Distinctive Financial Reporting

FAC3702
Important information

- Assignments
  - Assignment 1: 7 August 2013
  - Assignment 2: 4 September 2013
  - Assignment 3: 18 September 2013

- Next class: 17 August 2013

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- Additional information
  - https://sites.google.com/site/fac3702ctn/home
Distinctive Financial Reporting

FAC3702

Study unit 1
Property, Plant & Equipment
Study unit 1 - Overview

- Objective
- Scope
- Definitions
- Recognition
- Measurement
- Derecognition
- Revaluation
- Disclosure
- Tax
Objective

- Recognition as assets
- Depreciation
- Impairment
- Determining carrying amount
Property, plant & equipment

Definition

• Tangible assets
• Held for
  • Use in production or supply of goods/services,
  • Rental to others
  • Administrative purposes
• Expected to be used > 1 period.

(Tangible structure to generate income)
Definitions

• Cost
  • Amount of cash or cash equivalents paid, and
  • Fair value of other consideration given
  • To acquire asset
  • At time of acquisition or construction.

• Depreciable amount
  • Cost (or other substituted amount)
  • Less: residual value

• Depreciation
  • Systematic allocation
  • Of the depreciable amount of an asset
  • Over the asset’s useful life

• Carrying amount
  • Amount at which asset
  • Recognised in statement of financial position
  • After deducting
    • accumulated depreciation &
    • accumulated impairment losses.
Definitions

• Fair value
  • Amount for which asset could be exchanged between
  • Knowledgeable, willing parties
  • In arm’s length transaction

• Residual value
  • Estimated amount
  • Entity currently obtain from disposal of asset
  • After deducting estimated cost of disposal
  • If assets already of age & condition - end of useful life.

• Useful life
  • Period asset is expected to be available for use by entity, or
  • # production/similar units expected to be obtained from asset
Definitions

• Impairment loss
  • Carrying amount > recoverable amount

• Recoverable amount
  • Higher of:
    • Asset’s net selling price (Fair value – costs to sell), or
    • Value in use

• Entity-specific value
  • Present value of cash flows
  • Entity expects to arise from
    • Continuing use of asset and
    • Disposal @ end of asset’s useful life
  • Entity expects to incur
    • When settling liability
Recognition - asset

- Probable
  - Future
  - economic benefits associated with item
  - Will flow to entity
- Cost can be measured reliably
  - Initial cost
  - Subsequent costs
    - Servicing cost → Repairs & maintenance (P&L)
    - Replacement @ regular intervals
    - Regular major inspections

Aggregate individually insignificant items BUT account for significant components separately
Example

- Skyfall Ltd bought a machine on 1 January 2012 for R 1.6 m
- The machine needs to be inspected every 6 000 hours, i.e. it will have to undergo a major service every 2 years.
- The estimated cost of a major service is R 150 000.
- The helicopter has an estimated useful life of 8 years.

**Required**


2. How would these amounts differ if:
   - Inspection needs to be done after 20 months instead of planned 2 yrs, AND
   - Actual cost of first inspection was R 200 000
Measurement @ recognition

- PPE that qualifies for recognition as asset → cost
- Cost components
  - Purchase price
    - Incl. import duties & non-refundable tax
    - After deducting discounts & rebates
  - Costs directly attributable → location & condition **necessary** to operate
    - Initial delivery & handling costs
    - Installation & assembly cost
    - Testing
    - Professional fees
  - Estimate of dismantling, removal and restoration cost
- NOT
  - Cost of opening new facility, introduction of new product, overheads
- Stops
  - Asset is in location & condition necessary to be **capable** of operating
Measurement of cost

• Abnormal credit terms
  • Cost = cash equivalent @recognition date
  • Total payments – cash equivalent = interest
    • Recognise over period of credit
    • Except if capitalised (FAC3703)

• Exchange of PPE items
  • Cost of acquired asset = fair value of asset given up
  • Fair value of asset given up not reliably measured
    • Fair value of asset acquired.
  • Fair value of neither acquired/disposed asset reliably measured
    • Carrying value of asset given up
  • Exchange transaction lacks commercial substance
    • Carrying value of asset given up

• “Commercial substance”
  • Consider extent → future cash flows expected to change as result of transaction.
Subsequent measurement

• Cost or Revaluation model
  • Apply policy to entire class of PPE

• Cost
  • Cost – accumulated depreciation – accumulated impairment losses.

