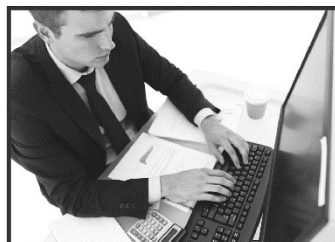


Only study guide for
FAC3701

GENERAL
FINANCIAL
REPORTING

Department of Financial Accounting
University of South Africa, Pretoria



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INTRODUCTION

Dear Student,

This study guide includes the following learning units:

- Learning unit 1 – Income taxes (IAS 12 and FRG 1)
- Learning unit 2 – Accounting policies, changes in accounting estimates and errors (IAS 8)
- Learning unit 3 – The Conceptual Framework for Financial Reporting 2010
- Learning unit 4 – Preface to International Financial Reporting Standards
- Learning unit 5 – Presentation of financial statements (IAS 1)
- Learning unit 6 – Events after the reporting period (IAS 10)
- Learning unit 7 – Provisions, contingent liabilities and contingent assets (IAS 37)
- Learning unit 8 – Fair value measurement (IFRS 13)
- Learning unit 9 – Revenue from contracts with customers (IFRS 15)

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LEARNING UNIT 1

**INCOME TAXES
(IAS 12 AND FRG 1)**



LEARNING OUTCOMES

Learners should be able to calculate deferred tax and to disclose deferred and current tax of companies in the annual financial statements in compliance with International Financial Reporting Standards.

OVERVIEW

This learning unit is divided into the following:

- 1.1 Definitions
- 1.2 Objectives
- 1.3 Exempt differences
- 1.4 Examples of taxable temporary differences and treatment thereof according to the statement of financial position approach
 - 1.4.1 Capital allowances
 - 1.4.2 Prepayments
- 1.5 Recognition of deferred tax assets
- 1.6 Unused (assessed) tax losses
- 1.7 Measurement
- 1.8 Presentation and disclosure
 - 1.8.1 Statement of profit or loss and other comprehensive income
 - 1.8.2 Statement of financial position
 - 1.8.3 Summary of disclosure requirements
- 1.9 Provisional tax
- 1.10 The formal tax assessment and the resulting over/underprovision of current tax
- 1.11 Capital gains tax on companies
- 1.12 Dividends tax (withholding tax on dividends)
 - 1.12.1 Tax liability
 - 1.12.2 Accounting treatment
 - 1.12.3 Dividends tax - exemptions
- 1.13 FRG 1 – Substantively enacted tax rates and tax laws

STUDY

PRESCRIBED

Descriptive accounting

Chapter 8 dealing with *IAS 12* and *FRG 1* (excluding 8.8.3, examples 8.24 and 8.25)

RECOMMENDED

A Guide Through IFRS

IAS 12 – Income Taxes

OVERVIEW OF LEARNING UNIT

The objective of this learning unit is to prescribe the accounting treatment for the current and future tax consequences of the following:

- the future recovery/(settlement) of the carrying amount of assets/(liabilities) that are recognised in an enterprise's statement of financial position; and
- transactions and other events of the current period that are recognised in an entity's financial statements.

IAS 12 – Income taxes prescribes the accounting treatment of both current and deferred tax. The income tax expense in the statement of profit or loss and other comprehensive income comprises of **both** current and deferred tax.

Current tax is calculated on the taxable income of an entity according to the rules of the Income Tax Act. Therefore, the amount of current tax payable by an entity is often not proportionate to the entity's profit for the period in the statement of profit or loss and other comprehensive income. Examples of these differences are:

- The carrying amount of assets/liabilities in the entity's statement of financial position is different from the tax base thereof.
- Income and expenses that are recognised in different periods for accounting and tax purposes. These differences are temporary differences and used as a basis to calculate deferred tax and are discussed in detail later in this learning unit.
- Income and expenses that are not taxable or deductible for tax purposes. These differences are known as exempt differences and discussed in detail in section 1.3.


1.1 DEFINITIONS

- (a) **Accounting profit** is the net profit or loss for a period before deducting tax expense.
- (b) **Taxable profit/(tax loss)** is the profit or loss for a period upon which income tax is payable to the SA Revenue Service. This figure is calculated by adjusting the accounting profit according to the rules established by the tax authorities.
- (c) **Tax expense/tax income** is the aggregate amount disclosed in the statement of profit or loss and other comprehensive income (P/L) as income tax expense/income. This includes both current tax and deferred tax.
- (d) **Current tax** is the amount of income taxes payable/(recoverable) in respect of the taxable profit/(tax loss) for the year. This is the tax calculated according to the rules and regulations of the SA Revenue Service
- (e) **Deferred tax liabilities** are the taxes provided in the statement of financial position (SFP) for the amount of income taxes payable in future periods in respect of taxable temporary differences.

- (f) **Deferred tax assets** are the amounts of income taxes recoverable in future periods in respect of
- deductible temporary differences;
 - the carry forward of unused tax losses; and
 - the carry forward of unused tax credits.


- (g) The following definitions must be applied when determining the tax base of an item:
The **tax base (TB)** of an asset or liability is the amount attributable to that asset or liability for tax purposes.

The **tax base of an asset** is the amount that will be deductible for tax purposes in future against any **taxable** economic benefits that will flow to the entity when it recovers/settles the carrying amount of the asset.

| | |
|---|--|
|  | <p>LECTURER'S COMMENT</p> <p>Work through examples 8.3 to 8.7 of <i>Descriptive accounting</i> to calculate the tax base of assets.</p> |
|---|--|

The **tax base of a liability** is the **carrying amount** of the liability, less any amount that will be deductible for tax purposes in respect of that liability in future.

The **tax base of the liability – revenue received in advance** – is its **carrying amount** less any amount of revenue that will **not** be taxable in future.

| | |
|---|--|
|  | <p>LECTURER'S COMMENT</p> <p>Work through examples 8.8 to 8.11 of <i>Descriptive accounting</i> to calculate the tax base of liabilities.</p> |
|---|--|

- (h) **Temporary differences** are differences between the tax base of an asset or liability and the carrying amount of the asset or liability in the statement of financial position. The tax base represents the amount at which the asset and liability would be included in the statement of financial position for tax purposes (calculated based on the application of tax rules) and the carrying amount is the amount for accounting purposes at which the asset and liability is accounted for (using accounting rules) in the statement of financial position.

- (i) Temporary differences may be either of the following:
- (a) **Taxable temporary differences** are temporary differences that will result in taxable amounts in determining taxable profit/(tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled. This will happen when:

**Rule 1: Carrying amount of the asset > tax base of the asset
= DEFERRED TAX LIABILITY (SFP)**

OR

**Rule 2: Carrying amount of the liability < tax base of the liability
= DEFERRED TAX LIABILITY (SFP)**

If the carrying amount of the asset is greater than the tax base of the asset (**rule 1**), it will result in taxable profit in the future, because the amount deductible in the future for tax purposes is smaller than the amount deductible for accounting purposes. In the future, the taxable profit will be greater than the accounting profit.

Therefore provision is made in the current year for the tax payable in future by debiting deferred tax in the statement of profit or loss and other comprehensive income and crediting a deferred tax liability in the statement of financial position.

| | | |
|---|-----------|-----------|
| Journal entry: | Dr | Cr |
| | R | R |
| Deferred tax expense (P/L) | xxx | |
| Deferred tax liability (SFP) | | xxx |
| <i>Provision made for deferred tax expense.</i> | | |

If the carrying amount of the liability is less than the tax base of the liability (**rule 2**), it will result in future taxable profit. The taxable profit will be greater than the accounting profit in the future and we therefore provide deferred tax in the current year for the tax payable in future.

Provision is made in the current year for the future tax payable by debiting the deferred tax in the statement of profit or loss and other comprehensive income and crediting a deferred tax liability in the statement of financial position.

| | | |
|---|-----------|-----------|
| Journal entry: | Dr | Cr |
| | R | R |
| Deferred tax expense (P/L) | xxx | |
| Deferred tax liability (SFP) | | xxx |
| <i>Provision made for deferred tax expense.</i> | | |

- (b) **Deductible temporary differences** are temporary differences that will result in amounts that are deductible in determining taxable profit/(tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled. This will happen when:

**Rule 3: Carrying amount of the asset < tax base of the asset
= DEFERRED TAX ASSET (SFP)**

OR

**Rule 4: Carrying amount of the liability > tax base of the liability
= DEFERRED TAX ASSET (SFP)**

If the carrying amount of the asset is less than the tax base of the asset (rule 3), then it will result in deductions in determining taxable profit of future periods when the carrying amount of the asset is recovered. This will result in taxable profit being less than the accounting profit in the future.

To match the future lower tax expense with the accounting profit, we have to debit a further tax expense in the statement of profit or loss and other comprehensive income in the form of a deferred tax charge. To achieve this, a deferred tax asset must be created in the current year by crediting the statement of profit or loss and other comprehensive income and debiting the deferred tax asset in the statement of financial position (provided that it is probable that taxable profit against which the deductible temporary differences can be utilised will be available in future). In future, the debit deferred tax asset in the statement of financial position will be reversed as a debit to the statement of profit or loss and other comprehensive income.

Journal entry:

| | Dr | Cr |
|---|-----------|-----------|
| | R | R |
| Deferred tax asset (SFP) | xxx | |
| Deferred tax (P/L) | | xxx |
| <i>Provision made for deferred tax.</i> | | |

If the carrying amount of the liability is greater than the tax base of that liability (rule 4), it will result in deductions in determining taxable profit of future periods when the carrying amount of the liability is settled. The tax charge in future will therefore not match; it will be too low, compared to the accounting profit. To match the future tax expense with the accounting profit the tax expense in the statement of profit or loss and other comprehensive income will have to be debited in the form of a deferred tax charge.

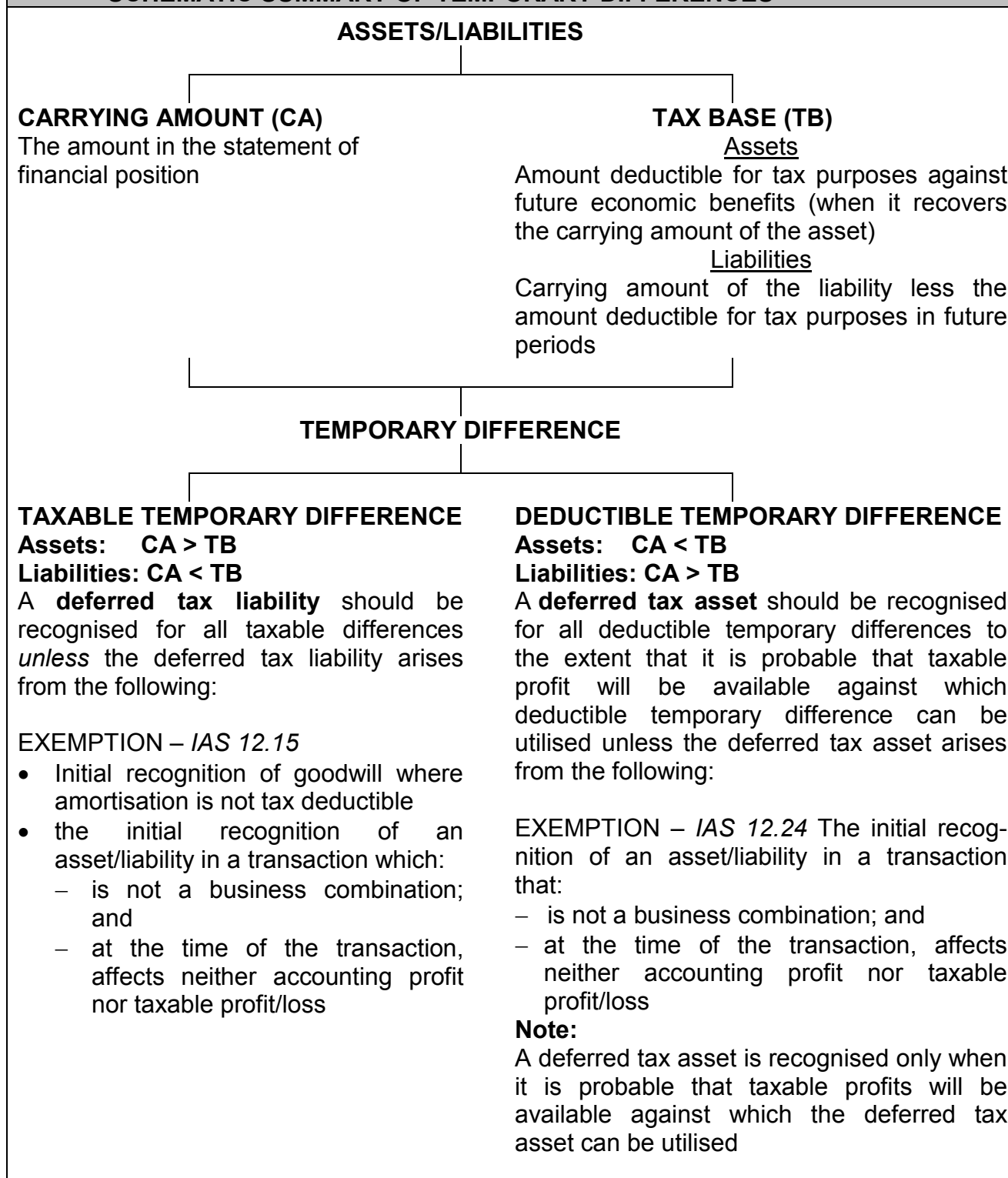
In order to accomplish this in the future, a deferred tax asset has to be created in the current year (provided that taxable profit will be available in future against which the deductible temporary differences can be utilised) by crediting the statement of profit or loss and other comprehensive income and debiting the deferred tax asset in the statement of financial position. In the future, the debit deferred tax asset in the statement of financial position will be reversed as a debit to the statement of profit or loss and other comprehensive income.

Journal entry:

Deferred tax asset (SFP)
 Deferred tax (P/L)
Provision made for deferred tax.

| Dr | Cr |
|-----|-----|
| R | R |
| xxx | xxx |

SCHEMATIC SUMMARY OF TEMPORARY DIFFERENCES



* CA – Carrying amount
 TB – Tax base

1.2 OBJECTIVES

IAS 12 requires an entity to account for the tax consequences of transactions and other events in the same way that it accounts for the transactions and other events themselves. Thus for transactions and other events recognised in the statement of profit or loss and other comprehensive income, any related tax effects are also recognised in the statement of profit or loss and other comprehensive income, except for transactions and other events recognised directly in equity. The tax effect relating to those transactions must be recognised directly in equity.

IAS 12 refers to the statement of financial position approach. This method requires that deferred tax be measured on the difference between:

- the carrying amount of the entity's assets and liabilities; and
- the tax base of each of the entity's assets and liabilities.

The income tax expense is calculated in the following manner:

| | R |
|--|------------|
| Profit before tax (as per the P/L) | XXX |
| Exempt differences (refer section 1.3) | XXX |
| Profit after exempt differences | <u>XXX</u> |
| Temporary differences (taxable/deductible) | XXX |
| Taxable profit/tax loss | <u>XXX</u> |
| Current tax expense (28% of taxable profit) (Current tax expense is Rnil if there is a tax loss for the year) | XXX |
| Deferred tax expense (28% of temporary differences) (Can be deferred tax credit or debit to the P/L) | XXX |
| SA Normal tax* | <u>XXX</u> |

* Assuming that the tax rate is 28%, the SA normal tax should be 28% of the profit after exempt differences.

1.3 EXEMPT DIFFERENCES

A deferred tax liability should be recognised for all taxable temporary differences unless the deferred tax liability arises from

- (a) goodwill for which amortisation is not deductible for tax purposes; or
- (b) the initial recognition of an asset or liability in a transaction which
 - (i) is not a business combination*; and
 - (ii) at the time of the transaction, affects neither the accounting profit nor the taxable profit (tax loss)

* Business combinations do not form part of this module.

These differences are then treated as exempt differences and no deferred tax expense is provided on them.

The initial recognition of an asset or a liability will therefore be treated as an exempt difference if that item does not affect the tax computation, meaning that specific asset or liability is never taxable or deductible for tax purposes.

Exempt differences are items that are **never taxable nor tax deductible** and therefore no tax is provided on them. The exempt differences are reconciling items if the total of the current and deferred tax expenses in the statement of profit or loss and other comprehensive income do not amount to 28% of the profit before tax.

Examples of exempt differences are

- exempt income (income that will never be taxed), namely:
 - dividends received; and
 - the portion of capital profits on the sale of assets that is not taxable;
- non tax deductible expenses (expenses that will never be allowed as a deduction), namely
 - fines; and
 - donations.

EXAMPLE 1

The company has profit before tax of R10 000. Included in the profit are dividends received of R1 000 and fines paid of R200. There are no temporary differences. The tax rate is 28%.



REQUIRED

Calculate the current tax expense and deferred tax expense for the year.

SOLUTION 1

| | R |
|---|----------|
| Profit before tax | 10 000 |
| Exempt differences | |
| – Dividends received – not taxable | (1 000) |
| – Fines paid – not deductible for tax | 200 |
| Profit after exempt differences | 9 200 |
| Temporary differences | – |
| Taxable profit | 9 200 |
| Current tax expense – 28% of taxable profit | 2 576 |
| Deferred tax expense – 28% of temporary differences | – |
| SA normal tax | 2 576 |

The income tax expense in the statement of profit or loss and other comprehensive income should have been R2 800 (R10 000 x 28%). The income tax expense is currently shown as R2 576.

The reason for the difference is that no tax is provided for on the exempt differences. IAS 12 requires a reconciliation of the relationship between the tax expense and the profit before tax (accounting profit). The reconciliation can be done in percentages or rand, as follows:

| | Rand | OR | % |
|--|---------------------|-----------|---------------------|
| Standard tax (applicable tax rate) ¹ (10 000 x 28%) | 2 800 | | 28,0 |
| Exempt differences | | | |
| – Dividends received ² (1 000 x 28%); (1 000 / 10 000 x 28% x 100) | (280) | | (2,8) |
| – Fines paid ³ (200 x 28%); (200 / 10 000 x 28% x 100) | <u>56</u> | | <u>0,56</u> |
| Effective tax ⁴ (2 576 / 10 000 x 100) | <u><u>2 576</u></u> | | <u><u>25,76</u></u> |

¹ Tax on profit before tax of 28% (tax rate).

² Not taxable, therefore deduct from profit before tax.

³ Not deductible for tax purposes, therefore add back to profit before tax.

⁴ This is the total tax expenses that is being shown in the statement of profit or loss and other comprehensive income.

1.4 EXAMPLES OF TAXABLE TEMPORARY DIFFERENCES AND THE TREATMENT THEREOF ACCORDING TO THE STATEMENT OF FINANCIAL POSITION APPROACH

Rule 1: Carrying amount of asset > tax base of asset = DEFERRED TAX LIABILITY (SFP)

Where the carrying amount of the asset is greater than the tax base of the asset as a result of taxable temporary differences, taxable profit arises in future periods. In the current year, deferred tax expense in the statement of profit or loss and other comprehensive income will be debited and a deferred tax liability in the statement of financial position will be credited to provide for the tax payable in future.

1.4.1 Capital allowances

IAS 16 governs property, plant and equipment, and requires assets to be depreciated at a rate based on the expected useful life. However, tax legislation requires assets to be depreciated based on the standard rates of depreciation set out in the legislation, irrespective of the actual expected rate of usage by the entity. The depreciation calculated by the tax authorities is often referred to as a capital allowance or tax allowance.

If the depreciation rate and the tax allowance rate (capital allowances) on the same asset differ, it will result in a different carrying amount and tax base for that asset. The difference between the carrying amount and the tax base of the asset leads to taxable or deductible temporary differences.

This in turn may result in the profit or loss on sale of the asset in the statement of profit or loss and other comprehensive income differing from that calculated in accordance with the tax legislation. A profit on sale is generally referred to in the tax legislation as a recoupment whereas a loss on sale is often referred to as a scrapping allowance (generally granted as a deduction if certain criteria are met).

Accounting purposes

| | |
|---|------------|
| The carrying amount of a non-current asset is calculated as follows: | R |
| Original cost | xxx |
| Less accumulated depreciation | (xxx) |
| Carrying amount | <u>xxx</u> |

| | |
|--|------------|
| The profit or loss on sale of a non-current asset (capital and non-capital portions) is as follows: | R |
| Proceeds on sale | xxx |
| Less carrying amount | (xxx) |
| Profit/(loss) on sale | <u>xxx</u> |

| | |
|--|------------|
| The non-capital profit included in the profit on sale of a non-current asset is as follows: | R |
| Proceeds on sale, limited to original cost | xxx |
| Less carrying amount | (xxx) |
| Non-capital profit/(loss) | <u>xxx</u> |

Tax purposes

| | |
|---|------------|
| The tax base is calculated as follows: | R |
| Original cost | xxx |
| Less accumulated capital allowances (tax allowance) | (xxx) |
| Tax base | <u>xxx</u> |

| | |
|--|------------|
| The taxable recoupment (or scrapping allowance) is calculated as follows: | R |
| Proceeds on sale, limited to original cost | xxx |
| Less tax base | (xxx) |
| Recoupment/(scrapping allowance) | <u>xxx</u> |

EXAMPLE 2

A manufacturing plant was purchased on 1 January 20.12 at a cost of R120 000. The depreciation for the year amounted to R24 000 and the tax allowance to R40 000. The company has been incorporated in the current year and has profit before tax of R100 000 for the year ended 31 December 20.12. The tax rate is 28%.

Deferred tax is provided on all temporary differences using the statement of financial position approach.



REQUIRED

Calculate the deferred tax expense for the year ended 31 December 20.12.

