profits of the joint venture from the transaction until it resells the assets to an unrelated third party. A venturer recognizes its share of the losses resulting from these transactions in the same way as profits, except that losses should be recognized immediately when they represent a reduction in the net realizable value of current assets or an impairment loss.<br>Where non-monetary assets are contributed to a jointly controlled entity, the additional guidance in SIC 13 *Jointly Controlled Entities – Non-Monetary Contributions by Venturers* must be considered. |

| **Section 14/IAS 28** ***Investments in Associates and Joint Ventures*** | | |
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| Scope | Section 14 applies to accounting for associates in consolidated financial statements and in financial statements of an investor that is not a parent, but has an interest in one or more associates.<br>Accounting for interests in associates and in an investor's separate financial statements is covered in Section 9. | IAS 28 applies to accounting for investments in associates. However, the scope excludes investments in associates held by venture capital organizations or mutual funds, unit trusts and similar entities that on initial recognition are designated at fair value through profit or loss or classified as held-for-trading under IAS 39.<br>The standard refers to IAS 27 for the requirements on accounting for an investor's separate financial statements. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| Measurement | An investor must account for all of its investments in associates using one of the following:<br>• The cost model, where investment is measured at cost less any accumulated impairment losses. This model may not be used for investments for which there is a published price quotation, in which case the fair value model is applied.<br>• The equity method, where investment is initially measured at transaction price and subsequently adjusted to reflect the investor's share of profit or loss and other comprehensive income of the associate. | An investor accounts for all its investments in associates using the equity method. Investments in associates that are classified as held-for-sale are accounted for in accordance with IFRS 5 *Non-Current Assets Held for Sale and Discontinued Operations*.<br>The equity method requires that the investment is initially recognized at cost and adjusted thereafter for the post-acquisition changes in the investor's share of the net assets of the investee. The profit or loss of the investor includes the investor's share of the profit or loss of the investee. |

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| | • The fair value model, where investment is initially measured at transaction price and subsequently remeasured to fair value at each reporting date, with changes in fair value recognized in profit or loss. Cost model may be applied to investments for which it is impracticable to measure fair value without undue cost or effort. | |
| Equity method – implicit goodwill and fair value adjustments | Any difference between the cost of acquisition and the investor's share of the net identifiable assets of the associate is accounted for as goodwill or discount on acquisition. | Any difference between the cost of acquisition and the investor's share of net identifiable assets of the associate is accounted for as goodwill or discount on acquisition. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| | The investor's share of an associate's profits or losses is adjusted to account for any additional depreciation/amortization on the basis of the excess of their fair values over carrying amounts at acquisition of the investment. | The investor's share of an associate's profits or losses is adjusted to account for any additional depreciation/amortization on the basis of the excess of their fair values over carrying amounts at acquisition of the investment. |
| Equity method – date of associate's financial statements | IFRSSME requires use of financial statements of the associates as of the same date as those of the investor, unless it is impracticable to do so.<br>If it is impracticable, the investor must use the most recent available financial statements of the associate, adjusted for significant transactions or events between the accounting period ends. | IAS 28 requires the use of the most recent available financial statements of the associate, and where the associate's and investor's reporting period end differs, the associate must prepare financial statements as of the same date as the investor's financial statements, unless impracticable. |

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| | | Where the associate's financial statements are prepared as of a different date to the investor, the associate's financial statements are adjusted for significant transactions or events between the accounting period ends. In any case, the difference between the reporting period ends may be no longer than three months, and the length of the reporting periods and any difference between the ends of the reporting periods must be the same from period to period. |
| Equity method – accounting policies | If the associate's accounting policies differ from those of the investor, the investor must adjust the associate's policies to reflect the investor's policies unless this is impracticable. | If the associate's accounting policies differ from those of the investor for like transactions and events, adjustments must be made to the associate's policies to conform to the investor's policies. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| Equity method – loss in excess of investment | If an investor's share of losses of an associate equals or exceeds the carrying amount of its investment in the associate, the investor must discontinue to recognize its share of further losses.<br>After the investor's interest is reduced to zero, the investor must recognize additional losses by a provision only to the extent that the investor has incurred legal or constructive obligations or has made payments on behalf of the associate. If the associate subsequently reports profits, the investor must resume recognizing its share of those profits only after its share of the profits equals the share of losses not recognized. | If an investor's share of losses of an associate equals or exceeds its interest in the associate, the investor discontinues recognizing its share of further losses. The interest in the associate is the carrying amount of the investment under the equity method plus any long-term interests that, in substance, form part of the investor's net investment in the associate. Losses recognized under the equity method in excess of the investor's investment in ordinary shares are applied to the other components of the investor's interest in an associate in the reverse order of their seniority. |

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| | | After the investor's interest is reduced to zero, additional losses are provided for, and a liability is recognized, only to the extent that the investor has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the investor resumes recognizing its share of those profits only after its share of the profits equals the share of losses not recognized. |
| Discontinuing the equity method | An investor must cease using the equity method from the date that significant influence ceases.<br>If the associate becomes a subsidiary or joint venture, the investor remeasures its previously held equity interest to fair value and recognizes any resulting gain or loss in profit or loss. | An investor must discontinue use of the equity method from the date it ceases to have significant influence.<br>On loss of significant influence, the investor must measure at fair value any investment the investor retains in the former associate. The investor must recognize in profit or loss any difference between: |