• Revalue assets
  • Only if: Fair value can be measured reliably
    • Generally market-based evidence
  • Carry asset at revalued amount less subsequent accumulated depreciation & impairment losses.
  • Revaluation effectively replace carrying amount of asset @ revaluation date.
Depreciation

- Each significant PPE item depreciated separately
  - May be grouped
- Recognise in profit/loss
  - Unless included in carrying amount of another asset
- Depreciate even if fair value > carrying amount
  - Provided carrying value > residual value.
- Commence depreciation
  - Asset **available** for use
    - In location and condition **necessary** to be capable of operating in manner intended by management.
  - Actual use not required.
- Cease depreciation
  - Earlier of:
    - Asset classified as ‘held for sale’
    - Asset derecognised
Depreciation (2)

- Useful life – Factors to consider
  - Expected usage of asset
    - Capacity/physical output
  - Expected physical wear & tear
    - Number of shifts and repairs & maintenance program
  - Technical/commercial obsolescence
    - Changes/improvement in production
    - Changes in market demand
  - Legal or similar limits on use of asset
    - Expiry dates of related leases

- Land & buildings → account separately
  - Land generally unlimited useful life
Depreciation \(^{(3)}\)

- Depreciation methods
  - Straight-line
  - Diminishing balance
  - Units of production

Choose method which reflects expected pattern of consumption best.

**Class example:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of equipment</td>
<td>R 500 000</td>
</tr>
<tr>
<td>Residual value</td>
<td>R 20 000</td>
</tr>
<tr>
<td>Useful life (yrs)</td>
<td>4</td>
</tr>
</tbody>
</table>
Impairment

- Carrying amount > recoverable amount
- Compensation from 3rd parties
  - Include in profit/loss when receivable
  - Can include:
    - Indemnity payments from insurers
    - Government payments, e.g. expropriation
    - Physical replacement of impaired/lost asset
- Account separately
  - Impairment/loss of PPE item
  - Related compensation from 3rd party
  - Subsequent purchase/construction of assets
Revaluation

- First revaluation → change in accounting policy (IAS8)
- Review residual values & estimated useful life every year
- Replacement value (RV)
  - Gross → replacement cost (market value) of similar asset
  - Net → fair market value of similar asset of same age/condition
- Treatment of accumulated depreciation
  - Gross replacement value basis
    - Restate proportionally with changes in gross RV
    - ‘New’ carrying amount = revalued amount
    - General use: Revalue using an index
  - Net replacement value basis
    - Eliminate against gross carrying amount
    - Net amount = revalued amount
    - General use: Buildings
Revaluation (2)

- **Surplus: Carrying amount ↑**
  - Other comprehensive income, equity
  - ‘Revaluation surplus’
  - Non-distributable reserve
    - Only used for subsequent write-downs or a capitalisation share issue
    - Can transfer directly to retained earnings if asset is derecognised

- **Carrying amount ↓**
  - Profit/loss
  - Other comprehensive income to extent of any credit balance in revaluation surplus of that asset
Derecognition

• When?
  • Disposal
  • No future economic benefits expected to arise from use/disposal

• Gain/loss on derecognition
  • Profit/loss
  • Net disposal proceeds less carrying amount

• Date – when ALL of the following satisfied:
  • Significant risks & rewards of ownership transferred to buyer
  • Not continuous managerial involvement nor effective control over goods sold
  • Amount can be measured reliably
  • Probable economic benefits will flow to enterprise
  • Costs incurred iro transaction can be measured reliably

[IAS18]
CGT

- Capital gain/loss
  - Disposal of asset
    - Sale, donation, loss or destruction
  - Proceeds less base cost

- Base cost
  - Incl: acquisition cost, improvements \& costs incurred directly in the acquisition, creation or disposal of the asset
  - Excl: holding costs (interest, repairs \& maintenance), recoverable expenses (deductible for income tax) adjustments for inflation.

- Framework – page 38 of Study Guide
  - Inclusion rate for companies – 66%
Deferred tax [FAC3701]

- Revaluation → Temporary difference → Deferred tax
- Carrying value (accounting) and Tax base differs
- Depreciable assets

- Non-depreciable assets
  - No decision to sell asset
    - Tax rate (28%) x total revaluation surplus
  - Decision to sell asset
    - Revaluation surplus up to original cost x 28%, and
    - Revaluation surplus excess above base cost at 18.6% (28% x 66.6%)

[Example 14 & 15]
Disclosure – NB!!!!!

Page 36 & 37 of Study Guide