SOLUTION 2

Deferred tax on plant:

| | Carrying Amount R | Tax base R | Temporary difference R |
|----------------------------|----------------------------------|---------------------------|---------------------------------------|
| Cost | 120 000 | 120 000 | - |
| Depreciation/tax allowance | (24 000) | (40 000) | 16 000 |
| Carrying amount/tax base | <u>96 000</u> | <u>80 000</u> | <u>16 000</u> |

The carrying amount of the asset is greater than the tax base thereof and therefore the recovery of the carrying amount will result in taxable profit in the future. The taxable temporary difference is R16 000 and the deferred tax liability at 28% is R4 480 (R16 000 x 28%).

Journal entry:

| | Dr R | Cr R |
|---|-----------------|-----------------|
| Deferred tax expense (P/L) | 4 480 | |
| Deferred tax liability (SFP) | | 4 480 |
| <i>Provision made for deferred tax expense.</i> | | |



LECTURER'S COMMENT

IAS 12 adopts the statement of financial position approach for calculating deferred tax. This approach entails the following:

- Calculate the carrying amounts of all assets and liabilities evident from the information.
- For each asset and liability identified, determine the relevant tax base.
- Thereafter calculate the temporary differences and take into account the carrying amount and tax base of each asset and liability.
- For each temporary difference, determine whether it results in a deferred tax asset or liability.
- Each temporary difference must then be multiplied with the tax rate.
- The net deferred tax liability or asset for the current year should then be determined.
- As soon as the deferred tax liability or asset has been determined for the current year, the deferred tax movement in the statement of profit or loss and other comprehensive income can be calculated as the difference between the opening and closing balance of the deferred tax liability or asset.

EXAMPLE 3

On 1 January 20.12, A Ltd was incorporated and acquired a manufacturing building at a cost of R2 000 000, an administration building at cost of R500 000 and land at a cost of R300 000 for its own use. Land is not depreciated and no tax allowance is claimable. The manufacturing building is depreciated at 4% per year using the straight-line method and the SA Revenue Service allows a 5% annual allowance on the manufacturing building. The administration building is depreciated over 20 years, but no tax allowance is claimable.

The company's year-end is 31 December 20.12.

Assume that the profit before tax is R200 000 for the year ended 31 December 20.12 and the tax rate is 28%.

Deferred tax is provided on all temporary differences according to the statement of financial position approach.

**REQUIRED**

Calculate the deferred tax expense for the year ended 31 December 20.12.

SOLUTION 3

According to the statement of financial position approach, the following are the balances for accounting and tax purposes:

| | Carrying amount R | Tax base R | Temporary difference R |
|---|-------------------------|---------------|------------------------------|
| Manufacturing building | | | |
| Cost | 2 000 000 | 2 000 000 | - |
| Depreciation/annual allowance (2 000 000 x 4%); (2 000 000 x 5%) | (80 000) | (100 000) | 20 000 |
| Carrying amount/tax base | 1 920 000 | 1 900 000 | 20 000 |

The carrying amount is greater than the tax base and therefore the recovery of the carrying amount will result in taxable profit in the future. The taxable temporary difference resulted in a deferred tax liability of R5 600 (R20 000 x 28%).

Journal entry:

| | Dr R | Cr R |
|---|---------|---------|
| Deferred tax expense (P/L) | 5 600 | |
| Deferred tax liability (SFP) | | 5 600 |
| <i>Provision made for deferred tax expense.</i> | | |

| | Carrying Amount R | Tax base R | Temporary difference R |
|-------------------------------|-------------------------|---------------|------------------------------|
| Land | | | |
| Cost | 300 000 | – | 300 000 |
| Depreciation/annual allowance | – | – | – |
| Carrying amount/tax base | 300 000 | – | 300 000 |

The temporary difference on the land is exempt in terms of *paragraph .15 of IAS 12* as it arises from the initial recognition of an asset in a transaction which, at the time of the transaction, affects neither accounting nor taxable profit/loss. When the land is recognised for the first time, a temporary difference arises immediately, as the carrying amount of the land amounts to R300 000, while the tax base (future tax deductions) amounts to Rnil. However, the acquisition of the land does not affect accounting profit (debit – Land, credit – Bank) and there is no immediate tax deduction that will affect taxable income. Therefore the exemption in terms of *paragraph .15(b) of IAS 12* applies.

| | Carrying Amount R | Tax base R | Temporary difference R |
|--------------------------------|-------------------------|---------------|------------------------------|
| Administration building | | | |
| Cost | 500 000 | – | 500 000 |
| Depreciation/annual allowance | (25 000) | – | (25 000) |
| Carrying amount/tax base | 475 000 | – | 475 000 |

The temporary difference on the administration building is exempt in terms of *paragraph .15 of IAS 12* as it arises from the initial recognition of an asset in a transaction which at the time of the transaction affects neither accounting nor taxable profit/loss.



LECTURER'S COMMENT

Work through example 8.13 of *Descriptive accounting*, which illustrates the exemption from recognising a deferred tax liability.

1.4.2 Prepayments

Prepayments are amounts actually incurred in the current year and therefore tax deductible in terms of *section 11(a) of the Income Tax Act*. For accounting purposes, however, the amount is not taken to the statement of profit or loss and other comprehensive income as a deduction, but is disclosed as a current asset in the statement of financial position. The temporary difference occurs because the amount will be claimed as a deduction for tax in the current year, but will only be taken to the statement of profit or loss and other comprehensive income as an expense in the following year. The carrying amount will be equal to the amount of the prepayment and the tax base is Rnil (no amount in the statement of financial position for tax purposes since it has already been claimed).

EXAMPLE 4

Assume that a company, incorporated in the current year, paid insurance in advance amounting to R1 000. The profit before tax is R5 000 for the year ended 31 December 20.12. The tax rate is 28%.

Deferred tax is provided on all temporary differences according to the statement of financial position approach.

**REQUIRED**

Calculate the deferred tax expense for the year ended 31 December 20.12.

SOLUTION 4

The following journal entry for insurance prepayments is prepared for accounting purposes:

| | Dr | Cr |
|-------------------------|-----------|-----------|
| | R | R |
| Insurance prepaid (SFP) | 1 000 | |
| Bank (SFP) | | 1 000 |

According to the statement of financial position approach, the following are the balances for accounting and tax purposes:

| | Carrying amount | Tax base | Temporary difference |
|------------------------------|----------------------------|---------------------|---------------------------------|
| | R | R | R |
| Prepayments – current assets | <u>1 000</u> | <u>–</u> | <u>1 000</u> |

This temporary difference will result in future taxable amounts when the carrying amount of the asset is recovered. (The prepayment has already been claimed for tax purposes in the current year and will not be claimed when the expense is taken to the statement of profit or loss and other comprehensive income in the future.) The carrying amount of the asset, which is greater than the tax base, is a taxable temporary difference and therefore a deferred tax liability is created.

The tax base of the asset is Rnil as there is no future deductible amount for tax purposes. The carrying amount of the asset will be recovered in the future as a deduction against profit before tax (credit the asset and debit the statement of profit or loss and other comprehensive income), which will result in taxable profit being greater than the profit before tax in the future. This resulting future liability requires a deferred tax provision in the current year.

Journal entry:

| | Dr | Cr |
|---|-----|-----|
| | R | R |
| Deferred tax expense (P/L) | 280 | |
| Deferred tax liability (SFP) | | 280 |
| <i>Provision made for deferred tax expense.</i> | | |



LECTURER'S COMMENT

Work through example 8.12 of *Descriptive accounting*, which illustrates taxable temporary differences.

Rule 2: Carrying amount of liability < tax base of liability = DEFERRED TAX LIABILITY (SFP)

Where, as a result of temporary differences, the carrying amount of the liability is less than the tax base of the liability, this will result in taxable temporary differences leading to taxable amounts in determining taxable profit of future periods. In the current year, we have to debit deferred tax expense in the statement of profit or loss and other comprehensive income, and credit a deferred tax liability in the statement of financial position.

It is difficult to imagine circumstances where the carrying amount of a liability would be smaller than the tax base of a liability.

In the case of the section 24C allowance, which is granted by the SA Revenue Service in respect of construction contracts, the carrying amount for accounting purposes is Rnil, but the tax base is the value of the section 24C allowance. A deferred tax liability is therefore created.

1.5 RECOGNITION OF DEFERRED TAX ASSETS

IAS 12 states that a deferred tax asset should be recognised to the extent that it is probable that taxable profit will be available in the future against which the deductible temporary differences can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction which

- (a) is not a business combination*; and
- (b) at the time of the transaction, affects neither accounting profit nor taxable profit/(loss).

* Business combinations do not form part of this module.

Rule 3: Carrying amount of asset < tax base of asset = DEFERRED TAX ASSET (SFP)

Rule 4: Carrying amount of liability > tax base of liability = DEFERRED TAX ASSET (SFP)

This results in deductible temporary differences leading to amounts which are deductible in determining taxable profit of future periods. In the current year, we have to credit

deferred tax income in the statement of profit or loss and other comprehensive income, and debit a deferred tax asset in the statement of financial position.

It is inherent in the recognition of a liability that the carrying amount will be settled in future periods through the outflow of resources from the company. When resources flow from the enterprise, part or all of their amounts may be deductible in determining taxable profit in a period later than the period in which the liability is recognised. In such cases, a temporary difference exists between the carrying amount of the liability and its tax base. Accordingly, a deferred tax asset arises in respect of the income taxes that will be recoverable in future periods when that part of the liability is allowed as a deduction in determining taxable profit.

EXAMPLE 5

Revenue received in advance is not accounted in the statement of profit or loss and other comprehensive income in the current year, but disclosed as a liability in the statement of financial position (debit – Bank; credit – Revenue received in advance). The amount is taxable in the current year since all amounts received or accrued are taxed according to the rules of the *Income Tax Act*.

A company has been incorporated in the current year and has received deposits in advance to the amount of R20 000 from their customers to book holiday accommodation. The accounting profit of the company amounted to R150 000 for the year ended 31 December 20.12 and the tax rate is 28%.

Deferred tax is provided on all temporary differences according to the statement of financial position approach. There is assurance beyond reasonable doubt that there will be sufficient taxable profit in the future to realise any tax benefits.



REQUIRED

Calculate the deferred tax expense for the year ended 31 December 20.12

SOLUTION 5

The following journal entry for deposits received in advance is prepared for accounting purposes:

| | Dr R | Cr R |
|------------------------------------|---------|---------|
| Bank (SFP) | 20 000 | |
| Deposits received in advance (SFP) | | 20 000 |

According to the statement of financial position approach, the following are the balances for accounting and tax purposes:

| | Carrying amount | Tax base | Temporary difference |
|------------------------------|----------------------------|---------------------|---------------------------------|
| | R | R | R |
| Deposits received in advance | <u>20 000</u> | <u>–</u> | <u>20 000</u> |

(The tax base is equal to the carrying amount less the amount of revenue that will not be taxed in future (20 000 – 20 000)).

As a result of the deposits received in advance, the carrying amount of the liability is greater than the tax base of the liability and this will result in amounts which are deductible in determining future taxable profit.


Journal entry:

| | Dr | Cr |
|---|-----------|-----------|
| | R | R |
| Deferred tax asset (SFP) | 5 600 | |
| Deferred tax (P/L) | | 5 600 |
| <i>Provision made for deferred tax.</i> | | |

EXAMPLE 6

A company has been incorporated in the current year, and it sells vacuum cleaners with a one-year warranty. The company provides for the warranty costs and the total of the provision account at the end of the year is R150 000. Assume that the profit before tax is R500 000 for the year ended 31 December 20.12 and the tax rate is 28%. The SA Revenue Service will allow the warranty costs as a deduction once they are actually incurred. The directors of the company are certain that the amount provided is not excessive.

Deferred tax is provided on all temporary differences using the statement of financial position approach. There is assurance beyond reasonable doubt that there will be sufficient taxable profit in the future to realise any tax benefits.

| | |
|---|--|
|  | REQUIRED |
| | Calculate the deferred tax expense for the year ended 31 December 20.12. |

SOLUTION 6

The following journal entry for warranty costs is prepared for accounting purposes:

| | Dr | Cr |
|------------------------------------|-----------|-----------|
| | R | R |
| Warranty costs (P/L) | 150 000 | |
| Provision for warranty costs (SFP) | | 150 000 |

According to the statement of financial position approach, the following are the balances for accounting and tax purposes:

| | Carrying amount | Tax base | Temporary difference |
|------------------------------|----------------------------|---------------------|---------------------------------|
| | R | R | R |
| Provision for warranty costs | <u>150 000</u> | <u>–</u> | <u>150 000</u> |

The tax base is equal to the carrying amount less the amount deductible for tax purposes in future (150 000 – 150 000)).

The tax base represents two amounts, namely the liability for warranty costs of R150 000 and the tax allowance of R150 000 still due as a deduction from tax in the future. The carrying amount of the liability is greater than the tax base of the liability, which means that this will result in future deductions for tax purposes.

Journal entry

| | Dr | Cr |
|---|-----------|-----------|
| | R | R |
| Deferred tax asset (SFP) | 42 000 | |
| Deferred tax (P/L) (150 000 x 28%) | | 42 000 |
| <i>Provision made for deferred tax.</i> | | |

EXAMPLE 7

On 1 January 20.12 a company was incorporated and it entered into an instalment sale agreement, buying manufacturing machines. The company's year-end is 31 December.

| | |
|--|----------|
| Cost of machines | R171 000 |
| Instalment – payable annually in arrears | R63 567 |
| Finance term | 4 years |
| Nominal interest rate | 18% |
| Depreciation rate – straight-line | 20% |
| Tax allowance (SA Revenue Service) – straight-line | 33,33% |

The interest paid in year 1 is R30 780 and the outstanding capital balance of the liability at the end of year 1 is R138 213.

The tax rate is 28% and the profit before tax is R500 000.

Deferred tax is provided on all temporary differences using the statement of financial position approach. There is assurance beyond reasonable doubt that there will be sufficient taxable profit in the future to realise any tax benefits.



REQUIRED

Calculate the deferred tax expense for the year ended 31 December 20.12.

SOLUTION 7

In the case of an instalment sale agreement, the tax authorities recognise the capitalisation of the asset and allow a tax allowance to be claimed on the asset. A liability also exists for tax purposes and the interest is claimable for tax purposes.

For accounting purposes, the asset is capitalised and the liability raised. The depreciation and interest paid are expensed to the statement of profit or loss and other comprehensive income.

According to the statement of financial position approach, the following are the balances for accounting and tax purposes:

| | Carrying amount | Tax base | Temporary difference |
|--|------------------------|-----------------|-----------------------------|
| | R | R | R |
| Property, plant and equipment ¹ | <u>136 800</u> | <u>114 000</u> | <u>22 800</u> |

¹ (171 000 x 80%); (171 000 x 66,67%)

(The tax base of the asset is the amount that will be deductible for tax purposes in future years.)

The carrying amount of the asset is greater than the tax base of the asset and it will result in a deferred tax liability. The carrying amount of the asset will be recovered in the future as a deduction against profit before tax (credit the asset in the statement of financial position and debit the statement of profit or loss and other comprehensive income), which will result in taxable profit in future periods. We have to provide for deferred tax in the current year to account for the effect of the lower tax base being recoverable in the future.

Deferred tax in the statement of profit or loss and other comprehensive income will be debited with R6 384 (R22 800 x 28%) and the deferred tax liability in the statement of financial position will be credited with R6 384.

| | Carrying amount | Tax base | Temporary difference |
|------------------------|------------------------|-----------------|-----------------------------|
| | R | R | R |
| Liability ² | <u>138 213</u> | <u>138 213</u> | <u>–</u> |

² 171 000 – (63 567 – 30 780)

(The tax base is equal to the carrying amount less amount still deductible in future for tax purposes (138 213 – 0).)

The carrying amount of the liability and the tax base of the liability are equal and therefore there is no temporary difference. Please note that the interest paid is deductible for both accounting and tax purposes.

Temporary differences according to the statement of financial position approach are:

| | |
|-------------------------------|---------------|
| | R |
| Property, plant and equipment | 22 800 |
| Liability | — |
| Net temporary differences | <u>22 800</u> |
| Deferred tax liability @ 28% | <u>6 384</u> |

Journal entry:

| | | |
|---|-----------|-----------|
| | Dr | Cr |
| | R | R |
| Deferred tax expense(P/L) | 6 384 | |
| Deferred tax liability (SFP) | | 6 384 |
| <i>Provision made for deferred tax expense.</i> | | |

1.6 UNUSED (ASSESSED) TAX LOSSES

A deferred tax asset should be recognised for the carry forward of unused (assessed) tax losses to the extent that it is probable that future taxable profit will be available against which the unused tax losses can be utilised.

The unused tax losses result when the company has calculated a tax loss and therefore no tax is payable. However, the SA Revenue Service will not refund the tax loss to the company, but allows the company to carry forward the tax loss to future periods to net off against the taxable profit of those periods, thereby reducing the tax payable in future periods.

EXAMPLE 8

A company have been incorporated in the current year and the company's profit before tax for the year ended 31 December 20.12 is R20 000. Included in the profit before tax is R10 000 depreciation. The tax allowance for the year is R40 000. The tax rate is 28%.

Deferred tax is provided on all temporary differences using the statement of financial position approach. There is assurance beyond reasonable doubt that there will be sufficient taxable profit in the future to realise any tax benefits.

| | |
|---------------------------------|-----------------|
| | R |
| Profit before tax | 20 000 |
| Exempt differences | — |
| Profit after exempt differences | <u>20 000</u> |
| Temporary differences | (30 000) |
| Depreciation | 10 000 |
| Tax allowance | <u>(40 000)</u> |
| Tax loss | <u>(10 000)</u> |
| Current tax expense | <u>Nil</u> |



REQUIRED

Calculate the deferred tax expense for the year ended 31 December 20.12.

SOLUTION 8

No current tax is payable due to the tax loss in the current year. The SA Revenue Service does not refund tax losses. The tax loss is treated as a temporary difference in the year that the tax loss arises. Deferred tax in the statement of profit or loss and other comprehensive income will be credited and a deferred tax asset will be debited in the statement of financial position.

In terms of the statement of financial position approach, the tax loss is treated as follows:

| | Carrying amount R | Tax base R | Temporary difference R |
|----------|----------------------------------|-----------------------|---------------------------------------|
| Tax loss | – | 10 000 | (10 000) |

The tax base of the asset is the amount that will be deductible for tax purposes in future years that is R10 000. The carrying amount of the tax loss is Rnil. The tax loss is not recorded in the accounting records.

The carrying amount of the asset is lower than the tax base of the asset (tax loss) and it will result in a deferred tax asset.

Deferred tax in the statement of profit or loss and other comprehensive income is credited with R2 800 (10 000 x 28%) and the deferred tax asset in the statement of financial position is debited with R2 800.

The tax loss will be utilised in the following year.

Assume in the following year the company made a profit before tax of R50 000 after depreciation of R10 000. The tax allowance is R10 000. The tax rate is 28%.

The tax computation and the deferred tax entries for the following year are as follows:

| | |
|--|----------|
| | R |
| Profit before tax | 50 000 |
| Exempt differences | – |
| Profit after exempt differences | 50 000 |
| Temporary differences | – |
| Depreciation | 10 000 |
| Tax allowance | (10 000) |
| Taxable profit | 50 000 |
| Assessed tax loss carried forward from previous year | (10 000) |
| Taxable profit for the year | 40 000 |
| Current tax at 28% | 11 200 |

The assessed tax loss was utilised against the current year's taxable profit. It was treated as a temporary difference in the previous year, resulting in a deferred tax asset.

The deferred tax asset is reversed in the current year, the journal entry being:

| | | |
|--|-----------|-----------|
| | Dr | Cr |
| | R | R |
| Deferred tax expense (P/L) (10 000 x 28%) | 2 800 | |
| Deferred tax asset (SFP) | | 2 800 |
| <i>Utilisation of the tax loss from the previous year in the current year.</i> | | |

| | Carrying amount | Tax base | Temporary difference |
|----------|----------------------------|-----------------|---------------------------------|
| | R | R | R |
| Tax loss | <u>Nil</u> | <u>Nil</u> | <u>Nil</u> |

The tax base of the asset is Rnil because there is no amount left that will be deductible for tax purposes in future years. The tax loss was utilised in the current year.

The utilisation of the tax loss is therefore a debit entry to the deferred tax in the statement of profit or loss and other comprehensive income to increase the tax charge in the current year.

The criteria for recognising deferred tax assets arising from the carry forward of unused assessed tax losses are the same as the criteria for recognising deferred tax assets arising from deductible temporary differences. The existence of unused assessed tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused assessed tax losses only to the extent that the entity has sufficient taxable temporary differences or there is evidence that sufficient profit will be available against which the unused assessed tax losses can be utilised.


An entity considers the following criteria in assessing the probability that taxable profit will be available against which the unused assessed tax losses can be utilised:

- whether the entity has sufficient taxable temporary differences, which will result in taxable amounts against which the unused tax losses can be utilised;
- whether it is probable that the entity will have taxable profits before the unused tax losses expire;
- whether the tax losses have resulted from identifiable causes which are unlikely to recur; and
- whether tax-planning opportunities are available to the entity that will create taxable profit in the period in which the unused tax losses can be utilised.

To the extent that it is not probable that the taxable profit will be available against which the unused tax losses can be utilised, the deferred tax asset is not recognised. (Refer to example 12.)

At each end of the reporting period, an entity reassesses unrecognised deferred tax assets. The entity recognises a previously unrecognised deferred tax asset to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered.

For example, an improvement in trading conditions may make it more probable that the entity will be able to generate sufficient taxable profit in the future to comply with the criteria for the recognition of the deferred tax asset.

| | |
|---|---|
|  | <p>LECTURER'S COMMENT</p> <p>Work through example 8.17 of <i>Descriptive accounting</i>, which illustrate deferred tax on assessed tax losses.</p> |
|---|---|

1.7 MEASUREMENT

Current tax expenses, deferred tax assets and deferred tax liabilities are measured using the enacted tax rates. If there had been a change in the tax rate during the year, the opening balance of the deferred tax asset and deferred tax liability in the statement of financial position should be adjusted with the applicable new tax rate.