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| Issue | IFRSSME treatment | IFRS treatment |
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| | If an investor loses significant influence over an associate as a result of a full or partial disposal, it must derecognize that associate and recognize in profit or loss the difference between:<br>• the sum of the proceeds received plus the fair value of any retained interest; and<br>• the carrying amount of the investment in the associate at the date significant influence is lost.<br>Thereafter, the investor accounts for any retained interest as a financial asset using Section 11 and Section 12 as appropriate. | • the fair value of any retained investment and any proceeds from disposing of the part interest in the associate; and<br>• the carrying amount of the investment at the date when significant influence is lost.<br>If the associate becomes a subsidiary or joint venture, the investment is accounted for in accordance with IAS 27/IFRS 10/IFRS 11/IFRS 12 respectively. Otherwise the investment is accounted for in accordance with IAS 39 and the fair value of the investment at the date when it ceases to be an associate is regarded as its fair value on initial recognition as a financial asset. |

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| | If an investor loses significant influence for reasons other than a partial disposal of its investment, the investor regards the carrying amount of the investment at that date as a new cost basis and accounts for the investment using Sections 11 and 12 as appropriate. | |
| **Section 17/IAS 16 *Property*, *Plant and Equipment*** | | |
| Borrowing costs | Borrowing costs do not form part of the cost of an item of property, plant and equipment. | Borrowing costs under IAS 23 *Borrowing Costs* are capitalized if they are directly attributable to the acquisition, construction or production of a qualifying asset. |
| Subsequent measurement of cost | An entity must measure all items of property, plant and equipment after initial recognition at cost less any accumulated depreciation and any accumulated impairment losses. | Property, plant and equipment may be valued using either:<br>• the cost model – cost less accumulated depreciation and impairment losses; or<br>• the revaluation model – revalued amount less accumulated amortization and impairment losses. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| | | An entity must apply that policy to an entire class of property, plant and equipment. |
| | Factors such as a change in how an asset is used, significant unexpected wear and tear, technological advancement and changes in market prices may indicate that the residual value or useful life of an asset has changed since the most recent annual reporting date. If such indicators are present, an entity must review its previous estimates and, if current expectations differ, amend the residual value, depreciation method or useful life. | The residual value and the useful life of an asset must be reviewed at least at each financial year end. |

| **Section 16/IAS 40 *Investment Property*** | | |
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| Scope | Section 16 applies to accounting for investments in land or buildings that meet the definition of investment property.<br>Only investment property whose fair value can be measured reliably without undue cost or effort on an ongoing basis is accounted for in accordance with Section 16. All other investment property is accounted for as property, plant and equipment in accordance with Section 17 *Property, Plant and Equipment*. | IAS 40 *Investment Property* must be applied in the recognition, measurement and disclosure of investment property. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| Subsequent measurement | Investment property whose fair value can be measured reliably without undue cost or effort must be measured at fair value at each reporting date with changes in fair value recognized in profit or loss. If a property interest held under a lease is classified as investment property, the item accounted for at fair value is that interest and not the underlying property. An entity accounts for all other investment property as property, plant and equipment using the cost depreciation impairment model in Section 17. | Investment property may be carried at either:<br>• cost less accumulated amortization and impairment losses; or<br>• revalued amount less accumulated amortization and impairment losses. |

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| Transfers | An entity must transfer a property to, or from, investment property only when the property first meets, or ceases to meet, the definition of investment property. | Transfers to, or from, investment property must be made when, and only when, there is a change in use. |
| **Section 18/IAS 38 *Intangible Assets (Other Than Goodwill)*** | | |
| Scope | Section 18 applies to all intangible assets other than goodwill and intangible assets held for sale in the ordinary course of business. Furthermore, the scope excludes financial assets, and mineral rights and mineral reserves. | IAS 38 *Intangible Assets* applies to all intangibles other than those within the scope of another standard, financial instruments, exploration and evaluation assets, and expenditure on the development and extraction of minerals, oil, natural gas and similar non-regenerative resources. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| Recognition | An entity may recognize an intangible asset if it is probable that there are expected future economic benefits, a reliably measureable cost/value and it does not result from expenditure incurred internally on an intangible asset. | An intangible asset is recognized if, and only if, it is probable that there are expected future benefits and cost that can be measured reliably. |
| Initial measurement | Initial measurement is dependent on the manner in which the intangible asset is acquired:<br>• separate acquisition – at cost;<br>• business combination – at fair value at the acquisition date;<br>• government grant – at the fair value of the grant; or<br>• exchange of assets – at the fair value of the asset or cost when the transaction lacks commercial substance or fair values cannot be reliably measured. | Initial measurement is dependent on the manner in which the intangible asset is acquired:<br>• separate acquisition – at cost;<br>• business combination – at fair value at the acquisition date;<br>• government grant – at the fair value of the grant or at the nominal amount; or<br>• exchange of assets – at the fair value of the asset or cost when the transaction lacks commercial substance or fair values cannot be reliably measured. |

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| Subsequent measurement | Intangible assets are measured at cost less accumulated amortization and impairment losses. | Intangible assets may be carried at either:<br>• cost less accumulated amortization and impairment losses; or<br>• revalued amount less accumulated amortization and impairment losses. |
| Amortization | Intangible assets must be amortized over their useful lives. If the useful life is not determinable, then it is presumed to be ten years.<br>The depreciable amount is allocated over the life of the asset that reflects the pattern in which the asset's future economic benefits are expected to be consumed. If the pattern cannot be reliably determined, the straight-line method is utilized. | Intangible assets must be assessed as to whether they have a finite or indefinite life. Intangible assets with finite lives are amortized over their useful lives. Those with an indefinite useful life are not amortized and are subjected to annual impairment tests.<br>The depreciable amount is allocated over the life of the asset that reflects the pattern in which the asset's future economic benefits are expected to be consumed. If the pattern cannot be reliably determined, the straight-line method is utilized. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| Review of amortization | The entity will consider at each reporting date whether there are any indicators that there has been a change in useful life, residual amount or amortization method. If there is an indicator, this will be adjusted as a change in estimate. | The entity must review at each reporting date whether there has been a change in useful life, residual amount or amortization method. If there is an indicator, this will be adjusted for as a change in estimate. |
| **Section 20/IAS 17 *Leases*** | | |
| Scope | Applies to leases other than the following:<br>• Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources.<br>• Licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights. | IAS 17 applies to all leases other than:<br>• Those to explore for or use minerals, oil, natural gas and similar non-regenerative resources.<br>• Licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights. |