The carrying amount of deferred tax assets and deferred tax liabilities may change even though there is no change in the amount of the related temporary differences.

This can result from:

- a change in tax rates or tax laws;
- a re-assessment of the recoverability of deferred tax assets; or
- a change in the expected manner of recovery of an asset.

1.8 PRESENTATION AND DISCLOSURE

1.8.1 Statement of profit or loss and other comprehensive income

(a) Current tax and deferred tax should be recognised as an income or expense and included in the net profit or loss for the period, except when the tax arises from:

- transactions or events which are recognised directly in equity; or
- a business combination that is an acquisition.

(b) The income tax expense or income relating to the net profit or loss should be presented on the face of the statement of profit or loss and other comprehensive income. The major components of income tax expense/(income) should be disclosed separately. The components of income tax expense/(income) may include the following:

- Current tax expense/(income).
- Any adjustments recognised in the period for current tax of prior periods. An example of this is an over or underprovision of the previous years' current tax.
- The amount of deferred tax expense/(income) relating to the origination (taxable) and reversal (deductible) of temporary differences.
- The amount of deferred tax expense/(income) relating to the changes in tax rate or enactment of new taxes.

- The amount of the benefit arising from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce the current and/or deferred tax expense. This will happen when the deferred tax asset was not recognised in respect of the tax loss because of uncertainty whether there would be sufficient future taxable profit that would be available against which the unused tax loss could be utilised. If in the current year it becomes clear that there will be sufficient future taxable profit to recognise the unused tax loss, a deferred tax asset is provided.
 - Deferred tax expense arising from the write-down, or reversal of a previous write-down, of a deferred tax asset.
 - The amount of tax expense (income) relating to those changes in accounting policies and errors that are included in profit or loss in accordance with *IAS 8*, because they cannot be accounted for retrospectively.
 - The amount of income tax relating to each component of other comprehensive income.
 - An explanation of changes in the applicable tax rate(s) compared to the previous accounting period.
- (c) An explanation is needed of the relationship between income tax expense/(income) and the accounting profit in either rand or percentages. The explanation will reconcile standard tax (applicable tax in rand or percentages) to effective tax (rand or percentages).

Standard tax (applicable tax) is the income tax expense (in rand) calculated at 28% (the current rate of tax for companies) of the accounting profit without considering exempt differences, rate changes and other taxes. It is what the income tax expense would have been had the matching principle been applied to all items. If the reconciliation is done in terms of percentages, the standard tax rate is always the official tax rate per the tax legislation – currently 28%.

Effective tax is the actual income tax expense disclosed in the statement of profit or loss and other comprehensive income and does not necessarily equal 28% of profit before tax. The reason being the income tax expense in the statement of profit or loss and other comprehensive income would not have been provided for on exempt differences and may also include other items like rate adjustments, over- and underprovisions of current tax and other taxes like foreign taxes. The effective tax percentage is the income tax expense/(income) divided by the accounting profit before tax.

The most common reconciling items are:

(i) Exempt differences

No tax is provided on these differences and, as the income tax expense/(income) in the statement of profit or loss and other comprehensive income is supposed to be 28% of the accounting profit before tax, this forms part of the reconciliation, as it is included in the accounting profit before tax. However, no tax has been provided on these items.

- **Dividends**

Dividends received are not taxable, but are included in the accounting profit before tax. When calculating the taxable profit, dividends received are deducted and the tax expense is calculated on a lower taxable profit than the accounting profit before tax. The tax expense does not match with the accounting profit before tax because it was calculated on accounting profit less dividends received. The "tax" on dividends received will be deducted as a reconciling item from standard tax to arrive at effective tax.

EXAMPLE 9

The company's profit before tax for the current year is R10 000, which includes dividends received of R2 000. There are no temporary differences. The tax computation will be as follows if the official tax rate is 28%:

| | R |
|---|---------------------|
| Profit before tax | 10 000 |
| Exempt differences – dividends received are not taxable | <u>(2 000)</u> |
| Profit after exempt differences | 8 000 |
| Temporary differences | – |
| Taxable profit | <u>8 000</u> |
| Current tax expense @ 28% | <u>2 240</u> |
| Deferred tax expense – there are no temporary differences | – |
| SA normal tax | <u><u>2 240</u></u> |

The SA normal tax of R2 240 is the effective tax.

The tax rate reconciliation (done in either rand or percentages) is as follows:

| | R | OR | % |
|---|---------------------|-----------|--------------------|
| Standard tax (or applicable tax) (10 000 x 28%) | 2 800 | | 28,0 |
| Exempt differences – dividends received (included in profit before tax, but not taxable, therefore deducted from standard tax) (2 000 x 28%); ((2 000/10 000) x 28% x 100) | <u>(560)</u> | | <u>(5,6)</u> |
| Effective tax ((2 240/10 000) x 100) | <u><u>2 240</u></u> | | <u><u>22,4</u></u> |

- **Fines**

Fines paid by the entity are not deductible for tax purposes since it has not been incurred in the production of income. The fines would have been deducted as an expense from profit before tax. When the tax computation is done, the fines paid must be added back as an exempt difference.

EXAMPLE 10

Assume the same information as in example 9, except that fines of R300 have also been deducted from profit before tax. The tax computation and the tax reconciliation are as follows:

| | R |
|---|--------------|
| Profit before tax | 10 000 |
| Exempt differences: | |
| Dividends received | (2 000) |
| Fines paid – deducted as an expense from the profit, but will have to be added back for purposes of the tax computation | <u>300</u> |
| Profit after exempt differences | 8 300 |
| Temporary differences | – |
| Taxable profit | <u>8 300</u> |
| Current tax expense @ 28% | 2 324 |
| Deferred tax expense – there are no temporary differences | – |
| SA normal tax | <u>2 324</u> |

The SA normal tax of R2 324 is the effective tax. The tax rate reconciliation (done in either Rand or percentages) is as follows:

| | R | OR | % |
|---|--------------|-----------|--------------|
| Standard tax (or applicable tax) (10 000 x 28%) | 2 800 | | 28,0 |
| Exempt differences – dividends received (explained in example 9) (2 000 x 28%); ((2 000/10 000) x 28% x 100) | (560) | | (5,6) |
| Fines – deducted from the profit before tax, but is not tax deductible and must be added back to the standard tax (300 x 28%); ((300/10 000) x 28% x 100) | 84 | | 0,84 |
| Effective tax ((2 324/10 000) x 100) | <u>2 324</u> | | <u>23,24</u> |

- **Other exempt differences**

- Legal fees relating to items of a capital nature, such as legal fees incurred to purchase a new business or to buy capital assets.
- Donations are not tax deductible.

(ii) Rate changes and over/underprovision of prior years' current tax expense are also reconciling items.

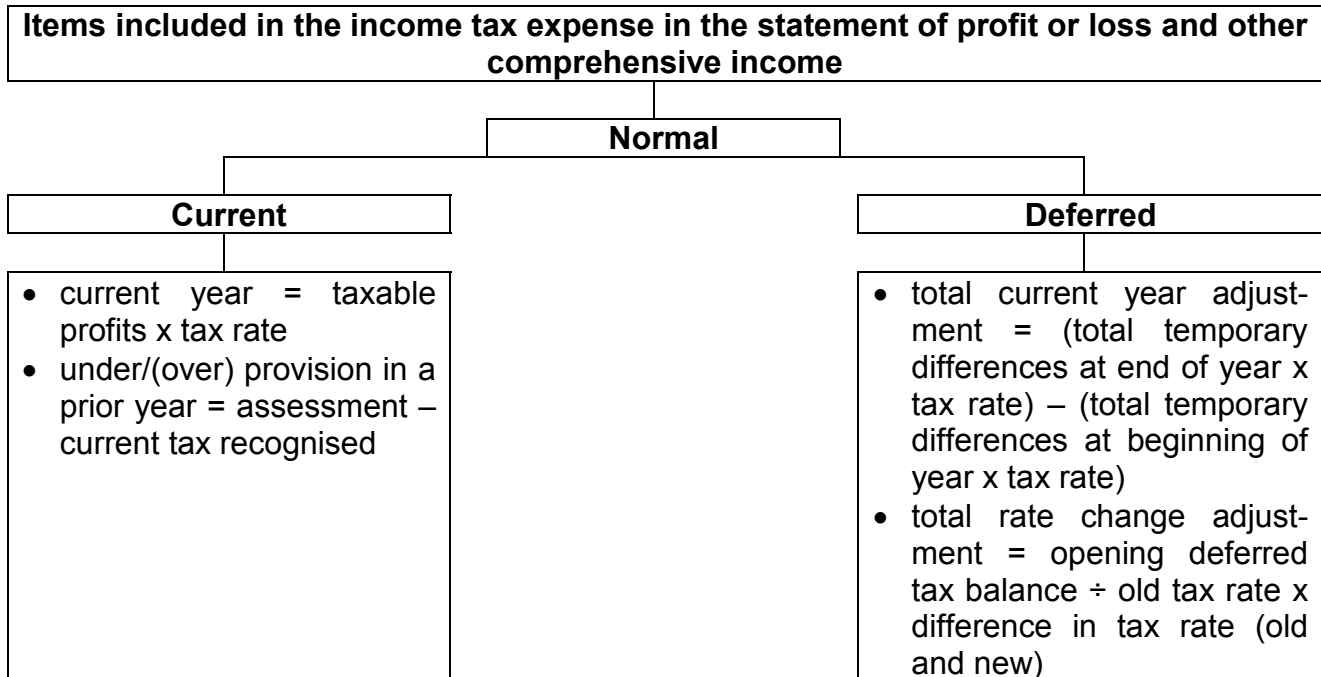
The reason being that the rate adjustment relates to adjustments made to the opening balance of the deferred tax account in the statement of financial position. The opening balance of the deferred tax account relates to previous years' temporary differences and not to the current years' profit before tax. The purpose of the tax reconciliation is to reconcile the standard tax (applicable tax), which is based on the current years' profit before tax, to the effective tax. The effective tax is the income tax expense amount disclosed in the statement of profit or loss and other comprehensive income and includes current tax, deferred tax as well as rate changes and over(underprovisions) of previous years' current tax. The effects of a rate change are dealt with in example 11. The effects of a under/over provision are discussed in part 4.10 of this chapter. Example 14 deals with an underprovision of tax.



LECTURER'S COMMENT

Work through example 8.23 of *Descriptive accounting*, which illustrates the change in tax rate.

- (d) The following is a summary of the income tax expense in the statement of profit or loss and other comprehensive income:



1.8.2 Statement of financial position

- (a) Tax assets and tax liabilities should be presented separately from other assets and liabilities in the statement of financial position. Deferred tax assets and deferred tax liabilities should be distinguished from current tax assets and liabilities.

When an entity makes a distinction between current and non-current assets and liabilities in its financial statements, it should classify deferred tax assets and liabilities as non-current assets or liabilities.

An entity should offset current tax assets and current tax liabilities when they relate to income taxes levied by the same tax authorities and the entity has a legally enforceable right to set off current tax assets against current tax liabilities.

- (b) The aggregate current and deferred tax relating to items that are charged or credited to equity should be disclosed separately.
- (c) The amount (and expiry date, if any) of deductible temporary differences, unused tax losses and unused tax credits for which no deferred tax asset is recognised in the statement of financial position should be disclosed separately.

(d) The following is required in respect of each type of temporary difference, and in respect of each type of unused tax losses and unused tax credits:

- The amount of the deferred tax assets and liabilities recognised in the statement of financial position for each given period
- The amount of the deferred tax expense or income recognised in the statement of profit or loss and other comprehensive income, if this amount is not apparent from the changes in the amounts recognised in the statement of financial position

This means that the deferred tax balance in the statement of financial position must be analysed and divided into the major types of temporary differences included in the balance. It could relate to the following:

- Temporary differences that relate to property, plant and equipment and the differing timing of the accounting deductions and tax allowances
- The deferred tax provided for on unused tax losses
- Other temporary differences that arise when income or expenses are included in one period for accounting and another for tax purposes, such as deposits received in advance and prepayments

(e) An entity should disclose the amount of a deferred tax asset and the nature of the evidence supporting its recognition, when:

- the utilisation of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences; and
- the entity has suffered a loss in either the current or the preceding period in the tax jurisdiction to which the deferred tax asset relates.

1.8.3 Summary of disclosure requirements

Suggested disclosure relevant to the areas of deferred tax studied in this learning unit is as follows:

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED ... 20.12

| | Notes | 20.12 R | 20.11 R |
|--|-------|------------|------------|
| Profit before tax | | xxx | xxx |
| Income tax expense | 3 | (xxx) | (xxx) |
| Profit for the year | | <u>xxx</u> | <u>xxx</u> |
| Total comprehensive income for the year | | <u>xxx</u> | <u>xxx</u> |

STATEMENT OF FINANCIAL POSITION AS AT ... 20.12

| | Notes | 20.12 R | 20.11 R |
|---|-------|------------|------------|
| ASSETS/LIABILITIES | | | |
| Non-current assets/Non-current liabilities | | | |
| Deferred tax | 4 | xxx | xxx |
| Current assets/Current liabilities | | | |
| SA Revenue Service – Normal | | xxx | xxx |
| SA Revenue Service – VAT | | xxx | xxx |

NOTES FOR THE YEAR ENDED ... 20.12

| | 20.12 | 20.11 |
|--|--------------|--------------|
| | R | R |
| 3. Income tax expense | | |
| Major components of tax expense | | |
| Current tax expense | xxx | xxx |
| Current period | xxx | xxx |
| Under/(over)-provision in prior period | xxx | xxx |
| Deferred tax expense | xxx | xxx |
| Current period | xxx | xxx |
| Change in tax rate | xxx | xxx |
| | <u>xxx</u> | <u>xxx</u> |
| Income tax relating to the components of other comprehensive income | | |
| Deferred tax relating to revaluation of building | <u>—</u> | <u>xxx</u> |
| Tax rate reconciliation (R or %) | | |
| Standard tax (applicable tax) | xxx | xxx |
| Tax effects of: | | |
| Exempt differences | | |
| Non-taxable capital profits | (xxx) | (xxx) |
| Dividend income | (xxx) | (xxx) |
| Fines | xxx | xxx |
| Donations | xxx | xxx |
| Under/(over)-provision of current tax in a prior year | xxx | (xxx) |
| Change in tax rate | xxx | (xxx) |
| Effective tax | <u>xxx</u> | <u>xxx</u> |
| 4. Deferred tax asset/(liability) | | |
| Analysis of temporary differences | | |
| Provisions | xxx | xxx |
| Accelerated tax allowance for tax purposes | xxx | xxx |
| | <u>xxx</u> | <u>xxx</u> |
| 5. The balance relating to an assessed loss for normal tax purposes for which no deferred tax asset has been recognised due to uncertainty about the probability of future taxable profits or dividend declarations, is as follows: | | |
| Unutilised assessed loss for which no deferred tax asset has been recognised | <u>xxx</u> | <u>(xxx)</u> |

EXAMPLE 11

The trial balance of Aries Ltd for the year ended 31 December 20.12 is as follows:

| | R | R |
|--|-----------|-----------|
| Credits | | |
| Share capital | | 500 000 |
| Retained earnings: 1 January 20.12 | | 1 036 400 |
| Long-term liabilities | | 330 200 |
| Accumulated depreciation: Buildings – 31 December 20.11 | | 9 000 |
| Accumulated depreciation: Plant and machinery – 31 December 20.11 | | 38 500 |
| Sale of goods | | 2 650 000 |
| Accounts payable | | 72 500 |
| Dividends received | | 45 000 |
| Debits | | |
| Land: At cost | 1 200 000 | |
| Buildings: At cost | 450 000 | |
| Plant and machinery: At cost | 385 000 | |
| Investments | 660 990 | |
| Deferred tax asset: 1 January 20.12 | 2 610 | |
| Inventory | 98 000 | |
| Accounts receivable | 125 000 | |
| Cost of sales | 1 325 000 | |
| Operating expenses (excluding depreciation) | 362 000 | |
| Interest paid | 23 000 | |
| Dividends paid | 50 000 | |
| | 4 681 600 | 4 681 600 |

Additional information

1. The provision for the current tax expense and deferred tax expense must still be made for the year ended 31 December 20.12. The following tax rates are applicable:

| | 20.12 | 20.11 |
|-----------------|--------------|--------------|
| Normal tax rate | 28% | 29% |

2. The assets of Aries Ltd were purchased as follows:

| | |
|----------------------------|-----------------|
| Land (owner-occupied) | 1 January 20.11 |
| Buildings (owner-occupied) | 1 January 20.11 |
| Plant and machinery | 1 July 20.11 |

Aries Ltd accounts for all assets according to the cost model.

3. The following are the differences between the allowances for tax purposes and the allowances that the company applies in the financial statements:

| | Company | SA Revenue Service |
|-----------------------------------|----------------------|--------------------|
| Land | None | None |
| Buildings | 2% per year | None |
| Plant and machinery (apportioned) | 20% reducing balance | 20% straight line |
| Allowance for credit losses | Full list | 25% of list |

4. Included in operating expenses are donations of R15 000 and fines of R70 000 for environmental pollution. The donations made by Aries Ltd and the fines incurred for environmental pollution are not deductible for tax purposes.

5. The accounts receivable figure in the trial balance is made up as follows:

| | 20.12 R | 20.11 R |
|-----------------------------|----------------|----------------|
| Age analysis | 145 000 | 180 000 |
| Allowance for credit losses | (20 000) | (12 000) |
| | <u>125 000</u> | <u>168 000</u> |

6. The deferred tax balance at 31 December 20.11 arose as a result of deductible temporary differences of R9 000 relating to the allowance for credit losses.

7. Deferred tax is provided on all temporary differences using the statement of financial position approach. There is assurance beyond reasonable doubt that there will be sufficient taxable profit in the future to realise any tax benefits.



REQUIRED

Prepare the notes to the annual financial statements of Aries Ltd for the year ended 31 December 20.12 as far as the aspects of tax are concerned. Your answer must comply with the requirements of International Financial Reporting Standards (IAS 12).



LECTURER'S COMMENT

HOW TO APPROACH A QUESTION WHEN THE DISCLOSURE OF THE INCOME TAX EXPENSE NOTE IS REQUIRED:

1. Calculate the current tax expense for the year.
2. Calculate the deferred tax balance for the previous year if not given.
3. Calculate the deferred tax balance for the current year.
4. Calculate the deferred tax movement based on calculations (2) and (3) above.
5. Calculate the tax rate change if any.
6. Prepare the first part of the income tax expense note using the information calculated in (1) to (5) above. Thereafter, prepare the tax rate reconciliation note in rand or percentages (as required by the question).

| |
|--------------------|
| SOLUTION 11 |
|--------------------|

Calculations**1. Calculation of profit before tax**

| | 20.12 |
|---|--------------|
| | R |
| Sales | 2 650 000 |
| Cost of sales | (1 325 000) |
| Gross profit | 1 325 000 |
| Operating expenses (excluding depreciation) | (362 000) |
| Depreciation: Building | (9 000) |
| Depreciation: Plant and machinery | (69 300) |
| Finance costs | (23 000) |
| Investment income – dividends received | 45 000 |
| Profit before tax | 906 700 |

2. Calculation of current tax expense for the year

| | 20.12 |
|---|--------------|
| | R |
| Profit before tax | 906 700 |
| Exempt differences | 49 000 |
| Donations – not tax deductible | 15 000 |
| Fines for environmental pollution – not tax deductible | 70 000 |
| Depreciation: Building | 9 000 |
| Dividends received | (45 000) |
| Profit after exempt differences | 955 700 |
| Temporary differences | (1 700) |
| Depreciation for accounting purposes ¹ – add back | 69 300 |
| Tax allowance ¹ – deduct | (77 000) |
| Allowance for credit losses ² (20 000 – 12 000) | 8 000 |
| Allowance for credit losses – 20.11 ³ (12 000 x 25%) | 3 000 |
| Allowance for credit losses – 20.12 ⁴ (20 000 x 25%) | (5 000) |
| Taxable profit | 954 000 |
| Current tax expense at 28% | 267 120 |

¹ The depreciation has already been deducted in order to calculate the accounting profit of R906 700. The SA Revenue Service calculates its own form of depreciation called a capital allowance (tax allowance), therefore the depreciation must first be added back (reversed) and then the tax allowance must be deducted.

² The allowance for credit losses is a statement of financial position account (general ledger account), therefore the movement in this account will either be debited or credited to the statement of profit or loss and other comprehensive income (profit before tax). The increase of R8 000 in the allowance for credit losses account will

therefore be debited to the statement of profit or loss and other comprehensive income (profit before tax). This amount (R8 000) is not allowed as a deduction for tax purposes and should therefore be added back (reversed).

- 3 This amount of R3 000 has already been allowed as a deduction for tax purposes in 20.11 and should therefore be added back.
- 4 This amount of R5 000 is allowed as a deduction for tax purposes in the current year (20.12) and should therefore be deducted.

3. Carrying amounts of property, plant and equipment

| | Land R | Buildings R | Plant and machinery R | Total R |
|--|-------------------|------------------------|--------------------------------------|--------------------|
| Purchase date 01/01/20.11 | 1 200 000 | 450 000 | – | 1 650 000 |
| Purchase date 01/07/20.11 | – | – | 385 000 | 385 000 |
| Depreciation for the year ended 31/12/20.11 | – | (9 000) | (38 500) | (47 500) |
| Carrying amount at 31/12/20.11 | 1 200 000 | 441 000 | 346 500 | 1 987 500 |
| Depreciation for the year ended 31/12/20.12 | – | (9 000) | (69 300) | (78 300) |
| Carrying amount at 31/12/20.12 | <u>1 200 000</u> | <u>432 000</u> | <u>277 200</u> | <u>1 909 200</u> |

4. Tax base of property, plant and equipment

| | Land R | Buildings R | Plant and machinery R |
|---|-------------------|------------------------|--------------------------------------|
| Purchase date 01/12/20.11 | <u>1 200 000</u> | <u>450 000</u> | – |
| Purchase date 01/07/20.11 | | | 385 000 |
| Tax allowance for year ended 31/12/20.11 | | | <u>(38 500)</u> |
| Tax base at 31/12/20.11 | <u>–</u> | <u>–</u> | 346 500 |
| Tax allowance for year ended 31/12/20.12 | | | <u>(77 000)</u> |
| Tax base at 31/12/20.12 | <u>–</u> | <u>–</u> | <u>269 500</u> |

5. Deferred tax balance computation for the year ended 31 December 20.12 – statement of financial position approach

| | Carrying amount R | Tax base R | Temporary differences R | Deferred tax asset/ (liability) @ 28% R |
|---|----------------------|---------------|----------------------------|--|
| Property, plant and equipment: | | | | |
| Property | 1 200 000 | – | 1 200 000 (Exempt) | – |
| Buildings | 432 000 | – | 432 000 (Exempt) | – |
| Plant and machinery ¹ | 277 200 | 269 500 | 7 700 | (2 156) |
| Accounts receivable ² | 125 000 | 140 000 | 15 000 | 4 200 |
| Net deferred tax asset at 31 December 20.12 | | | | <u>2 044</u> |

Deferred tax movement – current year

| | |
|--|--------------|
| Deferred tax asset on 1 January 20.12 | (2 610) |
| Deferred tax asset at 31 December 20.12 | <u>2 044</u> |
| Net movement for the year – debit to the P/L | <u>(566)</u> |

Made up as follows:

| | |
|---|--------------|
| | R |
| | (566) |
| Rate change from 29% to 28% [2 610 – (2 610/0,29 x 0,28)] | (90) |
| Temporary differences (1 700(2) x 28%) | <u>(476)</u> |

(See current tax expense computation for temporary differences for the year.)

¹ Carrying amount of asset > tax base of asset, therefore a deferred tax liability exists

² Tax base = (125 000 + 20 000 – (20 000 x 25%))

Carrying amount of asset < tax base of asset, therefore a deferred tax asset exists



LECTURER'S COMMENT

The temporary differences on the property and the buildings are exempt in terms of *paragraph .15 of IAS 12* as it arises from the initial recognition of an asset in a transaction, which at the time of the transaction affects neither accounting nor taxable profit.

DISCLOSURE

ARIES LTD

NOTES FOR THE YEAR ENDED 31 DECEMBER 20.12

1. Accounting policy

The financial statements have been prepared in accordance with International Financial Reporting Standards.

The financial statements have been prepared on the historical cost basis, as modified by the revaluation of land and buildings, investment property, available-for-sale financial assets and financial assets and financial liabilities at fair value through profit or loss.

They incorporate the following principal accounting policies, which are consistent with the policies applied in previous years, except where otherwise stated

1.1 Taxation

Current and deferred tax are recognised as income or an expense and included in profit or loss for the period, except when the tax relates to items that are recognised outside profit or loss. Tax that relates to items that are recognised in other comprehensive income are also recognised in other comprehensive income. Tax that relates to items that are recognised directly in equity are also recognised directly in equity.

Deferred taxation

Deferred tax is recognised for all temporary differences according to the statement of financial position approach and based on tax rates that have been enacted or substantively enacted by the reporting date. The measurement of deferred tax reflects the tax consequences that would follow from the manner in which the company expects to recover or settle the carrying amount of its assets and liabilities at the reporting date.

Temporary differences are differences between the carrying amounts of assets and liabilities (used in the financial statements) and the corresponding tax bases used in the calculation of taxable profit.

Deferred tax liabilities are recognised for all taxable temporary differences, unless the deferred tax liability arises from

- the initial recognition of goodwill; or
- the initial recognition of an asset and liability in a transaction which
 - is not a business combination; and
 - at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

Deferred tax assets are recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises on the initial recognition of an asset and liability in a transaction which:

- is not a business combination; and
- at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

A deferred tax asset is recognised for the carry forward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.

Current tax

Current tax payable is based on the taxable profit for the year, calculated in terms of the Income Tax Act. Taxable profit differs from the profit for the period as reported in the statement of profit or loss and other comprehensive income, as it excludes items of income or expense that are taxable or deductible in a different period or that are never taxable or deductible. The liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the reporting date.

2. Taxation

2.1 Income tax expense

| | R |
|--|----------------|
| Major components of tax expense | |
| Current tax expense – current year (calculation 2) | 267 120 |
| Deferred tax expense | 566 |
| – Current (calculation 5) | 476 |
| – Change in tax rate (calculation 5) | 90 |
| | <u>267 686</u> |

2.2 Tax rate reconciliation

| | R |
|---|----------------|
| Standard tax (applicable tax)(1) (906 700 x 28%) | 253 876 |
| Exempt differences | |
| Capital allowances on buildings (9 000 x 28%) | 2 520 |
| Donations (15 000 x 28%)(2) | 4 200 |
| Fines for environmental pollution (70 000 x 28%)(3) | 19 600 |
| Dividends received (45 000 x 28%) | (12 600) |
| Adjustments to tax rate (see calculation 5) | 90 |
| Effective tax | <u>267 686</u> |

OR

| | % |
|---|--------------|
| Standard tax rate (applicable tax rate) | 28,00 |
| Exempt differences | |
| Capital allowances on building $((9\ 000/906\ 700) \times 28\% \times 100)$ | 0,28 |
| Donations $((15\ 000/906\ 700) \times 28\% \times 100)$ (2) | 0,46 |
| Fines for environmental pollution (3) $((70\ 000/906\ 700) \times 28\% \times 100)$ | 2,16 |
| Dividends received $((45\ 000/906\ 700) \times 28\% \times 100)$ | (1,39) |
| Adjustments to tax rate $(90/906\ 700 \times 100)$ (5) | 0,01 |
| Effective tax rate $(267\ 686/906\ 700 \times 100)$ | <u>29,52</u> |

The government enacted a change in the tax rate during 20.12 from 29% to 28%.

- (1) Standard tax (should be 28% of profit before tax according to the matching principle).
- (2) Donations – not tax deductible and should be added back.
- (3) Fines for environmental pollution – not tax deductible, should be added back.
- (4) Adjustment to tax rate – the rate was reduced from 29% to 28%, therefore the deferred tax asset in the statement of financial position is reduced (credited) and the tax expense in the statement of profit or loss and other comprehensive income is increased (debited).

3. Deferred tax

Analysis of temporary differences

| | R |
|---|--------------|
| Accelerated depreciation for tax purposes | (2 156) |
| [The difference between the carrying amount and the tax base of the plant and machinery $((277\ 200 - 269\ 500) \times 28\%)$] | |
| Allowance for credit losses | |
| $[(20\ 000 - 5\ 000) \times 28\%]$ | <u>4 200</u> |
| Deferred tax asset | <u>2 044</u> |

EXAMPLE 12

Fox Ltd was incorporated on 1 January 20.11. The profit before tax for the year ended 31 December 20.12 amounted to R410 000.

The following items are included in the calculation of profit before tax:

| | 20.12 R |
|---------------------|------------|
| Depreciation | |
| Plant and machinery | 30 000 |

The South African Revenue Service allows the following deductions:

- Tax allowance on plant 120 000

Additional information

1. During December 20.12 rental amounting to R24 000 was received in respect of January 20.13. The rental is taxable in the tax year ending 31 December 20.12.
2. The assessment for the 20.11 tax year showed an assessed loss of R160 000. This agreed with the records of the company.
3. The company operates in a risky industrial sector and at this early stage of the company's existence, there is no certainty of future taxable income against which tax losses can be utilised.
4. For the 20.11 tax year temporary differences consisted of taxable temporary differences on the plant amounting to R130 000, before taking into account the assessed loss. The cost price of the plant was R300 000 and depreciation on the plant amounted to R30 000 for 20.11.
5. Deferred tax is provided on all temporary differences using the statement of financial position approach. The tax rate for both years is 28%.
6. Assume that the residual value, useful life and depreciation method of all assets were reviewed at each financial year end and that there were no changes.



REQUIRED

- a. Calculate the current tax expense and deferred tax expense of Fox Ltd for 20.12.
- b. Disclose the relevant tax notes to the statement of profit or loss and other comprehensive income and the statement of financial position of Fox Ltd for the year ended 31 December 20.12. Your answer must comply with the requirements of International Financial Reporting Standards. Only the notes required by *IAS 12* must be disclosed. Comparative amounts are not required.

SOLUTION 12

a. Calculation of current tax expense

| | R |
|--|-----------|
| Profit before tax (given) | 410 000 |
| Deductible/(taxable) temporary differences | (66 000) |
| | (120 000) |
| Tax allowance (given) | 30 000 |
| Depreciation (given) | 24 000 |
| Rental received in advance | 344 000 |
| Taxable income | (160 000) |
| Assessed tax loss utilised | 184 000 |
| Taxable income | 51 520 |
| Current tax expense @ 28% | |


Calculation of deferred tax expense

| | Carrying amount R | Tax base R | Temporary differences R | Deferred tax asset/ (liability) R |
|--|----------------------|---------------|----------------------------|---|
| 31 December 20.11 | | | | |
| Plant (1) | 270 000 | 140 000 | 130 000 | (36 400) |
| Assessed tax loss (2) | – | 160 000 | 160 000 | <u>36 400</u> |
| | | | | <u>–</u> |
| 31 December 20.12 | | | | |
| Plant (3) | 240 000 | 20 000 | 220 000 | (61 600) |
| Rental income received in advance | 24 000 | – | 24 000 | <u>6 720</u> |
| | | | | <u>(54 880)</u> |
| Deferred tax liability – 31 December 20.12 | | | | 54 880 |
| Deferred tax liability – 31 December 20.11 | | | | <u>–</u> |
| Deferred tax movement (Dr to P/L) | | | | <u>54 880</u> |

(1) $300\ 000 - 30\ 000 = 270\ 000$; $270\ 000 - 130\ 000$ (given) = 140 000

(2) $160\ 000 \times 28\% = 44\ 800$, but only R36 400 (max) can be recognised before a debit balance is created. R8 400 ($44\ 800 - 36\ 400$) is therefore unprovided

(3) $270\ 000 - 30\ 000 = 240\ 000$; $140\ 000 - 120\ 000 = 20\ 000$

| | |
|---|---|
|  | <p>LECTURER'S COMMENT</p> <p>The assessed loss that only arose during 20.11 amounted to R160 000. A deferred tax asset was recognised in respect of only R130 000 ($R36\ 400/28 \times 100$) of the loss. The remaining R30 000 caused a reconciling item in the tax rate reconciliation, as no deferred tax was provided on it. This will also be the case when the loss is utilised to reduce current tax in 20.12.</p> |
|---|---|

b. Disclosure – IAS 12

FOX LTD

NOTES FOR THE YEAR ENDED 31 DECEMBER 20.12

1. Income tax expense

| | R |
|--|----------------|
| Major components of tax expense | |
| Current tax expense – current year | 51 520 |
| Deferred tax expense – current | <u>54 880</u> |
| | <u>106 400</u> |

| Tax rate reconciliation | R | OR | % |
|--|----------------|-----------|--------------|
| Standard tax (applicable tax) (410 000 x 28%) | 114 800 | | 28,00 |
| Utilisation of unrecognised portion of tax loss (44 800 – 36 400); (44 800 – 36 400)/410 000 x 100) | (8 400) | | (2,04) |
| Effective tax (106 400/410 000 x 100) | <u>106 400</u> | | <u>25,96</u> |

2. Deferred tax

20.12
R

Analysis of temporary differences:

| | | |
|---------------------------------------|--|----------------|
| Accelerated tax allowance (a) | | 61 600 |
| Rental income received in advance (a) | | <u>(6 720)</u> |
| Deferred tax liability | | <u>54 880</u> |

1.9 PROVISIONAL TAX

Provisional taxpayers are required to make and may volunteer advance payments, known as provisional tax payments, on account of their estimated liability for normal tax for a particular year of assessment. All companies are provisional taxpayers.

All provisional taxpayers are obliged to make two obligatory estimates of taxable income for each year of assessment. The first of these estimates must be made on or before the last day of the sixth month of the year of assessment, while the second estimate must be made on or before the last day of the year of assessment.

It is on the basis of these estimates that compulsory payments of provisional tax will be made.

The following journal entry will be made in the company's accounting records on payment of provisional tax:

| | | |
|--|-----------|-----------|
| | Dr | Cr |
| | R | R |
| SA Revenue Service (SFP) | xxx | |
| Bank | | xxx |
| <i>Recording of provisional tax payment.</i> | | |

1.10 THE FORMAL TAX ASSESSMENT AND THE RESULTING OVER/UNDER PROVISION OF CURRENT TAX

After the company has finalised its financial statements and its estimate of its current tax charge for the year, this estimate is submitted to the SA Revenue Service. The SA Revenue Service assesses the estimate made by the company and send a copy of this assessment back to the company.

The assessment shows the tax charge for the whole year according to the tax authority, minus the provisional payments made by the company, leaving a balance owing to, or by the tax authority.

Generally, the current tax that is estimated by the company should equal the actual current tax per the assessment. In some cases, however, the tax authority may not allow the deduction of certain of the expenses claimed, for example. In an instance like this, it will mean that the current income tax charged per the assessment will be greater than the estimate of the current income tax that has been recognised in the company's financial statements.

Since the company receives the assessment after the financial statements have been finalised, the adjustment relating to the tax expense of the previous year has to be processed in the current financial year. The adjustment appears as an under-provision or over-provision of tax in the statement of profit or loss and other comprehensive income. This adjustment is calculated as follows:

| | R |
|--|------------|
| Tax charge per the assessment for year 20.11 (received in year 20.12) | xxx |
| Less current tax estimated for 20.11 and processed in 20.11 statement of profit or loss and other comprehensive income | (xxx) |
| | ----- |
| Under/(over)-provision in 20.11, journalised in 20.12 statement of profit or loss and other comprehensive income | <u>xxx</u> |

The journal entry for an **underprovision** is as follows:

Dr Current tax expense (P/L)
 Cr Current tax payable (SA Revenue Service) (SFP)
The underprovision of tax in year 1 is adjusted in year 2.

The journal entry for an **overprovision** is as follows:

Dr Current tax payable (SA Revenue Service) (SFP)
 Cr Current tax expense (P/L)
The overprovision of tax in year 1 is adjusted in year 2.

EXAMPLE 13

The following is the abridged trial balance of Winny Ltd at 31 July 20.12:

| | Dr R | Cr R |
|---|------------------|------------------|
| Share capital | – | 13 000 |
| Retained earnings – 31 July 20.11 | – | 160 450 |
| Long-term borrowing | – | 550 000 |
| Deferred tax liability – 31 July 20.11 | – | 42 042 |
| Land at cost (it is not depreciated) | 70 000 | – |
| Factory building at cost | 600 000 | – |
| Plant at cost | 250 000 | – |
| Accumulated depreciation – factory building | – | 180 000 |
| Accumulated depreciation – plant | – | 70 000 |
| Investments at fair value | 65 000 | – |
| Prepayments (balance at 31 July 20.11 – Rnil) | 30 000 | – |
| Accounts receivable | 110 000 | – |
| Bank | 137 492 | – |
| Accounts payable | – | 50 000 |
| Profit before tax | – | 227 000 |
| SA Revenue Service – provisional tax payments | 30 000 | – |
| | <u>1 292 492</u> | <u>1 292 492</u> |

Additional information

- The trial balance has not been finalised since the tax computation for the year is still outstanding.
- Included in profit before tax are dividends received of R10 000, fines paid of R2 500 and the total depreciation charge for the year of R85 000.
- The tax base of the property, plant and equipment at 31 July 20.12 is as follows:


| | R |
|--|----------------|
| Land – no allowance is claimable | – |
| Factory building – tax allowance of 20% p.a. straight-line | 240 000 |
| Plant – tax allowance of 16,7% p.a. straight-line | 133 100 |
| | <u>373 100</u> |

The total tax allowances claimable on property, plant and equipment for the year ended 31 July 20.12 are R161 750.

- The company provides for deferred tax on all temporary differences using the statement of financial position approach. There are no other temporary differences except for those mentioned in the question.
- The tax rate remained at 28% for the past two years.
- The long-term borrowing is a mortgage loan financing the land and factory building.

7. There is no assessed tax loss to be carried forward from previous years.
8. The company made the following provisional tax payments:

| | |
|------------------|---------|
| 31 January 20.12 | R15 000 |
| 31 July 20.12 | R15 000 |
9. On 31 October 20.11 the company received the tax assessment for the 20.11 tax year and paid R5 500 in respect of current tax due for the year ended 31 July 20.11.

| | |
|---|---|
|  | <p>REQUIRED</p> <p>PART A</p> <p>Disclose tax in the notes to the annual financial statements of Winny Ltd for the year ended 31 July 20.12 in accordance with the requirements of International Financial Reporting Standards. Accounting policy notes are not required.</p> <p>All calculations must be done to the nearest R1.</p> <p>PART B</p> <p>Prepare the general ledger accounts in respect of tax in the general ledger of Winny Ltd for the year ended 31 July 20.12.</p> |
|---|---|

| |
|---|
| <p>HOW SHOULD YOU ATTEMPT THIS QUESTION?</p> <ol style="list-style-type: none"> 1. Read the "REQUIRED" section. Only tax information for the general ledger accounts and "notes to the financial statements" is required. As soon as you are familiar with what is required, you can start by calculating the amounts to be disclosed. 2. Use the information in the question to calculate current tax. 3. If the current tax calculation leads to an assessed loss, the benefit of the assessed loss should be carried forward to the deferred tax calculation. 4. Calculate the carrying amounts of all assets and liabilities evident from the information. 5. For each asset and liability identified, determine the relevant tax base. 6. Thereafter calculate the temporary differences by taking into account the carrying amount and tax base of each asset and liability. 7. For each temporary difference, determine whether the difference results in a deferred tax asset or a liability. 8. Each temporary difference must then be multiplied with the tax rate. 9. The net deferred tax liability or asset for the current year should then be determined. 10. As soon as the deferred tax liability or asset has been determined for the current year, the deferred tax movement in the statement of profit or loss and other comprehensive income can be calculated as the difference between the opening and closing balance of the deferred tax liability or asset. 11. Disclose tax in the notes to the financial statements according to <i>IAS 12 – Income taxes</i>. 12. Prepare the relevant general ledger accounts. |
|---|

| |
|--------------------|
| SOLUTION 13 |
|--------------------|

PART A**WINNY LTD****NOTES FOR THE YEAR ENDED 31 JULY 20.12****1. Income tax expense****Major components of tax expense**

| | R |
|--|----------|
| Current tax expense: current year (1) | 31 570 |
| Deferred tax expense: current (2) or (106 750 (1) x 28%) | 29 890 |
| | 61 460 |

Tax rate reconciliation

| | R | OR | % |
|--|----------|-----------|----------|
| Standard rate of tax (227 000 x 28%) | 63 560 | | 28,0 |
| Adjusted for exempt differences: | | | |
| Dividends received (10 000 x 28%); [(10 000 / 227 000) x 28% x 100] | (2 800) | | (1,23) |
| Fines (2 500 x 28%); [(2 500 / 227 000) x 28% x 100] | 700 | | 0,31 |
| Effective rate of tax (61 460 / 227 000 x 100) | 61 460 | | 27,08 |

2. Deferred tax**Analysis of temporary differences**

| | R |
|---|----------|
| Accelerated capital allowances for tax purposes (50 400 + 13 132) | 63 532 |
| Prepayment | 8 400 |
| Deferred tax liability (3) | 71 932 |

Calculations**1. Taxable income for the year**

| | R |
|---|-----------|
| Profit before tax | 227 000 |
| Exempt differences | (7 500) |
| Dividends received | (10 000) |
| Fines paid | 2 500 |
| Profit after exempt differences | 219 500 |
| Temporary differences | (106 750) |
| Depreciation | 85 000 |
| Tax allowance | (161 750) |
| Prepayments – deductible for tax purposes | (30 000) |
| Taxable income for the year | 112 750 |
| Current tax expense at 28% | 31 570 |

2. Deferred tax balance

| | Carrying amount R | Tax base R | Temporary differences R | Deferred tax asset/ (liability) @ 28% R |
|---|-------------------------|---------------|-------------------------------|---|
| Factory building | 420 000 ¹ | 240 000 | 180 000 | 50 400 |
| Carrying amount of asset > tax base of asset therefore deferred tax liability @ 28% | | | | |
| Plant | 180 000 ² | 133 100 | 46 900 | 13 132 |
| Carrying amount of asset > tax base of asset therefore deferred tax liability @ 28% | | | | |
| Prepayment | 30 000 | – | 30 000 | 8 400 |
| Carrying amount of asset > tax base of asset therefore deferred tax liability @ 28% | | | | |
| Total deferred tax liability | | | | <u>71 932</u> |

¹ 600 000 – 180 000

² 250 000 – 70 000

Deferred tax movement – current year

| | |
|---|---------------|
| Deferred tax liability at 1 August 20.11 (given) | R 42 042 |
| Temporary differences – current year (balancing figure)(debit to P/L) | <u>29 890</u> |
| Deferred tax liability at 31 July 20.12 | <u>71 932</u> |