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| | • Measurement of property held by lessees for investment property and by lessors under operating leases.<br>• Measurement of biological assets by lessees under finance leases and by lessors under operating leases.<br>• Leases that could lead to a loss as a result of contractual terms unrelated to changes in the price of the leased asset, changes in foreign exchange rates or default by one of the counterparties.<br>• Onerous operating leases. | • Measurement of property held by lessees for investment property and by lessors under operating leases.<br>• Measurement of biological assets by lessees under finance leases and by lessors under operating leases. |
| Lessees – operating leases | Operating leases are expensed on a straight-line basis or another basis that represents the use of the asset, unless payments to the lessor increase with expected inflation in which case the payments are expensed when payable. | Operating lease payments are expensed on a straight-line basis over the lease term unless another systematic basis is more representative of the use of the asset. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| Lessors – operating leases | Lessors present assets subject to operating leases in the statement of financial position according to the nature of the asset.<br>Lease income from operating leases is recognized on a straight-line basis or another basis that represents the benefit from the asset, unless payments to the lessor increase with expected inflation, in which case the payments are recognized as income when payable.<br>Depreciation is recognized on the same basis as for similar assets. | Lessors present assets subject to operating leases in the statement of financial position according to the nature of the asset. Lease income from operating leases is recognized on a straight-line basis over the lease term, unless another systematic basis is more representative.<br>Depreciation policy is consistent with lessor's normal depreciation policy for similar assets.<br>Initial direct costs incurred by lessors in arranging leases are added to the carrying amount of the leased asset and expensed over the lease term on the same basis as lease income.<br>Manufacturer or dealer lessor does not recognize any selling profit on entering into an operating lease because it is not the equivalent of a sale. |

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| | Initial direct costs incurred by lessors in arranging leases are added to the carrying amount of the leased asset and expensed over the lease term on the same basis as the lease income.<br>A manufacturer or dealer does not recognize selling profit on entering into an agreement; this is not equivalent to a sale. | |
| **Section 27/IAS 36** ***Impairment of Assets*** | | |
| General principles | An entity must recognize an impairment loss immediately in profit or loss. | An impairment loss must be recognized immediately in profit or loss, unless the asset is carried at revalued amount in accordance with another standard. Any impairment loss of a revalued asset must be treated as a revaluation decrease in accordance with that standard. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| Indicators of impairment | An entity must assess at each reporting date whether there is any indication that an asset may be impaired. If any indication exists, the entity must estimate the recoverable amount of the asset. If there is no indication of impairment, it is not necessary to estimate the recoverable amount.<br>In assessing whether there is any indication that an asset may be impaired, an entity must consider, as a minimum, external and internal sources of information. | An entity must assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity must estimate the recoverable amount of the asset. Irrespective of whether there is any indication of impairment, the entity must also:<br>• test an intangible asset with an indefinite useful life or an intangible asset not yet available for use for impairment annually by comparing its carrying amount with its recoverable amount; and<br>• test goodwill acquired in a business combination for impairment annually.<br>In assessing whether there is any indication that an asset may be impaired, an entity must consider, as a minimum, external and internal sources of information. |

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| **Section 29/IAS 12 *Income Taxes*** | | |
| Tax base | The tax base of an asset is determined by the tax consequences that would arise if it were recovered for its carrying amount through sale at the reporting date. | 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. |
| | The tax base of a liability is determined by the tax consequences that would arise if it were settled for its carrying amount at the reporting date. | 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 period. |
| | | An entity's expectation as to the manner in which it will recover the carrying amount of an asset or settle the carrying amount of a liability can affect the tax base. For example, if an entity were to pay a different amount of tax depending on whether an asset is consumed in the business or sold, the entity measures deferred tax according to the expected method of realization. This effectively makes deferred tax under IAS 12 a function of management's intent. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| Recognition of deferred tax assets | Deferred tax must be recognized for all temporary differences that are expected to reduce taxable profit in the future as a total amount.<br>An entity must recognize a valuation allowance against deferred tax assets so that the net carrying amount equals the highest amount that is more likely than not to be recovered based on current or future taxable profit. | A deferred tax asset must be recognized 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 utilized.<br>IAS 12 also requires an entity to reassess the recognition of deferred tax assets and recognize previously unrecognized deferred tax assets at each reporting date to the extent it has become probable that the asset will be recovered.<br>A deferred tax asset is not reported gross, less valuation allowance, but as an amount representing the 'amount of income taxes recoverable in future periods in respect of deductible temporary differences, the carry forward of unused tax losses and the carry forward of unused tax credits'. |

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| | An entity must review the net carrying amount of a deferred tax asset at each reporting date and adjust the valuation allowance to reflect the current assessment of future taxable profits. Such adjustment is recognized in profit or loss, except that an adjustment attributable to an item of income or expense recognized in accordance with this section as other comprehensive income is recognized in other comprehensive income. | Movements in deferred tax assets are recognized in profit or loss, unless the tax relates to items outside profit or loss. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| Uncertain tax positions | An entity must measure current and deferred tax assets and liabilities using the probability-weighted average amount of all the possible outcomes, assuming that the tax authorities will review the amounts reported and have full knowledge of all relevant information.<br>Changes in the probability-weighted average amount of all possible outcomes must be based on new information, not a new interpretation by the entity of previously available information. | IAS 12 currently does not explicitly address the recognition and measurement of uncertain tax positions. IAS 12 indicates that tax assets and liabilities should be measured at the amount expected to be paid. However, it notes that, while IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* generally excludes income taxes from its scope, its principles are relevant to the disclosure of tax-related contingent assets and contingent liabilities such as unresolved disputes with taxation authorities. |

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| | There is no probability threshold applied to the recognition of an uncertain tax position, implying that an entity needs to review and measure all its uncertain tax positions. It also does not define how, or at what level of detail, or unit of account, a tax position is to be analyzed. | Since there is no direct guidance on this issue in IAS 12, there are some variations on how entities currently account for uncertain tax positions in practice. Some adopt a one-step approach that recognizes all uncertain tax positions at an expected value. Others adopt a two-step approach that recognizes only those uncertain tax positions that are considered more likely than not to result in a cash outflow. |
| Backward tracing | An entity must recognize tax expense in the same component of total comprehensive income or equity as the transaction or other event that resulted in the tax expense. | IAS 12 requires current tax and deferred tax to be charged or credited in other comprehensive income (OCI), or directly in equity if the tax relates to items that were credited or charged, whether in the current or previous period, in OCI or directly in equity. Subsequent changes to those amounts are also allocated to OCI or equity as appropriate. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| Initial recognition exemption | An entity must not recognize a deferred tax liability or a temporary difference associated with the initial recognition of goodwill. | IAS 12 currently requires a deferred tax asset or liability to be recognized for all deductible or taxable temporary differences, except for:<br>• a deferred tax liability arising from the initial recognition of goodwill; or<br>• a deferred tax asset or liability arising 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 table profit or loss. |

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| Investments | An entity must not recognize a deferred tax asset or liability for temporary differences associated with unremitted earnings from foreign subsidiaries, branches, associates and joint ventures to the extent that the investment is essentially permanent in nature, unless it is apparent that the temporary difference will reverse in the foreseeable future. | IAS 12 currently requires an entity to recognize a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, except to the extent that both of the following conditions are satisfied:<br>• The parent, investor or venturer is able to control the timing of the reversal of the temporary difference.<br>• It is probable that the temporary difference will not reverse in the foreseeable future. A deferred tax asset for all deductible temporary differences arising from investments in subsidiaries, branches and associates, and interests in joint ventures, is not recorded, expect to the extent that, and only to the extent that, it is probable that:<br>∘ the temporary difference will reverse in the foreseeable future; and<br>∘ taxable profit will be available against which the temporary difference can be utilized. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| **Section 22** ***Liabilities and Equity*/IAS 32** ***Financial Instruments*: *Presentation*** | | |
| Definitions | The appendix to IFRSSME contains the definition of a financial liability as any liability that is:<br>• A contractual obligation:<br>∘ to deliver cash or another financial asset; or<br>∘ to exchange financial assets or financial liabilities under unfavourable conditions; or<br>• A contract that will or may be settled in the entity's own equity instruments and:<br>∘ the entity is or may be obliged to deliver a variable number of its own equity instruments; or | A financial liability is any liability that is:<br>• A contractual obligation:<br>∘ to deliver cash or another financial asset or;<br>∘ to exchange financial assets or financial liabilities under unfavourable conditions; or<br>• A contract that will or may be settled in the entity's own equity instruments and is:<br>∘ a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or |

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| ◦ will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include instruments that are contracts for the future receipt or delivery of the entity's own equity instruments. | ◦ a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include puttable financial instruments and instruments that impose on the entity an obligation to deliver a pro rata share of the net assets on liquidation, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments. |
| Equity is the residual interest in the assets of an entity after deducting all of its liabilities. | An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| Classification as a liability of equity | Equity is the residual interest in the assets of an entity after deducting all its liabilities. A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.<br>Some financial instruments that meet the definition of a liability are classified as equity because they represent the residual interest in the net assets of the entity: | IAS 32 provides the principle that the issuer of a financial instrument classifies the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions.<br>Some financial instruments that meet the definition of a liability are classified as equity because they represent the residual interest in the net assets of the entity:<br>• A puttable instrument that gives the holder the right to sell back to the issuer, or is automatically repurchased by an issuer on occurrence of uncertain future events, death or retirement. |

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• A puttable instrument that gives the holder the right to sell back to the issuer or is automatically repurchased by the issuer on occurrence of uncertain future events, death or retirement.<br>
• Instruments subordinated to all other classes classified as equity if there is an obligation to deliver share of net assets only on liquidation.<br>
• Members shares in cooperative entities (and similar) are equity if the entity has an unconditional right to refuse redemption, or redemption is unconditionally prohibited by local legislation, regulation or the entity’s governing charter.
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• Instruments subordinated to all other classes classified as equity if obligation to deliver share of net assets only liquidation.<br>
• IFRIC 2 Members’Shares in Co-Operative Entities and Similar Instruments deals with these issues and concludes that these are equity instruments if it meets the requirements of puttable financial instruments; or if the entity has an unconditional right to refuse redemption, or redemption is unconditionally prohibited by local legislation, regulation or the entity’s governing charter.<br>
Other issues that IAS 32 addresses include:<br>
∘ reclassification of puttable instruments;<br>
∘ contractual obligations to deliver cash;<br>
∘ settlement in the entity’s own equity;<br>
∘ contingent settlement provisions; and<br>
∘ settlement options.
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| Issue | IFRSSME treatment | IFRS treatment |
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| Equity transactions | An entity recognizes the issue of shares or other equity instruments as equity (including sale of options, rights and warrants) when the other party is obliged to provide cash or other resources in exchange for the instruments.<br>The entity measures these instruments at fair value of cash or resources received or receivable, net of any transaction costs (net of any tax benefits).<br>Presentation in the statement of financial position is determined by applicable jurisdiction. | If an entity reacquires its own equity instruments, these instruments (referred to as 'treasury shares') are deducted from equity. No gain or loss is recognized in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. |

Capitalization issues, bonus issues and share splits that are performed on a pro rata basis do not change equity. Equity would, however, be reclassified in such instances in terms of applicable legislation.