PART B

| Dr | | Current tax expense (P/L) | | Cr | | |
|------------|--------------------------|----------------------------------|--|------------|--|--------|
| 31/7/20.12 | SA Revenue Service (SFP) | 31 570 | | 31/7/20.12 | Statement of profit or loss and other comprehensive income | 31 570 |

| Dr | | Deferred tax expense (P/L) | | Cr | | |
|------------|--------------------|-----------------------------------|--|------------|--|--------|
| 31/7/20.12 | Deferred tax (SFP) | 29 890 | | 31/7/20.12 | Statement of profit or loss and other comprehensive income | 29 890 |

| Dr | | SA Revenue Service – current tax (SFP) | | Cr | | |
|-------------|-----------------------|---|--|------------|---------------------------------------|---------------|
| 31/10/20.11 | Bank (20.11 tax year) | 5 500 | | 1/8/20.11 | Opening balance | b/d 5 500 |
| 31/1/20.12 | Bank (20.12 tax year) | 15 000 | | 31/7/20.12 | Current tax expense (20.12 year)(P/L) | 31 570 |
| 31/7/20.12 | Bank (20.12 tax year) | 15 000 | | | | |
| 31/7/20.12 | Closing balance | c/d 1 570 | | | | |
| | | <u>37 070</u> | | | | <u>37 070</u> |
| | | | | 1/8/20.12 | Opening balance | b/d 1 570 |

| Dr | | Deferred tax (SFP) | | Cr | | |
|------------|-----------------|---------------------------|--|------------|----------------------------|---------------|
| 31/7/20.12 | Closing balance | c/d 71 932 | | 1/8/20.11 | Opening balance | b/d 42 042 |
| | | <u>71 932</u> | | 31/7/20.12 | Deferred tax expense (P/L) | 29 890 |
| | | | | | | <u>71 932</u> |
| | | | | 1/8/20.12 | Opening balance | b/d 71 932 |

EXAMPLE 14

The following is an extract from the statement of financial position general ledger accounts of Rigoletto Ltd, a manufacturer of bicycles, for the year ended 29 February 20.12:

| Dr | | SA Revenue Service – current tax | | | Cr | |
|------------|---------------------------|----------------------------------|---------------|------------|--|---------------|
| 31/8/20.11 | Bank (for 20.12 tax year) | | 18 000 | 1/3/20.11 | Opening balance | b/d 7 600 |
| 30/9/20.11 | Bank (for 20.11 tax year) | | 16 000 | 15/8/20.11 | Current tax expense (20.11 tax adjustment) | 8 120 |
| 29/2/20.12 | Bank (for 20.12 tax year) | | 18 000 | 29/2/20.12 | Current tax expense (for 20.12 tax year) | <u>39 900</u> |
| 29/2/20.12 | Closing balance | c/d | 3 620 | | | <u>55 620</u> |
| | | | <u>55 620</u> | 1/3/20.12 | Opening balance | b/d 3 620 |

| Dr | | UK Inland Revenue Service | | | Cr | |
|------------|-----------------|---------------------------|---------------|------------|----------------------------------|---------------|
| 29/2/20.12 | Closing balance | c/d | 21 000 | 29/2/20.12 | Tax expense (for 20.12 tax year) | 21 000 |
| | | | <u>21 000</u> | | | <u>21 000</u> |
| | | | | 1/3/20.12 | Opening balance | b/d 21 000 |


| Dr | | Deferred tax | | | Cr | |
|------------|--|--------------|---------------|------------|---|---------------|
| 1/3/20.11 | Deferred tax expense (rate adjustment) | | 1 500 | 1/3/20.11 | Opening balance | b/d 43 500 |
| 29/2/20.12 | Closing balance | c/d | 50 400 | 29/2/20.12 | Deferred tax expense (for 20.12 tax year) | 8 400 |
| | | | <u>51 900</u> | | | <u>51 900</u> |
| | | | | 1/3/20.12 | Opening balance | b/d 50 400 |

Additional information

1. The SA normal tax rate changed from 29% in 20.11 to 28% in 20.12
2. The deferred tax balance account comprised of a taxable temporary differences relating to an accelerated tax allowance on plant and machinery. Deferred tax is provided for on all temporary differences using the statement of financial position approach.
3. The adjustment in respect of the 20.11 current tax expense relates to the 20.11 tax assessment received on 15 August 20.11. Rigoletto Ltd claimed expenses of R28 000 which were not allowed as a deduction by the SA Revenue Service.
4. The profit before tax for the year ended 29 February 20.12 amounted to R325 000. Included in profit before tax are the following items:

| | R |
|--|----------|
| Donations paid | 5 500 |
| Dividends received – unlisted investment | 20 000 |
| Fines paid on late payment of PAYE | 2 000 |
| Income received from the United Kingdom (UK) | 140 000 |

- The income received from the UK is not taxable in South Africa in terms of a double taxation agreement.
- You can assume that the calculations of current tax and deferred tax in the above general ledger accounts are correct.

| | |
|---|--|
|  | <p>REQUIRED</p> <p>Disclose tax in the notes to the annual financial statements of Rigoletto Ltd for the year ended 29 February 20.12 according to the requirements of <i>IAS 12 – Income taxes</i>. The tax rate reconciliation must be given using R - values only.</p> <p>No calculations of current tax and deferred tax are required.</p> <p>No accounting policy notes are required.</p> <p>No other notes are required.</p> <p>Comparatives are not required.</p> |
|---|--|

SOLUTION 14

RIGOLETTO LTD

NOTES FOR THE YEAR ENDED 28 FEBRUARY 20.12

1. Income tax expense

Major components of tax expense

| | R |
|-----------------------------|----------|
| Current tax expense | 48 020 |
| – current year | 39 900 |
| – underprovision prior year | 8 120 |
| Deferred tax expense | 6 900 |
| – current | 8 400 |
| – rate change | (1 500) |
| Foreign tax | 21 000 |
| | 75 920 |

Tax rate reconciliation

| | R |
|---|----------|
| Standard rate of tax (325 000 x 28%) | 91 000 |
| Adjusted for exempt differences: | |
| Fines (2 000 x 28%) | 560 |
| Foreign income ((140 000 x 28%) – 21 000) | (18 200) |
| Donations (5 500 x 28%) | 1 540 |
| Dividends received (20 000 x 28%) | (5 600) |
| Tax rate change | (1 500) |
| Underprovision prior year | 8 120 |
| | 75 920 |

2. Deferred tax

Analysis of temporary difference:

| | R |
|--|--------|
| Accelerated tax allowance on plant and machinery | 50 400 |

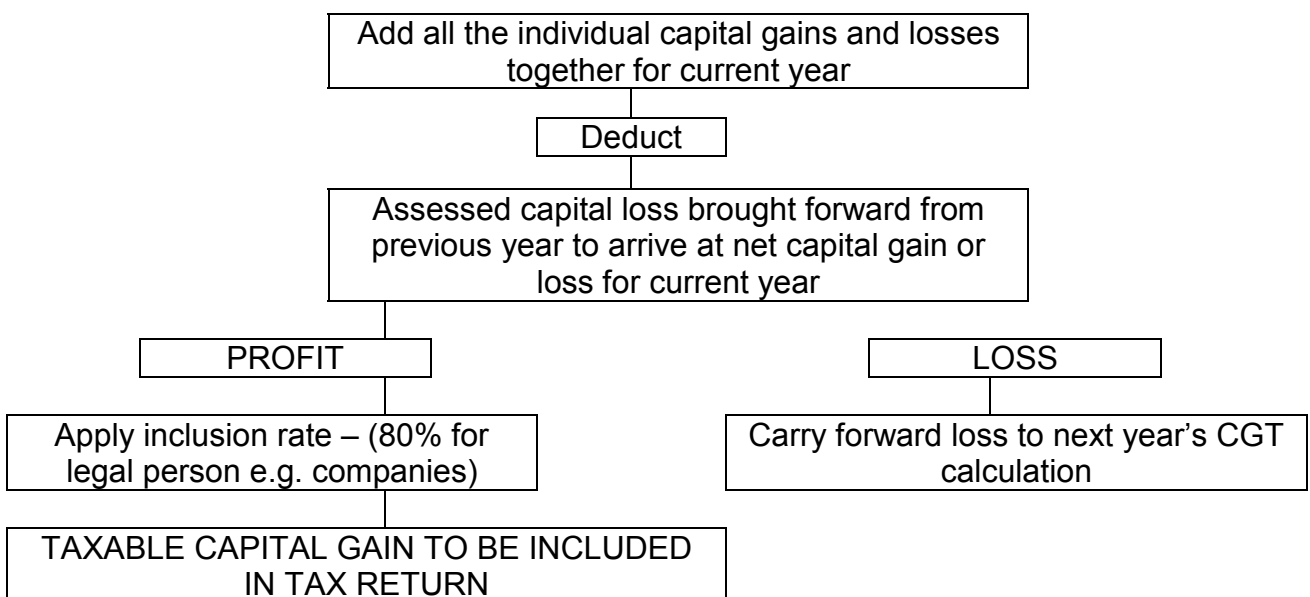
1.11 CAPITAL GAINS TAX ON COMPANIES

General

Capital gains tax (part of current tax) is payable on capital gains realised on assets sold after 1 October 2001. For assets acquired before 1 October 2001, only the part of the gain arising after 1 October 2001 will be subject to capital gains tax. If the portion after 1 October 2001 is a loss, it may be set off against other capital gains during that financial year. If the sum of all the capital gains and capital losses for the financial year results in a capital gain, 80% thereof must be included in the company's taxable income and subjected to tax at a rate of 28%. The effect is thus an effective tax of 22,4%. If the sum of all capital gains and capital losses for the financial year results in a capital loss, that loss must be carried forward to the following year of assessment.

From 1 October 2001 50% of the capital gain arising on the sale of an asset is subject to capital gains tax at the normal tax rate (currently 28%). The capital gains inclusion rate increased to 66,6% from 1 March 2012 and to 80% from 1 March 2016.

Framework for capital gains tax



The capital gain is calculated as the difference between the proceeds on disposal of an asset and the asset's "base cost".

The base cost of the asset acquired **before** 1 October 2001 can be calculated by any of the following methods:

- the market value of the asset on 1 October 2001;
- 20% of the proceeds received; and
- a time-based apportionment basis (the total gain is apportioned over the period the asset was held before and after 1 October 2001).

The base cost of an asset acquired **after** 1 October 2001 should be determined as follows:

Inclusions

- Cost of acquisition
- Cost of moving an asset and improvement cost
- Cost incurred directly in the acquisition or disposal of an asset, such as legal fees, agents' commission, broker's fees, stamp duty, transfer duty, advertising and valuation costs
- Vat paid and not claimed as an input
- Costs of maintaining rights to an asset, such as legal costs

Exclusions

- Holding costs such as interest, repairs and insurance premiums
- All recoverable expenses and expenses deductible for income tax purposes
- Adjustment for inflation

The following steps are followed when capital gains tax is calculated:

- Add all the individual capital gains and losses together for the current year.
- Deduct any assessed capital loss brought forward from previous years to arrive at the net capital gain (increased loss) for the year.
- Multiply the net capital gain with 80% (rate for companies) to arrive at the taxable capital gain to be included in other taxable income in the current tax calculation for the year.

Please note: For exam purposes the capital gains tax inclusion rate of 80% will be used.

EXAMPLE 15

The purpose of this example is not to give a detailed explanation of the determination of capital gains/(losses) for tax purposes (including the calculation of the base cost), but to show the accounting treatment and disclosure of these capital gains.

Fashion Ltd, incorporated on 1 March 20.10, is a manufacturer of quality costume jewellery. The jewellery is distributed through a network of independent consultants throughout South Africa.

The following is an extract of the trial balance of Fashion Ltd for the years ended 28 February 20.11 and 29 February 20.12


| | Dr/(Cr) 20.12 R | Dr/(Cr) 20.11 R |
|--------------------------------------|--|--|
| Profit before tax | (400 000) | (550 000) |
| Machinery at cost | 300 000 | 250 000 |
| Accumulated depreciation – machinery | (37 500) | (37 500) |

Machinery in the above extract of the trial balance includes only machine X which was replaced by machine Y. On 31 August 20.11, the old machine, machine X, was withdrawn from the manufacturing process and was sold for R270 000. The carrying amount and tax base of machine X at the date of the sale amounted to R193 750 and R150 000 respectively. On 1 September 20.11, the new machine, machine Y, with a cost price of R300 000, was brought into use. Depreciation on machine X is written off at 15% per annum according to the straight-line method. The directors decided to depreciate the newly acquired machine Y over four years according to the straight-line method. Included in profit before tax is depreciation on these machines amounting to R56 250 (20.11: R37 500), as well as the profit on the disposal of machine X.

The SA Revenue Service allows a tax allowance of 20% p.a. according to the straight-line method on machinery. The tax allowance is not apportioned on a pro rata basis for periods shorter than a year.

Deferred tax is provided on all temporary differences using the statement of financial position approach. There are no other temporary differences except those mentioned in the question. There is certainty beyond reasonable doubt that there will be sufficient taxable profit in future to utilise tax losses.

The normal tax rate remained unchanged at 28% for the past two years. All capital gains are taxable at 80%.

| | |
|---|---|
|  | <p>REQUIRED</p> <p>(a) Calculate the current tax expense of Fashion Ltd for the years ended 28 February 20.11 and 29 February 20.12.</p> <p>(b) Calculate the deferred tax balance in the statement of financial position of Fashion Ltd for the year ended 29 February 20.12, using the statement of financial position approach, and indicate whether it is an asset or a liability.</p> |
|---|---|

SOLUTION 15

Calculations

a. Current tax expense

| | 20.12 R | 20.11 R |
|---|------------|------------|
| Profit before tax (given) | 400 000 | 550 000 |
| Exempt differences: | | |
| Capital profit on sale of asset (100% – 80%) x (270 000 – 250 000) | (4 000) | – |
| | 396 000 | 550 000 |
| Temporary differences: | | |
| Depreciation (given) | (10 000) | (12 500) |
| Tax allowance | 56 250 | 37 500 |
| [(250 000 x 20%) + (300 000 x 20%)]; (250 000 x 20%) | (110 000) | (50 000) |
| Profit on disposal (250 000 – 193 750) | (56 250) | – |
| Recoupment of tax allowance (250 000 – 150 000) | 100 000 | – |
| Taxable income | 386 000 | 537 500 |
| Current tax expense @ 28% | 108 080 | 150 500 |

b. Deferred tax balance for the year ended 29 February 20.12

| | Carrying amount R | Tax base R | Temporary differences R | Deferred tax asset/ (liability) @ 28% R |
|------------------------|-------------------------|----------------------|-------------------------------|---|
| Machine Y | 262 500 ¹ | 240 000 ² | 22 500 | (6 300) |
| Deferred tax liability | | | | (6 300) |

¹ 300 000 – 37 500 (given)

² 300 000 – (300 000 x 20%)



LECTURER'S COMMENT

If the selling price (SP) (proceeds on sale) is higher than the original cost price (CP) of the asset sold, then

- the difference between the SP and the CP is a capital profit, of which 80% is taxable in the case of companies and which results in an exempt difference; and
- the difference between the CP and the carrying amount (CA) is a profit on sale, which results in a temporary difference.

1.12 DIVIDENDS TAX (Withholding tax on dividends)

OVERVIEW

Dividends tax replaced secondary tax on companies on 1 April 2012. Dividends tax is applicable to any dividend declared on or after 1 April 2012. The relevant legislation has been developed and passed in to the Income Tax Act (refer to sections 64D to 64N of the Income Tax Act No. 58 of 1962). Dividends tax is a tax on the beneficial owners of dividends (normally this will be the shareholder) on the amount of any dividend received from a company. A dividend is defined in section 1 of the Act, but in essence is any payment by a company for the benefit of a shareholder in respect of a share in that company (excluding the return of contributed tax capital, i.e. consideration received by a company for the issue of shares). Dividends are usually given as cash (cash dividend), but they can also take the form of an asset or other property (in specie dividend). The dividends tax is a withholding tax and should be withheld from dividend distributions and paid to SARS by the company paying the dividend or, where the company makes use of a withholding agent, by the latter.

1.12.1 Tax liability

As a general principal, the liability for dividends tax triggered by payment falls on the recipient (i.e. the beneficial owner) of the dividend, and is withheld from the dividend payment by either the company distributing or, where relevant, certain withholding agents. A beneficial owner is a person who is entitled to receive a dividend attaching to a share. In most cases, this person is also the shareholder.

The current dividend tax is 20% effective from 22 February 2017 in respect of dividends distributed by:

- South African resident companies; and
- non-resident companies in respect of shares listed on the JSE Limited.

Prior to 22 February 2017 the dividend tax rate was 15% in respect of dividends distributed by:

- South African resident companies; and
- non-resident companies in respect of shares listed on the JSE Limited.

The dividends tax has to be paid by the end of the month following the month in which the dividend was paid or became payable to the beneficial owner(s).

- Cash dividend – the beneficial owner is liable for paying dividend tax, but the company withholds the tax and pays over the amount to the SA Revenue Service on behalf of the beneficial owner.
- In specie dividend – the company declaring and paying the dividend must pay the dividend tax and not the beneficial owner.

1.12.2 Accounting treatment

EXAMPLE 16

On 28 February 2017, Money Ltd declared and paid a dividend of R1 000 to Mr Own, its only shareholder, for the financial year ended 31 March 2017. The dividend tax was paid by Money Ltd on 10 April 2017 to the SA Revenue Service (SARS).

| | R |
|--|------------|
| Dividend paid in cash | 1 000 |
| Amount paid to shareholder as a dividend | 800 |
| Dividends tax payable by company | - |
| Dividends tax payable by Mr Own (shareholder) | 200 |
| Dividend tax rate | 20% |

The following journal entries are applicable to Money Ltd:

| | | Dr R | Cr R |
|------------------|---|-----------------|-----------------|
| 28 February 2017 | Dividends paid (equity) | 1 000 | |
| | Bank (SFP) | | 800 |
| | SARS – dividends tax payable (SFP) | | 200 |
| | <i>Dividend paid and dividend tax withheld on cash dividend paid.</i> | | |
| 10 April 2017 | SARS – dividends tax payable (SFP) | 200 | |
| | Bank (SFP) | | 200 |
| | <i>Recording of dividends tax paid.</i> | | |

Please note: For exam purposes the dividend tax inclusion rate of 20% will be used.

1.12.3 Dividends tax – exemptions

A company will be exempt from dividends tax if the beneficial owners are any of the following:

- South African resident companies
- Government, provincial administration or municipality organisations
- Public benefit organisations (approved to section 30(3) of the Act)
- Mining rehabilitation trusts (section 37A of the Act)
- Persons referred to in section 10(1)(cA) of the Act
- Section 10(1)(d) funds (such as a pension fund, provident fund, RA or medical scheme)
- Persons referred to in section 10(1)(t) (such as the CSIR and SANRAL)
- Shareholders in a registered micro business (Schedule 6)(in so far as the dividend does not exceed R200 000 per year)
- Non-residents where the dividend is received from a foreign company listed on the JSE Limited (such as a dual listed company)

1.13 FRG 1 – SUBSTANTIVELY ENACTED TAX RATES AND TAX LAWS

1. Background

The minister of finance may announce changes in tax rates and tax laws during the annual budget statement. In terms of *paragraphs .46 and .47 of IAS 12*, both current and deferred tax assets and liabilities are to be measured using the tax rates and tax laws that have been enacted or substantively enacted by the end of the reporting period.

2. Issue

When should changes in tax rates and tax laws that are announced by the minister of finance during the annual budget statement be regarded as substantively enacted?

3. Consensus

- Changes in tax rates should be regarded as substantively enacted from the time that they are announced in the minister of finance's budget statement. However, this only applies to scenarios in which the change in tax rates is not inextricably linked to other changes in the tax laws. To be regarded as substantively enacted there should be the required degree of certainty that the announced changes would be promulgated in a substantially unchanged manner.
- When changes in the tax rates are inextricably linked to other changes in the tax laws, they should be regarded as being substantively enacted when they have been approved by parliament and signed by the president.
- Changes in tax laws other than those covered in the above-mentioned paragraphs should be regarded as being substantively enacted when they have been approved by parliament and signed by the president.
- The changes in tax rates and tax laws should be applied to the period to which they relate. For example, a change in tax rates could be announced during a tax year as being applicable to the following year, in which case the current tax balances in the statement of financial position would be based on the previous tax rate, whereas the deferred tax balance in the statement of financial position would be based on the new tax rate.



LECTURER'S COMMENT

Work through the illustrative examples and disclosure guidance with specific reference to *IE4–IE6* of *FRG 1*.



ASSESSMENT CRITERIA

Are you now able to do the following?

- Calculate the current tax expense of a company.
- Explain the difference between exempt and temporary differences.
- Calculate deferred tax of a company using the statement of financial position approach.
- Disclose deferred and current tax properly in the annual financial statements of companies in accordance with International Financial Reporting Standards.
- Calculate and disclose dividends tax in the accounting records of a company.

LEARNING UNIT 2

**ACCOUNTING POLICIES,
CHANGES IN ACCOUNTING
ESTIMATES AND ERRORS
(IAS 8)**



LEARNING OUTCOMES

Learners should be able to calculate, select and disclose the effects of accounting policies, changes in accounting estimates and errors in accordance with the requirements of International Financial Reporting Standards.