Where treasury shares are reacquired, the entity deducts the fair value of the consideration given from equity – no gain or loss is recognized in profit or loss.

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| Issue | IFRSSME treatment | IFRS treatment |
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| **Section 11 *Basic Financial Instruments*, Section 12 *Other Financial Instrument Issues* and IAS 39 *Financial Instruments: Recognition and Measurement*** | | |
| Accounting policy | An entity makes a policy choice to either:<br>• comply with Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues*; or<br>• use the recognition and measurement criteria in IAS 39 *Financial Instruments: Recognition and Measurement*, and apply the disclosure requirements in IFRSSME. | An entity must comply with the provisions in IAS 32 *Financial Instruments: Presentation* and IAS 39 *Financial Instruments: Recognition* and Measurement, and make disclosures in terms of IFRS 7 *Financial Instruments: Disclosures*. |
| Scope | Section 11 applies to all basic financial instruments except for:<br>• investments in subsidiaries, associates and joint ventures;<br>• instruments that meet the definition of the entity's own equity; | IAS 39 is applied to all financial instruments, except:<br>• interests in subsidiaries, associates and joint ventures;<br>• rights and obligations under leases (with certain exceptions);<br>• employers rights and obligations under employee benefit plans; |

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| • leases (other than derecognition of lease receivables); and<br>• employers rights and obligations under employee plans.<br>Section 12 applies to all financial instruments except for:<br>• basic financial instruments in Section 11;<br>• interests in subsidiaries, associates and joint ventures;<br>• employers rights and obligations under employee benefit plans;<br>• rights under insurance contracts (with certain exceptions);<br>• own equity instruments;<br>• leases (with certain exceptions); and<br>• contracts for contingent consideration in a business combination. | • own equity instruments;<br>• rights and obligations under an insurance contract (with certain exceptions);<br>• forward contracts between an acquirer and shareholder that will result in a future business combination;<br>• loan commitments other than those included in IAS 39;<br>• financial instruments, contracts and obligations under share-based payment transactions; and<br>• rights to reimbursement of a provision.<br>The standard is applied to contracts to buy or sell a non-financial item that can be settled net, as if the contracts were financial instruments, with the exception of contracts that were entered into (and continue to be held) for the purpose of the entity's expected purchase, sale or usage requirements. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| | Contracts to buy and sell a non-financial item are also excluded unless they impose risks not typical of such contracts. In addition, if contracts to buy or sell a non-financial item can be net settled they are included in Section 12, except those that are held for normal purchase, sale and usage requirements. | |
| Embedded derivatives | Beyond the scope of IFRSSME. | An embedded derivative is separated from the host contract and accounted for as a derivative under IAS 39, if:<br>• the economic characteristics and risks of the embedded derivative are not closely related to those of the host contract; |

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| | | • a separate instrument with the same terms would meet the definition of a derivative; and<br>• the hybrid is not measured at fair value through profit or loss. |
| Classification | The following are basic financial instruments covered in Section 11:<br>• cash;<br>• a debt instrument that satisfies specific criteria;<br>• a commitment to receive a loan that:<br>∘ cannot be settled net in cash; and<br>∘ when the commitment is executed, is expected to meet the conditions of a debt instrument above; and | IAS 39 *Financial Instruments: Recognition and Measurement* requires that financial instruments be classified into the following groups:<br>Financial assets grouped as:<br>• fair value through profit or loss;<br>• loans and receivables;<br>• held-to-maturity; or<br>• available-for-sale.<br><br>Financial liabilities are grouped as:<br>• fair value through profit or loss; or<br>• other liabilities.<br>• Note: IFRS 9 *Financial Instruments* eliminates held-to-maturity financial assets and available-for-sale financial assets. |

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| Issue | IFRSSME treatment | IFRS treatment |
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| | • an investment in non-convertible preference shares and non-puttable ordinary shares or preference shares.<br>Other financial instruments would include all other financial instruments that are within the scope of Section 12 but not within the scope of Section 11. | |
| Initial measurement | Basic financial instruments are measured at their transaction price including transaction costs. | When a financial instrument is recognized initially, an entity measures it at its fair value plus – in the case of a financial asset or financial liability not at fair value through profit or loss – transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability. |

If the contract constitutes a financing arrangement, it is measured at the present value of future payments discounted at a market rate of interest for a similar instrument. This does not apply to assets and liabilities, which are classified as current unless they incorporate a financing arrangement.

If interest is not at a market rate, the fair value would be future payments discounted at a market rate of interest.

Other financial instruments are initially measured at fair value, which is usually their transaction price. This will exclude transaction costs.