OVERVIEW

This learning unit is divided into the following:

- 2.1 Definitions
- 2.2 Accounting policies
 - 2.2.1 Selection and application of accounting policies
 - 2.2.2 Changes in accounting policies
 - 2.2.3 Disclosure
- 2.3 Changes in accounting estimates
 - 2.3.1 Accounting treatment of a change in accounting estimates
 - 2.3.2 Disclosure
- 2.4 Errors
 - 2.4.1 Prior period errors
 - 2.4.2 Retrospective correction of errors
 - 2.4.3 Disclosure
- 2.5 Summary of changes in accounting policies, changes in accounting estimates and errors

STUDY

PRESCRIBED

Descriptive accounting
Chapter 6

RECOMMENDED

A Guide Through IFRS
IAS 8 – Accounting policies, Changes in accounting estimates and errors

OVERVIEW OF THE LEARNING UNIT

The objective of this learning unit is to prescribe the criteria for selecting and changing accounting policies, together with the accounting treatment and disclosures of changes in accounting policies, changes in accounting estimates and corrections of errors. *IAS 8* is intended to enhance the relevance and reliability of an entity's financial statements, and the comparability of those financial statements over time and with the financial statements of other entities.

2.1 DEFINITIONS

The following are terms used in *IAS 8.5* and their definitions:

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

A change in accounting estimate is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, which results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and accordingly are not corrections of errors.

Material omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

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

- (a) was available when financial statements for those periods were authorised for issue; and
- (b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

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

Retrospective restatement is correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error has never occurred.

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

- (a) applying the new accounting policy to transactions, other events and conditions occurring after the date at which the policy is changed; and
- (b) recognising the effect of the change in the accounting estimate in the current and future periods affected by the change.

2.2 ACCOUNTING POLICIES

2.2.1 Selection and application of accounting policies

When a statement or an interpretation specifically applies to a transaction, another event or a condition, the accounting policy or policies applied to that item must be determined by applying the statement or interpretation and considering any relevant Implementation Guidance issued by the International Accounting Standards Board for the statement or interpretation.

In the absence of a statement, management must use its judgement in developing and applying an accounting policy that results in information that is

- relevant to the economic decision-making needs of users; and
- reliable, in that the financial statements
 - represent faithfully the financial position, financial performance and cash flows of the entity;
 - reflect the economic substance of transactions, other events and conditions, and not merely the legal form;
 - are neutral, that is free from bias;
 - are prudent; and
 - are complete in all material respects (*IAS 8.10*).

The accounting policies must be consistently applied for similar transactions, other events and conditions, unless a statement or interpretation requires categorisation of items for which different policies may be appropriate (*IAS 8.13*).

The accounting policies should be stated clearly, fairly and briefly by way of a note to the annual financial statements, with the heading "Accounting policies". This note is the first note to the annual financial statements.

2.2.2 Changes in accounting policies

A change in accounting policy should only be made if

- required by a statement or an interpretation; or
- it 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*).

(a) Change in accounting policy due to initial adoption of statement or interpretation

If the change in accounting policy is required due to the initial application of a statement or interpretation, the change should be accounted for in accordance with the transitional provisions of that statement or interpretation. If no transitional provisions are supplied, the change should be accounted for retrospectively (*IAS 8.19(a) and (b)*).

(b) Voluntary change in accounting policy

If the change in accounting policy is made to reflect more relevant and reliable information (a voluntary change in accounting policy), the change should be accounted for retrospectively (*IAS 8.19b*).

(c) Retrospective application

When a change in accounting policy is applied retrospectively, the entity adjusts the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy has always been applied (*IAS 8.22*).

(d) Prospective application

When it is impracticable to determine the cumulative effect at the beginning of the current period for all prior periods, the entity must adjust the comparative information to apply the new accounting policy prospectively from the earliest date practicable (*IAS 8.25*).

2.2.3. Disclosure**(a) Application of IAS 1**

The revised *IAS 1.40A* has introduced a requirement to include a third statement of financial position as at the beginning of the preceding period whenever an entity

- retrospectively applies an accounting policy;
- makes a retrospective restatement of items in its financial statements;
- reclassifies items in its financial statements; and
- such adjustments have a material effect on the information in the statement of financial position at the beginning of the preceding period.

In the above circumstances, an entity is required to present a minimum of three statements of financial position, together with the related notes. A statement of financial position must be prepared as at

- the end of the current period;
- the end of the preceding period; and
- the beginning of the preceding period (*IAS1.40B*).

(b) Initial application of a statement or interpretation

The following should be disclosed if an initial application of a statement or interpretation has an effect on the current period or any prior period presented, or may have an effect on future periods:

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

- when applicable, a description of the transitional provisions;
- when applicable, the transitional provisions that might have an effect on future periods;
- 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 for basic and diluted earnings per share, if presented as per IAS 33;
- 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 (*IAS 8.28*).

Financial statements of subsequent periods need not repeat these disclosures.

(c) Voluntary change

The following should be disclosed if a voluntary change has an effect on the current period or any prior period presented, or may have an effect on future periods:

- 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 for basic and diluted earnings per share, if presented as per IAS 33;
- 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 (*IAS 8.29*).

Financial statements of subsequent periods need not repeat these disclosures.

Examples 1 and 2 are both examples of changes in accounting policy applied retrospectively.

EXAMPLE 1

The following information is an extract from the books of Elegance Ltd at 30 September 20.12. The company is involved in the manufacturing and selling of furniture and curtains.

| | 20.12 Dr/(Cr) R | 20.11 Dr/(Cr) R |
|--|--|--|
| Sales of furniture | (452 000) | (300 000) |
| Sales of curtains | (145 000) | (65 000) |
| Cost of sales | 225 580 | 221 000 |
| Interest received on staff loans | (4 800) | - |
| Retained earnings at beginning of year | (223 350) | (150 000) |
| Loss on sale of machinery (Tax loss of machinery: R3 000) | 3 000 | - |
| Advertising expenses | 24 000 | 15 000 |
| Bad debts written back (SA Revenue Service: R6 200) | (6 200) | - |
| Loss as a result of the expropriation of land (Not deductible for tax purposes) | 37 880 | - |
| Current tax expense | 99 518 | 36 120 |
| Dividends paid | 25 000 | 10 500 |

Additional information

1. Assume that the calculation of the current tax expense is correct.
2. After the afore-mentioned information had been obtained from the books of the company, the directors of the company decided to change the accounting policy with respect to the valuation of inventory. Elegance Ltd previously accounted for its inventory on the last-in, first-out (LIFO) method, but it has changed its policy of accounting for inventory to the first-in, first-out (FIFO) method in order to comply with the requirements of the accounting statement that disallows the use of the LIFO method of inventory valuation.

The value of inventory based on the two methods was as follows:

| At 30 September | 20.09 R | 20.10 R | 20.11 R | 20.12 R |
|------------------------|--------------------------|--------------------------|--------------------------|--------------------------|
| LIFO | 45 000 | 62 500 | 32 000 | 26 000 |
| FIFO | 48 500 | 67 000 | 37 500 | 33 700 |

3. Assume that all amounts are material and that the tax rate has remained unchanged at 28%. **The SA Revenue Service will not reopen the previous years' tax assessments, but the new policy will be accepted for tax purposes.**
4. The implications of capital gains tax and dividends tax should be ignored.



REQUIRED

Prepare the statement of profit or loss and other comprehensive income (expenses by function), the statement of changes in equity (only retained earnings section) and notes thereto of Elegance Ltd for the year ended 30 September 20.12 in accordance with International Financial Reporting Standards.

SOLUTION 1

ELEGANCE LTD

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 SEPTEMBER 20.12

| | Notes | 20.12 R | 20.11 R |
|--|-------|------------------------|------------------------|
| Revenue | | 597 000 ¹ | 365 000 ¹ |
| Cost of sales | | (223 380) ² | (220 000) ² |
| Gross profit | | 373 620 | 145 000 |
| Other expenses | | (58 680) ³ | (15 000) |
| Other investment income | | 4 800 | – |
| Profit before tax (1) | 2 | 319 740 | 130 000 |
| Income tax expense | 3 | (100 134) | (36 400) |
| PROFIT FOR THE YEAR | | 219 606 | 93 600 |
| TOTAL COMPREHENSIVE INCOME FOR THE YEAR | | 219 606 | 93 600 |

¹ (452 000 + 145 000); (300 000 + 65 000)

² (225 580 – 2 200(2)); (221 000 – 1 000(2))

³ (24 000 – 6 200 + 3 000 + 37 880)

ELEGANCE LTD

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 30 SEPTEMBER 20.12

| | Note | Retained earnings R |
|--|------|------------------------|
| Balance at 1 October 20.10 | | 150 000 |
| Changes in equity for 20.10 | | |
| Change in accounting policy (2) | 4 | 3 240 |
| Restated balance | | 153 240 |
| Total comprehensive income for the year (restated) | | 93 600 |
| Dividends | | (10 500) |
| Balance at 30 September 20.11 | | 236 340 |
| Changes in equity for 20.12 | | |
| Total comprehensive income for the year | | 219 606 |
| Dividends | | (25 000) |
| Balance at 30 September 20.12 | | 430 946 |

ELEGANCE LTD**NOTES FOR THE YEAR ENDED 30 SEPTEMBER 20.12****1. Accounting policy**

The financial statements have been prepared in accordance with International Financial Reporting Standards.

The financial statements have been prepared on the historical cost basis, as modified by the revaluation of land and buildings, investment property and financial assets and financial liabilities at fair value.

They incorporate the following principal accounting policies which are consistent with the policies applied in previous years, except where otherwise stated.

1.1 Revenue

Revenue is recognised at the fair value of the consideration received or receivable. Revenue represents the transfer of promised goods and services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. Revenue is recognised from contracts with customers when performance obligations are satisfied.

Interest is recognised on a time proportion basis.

1.2 Inventory

Inventory is valued on the first-in, first-out method of inventory valuation, at the lower of cost or net realisable value.

1.3 Taxation

Current and deferred tax are recognised as income or expenses and included in profit or loss for the period, except when the tax relates to items that are recognised outside profit or loss. Tax, which relates to items that are recognised in other comprehensive income, is also recognised in other comprehensive income. Tax, which relates to items that are recognised directly in equity, is also recognised directly in equity.

Deferred taxation

Deferred tax is generally recognised for all temporary differences using the statement of financial position approach and based on tax rates that have been enacted or substantively enacted by the reporting date. The measurement of deferred tax reflects the tax consequences that would follow from the manner in which the company expects to recover or settle the carrying amount of its assets and liabilities at the reporting date.

Temporary differences are differences between the carrying amounts of assets and liabilities (used in the financial statements), and the corresponding tax bases used in the calculation of taxable profit.

Deferred tax liabilities are recognised for all taxable temporary differences, unless the deferred tax liability arises from:

- the initial recognition of goodwill; or
- the initial recognition of an asset and liability in a transaction which:
 - is not a business combination; and
 - at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

Deferred tax assets are recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises on the initial recognition of an asset and liability in a transaction which

- is not a business combination; and
- at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

A deferred tax asset is recognised for the carrying forward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.

Current tax

Current tax payable is based on the taxable profit for the year, calculated in terms of the Income Tax Act. Taxable profit differs from the profit for the period as reported in the statement of profit or loss and other comprehensive income, as it excludes items of income or expense that are taxable or deductible in a different period or that are never taxable or deductible. The liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the reporting date.

2. Profit before tax

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

| | 20.12 | 20.11 |
|------------------------------|--------------|--------------|
| | R | R |
| Income | | |
| Income from sale of goods | 597 000 | 365 000 |
| Bad debts written back | 6 200 | – |
| Expenses | | |
| Loss – sale of machinery | 3 000 | – |
| Loss – expropriation of land | 37 880 | – |

3. Income tax expense

| | 20.12 | 20.11 |
|---|----------------|---------------|
| | R | R |
| Major components of tax expense | | |
| Current tax expense – current year [99 518 + 2 156 (2)] | 101 674 | 36 120 |
| Deferred tax expense – current (3) | (1 540) | 280 |
| | <u>100 134</u> | <u>36 400</u> |

4. Change in accounting policy

During the year, the company changed its accounting policy on the valuation of inventory. Elegance Ltd previously accounted for its inventory on the last-in, first-out (LIFO) method, but has changed its policy of accounting for inventory to the first-in, first-out (FIFO) method in order to comply with the new accounting statement that disallows the use of the LIFO method of inventory valuation.

This change in accounting policy has been accounted for retrospectively and the comparative amounts have been appropriately restated.

The effect of this change is as follows:

| | 20.12 | 20.11 | 1/10/20.10 |
|---|--------------|--------------|-------------------|
| | R | R | R |
| Decrease in cost of sales (2) | 2 200 | 1 000 | |
| Increase in taxation expense (2 200 x 28%); (1 000 x 28%) | <u>(616)</u> | <u>(280)</u> | |
| Increase in profit | <u>1 584</u> | <u>720</u> | |
| Increase in inventory (2) | 7 700 | 5 500 | 4 500 |
| Increase in current tax due (7 700 x 28%) | (2 156) | - | - |
| Increase in deferred tax liability (5 500 x 28%);(4 500 x 28%) | - | (1 540) | (1 260) |
| Increase in equity | <u>5 544</u> | <u>3 960</u> | <u>3 240</u> |
| Adjustment to retained earnings at beginning of year 20.11 4 500 – (4 500 x 28%) | | | <u>3 240</u> |

Calculations

1. Profit before tax

| | 20.12 | 20.11 |
|--|----------------------|----------------------|
| | R | R |
| Gross profit for the year | 371 420 ¹ | 144 000 ² |
| Adjustment – change in accounting policy (inventory) (2) | <u>2 200</u> | <u>1 000</u> |
| | 373 620 | 145 000 |
| Interest received | 4 800 | - |
| Loss on sale of machinery | (3 000) | - |
| Advertising expenses | (24 000) | (15 000) |
| Bad debts written back | 6 200 | - |
| Loss – expropriation of land | <u>(37 880)</u> | <u>-</u> |
| | <u>319 740</u> | <u>130 000</u> |

¹ 452 000 + 145 000 – 225 580

² 300 000 + 65 000 – 221 000

2. Change in accounting policy

| At 30 September | 20.10 | Differ- ence | 20.11 | Differ- ence | 20.12 |
|---|-----------------|-----------------|-----------------|-----------------|-----------------|
| | R | R | R | R | R |
| FIFO (new policy) | 67 000 | | 37 500 | | 33 700 |
| LIFO (old policy) | <u>(62 500)</u> | | <u>(32 000)</u> | | <u>(26 000)</u> |
| Increase in profit before tax due to increase in closing inventory | 4 500 | 1 000 | 5 500 | 2 200 | 7 700 |
| Income tax expense | <u>(1 260)</u> | <u>(280)</u> | <u>(1 540)</u> | <u>(616)</u> | <u>(2 156)</u> |
| Increase in profit after tax due to increase in closing inventory | <u>3 240</u> | <u>720</u> | <u>3 960</u> | <u>1 584</u> | <u>5 544</u> |

3. Current tax and deferred tax – calculations and explanations

3.1 20.10

| | Carrying amount | Tax base | Temporary difference |
|-------------------------|--------------------|---------------|-------------------------|
| | R | R | R |
| Closing inventory 20.10 | <u>67 000</u> | <u>62 500</u> | <u>4 500</u> |

The carrying amount of the asset is greater than the tax base that will result in an increase in taxable income in future years. Provide for a deferred tax liability of R1 260 (4 500 x 28%).

Journal to provide for deferred tax liability for 20.10:

| | Dr R | Cr R |
|---|---------|--------------|
| Deferred tax (P/L) | 1 260 | |
| Deferred tax liability (SFP) | | 1 260 |
| | | R |
| Deferred tax closing balance 30 September 20.10 | | 1 260 |
| Deferred tax opening balance 30 September 20.09 | | – |
| Deferred tax movement (Dr to P/L) | | <u>1 260</u> |

3.2 20.11

| | Carrying amount | Tax base | Temporary difference |
|-------------------------|--------------------|---------------|-------------------------|
| | R | R | R |
| Closing inventory 20.11 | <u>37 500</u> | <u>32 000</u> | <u>5 500</u> |

The carrying amount of the asset is greater than the tax base, which will result in an increase in taxable income in future years. The deferred tax liability will have to be increased to R1 540 (5 500 x 28%). R1 260 has already been provided for in 20.10. Thus the journal to provide for deferred tax for 20.11 is:

| | Dr R | Cr R |
|---|-----------------|-----------------|
| Deferred tax (P/L) (1 540 – 1 260) | 280 | |
| Deferred tax liability (SFP) | | 280 |
| | | R |
| Deferred tax closing balance 30 September 20.11 | | 1 540 |
| Deferred tax opening balance 30 September 20.10 | | <u>(1 260)</u> |
| Deferred tax movement (Dr to P/L) | | <u>280</u> |

3.3 20.12

| | Carrying amount R | Tax base R | Temporary difference R |
|-------------------------|----------------------------------|---------------------------|---------------------------------------|
| Closing inventory 20.12 | <u>33 700</u> | <u>33 700</u> | <u>Nil</u> |

**LECTURER'S COMMENT**

If the SA Revenue Service does **not** accept the new inventory valuation method, then the tax base of closing inventory in 20.12 is R26 000.

The carrying amount and tax base are equal and no deferred tax liability exists. Deferred tax provided in previous years on the asset (closing inventory) therefore has to be reversed. The journal for the reversal of the deferred tax liability is:

| | Dr R | Cr R |
|---|-----------------|-----------------|
| Deferred tax liability (SFP) | 1 540 | |
| Deferred tax (P/L) | | 1 540 |
| | | R |
| Deferred tax closing balance 30 September 20.12 | | – |
| Deferred tax opening balance 30 September 20.11 | | <u>1 540</u> |
| Deferred tax movement (Cr. to P/L) | | <u>1 540</u> |



LECTURER'S COMMENT

Before answering a question about the change in accounting policy it is important to determine the following:

1. Would the SA Revenue Service reopen the previous years' tax assessments?
2. Would the SA Revenue Service accept the new accounting policy?

In this question, the change in accounting policy is accepted by the SA Revenue Service, but the question states that the previous years' assessment will not be reopened. Normally, when the SA Revenue Service accepts the change in accounting policy and is prepared to reopen the previous years' assessments, there will be no deferred tax implication as the tax base of the closing inventory will be equal to the carrying amount of closing inventory. The current tax of each year will then be adjusted with the tax effect of the change in accounting policy.

However, in this example the correction of the tax effect of the change in accounting policy affects deferred tax because the carrying amount and tax base of closing inventory differ for the 20.10 and 20.11 tax years, as can be seen above

Deferred tax in the statement of profit or loss and other comprehensive income is debited in 20.10 with R1 260, which resulted in an opening retained earnings adjustment in 20.11 of R3 240 (4 500 – 1 260). In 20.11, deferred tax in the statement of profit or loss and other comprehensive income is debited with R280, which brought the total provision for deferred tax in the statement of financial position to R1 540 at the end of 20.11. In 20.12, the SA Revenue Service taxes Elegance Ltd on the total increase in profit as part of current tax **because the previous years' assessments have not been reopened.**

Current tax in 20.12 increases with R2 156 $[(4\ 500 + 1\ 000 + 2\ 200) \times 28\%]$ of which R1 540 has already been provided for as deferred tax in the 20.10 and 20.11 years. Deferred tax in the statement of profit or loss and other comprehensive income is now credited/reversed to bring the tax expense in the statement of profit or loss and other comprehensive income in line with profit before tax.

The calculation of SA normal taxation in the statement of profit or loss and other comprehensive income for 20.12 is as follows:

| | R |
|---|----------------------|
| Current taxation as previously reported | 99 518 |
| Current taxation increase due to increase in profit (only taxed by the SA Revenue Service in the current year) $[(4\ 500 + 1\ 000 + 2\ 200) \times 28\%]$ | 2 156 |
| | <hr/> |
| | 101 674 |
| Reversal of deferred taxation already provided for | (1 540) |
| SA normal taxation 20.12 | <hr/> <u>100 134</u> |

The calculation of SA normal taxation in the statement of profit or loss and other comprehensive income for 20.11 is as follows:

| | |
|---|---------------|
| | R |
| Current taxation as previously reported | 36 120 |
| Deferred taxation (3.2) | 280 |
| | <u>36 400</u> |

2.3 CHANGES IN ACCOUNTING ESTIMATES

2.3.1 Accounting treatment of a change in accounting estimates

As a result of the uncertainties inherent in business activities, many items in financial statements cannot be measured with precision but can only be estimated. Examples of estimates are as follows:

- bad debts;
- obsolete inventory;
- 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.

The effect of a change in accounting estimate should be included in the determination of net profit or loss prospectively in

- the period of the change, if the change effects that period only; or
- the period of the change and future periods, if the change affects both (*IAS 8.36*).

The useful life of any item of property, plant and equipment and the depreciation method that is applied, should be revised periodically. When it is apparent that an adjustment is required in either of the two cases, the adjustment is treated as **a change in estimate** in agreement with *IAS 8*. The depreciation charges for the current and future periods are adjusted and no adjustment is made to the depreciation charges of prior years.

Should it happen that a change in an accounting estimate gives rise to changes in assets and liabilities (without affecting equity), or relates to an item of equity (such as a revaluation reserve), the change should be accounted for by adjusting the carrying amount of the related asset, liability or equity item in the period of the change, instead of adjusting profit or loss (*IAS 8.37*).

2.3.2 Disclosure

Changes in accounting estimates can be disclosed in two ways, namely

- by including them in the profit or loss from operating activities without disclosing them separately, where the effect is not material; or
- by including them in operating activities and disclosing them separately for items that require separate disclosure in terms of *IAS 8*.

The following should be disclosed in respect of changes in accounting estimates:

- the nature of the change;
- the amount of the change; and
- the effect on future periods, if practicable to estimate, otherwise a statement that the future effect is impracticable to estimate (*IAS 8.39–.40*).

A change of estimate made in the current period need not again be disclosed separately in future periods.

EXAMPLE 2

Rekbel Ltd commenced business on 1 January 20.09, at which date machinery to the value of R1 000 000 was purchased. The expected useful life at this date was 11 years.