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| Issue | IFRSSME treatment | IFRS treatment |
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| Subsequent measurement | For basic financial instruments, at the end of a reporting period:<br>• debt instruments are measured at amortized cost using the effective interest rate;<br>• commitments to receive a loan are measured at cost less impairment; and<br>• investments in non-convertible preference shares and non-puttable ordinary, and preference shares that are publicly traded or their fair value can otherwise be reliably measured, are measured at fair value through profit or loss if a public market exists, otherwise at cost less impairment. | After initial recognition, an entity shall measure financial assets at their fair values, excluding transaction costs, except for the following:<br>• Loans and receivables and held-to-maturity investments are measured at amortized cost using the effective interest method.<br>• Investments in equity instruments (and related derivatives) that do not have a quoted market price in an active market and whose fair value cannot be reliably measured are measured at cost.<br>After initial recognition, an entity measures all financial liabilities at amortized cost using the effective interest method, except for:<br>• Financial liabilities at fair value through profit or loss that are measured at fair value. |

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| | All other financial instruments are measured at fair value at the reporting date. The only exception are equity instruments, and related contracts that would result in delivery of such instruments, that are not publicly traded and whose fair value cannot be reliably measured are measured at cost less impairment. | • Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition, financial guarantee contracts, commitments to provide a loan at a below-market interest rate all have their own particular requirements for subsequent recognition. |
| Hedged risks | IFRSSME only permits hedge accounting when the hedged risk is one of the following risks:<br>• interest rate risk of a debt instrument measured at amortized cost;<br>• foreign exchange or interest rate risk in a firm commitment or a highly probable forecast transaction; | IAS 39 permits the following hedging relationships:<br>• Fair value hedge: a hedge of the exposure to changes in fair value of a recognized asset or liability, or an unrecognized firm commitment, which is attributable to a particular risk and could affect profit or loss.<br>• Cash flow hedge: a hedge of the exposure to variability in cash flows that: |

*(continued overleaf)*

| Issue | IFRSSME treatment | IFRS treatment |
|---|---|---|
| | • price risk of a commodity that it holds or in a firm commitment or highly probable forecast transaction to purchase or sell a commodity; or<br>• foreign exchange risk in a net investment in a foreign operation. | ◦ is attributable to a particular risk associated with a recognized asset or liability, or a highly probable forecast transaction; and<br>◦ could affect profit or loss.<br>• Hedge of a net investment in a foreign operation as defined in IAS 21 *The Effects of Changes in Foreign Exchange Rates*. |
| Hedging instrument | Hedge accounting is only permitted if the hedging instrument meets all of the following:<br>• It is an interest rate swap, a foreign currency swap, a foreign currency forward exchange contract or a commodity forward exchange contract that is expected to be highly effective. | IAS 39 does not restrict the circumstances in which a derivative may be a hedging instrument, except for some written options. A non-derivative financial instrument can only be designated as a hedge of a foreign currency risk.<br>Only instruments that involve a party external to the reporting entity can be designated as hedging instruments. |

- It involves a party external to the reporting entity.
- Its notional amount equals the designated amount of the hedged item.
- It has a specified maturity date not later than:
  - the maturity of the hedged item;
  - the expected settlement of the commodity commitment; or
  - the occurrence of the highly probable forecast transaction.
- It has no prepayment of early termination or extension features.

| Issue | IFRSSME treatment | IFRS treatment |
|---|---|---|
| **Section 26/IFRS 2 *Share-based Payment*** | | |
| Scope | This section specifies the accounting for all share-based payment transactions for the acquisition of goods or services, including those that are equity-settled and those that are cash-settled, or a choice of either equity or cash.<br>Where an award is granted by a parent entity to the employees of a subsidiary and the parent presents consolidated financial statements using either IFRSSME or full IFRS, the subsidiary may recognize and measure the share-based payment expense based on a reasonable allocation of the expense recognized for the group. | IFRS 2 applies to all share-based payment transactions for the acquisition of goods and services, whether or not the entity can identify specifically some or all of the goods or services received. These include equity-settled and cash-settled transactions, and transactions that provide for settlement either by cash or equity instruments.<br>A share-based payment transaction may be settled by another group entity (or a shareholder of any group entity) on behalf of the entity receiving or acquiring the goods or services. |

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| | In some jurisdictions, equity investors are able to acquire equity without providing goods or services that can be specifically identified (or at less than fair value of the equity instrument granted). These are treated as equity-settled share-based payment transactions within the scope of this Section. | |
| Recognition of vesting conditions | IFRSSME only considers vesting in the context of employees.<br>The principle applied is that if the share-based payments do not vest until the completion of a specified period of service, the entity presumes the services rendered by the counterparty will be received during the vesting period. Hence, the entity recognizes the share-based payment for those services received during the vesting period. | If the equity instruments granted do not vest until the counterparty completes a specified period of service, the entity shall presume that the services will be received in the future, during the vesting period. |

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| Issue | IFRSSME treatment | IFRS treatment |
|---|---|---|
| Measurement | For equity-settled share-based payment transactions, the entity measures the goods or services received and the corresponding increase in equity at the fair value of the goods or services received. If this fair value cannot be estimated reliably (including employee transactions), the entity measures the transaction by reference to the fair value of the equity instruments granted. | For equity-settled share-based payment transactions, the entity measures the goods or services received and the corresponding increase in equity at the fair value of the goods or services received. If the entity cannot estimate reliably the fair value of the goods or services received, the entity measures the transaction by reference to the fair value of the equity instruments granted. |

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| The fair value of the equity instruments is measured at the grant date. This Section differentiates between a market vesting condition and a non-market vesting condition. Non-market vesting conditions are not taken into account to determine the fair value of the award. These conditions are used to determine the number of shares that are expected to vest. Market vesting conditions are used to determine the value of the award at the grant date. | The fair value of equity instruments issued in transactions with employees is measured at the grant date. IFRS 2 differentiates between a market vesting condition and a non-market vesting condition for the purposes of measurement. Non-market vesting conditions are not taken into account to determine the fair value of the award. These conditions are used to determine the number of shares expected to vest. Market vesting conditions are used to determine the value of the award at the grant date.<br>For cash-settled share-based payment transactions, the entity measures the goods or services acquired and the liability incurred at the fair value of the liability. Until the liability is settled, the entity remeasures the fair value of the liability at the end of each reporting period and at the date of settlement, with any changes in fair value recognized in profit or loss for the period. |

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| Issue | IFRSSME treatment | IFRS treatment |
|---|---|---|
| | For cash-settled share-based payment transactions, the entity measures the goods or services acquired and the liability incurred at the fair value of the liability. Until the liability is settled, the entity remeasures the fair value of the liability, with any changes in fair value recognized in profit or loss for the period.<br>For share-based payment transactions in which either the entity or the counterparty has the choice of whether settlement is in cash or equity instruments, the entity accounts for that transaction as a cash-settled share-based payment transaction if the entity has incurred a liability. The transaction is accounted for as an equity-settled share-based payment transaction if the entity has a past practice of settling shares or the option to receive cash has no commercial substance. | For share-based payment transactions in which either the entity or the counterparty has the choice of whether settlement is in cash or equity instrument, the entity accounts for that transaction as if the entity has incurred a liability. The transaction is accounted for as an equity-settled share-based payment transaction as if no such liability has been incurred. |

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| Fair value of equity instruments | IFRSSME uses a hierarchy to determine the fair value of shares issued based on:<br>• observable market prices;<br>• if unobservable, entity-specific observable market data, such as a recent transaction in the instruments or a recent independent valuation of the entity; or<br>• if the fair value is not observable and obtaining entity-specific market data is impracticable, the directors should use their judgement to apply the most appropriate valuation methodology. | An entity measures the fair value of equity instruments granted at the measurement date, based on market prices if available, taking into account the terms and conditions of the grant.<br>If market prices are not available, an entity estimates the fair value of the equity instruments granted using a valuation technique to derive an estimate of the price of the equity instruments in an arm's length transaction between knowledgeable, willing parties. |

| Issue | IFRSSME treatment | IFRS treatment |
|---|---|---|
| **Section 28/IAS 19 *Employee Benefits*** | | |
| Defined contribution plans | An entity recognizes the contribution payable for a period:<br>• as a liability, after deducting any amount already paid; or<br>• as an expense, unless another Section requires the cost to be part of the cost of an asset. | An entity recognizes the contribution payable for a period:<br>• as a liability, after deducting any amount already paid; or<br>• as an expense, unless another Section requires the cost to be part of the cost of an asset.<br>Where contributions to a defined contribution plan do not fall due wholly within 12 months after the end of the period in which the employees render the related service, they must be discounted. |
| Defined benefit plans | An entity recognizes:<br>• a liability for its obligations under defined benefit plans net of plan assets; and<br>• the net change in that liability during the period as the cost of its defined benefit plans during the period. | The amount recognized as a defined benefit liability is the present value of the defined benefit obligation at the end of the reporting period, less:<br>• any actuarial gains/losses not recognized;<br>• any past service cost not yet recognized; and<br>• the fair value at the end of the reporting period of plan assets. |

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| Measurement | An entity measures a defined benefit liability at the net total of the following amounts:<br>• the present value of its obligations under defined benefit plans at the reporting date; less<br>• the fair value at the reporting date of plan assets.<br>An entity recognizes a plan surplus as an asset that it is able to recover the surplus either through reduced contributions in the future or through refunds from the plan. | An asset is measured at the lower of:<br>• the amount above; or<br>• the total of any cumulative unrecognized net actuarial losses and past service cost, and the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.<br>An entity recognizes the net total of the following amounts in profit or loss:<br>• current service cost;<br>• interest cost;<br>• expected return on any plan assets;<br>• past service cost;<br>• effect of any curtailment or settlements; and<br>• effect of the limit on the recognition of the asset.<br>An entity determines the present value of its defined benefit obligations and the related current service cost and, where applicable, past service cost using the projected unit credit method. |

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| Issue | IFRSSME treatment | IFRS treatment |
|---|---|---|
| | The present value of an entity's obligations reflects the discounted estimated amount of benefit that employees have earned in return for their service in the current and prior periods. This requires the entity to determine how much benefit is attributable to the current and prior periods based on the plan's benefit formula and to make actuarial assumptions about demographic and financial variables.<br>An entity is required to use the projected unit credit method unless this would require undue cost or effort, in which case the entity makes the following simplifications:<br>• ignore estimated future salary increases;<br>• ignore future service of current employees; and | Actuarial gains and losses are recognized immediately in other comprehensive income<br>Past service costs are recognized as an expense on a straight-line basis over the average period until the benefits become vested.<br>Gains or losses on curtailment or settlement are recognized when the curtailment or settlement occurs. |

- ignore possible in-service mortality of current employees.

If a defined benefit plan has been introduced or changed in the current period, the entity increases or decreases its defined benefit liability to reflect the change and recognize the increase or decrease in measuring profit or loss. If a plan has been curtailed or settled, the defined benefit obligation is decreased or eliminated and the gain recognized in profit or loss.

Entities must select an accounting policy for recognition of actuarial gains and losses. They are recognized in their entirety, either in profit or loss, or in other comprehensive income.