Machinery is depreciated on the reducing balance method at 20% per annum. During December 20.12 the directors decided to change this method to the straight-line method. For purposes of this question you may assume that for each year a tax rate of 28% on taxable income is applicable. Net profit and taxable income earned for the years ended 20.11 and 20.12 amounted to R435 000 and R490 000 respectively, before providing for depreciation. The SA Revenue Service does not apply the new method for tax purposes and calculates the tax allowance at 20% per annum on the reducing balance method. Dividends amounting to R100 000 were declared in both years. Retained earnings at 31 December 20.10 were R223 000. Ignore the implications of dividends tax.



REQUIRED

Prepare the statement of profit or loss and other comprehensive income, the statement of changes in equity (only retained earnings section) and notes thereto for the year ended 31 December 20.12 for Rekbel Ltd. Your answer must comply with the requirements of International Financial Reporting Standards.

SOLUTION 2

REKBEL LTD

EXTRACT FROM THE STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.12

| | Notes | 20.12 R | 20.11 R |
|--|-------|-----------------------|-----------------------|
| Profit before tax (2) | 2 | 426 000 | 307 000 |
| Income tax expense | 3 | (119 280) | (85 960) |
| PROFIT FOR THE YEAR | | <u>306 720</u> | <u>221 040</u> |
| TOTAL COMPREHENSIVE INCOME FOR THE YEAR | | <u><u>306 720</u></u> | <u><u>221 040</u></u> |

REKBEL LTD**EXTRACT FROM STATEMENT OF CHANGES IN EQUITY FOR THE YEARS ENDED 31 DECEMBER 20.11 AND 20.12:**

| | Retained earnings R |
|---|------------------------------------|
| Balance at 1 January 20.11 | 223 000 |
| Changes in equity for 20.11 | |
| Total comprehensive income for the year | 221 040 |
| Dividends | (100 000) |
| Balance at 31 December 20.11 | <u>344 040</u> |
| Changes in equity for 20.12 | |
| Total comprehensive income for the year | 306 720 |
| Dividends | (100 000) |
| Balance at 31 December 20.12 | <u><u>550 760</u></u> |

REKBEL LTD**NOTES FOR THE YEAR ENDED 31 DECEMBER 20.12****1. Accounting policy**

The financial statements have been prepared in accordance with International Financial Reporting Standards.

The financial statements have been prepared on the historical cost basis, as modified by the revaluation of land and buildings, investment property, financial assets and financial liabilities at fair value.

They incorporate the following principal accounting policies that are consistent with the policies applied in previous years, except where otherwise stated.

1.1 Property, plant and equipment

Property, plant and equipment are initially recognised at cost price. Property, plant and equipment are subsequently measured at cost less accumulated depreciation and accumulated impairment losses. Depreciation is provided for on the straight-line method over the expected useful life of the asset. The remaining useful life of the machinery at 31 December 20.12 is seven years. This represents a change in accounting estimate as the asset has previously been written off at 20% on the reducing balance basis. The residual values and estimated lives of all items of property, plant and equipment are reviewed and adjusted, if necessary, at the end of each reporting period.

1.2 Taxation

Current and deferred taxes are recognised as income or expenses and included in profit or loss for the period, except when the tax relates to items that are recognised outside profit or loss. Tax, which relates to items that are recognised in other comprehensive income, is also recognised in other comprehensive income. Tax, which relates to items that are recognised directly in equity, is also recognised directly in equity.

Deferred taxation

Deferred tax is generally recognised for all temporary differences using the statement of financial position approach and based on tax rates that have been enacted or substantively enacted by the reporting date. The measurement of deferred tax reflects the tax consequences that would follow from the manner in which the company expects to recover or settle the carrying amount of its assets and liabilities at the reporting date.

Temporary differences are differences between the carrying amounts of assets and liabilities (used in the financial statements) and the corresponding tax bases used in the calculation of taxable profit.

Deferred tax liabilities are recognised for all taxable temporary differences, unless the deferred tax liability arises from

- the initial recognition of goodwill; or
- the initial recognition of an asset and liability in a transaction which:
 - is not a business combination; and
 - at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

Deferred tax assets are recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises on the initial recognition of an asset and liability in a transaction which

- is not a business combination; and
- at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

A deferred tax asset is recognised for the carrying forward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.

Current tax

Current tax payable is based on the taxable profit for the year, calculated in terms of the Income Tax Act. Taxable profit differs from the profit for the period as reported in the statement of profit or loss and other comprehensive income, as it excludes items of income or expense that are taxable or deductible in a different period or that are never taxable or deductible. The liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the reporting date.

2. Profit before tax

The profit before tax includes the following item:

| | 20.12 | 20.11 |
|---|--------------|--------------|
| | R | R |
| Depreciation on property, plant and equipment | 64 000 | 128 000 |

Included in depreciation for 20.12 is a change in estimate of R38 400, arising from the decision to depreciate machinery on the straight line method instead of the reducing balance method. This change will result in an increase* of depreciation in future periods of R38 400.

* The change in estimate will result in an increase in depreciation in the future because the carrying amount of the machinery calculated according to the new depreciation method is greater than the carrying amount of machinery calculated according to the old depreciation method.

Carrying amount of machinery according to old method

(512 000 – 102 400) = R409 600

Carrying amount of machinery according to new method

(512 000 – 64 000) = R448 000

3. Income tax expense

| | 20.12 | 20.11 |
|--|----------------|---------------|
| | R | R |
| Major components of tax expense | | |
| Current tax expense – current year (3) | 108 528 | 85 960 |
| Deferred tax expense – current (1) | 10 752 | – |
| | <u>119 280</u> | <u>85 960</u> |

Calculations

1. Schedule of depreciation and wear and tear

| Year ended 31 December | Carrying amount R | Tax base R | Tem- porary differ- ences R | Deferred tax R |
|--|-------------------------|------------------|---|----------------------|
| Cost | 1 000 000 | 1 000 000 | – | – |
| 20.09 Depreciation | (200 000) | (200 000) | – | – |
| Balance – 31 December 20.09 | <u>800 000</u> | <u>800 000</u> | – | – |
| 20.10 Depreciation | (160 000) | (160 000) | – | – |
| Balance – 31 December 20.10 | <u>640 000</u> | <u>640 000</u> | – | – |
| 20.11 Depreciation | (128 000) | (128 000) | – | – |
| Balance – 31 December 20.11 | <u>512 000</u> | <u>512 000</u> | – | – |
| 20.12 Depreciation (512 000 / 8); (512 000 x 20%) | (64 000) | (102 400) | 38 400 | 10 752 |
| Balance – 31 December 20.12 | <u>448 000</u> | <u>409 600</u> | <u>38 400</u> | <u>10 752</u> |

The carrying amount of machinery is greater than the tax base of machinery on 31 December 20.12, which will result in taxable profit in future years. A deferred tax liability of R10 752 (R38 400 x 28%) must be provided. The journal to provide for the deferred tax liability is as follows:

| | Dr R | Cr R |
|------------------------------|---------|---------|
| Deferred tax (P/L) | 10 752 | |
| Deferred tax liability (SFP) | | 10 752 |

2. Profit before tax

| | 20.12 | 20.11 |
|------------------------------------|----------------|----------------|
| | R | R |
| Profit for the year – given | 490 000 | 435 000 |
| Depreciation: Straight-line method | (64 000) | – |
| : Reducing balance method | – | (128 000) |
| | <u>426 000</u> | <u>307 000</u> |

3. Current taxation

| | 20.12 | 20.11 |
|---|----------------|----------------|
| | R | R |
| Profit for the year before depreciation | 490 000 | 435 000 |
| Tax allowance | (102 400) | (128 000) |
| Taxable income | <u>387 600</u> | <u>307 000</u> |
| Tax payable @ 28% | <u>108 528</u> | <u>85 960</u> |

2.4 ERRORS

2.4.1 Prior period errors

Errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Financial statements do not comply with International Financial Reporting Standards if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows. Potential current period errors discovered in that period are corrected before the financial statements are authorised for issue. However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period (*IAS 8.41*).

Errors that relate to a prior period but are discovered in the current period normally arise from the following type of situations:

- mathematical miscalculations;
- misinterpretation of facts;
- fraud; and
- the incorrect application of an accounting policy.

2.4.2 Retrospective correction of errors

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

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

2.4.3 Disclosure

Disclosures concerning the correction of prior period errors need only be presented in the year of the correction and not in subsequent periods, and consist of the following:

- the nature of the prior period error;
- for each prior period presented, to the extent practicable, the amount of the correction for each financial statement line item affected and for basic and diluted earnings per share, if presented; as per *IAS 33*;

- the amount of the correction at the beginning of the earliest prior period presented; and
- if retrospective restatement is impracticable for a particular prior period, the circumstances that led to the existence of that condition and a description of how and from when the error has been corrected (*IAS 8.49*).

The following is an example of a retrospective correction of prior period errors.

EXAMPLE 3

The following information of Cirrus Ltd is available for the years ended 31 December 20.11 and 20.12:

CIRRUS LTD

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.12

| | 20.12 | 20.11 |
|--|------------------|-----------------|
| | R | R |
| Profit before tax | 422 000 | 300 000 |
| Income tax expense | <u>(118 160)</u> | <u>(84 000)</u> |
| PROFIT FOR THE YEAR | <u>303 840</u> | <u>216 000</u> |
| TOTAL COMPREHENSIVE INCOME FOR THE YEAR | <u>303 840</u> | <u>216 000</u> |

CIRRUS LTD

EXTRACT FROM THE STATEMENT OF CHANGES IN EQUITY FOR THE YEARS ENDED 31 DECEMBER 20.11 AND 20.12

| | Retained earnings |
|---|--------------------------|
| | R |
| Balance at 1 January 20.11 | 168 000 |
| Changes in equity for 20.11 | |
| Total comprehensive income for the year | 216 000 |
| Dividends | <u>(7 500)</u> |
| Balance at 31 December 20.11 | 376 500 |
| Changes in equity for 20.12 | |
| Total comprehensive income for the year | 303 840 |
| Dividends | <u>(10 000)</u> |
| Balance at 31 December 20.12 | <u>670 340</u> |

Additional information

1. After the financial statements for 31 December 20.11 had been published, the directors of the company discovered that machinery to the value of R50 000, which had been purchased on 1 July 20.11, had been expensed instead of being capitalised. The bookkeeper had incorrectly stated that the cheque had been made out to BKN Electrical Supplies, a supplier from whom the company purchases electrical components. The cheque was then posted to material purchased. The company makes use of a periodic stocktaking system for inventory control. To date no adjustment has been made in the books of the company.
2. The company depreciates machinery at 20% per annum according to the straight-line method, which is in agreement with the policy applied by the SA Revenue Service.
3. Assume a tax rate of 28%.
4. The SA Revenue Service will issue a revised assessment in respect of the 20.11 tax year.



REQUIRED

Prepare the statement of profit or loss and other comprehensive income, the statement of changes in equity (only the retained earnings section) and notes to the annual financial statements of Cirrus Ltd for the year ended 31 December 20.12. Your answer must comply with the requirements of International Financial Reporting Standards.

SOLUTION 3

CIRRUS LTD

EXTRACT FROM STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.12

| | Notes | 20.12 R | 20.11 R |
|--|-------|----------------|----------------|
| Profit before tax (1) | 2 | 412 000 | 345 000 |
| Income tax expense (2) | 3 | (115 360) | (96 600) |
| PROFIT FOR THE YEAR | | <u>296 640</u> | <u>248 400</u> |
| TOTAL COMPREHENSIVE INCOME FOR THE YEAR | | <u>296 640</u> | <u>248 400</u> |

CIRRUS LTD**EXTRACT FROM STATEMENT OF CHANGES IN EQUITY FOR THE YEARS ENDED
31 DECEMBER 20.11 AND 20.12**

| | Retained earnings R |
|--|------------------------------------|
| Balance at 1 January 20.11 | 168 000 |
| Changes in equity for 20.11 | |
| Total comprehensive income for the year (restated) | 248 400 |
| Dividends | (7 500) |
| Balance at 31 December 20.11 | <u>408 900</u> |
| Changes in equity for 20.12 | |
| Total comprehensive income for the year | 296 640 |
| Dividends | (10 000) |
| Balance at 31 December 20.12 | <u>695 540</u> |

CIRRUS LTD**NOTES FOR THE YEAR ENDED 31 DECEMBER 20.12****1. Accounting policy**

The financial statements have been prepared in accordance with International Financial Reporting Standards.

The financial statements have been prepared on the historical cost basis, as modified by the revaluation of land and buildings, investment property, financial assets and financial liabilities at fair value.

They incorporate the following principal accounting policies, which are consistent with the policies applied in previous years unless otherwise stated.

1.1 Machinery

Machinery is stated at historical cost less accumulated depreciation. Depreciation is calculated on the straight-line method at rates considered appropriate to write off the cost of the asset over its estimated useful life as follows:

Machinery – 20% per annum.

1.2 Taxation

Current and deferred tax are recognised as income or an expense and included in profit or loss for the period, except when the tax relates to items that are recognised outside profit or loss. Tax, which relates to items that are recognised in other comprehensive income, is also recognised in other comprehensive income. Tax, which relates to items that are recognised directly in equity, is also recognised directly in equity.

Deferred taxation

Deferred tax is generally recognised for all temporary differences using the statement of financial position approach based on tax rates that have been enacted or substantively enacted by the reporting date. The measurement of deferred tax reflects the tax consequences that would follow from the manner in which the company expects to recover or settle the carrying amount of its assets and liabilities at the reporting date.

Temporary differences are differences between the carrying amounts of assets and liabilities (used in the financial statements) and the corresponding tax bases used in the calculation of taxable profit.

Deferred tax liabilities are recognised for all taxable temporary differences, unless the deferred tax liability arises from

- the initial recognition of goodwill; or
- the initial recognition of an asset and liability in a transaction which
 - is not a business combination; and
 - at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

Deferred tax assets are recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises on the initial recognition of an asset and liability in a transaction which

- is not a business combination; and
- at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

A deferred tax asset is recognised for the carrying forward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.

Current tax

Current tax payable is based on the taxable profit for the year, calculated in terms of the Income Tax Act. Taxable profit differs from the profit for the period as reported in the statement of profit or loss and other comprehensive income, as it excludes items of income or expense that are taxable or deductible in a different period or that are never taxable or deductible. The liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the reporting date.

2. Profit before tax

| | 20.12 R | 20.11 R |
|---|--------------------------|--------------------------|
| Included in profit before tax is the following: | | |
| Depreciation (1) | <u>10 000</u> | <u>5 000</u> |

3. Income tax expense**Major components of tax expense**

| | | |
|--|----------------|---------------|
| Current tax expense – current year (2) | <u>115 360</u> | <u>96 600</u> |
|--|----------------|---------------|

LECTURER'S COMMENT

Note that no deferred tax arises as a result of the error, since the previous tax assessments were re-opened to correct the error made earlier. If this were not the case, it would have resulted in deferred tax.

4. Prior period error

Correction of error in respect of machinery purchased being expensed instead of being capitalised in 20.11. The effect of the correction of this error on the results of 20.11 is as follows:

| | 20.11 R |
|--|--------------------------|
| Decrease in expenses (50 000 – 5 000) | 45 000 |
| Increase in tax expense (14 000 – 1 400) | <u>(12 600)</u> |
| Increase in profit | <u>32 400</u> |
| Increase in machinery account | 45 000 |
| Increase in current tax due | <u>(12 600)</u> |
| Increase in equity | <u>32 400</u> |

LECTURER'S COMMENT

Note that the effect of the adjustment on each line item must be disclosed.

Calculations

1. Profit before tax

| | 20.12 R | 20.11 R |
|---|----------------|----------------|
| Profit before tax – given | 422 000 | 300 000 |
| Plus: Cost of machinery expended | – | 50 000 |
| | <u>422 000</u> | <u>350 000</u> |
| Less: Depreciation (50 000 x 20%); (50 000 x 20% x 6/12) | (10 000) | (5 000) |
| | <u>412 000</u> | <u>345 000</u> |

2. Income tax expense

| | 20.12 R | 20.11 R |
|--|----------------|---------------|
| Current tax expense – given | 118 160 | 84 000 |
| Adjustments: | | |
| Cost of machinery expended (50 000 x 28%) | – | 14 000 |
| Tax allowance (50 000 x 20% x 28%); ((50 000 x 20% x 6/12) x 28%) | (2 800) | (1 400) |
| | <u>115 360</u> | <u>96 600</u> |

EXAMPLE 4

The profit before tax as reflected in the draft statement of profit or loss and other comprehensive income of Sword Ltd for the financial years ended 31 December 20.12 and 31 December 20.11 respectively was as follows:

| | 20.12 R | 20.11 R |
|-------------------|------------------|----------------|
| Profit before tax | <u>1 661 000</u> | <u>950 000</u> |

Additional information

The following items **have not yet been accounted** for in the above-mentioned draft statement of profit or loss and other comprehensive income of Sword Ltd:

- The board of directors decided on 31 December 20.12, after completing the draft statement of profit or loss and other comprehensive income, to change the accounting policy with respect to the inventory valuation from the weighted average method to the first-in, first-out method in order to comply with International Financial Reporting Standards.

Inventory is valued as follows using both methods:

| | 20.10 R | 20.11 R | 20.12 R |
|----------------------------|------------|------------|------------|
| Weighted average method | 62 000 | 132 000 | 226 000 |
| First-in, first-out method | 67 000 | 167 400 | 263 500 |

The SA Revenue Service will **not** re-open the previous years' tax assessments as a result of this new method of valuation of inventory, but the new policy will be accepted for tax purposes from 20.12.

2. Retained earnings at 31 December 20.10 amounted to R150 000.
3. During the current year the accountant found a batch of sales invoices not processed due to misfiling, to the value of R90 000 (excluding VAT) for the year ended 31 December 20.11. The sales invoices were filed in the order pending file instead of the sales invoice file. However, the costs of sales associated with these invoices were taken into account in 20.11. The effect thereof is considered material on the financial statements and the SA Revenue Service has re-opened the 20.11 assessment as a result of this error.
4. The current tax rate of 28% has remained unchanged for the past five years.
5. Deferred tax is provided for on all temporary differences using the statement of financial position approach.
6. Taxable income and profit before tax were the same for the past five years.
7. The implications of value added tax must be ignored.



REQUIRED

Prepare the statement of profit or loss and other comprehensive income, statement of changes in equity (only the retained earnings section) and **only** the following notes to the annual financial statements of Sword Ltd for the year ended 31 December 20.12:

- change in accounting policy; and
- error.

Your answer must comply with the requirements of International Financial Reporting Standards.

Comparative figures **are required**.

No accounting policy notes are required.

SOLUTION 4

SWORD LTD

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.12

| | 20.12 R | 20.11 R |
|--|------------------------|------------------------|
| Profit before tax | 1 663 100 ¹ | 1 070 400 ² |
| Income tax expense | (465 668) ³ | (299 712) ⁴ |
| PROFIT FOR THE YEAR | <u>1 197 432</u> | <u>770 688</u> |
| TOTAL COMPREHENSIVE INCOME FOR THE YEAR | <u>1 197 432</u> | <u>770 688</u> |

¹ 1 661 000 + 2 100(1)

² 950 000 + 30 400(1) + 90 000

³ 475 580(2.1) – 9 912(2.2)

⁴ 291 200(2.1) + 8 512(2.2)

SWORD LTD**EXTRACT FROM THE STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20.12**

| | Retained earnings R |
|---|------------------------------------|
| Balance at 1 January 20.11 | 150 000 |
| Changes in equity for 20.11 | |
| Change in accounting policy ((67 000 – 62 000) x 72%) | 3 600 |
| Restated balance | <u>153 600</u> |
| Total comprehensive income for the year (restated) | <u>770 688</u> |
| Balance at 31 December 20.11 | 924 288 ¹ |
| Changes in equity for 20.12 | |
| Total comprehensive income for the year | <u>1 197 432</u> |
| Balance at 31 December 20.12 | <u><u>2 121 720</u></u> |

¹ 150 000 + 950 000 – (950 000 x 28%) + 3 600 + 21 888(1) + (90 000 x 72%)

SWORD LTD**NOTES FOR THE YEAR ENDED 31 DECEMBER 20.12****1. Change in accounting policy**

During the financial year, the company changed its accounting policy on the valuation of inventories from the weighted average method to the first-in, first-out method. This change was necessary to comply with International Financial Reporting Standards. This change in policy was accounted for retrospectively and comparative amounts have been appropriately restated.