Gains or losses on curtailment or settlement are recognized when the curtailment or settlement occurs.

| Issue | IFRSSME treatment | IFRS treatment |
|---|---|---|
| **Section 34/IAS 34** ***Specialized Activities – Agriculture (Agriculture)*** | | |
| Recognition | An entity may recognize a biological asset or agricultural produce when:<br>• the entity controls the asset as a result of past events;<br>• it is probable that future economic benefits will flow to the entity; and<br>• the fair value or cost of the asset can be measured reliably without undue cost or effort. | A biological asset or agricultural produce is recognized when:<br>• the entity controls the asset as a result of past events;<br>• it is probable that future economic benefits will flow to the entity; and<br>• the fair value or cost of the asset can be measured reliably. |
| Measurement | An entity measures a biological asset on initial recognition and at each reporting date at its fair value less costs to sell, unless fair value cannot be reliably measured without undue cost or effort. Changes in fair value less costs to sell are recognized in profit or loss. | A biological asset is measured on initial recognition and at the end of each reporting period at its fair value less costs to sell, except in cases where the presumption to establish fair value is rebutted. In such cases, biological assets are measured at cost less accumulated depreciation and impairments. |

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| When the fair value is not readily determinable without undue cost or effort, the entity applies the cost model and measures the asset at cost less any accumulated depreciation and impairments.<br>Agricultural produce harvested from an entity's biological assets are measured at their fair value less costs to sell at the point of harvest under both models (thereafter, they are treated as inventory). | Agricultural produce harvested from an entity's biological assets is measured at its fair value less costs to sell at the point of harvest; thereafter it is treated as inventories or under other applicable standards.<br>Gains and losses on initial recognition (and subsequent remeasurement) of biological assets and agricultural produce are recognized in profit and loss. |

| Issue | IFRSSME treatment | IFRS treatment |
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| **Section 34/IFRS 6** ***Specialized Activities – Extractive Industries (Exploration for and Evaluation of Mineral Resource)*** | | |
| Recognition | An entity that is engaged in the exploration for, evaluation or extraction of mineral resources for expenditure on the acquisition or development of tangible or intangible assets will apply Section 17 *Property, Plant and Equipment*, and Section 18 *Intangible Assets Other than Goodwill* respectively.<br>When an entity has an obligation to dismantle or remove an item, or to restore the site, such obligations and costs are accounted for in accordance with Section 17 *Property, Plant and Equipment*, and Section 21 *Provisions and Contingencies*. | IFRS 6 specifies the accounting for exploration and evaluation of mineral resources. It allows entities to develop an accounting policy for these costs without specifically considering the requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, which may allow entities to continue recognizing assets on adoption of IFRS that would not otherwise be permitted. |

**Section 30 *Foreign Currency Translation*/IAS 21 *The Effects of Changes in Foreign Exchange Rates***

| | | |
|---|---|---|
| Recognition of exchange differences | Exchange differences on monetary items are recognized in profit or loss for the period except for those differences arising on a monetary investment in a foreign entity (subject to strict criteria of what qualifies as a net investment). In the consolidated financial statements, such exchange differences are recognized in other comprehensive income and reported as a component of equity.<br>Recycling through profit or loss of any cumulative exchange differences that were previously recognized in equity on disposal of a foreign operation is not permitted. | Exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements are recognized in profit or loss in the period in which they arise.<br>Exchange differences on a monetary item that forms part of a net investment in a foreign operation are reclassified from equity to profit or loss on disposal of the foreign operation. |

| Issue | IFRSSME treatment | IFRS treatment |
|---|---|---|
| **Section 25/IAS 23 *Borrowing Costs*** | | |
| Scope | Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds, and includes:<br>• interest expense calculated using the effective interest rate method;<br>• finance charges in respect of finance leases; and<br>• exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest cost. | Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds, and may include:<br>• interest expense calculated using the effective interest rate method;<br>• finance charges in respect of finance leases; and<br>• exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.<br>IAS 23 does not apply to borrowing costs relating to the acquisition, construction or production of:<br>• a qualifying asset measured at fair value, e.g. a biological asset; or<br>• inventories that are manufactured or otherwise produced in large quantities on a regular basis. |

<table>
<tr><td>Recognition</td><td>All borrowing costs are expensed in profit or loss in the period in which they are incurred.</td><td>Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset are capitalized. All other borrowing costs are expensed.</td></tr>
<tr><td colspan="3">Section 24 Government Grants/IAS 20 Accounting For Government Grants and Disclosure of Government Assistance</td></tr>
<tr><td>Recognition and measurement</td><td>An entity shall recognize government grants according to the nature of the grant as follows:<br>• A grant that does not impose specified future performance conditions on the recipient is recognized in income when the grant proceeds are receivable.<br>• A grant that imposes specified future performance conditions on the recipient is recognized in income only when the performance conditions are met.</td><td>Government grants, including non-monetary grants, shall not be recognized until there is reasonable assurance that:<br>• the entity will comply with the conditions attached to the grants; and<br>• the grants will be received.<br>Government grants are recognized in profit or loss on a systematic basis over the periods in which the entity recognizes as expenses the related costs for which the grants are intended to compensate.</td></tr>
</table>

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| Issue | IFRSSME treatment | IFRS treatment |
|---|---|---|
| | • Grants received before the income recognition criteria are satisfied are recognized as a liability and released to income when all attached conditions are complied with.<br>Grants are measured at the fair value of the asset received or receivable. | A government grant becomes receivable as compensation for expenses or losses already incurred or for the purpose of giving immediate financial support to the entity. No future related costs shall be recognized in profit or loss of the period in which it becomes receivable.<br>Grants in the form of the transfer of a non-monetary asset can be measured either at fair value of the asset received or at the nominal amount. |

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*Index compiled by Terry Halliday*