The effect of the change is as follows:

| | 20.12 R | 20.11 R | 1/1/20.11 |
|--|----------------------|----------------------|---------------------|
| Decrease in cost of sales (1) | 2 100 | 30 400 | |
| Increase in taxation expense (1) | (588) | (8 512) | |
| Increase in profit | <u>1 512</u> | <u>21 888</u> | |
| Increase in inventory (1) | 37 500 | 35 400 | 5 000 |
| Increase in current tax due (37 500 x 28%) | (10 500) | - | - |
| Increase in deferred tax liability (35 400 x 28%);(5 000 x 28%) | - | (9 912) | (1 400) |
| Increase in equity | <u><u>27 000</u></u> | <u><u>25 488</u></u> | <u><u>3 600</u></u> |
| Adjustment to retained earnings at beginning of 20.11 (1) | | | <u><u>3 600</u></u> |

2. Prior period error

Sales invoices, which were not processed due to misfiling, were corrected. The sales invoices were filed in the order-pending file instead of the sales invoice file. The comparative figures have been appropriately restated. The effect of the correction on the results of 20.11 is as follows:

| | 20.11 |
|--|----------------------|
| | R |
| Increase in sales | 90 000 |
| Increase in current tax expense (90 000 x 28%) | <u>(25 200)</u> |
| Increase in profit | <u>64 800</u> |
| | |
| Increase in debtors | 90 000 |
| Increase in current tax due (90 000 x 28%) | <u>(25 200)</u> |
| Increase in equity | <u><u>64 800</u></u> |

Calculations

1. Effect of the change in accounting policy

| | 20.10 | Differ- ence | 20.11 | Differ- ence | 20.12 |
|---|-----------------|-------------------------|------------------|-------------------------|------------------|
| | R | R | R | R | R |
| Inventory | | | | | |
| New method | 67 000 | | 167 400 | | 263 500 |
| Old method | <u>(62 000)</u> | | <u>(132 000)</u> | | <u>(226 000)</u> |
| Increase in profit due to increase in inventory | 5 000 | 30 400 | 35 400 | 2 100 | 37 500 |
| Tax effect | <u>(1 400)</u> | <u>(8 512)</u> | <u>(9 912)</u> | <u>(588)</u> | <u>(10 500)</u> |
| | <u>3 600</u> | <u>21 888</u> | <u>25 488</u> | <u>1 512</u> | <u>27 000</u> |

2. Income tax expense

2.1 Current tax expense

| | 20.12 | 20.11 |
|--|---------------------|------------------|
| | R | R |
| Profit before tax (given) | 1 661 000 | 950 000 |
| Increase in profit before tax resulting from increase in closing inventory | 37 500 ¹ | – |
| Correction of error | – | 90 000 |
| Taxable income | <u>1 698 500</u> | <u>1 040 000</u> |
| Current tax expense @ 28% | <u>475 580</u> | <u>291 200</u> |

¹ 5 000 + 30 400 + 2 100

2.2 Deferred tax expense

| | Carrying amount R | Tax base R | Temporary difference R | Deferred tax liability @ 28% R |
|--------------------------|-------------------------|------------------|------------------------------|--|
| 31 December 20.10 | | | | |
| Closing inventory | <u>67 000</u> | <u>62 000</u> | <u>5 000</u> | <u>1 400</u> |

The carrying amount of asset > tax base of asset,
therefore deferred tax liability

Deferred tax balance 1 January 20.10
Deferred tax liability 31 December 20.10
Deferred tax expense (**Dr to P/L**)

–
1 400
1 400

| | Carrying amount R | Tax base R | Temporary difference R | Deferred tax liability @ 28 R |
|--------------------------|-------------------------|------------------|------------------------------|---|
| 31 December 20.11 | | | | |
| Closing inventory | <u>167 400</u> | <u>132 000</u> | <u>35 400</u> | <u>9 912</u> |

The carrying amount of asset > tax base of asset, therefore
deferred tax liability

Deferred tax liability 1 January 20.11
Deferred tax liability 31 December 20.11
Deferred tax expense (**Dr to P/L**)

R
1 400
(9 912)
(8 512)

31 December 20.12

| | Carrying amount R | Tax base R | Temporary difference R | Deferred tax liability @ 28% R |
|-------------------|-------------------------|------------------|------------------------------|--|
| Closing inventory | <u>263 500</u> | <u>263 500</u> | <u>–</u> | <u>–</u> |

The carrying amount of asset is equal to the tax base
of the asset, therefore no deferred tax

Deferred tax liability 1 January 20.12
Deferred tax balance 31 December 20.12
Deferred tax expense (**Cr to P/L**)

(9 912)
–
(9 912)

2.5 SUMMARY OF CHANGES IN ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

| | Changes in accounting policy | Changes in accounting estimates | Errors |
|-----------------|---|---|--|
| Definition | <p>Change in the specific</p> <ul style="list-style-type: none"> • principles; • bases; • conventions; • rules; and • practices <p>applied by an entity in preparing and presenting financial statements (<i>IAS 8.5</i>)</p> | <p>An adjustment of the carrying amount of an asset or liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of and expected future benefits and obligations associated with assets and liabilities</p> <p>Changes in accounting estimates result from new information or new developments and accordingly are not corrections of errors (<i>IAS 8.5</i>)</p> | <p>Omissions from and misstatements in the entity's financial statements for one or more prior periods arising from a failure to use or the misuse of reliable information that:</p> <p>(a) was available when financial statements for those periods were authorised for issue; and</p> <p>(b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements (<i>IAS 8.5</i>)</p> |
| When applicable | <p>An entity changes an accounting policy only if the change</p> <p>(a) is required by a standard or an interpretation; or</p> <p>(b) 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. (<i>IAS 8.14</i>)</p> | <p>Change in estimate if</p> <p>(a) changes occur in the circumstances on which the estimate was based; or</p> <p>(b) new information is available or more experience has been gained (<i>IAS 8.34</i>).</p> | <p>Errors can arise in respect of the</p> <ul style="list-style-type: none"> • recognition; • measurement; • presentation; or • disclosure <p>of elements of financial statements (<i>IAS 8.41</i>)</p> |

| | Changes in accounting policy | Changes in accounting estimates | Errors |
|-----------------------------|--|---|---|
| Accounting treatment | <p>Retrospective application by adjusting the prior year figures except to the extent that it is impracticable (<i>IAS 8.19(b), .22, .23</i>)</p> <p>Retrospective application is applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied (<i>IAS 8.5</i>)</p> | <p>Prospective application is recognising the effect of the change in the current and future periods affected by the change (<i>IAS 8.36</i>)</p> | <p>Retrospective restatement is correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error has never occurred (<i>IAS 8.42</i>)</p> |
| Examples | <p>Change in inventory valuation method</p> | <p>(a) Bad debts (b) Inventory obsolescence. (c) Fair value of financial assets or liabilities (d) The useful lives or expected pattern of consumption of the future economic benefits embodied in depreciable as-sets (e) Warranty obligations (<i>IAS 8.32</i>)</p> | <p>(a) Incorrect recording of VAT (input and output) (b) Incorrect capitalisation of an expense (c) Incorrect expensing of assets (d) Incorrect classification of general ledger accounts</p> |
| Disclosure | <p>(a) The revised <i>IAS 1</i> has introduced a requirement to include a third statement of financial position as at the beginning of the preceding period whenever an entity</p> <ul style="list-style-type: none"> • retrospectively applies an accounting policy; • makes a retrospective restatement of items in its financial statements; or | <p>(a) The nature and amount that has an effect in the current period or is expected to have an effect in future periods (b) Disclose the fact if the amount of the effect in future periods is not disclosed because it is impracticable (<i>IAS 8.39–.40</i>)</p> | <p>(a) The nature of the prior period error (b) For each prior period presented the amount of the correction for each financial statement line item affected, and for basic and diluted earnings per share, if presented (c) The amount of the correction at the beginning of the earliest prior period presented (d) If retrospective restatement is</p> |

| | Changes in accounting policy | Changes in accounting estimates | Errors |
|-------------------------------|--|--|---|
| Disclosure (continued) | <ul style="list-style-type: none"> • when it reclassifies items in its financial statements. <p>In the above circumstances, an entity is required to present a minimum of three statements of financial position, together with the related notes.</p> <p>A statement of financial position must be prepared as at</p> <ul style="list-style-type: none"> • the end of the current period; • the end of the preceding period; and • the beginning of the preceding period. <p>(b) the title of the standard or interpretation;</p> <p>(c) when applicable, that the change in accounting policy is made in accordance with its transitional provisions;</p> <p>(d) the nature of the change in accounting policy;</p> <p>(e) when applicable, a description of the transitional provisions;</p> <p>(f) when applicable, the transitional provisions that might have an effect on future periods;</p> <p>(g) 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 for basic and diluted earnings per share, if presented;</p> | | <p>impracticable for a particular prior period, the circumstances that have led to the existence of that condition and a description of how and from when the error has been corrected (IAS 8.49)</p> |

| | Changes in accounting policy | Changes in accounting estimates | Errors |
|-------------------------------|---|---------------------------------|--------|
| Disclosure (continued) | <p>(h) the amount of the adjustment relating to periods before those presented, to the extent practicable; and</p> <p>(i) if retrospective application is impracticable for a particular prior period, or for periods before those presented, the circumstances that have led to the existence of that condition and a description of how and from when the change in accounting policy has been applied (<i>IAS 8.28</i>).</p> | | |



ASSESSMENT CRITERIA

Are you now able to do the following?

- Define accounting policies, change in accounting estimates and errors as contained in *IAS 8*.
- Determine whether an error in the preparation of the financial statements of prior periods discovered in the current year should be reported as an error or not.
- Determine whether an adjustment because of the revision of an estimate should be accounted for as a change in accounting estimate or as a change in accounting policy.
- Record a change in accounting estimates, a change in accounting policies and the correction of an error accurately in the financial statements in accordance with International Financial Reporting Standards.

LEARNING UNIT 3

**THE CONCEPTUAL
FRAMEWORK FOR
FINANCIAL REPORTING
2010**



LEARNING OUTCOME

Learners should be able to prepare and present financial statements according to the concepts underlying the preparation and presentation of financial statements.

OVERVIEW

This learning unit is divided into the following:

- 3.1 Scope of the Conceptual Framework
- 3.2 The objective of general-purpose financial reporting (Chapter 1)
- 3.3 Qualitative characteristics of useful financial information (Chapter 3)
- 3.4 The Framework (1989): The remaining text (Chapter 4)

STUDY

PRESCRIBED:

Descriptive accounting
Chapter 2

RECOMMENDED:

A Guide Through IFRS
The Conceptual Framework for Financial Reporting 2010

OVERVIEW OF LEARNING UNIT

The Conceptual Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. The Conceptual Framework is not an IFRS and hence does not define standards for any particular measurement or disclosure issue. Nothing in the Conceptual Framework overrides any specific IFRS.

3.1 Scope of the Conceptual Framework

The Conceptual Framework deals with the following four chapters:

Chapter 1 – The objective of general-purpose financial reporting

Chapter 2 – The reporting entity (This chapter has not been included in this learning unit as Chapter 2 has not been finalised by the IASB.)

Chapter 3 – Qualitative characteristics of useful financial information

Chapter 4 – The Framework (1989): The remaining text

Please note that the paragraph numbers in this learning unit are references to paragraph numbers that appear in the Conceptual Framework for Financial Reporting 2010. The Conceptual Framework for Financial Reporting appears in part A of volume 1 of the SAICA handbook.

3.2 The objective of general-purpose financial reporting (Chapter 1)

- **Objective, usefulness and limitations of general-purpose financial reporting**

The objective of general-purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit (*par OB2*).

To assess an entity's prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources. Examples of such responsibilities include protecting the entity's resources from unfavourable effects of economic factors such as price and technological changes, and ensuring that the entity complies with applicable laws, regulations and contractual provisions. Information about management's discharge of its responsibilities is also useful for decisions by existing investors, lenders and other creditors who have the right to vote on or otherwise influence management's actions (*par OB4*).

However, general-purpose financial reports do not and cannot provide all the information that existing and potential investors, lenders and other creditors need. Those users need to consider pertinent information from other sources, for example general economic conditions and expectations, political events and political climate, and industry and company outlooks (*par OB6*).

- **Information about a reporting entity's economic resources, claims, and changes in resources and claims**

General-purpose financial reports provide information about the financial position of a reporting entity, which is information about the entity's economic resources and the claims against the reporting entity. Financial reports also provide information about the effects of transactions and other events that change a reporting entity's economic resources and claims. Both types of information provide useful input for decisions about providing resources to an entity (*par OB12*).

- **Economic resources and claims**

Information about the nature and amounts of a reporting entity's economic resources and claims can help users to identify the reporting entity's financial strengths and weaknesses. That information can help users to assess the reporting entity's liquidity and solvency, its needs for additional financing and how successful it is likely to be in obtaining that financing. Information about priorities and payment requirements of existing claims helps users to predict how future cash flows will be distributed among those with a claim against the reporting entity (*par OB13*).

- **Changes in economic resources and claims**

Changes in a reporting entity's economic resources and claims result from that entity's financial performance and from other events or transactions such as issuing debt or equity instruments. To assess the prospects for future cash flows from the reporting entity properly, users need to be able to distinguish between these changes (*par OB15*).

- **Financial performance reflected by accrual accounting**

Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period. This is important because information about a reporting entity's economic resources and claims, and changes in its economic resources and claims during a period provides a better basis for assessing the entity's past and future performance than information solely about cash receipts and payments during that period (*par OB17*).

- **Financial performance reflected by past cash flows**

Information about a reporting entity's cash flows during a period also helps users to assess the entity's ability to generate future net cash inflows. It indicates how the reporting entity obtains and spends cash, including information about its borrowing and repayment of debt, cash dividends or other cash distributions to investors, and other factors that may affect the entity's liquidity or solvency. Information about cash flows helps users understand a reporting entity's operations, evaluate its financing and investing activities, assess its liquidity or solvency and interpret other information about financial performance (*par OB20*).

- **Changes in economic resources and claims not resulting from financial performance**

A reporting entity's economic resources and claims may also change for reasons other than financial performance, such as issuing additional ownership shares. Information about this type of change is necessary to give users a complete understanding of why the reporting entity's economic resources and claims changed, and the implications of those changes for its future financial performance (*par OB21*).

3.3 Qualitative characteristics of useful financial information (Chapter 3)

The qualitative characteristics of useful financial information discussed identify the types of information that are likely to be most useful to the existing and potential investors, lenders and other creditors for making decisions about the reporting entity on the basis of information in its financial report (financial information) (*par QC1*).

The fundamental qualitative characteristics are relevance and faithful representation (par QC5).

The qualitative characteristics of the Conceptual Framework can be summarised as follows:

- Relevance (.QC6–.QC10) – Materiality (.QC11)
- Faithful representation (.QC12–.QC16)
- Applying the fundamental qualitative characteristics (.QC17–.QC18)
- Enhancing qualitative characteristics (.QC19)
 - Comparability (.QC20–.QC25)
 - Verifiability (.QC26–.QC28)
 - Timeliness (.QC29)
 - Understandability (.QC30–.QC32)
- Applying the enhancing qualitative characteristics (.QC33–.QC34)
- The cost constraint on useful financial reporting (.QC35–.QC39)

References to the paragraphs in the Conceptual Framework are in brackets.

3.4 The Framework (1989): The remaining text (Chapter 4)

3.4.1 Underlying assumption

- **Going concern**

The financial statements are normally prepared on the assumption that an entity is a going concern and that it will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed (*par 4.1*).

3.4.2 The elements of financial statements can be summarised as follows:

- Elements of financial statements
 - Financial position (4.4–4.7)
 - Assets (4.8–4.14)
 - Liabilities (4.15–4.19)
 - Equity (4.20–4.23)
 - Performance (4.24–4.28)
 - Income (4.29–4.32)
 - Expenses (4.33–4.35)
 - Capital maintenance adjustments (4.36)

Recognition of the elements of the financial statements (4.37–4.53)

Measurement of the elements of the financial statements (4.54–4.56)

References to the paragraphs in the Conceptual Framework are in brackets.

3.4.3 Recognition of the elements of financial statements

For an item to be recognised in the statement of financial position or statement of profit or loss and other comprehensive income, the item must fall within the definition of an element and satisfy the criteria for recognition.

The criteria for recognition are as follows:

- it is probable that any future economic benefit will flow to or from the entity; and
- the item has a cost or value that can be measured with reliability (*par 4.38*).

The decision regarding the probable future economic benefit of an item is taken at the time of finalising the financial statements. For example, if there is a possibility that a debtor will not be collected, it is prudent to make a provision for bad debts. A reduction in economic benefit in respect of that item is recognised.

The recognition of the following elements is discussed in the Conceptual Framework:

- Assets (*paragraphs 4.44–4.45*)
- Liabilities (*paragraphs 4.46*)
- Income (*paragraphs 4.47–4.48*)
- Expenses (*paragraphs 4.49–4.53*)

3.4.4 Measurement of the elements of financial statements

Measurement is the process of allocating a monetary value to the elements of financial statements. A number of different measurement bases exist for the determination of the carrying value of an element. These bases are:

- Historical cost
- Current cost
- Realisable (settlement) value
- Present value

(Refer to *par 4.55*.)

3.4.5 Concepts of capital and capital maintenance

Capital as a financial concept refers to invested money or invested purchasing power. Capital is therefore equivalent to the net assets or equity of the entity.

Capital as a physical concept refers to operating capability. Capital is therefore equivalent to productive capacity of the entity (*par 4.57*).

The two concepts of capital give rise to the following concepts of capital maintenance:

- **Financial capital maintenance**

Financial capital maintenance means that profit will be recognised if the financial amount of net assets at the end of the financial period is greater than the financial amount of net assets at the beginning of the financial period.

- **Physical capital maintenance**

Physical capital maintenance means that profit will be recognised if the physical productive capacity of the entity at the end of the financial period exceeds the physical productive capacity at the beginning of the period (*par 4.59*).

EXAMPLE 1



REQUIRED

- (a) Define the following elements of financial statements:
- (i) An asset
 - (ii) A liability
 - (iii) Equity
 - (iv) Income
 - (v) Expenses

| | |
|--|--|
| | <p>(b) Name the various measurement bases that can be used to determine the monetary amounts at which elements of the financial statements can be recorded and recognised in the statement of financial position and the statement of profit or loss and other comprehensive income, and show how the monetary amount of assets and liabilities is determined under each base.</p> <p>(c) During 20.12 Conceptual Framework Ltd purchased the business of Policy Ltd and paid R200 000 more for the assets of Policy Ltd than they were worth. The accountant of Conceptual Framework Ltd does not know how to treat the goodwill of R200 000 in the financial statements and asks you to comment on each of the following alternatives:</p> <p>(i) The R200 000 is to be capitalised and shown as an asset.</p> <p>(ii) The R200 000 is expensed in the statement of profit or loss and other comprehensive income as an operating expense.</p> |
|--|--|

SOLUTION 1

(a) Definitions of elements

(i) An asset

An asset is 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 (*par 4.4(a)*).

Assets can be of a physical substance (a plant) or without physical substance (a patent or goodwill)

(ii) A liability

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 (*par 4.4(b)*).

A future obligation is not a liability (*refer to IAS 37*).

(iii) Equity

Equity is the residual interest in the assets of the entity after deducting all its liabilities (*par 4.4(c)*).

(iv) Income

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 (e.g. shareholders) (*par 4.25(a)*).

(v) Expenses

Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants (e.g. shareholders) (*par 4.25(b)*).

(b) Measurement bases identified in the Conceptual Framework

The following measurement bases have been identified:

| Measurement basis | Basis upon which elements are measured/recognised | |
|--|---|---|
| | Assets | Liabilities |
| Historical cost (par 4.55(a)) | Recorded at the amount of cash or cash equivalents paid or fair value of the consideration given to acquire them at the time of their acquisition | Recorded at the amount of proceeds received in exchange for the obligation, or at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business |
| Current cost (par 4.55(b)) | Carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently | Carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently |
| Realisable (settlement) value (par 4.55(c)) | Carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal | Carried at their settlement values, that is, the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business |
| Present value (par 4.55(d)) | Carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business | Carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business |

(c) Recognition of the elements of financial statements

Recognition is the process of incorporating in the statement of financial position or statement of profit or loss and other comprehensive income an item that meets the definition of an element (asset, liability, income or expense) and satisfies the criteria for recognition (*par 4.37*). An item that meets the definition of an element should be recognised if

- it is probable that any future economic benefit associated with the item will flow to or from the entity; and
- the item has a cost or value that can be measured with reliability (*par 4.38*).

The alternatives should be evaluated against the above.

(i) Capitalised and shown as an asset

It should be established whether the item meets the definition of an asset and satisfies the criteria for recognition. As the value can be measured with reliability, the question is whether any future economic benefits associated with the item will flow to the company. It could be argued that the assets acquired will generate income in the future and thus economic benefits will flow to the company. The R200 000 can thus be capitalised and shown as an asset.

(ii) Expensed as an operating expense

An expense is recognised immediately in the statement of profit or loss and other comprehensive income when an expenditure produces no future economic benefits or when, and to the extent that, future economic benefits do not qualify or cease to qualify for recognition in the statement of financial position as an asset (*par 4.52*).

If it is expected that the goodwill holds no future economic benefits for the company, it can be directly expensed in the statement of profit or loss and other comprehensive income as an operating expense.

When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, the expense is recognised in the statement of profit or loss and other comprehensive income based on systematic and rational allocation procedures. The expense is thus recognised in the accounting periods in which the economic benefits, associated with the item, are consumed or expire, like the depreciation or amortisation of assets such as property, plant, equipment, goodwill, patents and trademarks (*par 4.51*).

EXAMPLE 2

City Ltd and Town Ltd are leading cellular service provider companies that sell network cards to 90% of all network airtime customers.

During the year ended 31 December 20.11 City Ltd lent R5 million to Town Ltd to finance operating expenditure not in the normal course of its business activities. This loan was not secured. In September 20.12 Town Ltd went into liquidation and it was expected that concurrent creditors would receive no liquidation dividend. As Town Ltd also provided network airtime for City Ltd's network, City Ltd made a public announcement on 1 November 20.12 that it would honour all network airtime at no additional cost to customers of Town Ltd. The only stipulation was that this network airtime had to be used only during the evenings.

The accountant of City Ltd is of the opinion that the company stands to benefit substantially from the additional customers that will use the network airtime in the future and that this benefit should be recognised as an asset. He therefore processed the following journal entries on 31 December 20.12 in respect of the loan:

| | Dr | Cr |
|------------------------------------|-----------|-----------|
| | R | R |
| Loan to Town Ltd | 5 000 000 | |
| Bank | | 5 000 000 |
| <i>Recording of loan</i> | | |
| Asset | 5 000 000 | |
| Loan to Town Ltd | | 5 000 000 |
| <i>Conversion of loan to asset</i> | | |

He is further of the opinion that honouring the network airtime of Town Ltd's customers will cause no loss to the company, as surplus network airtime on City Ltd's network is available during evenings. No further transactions were therefore recorded.

**REQUIRED**

Discuss whether City Ltd has correctly accounted for the above events (the loan and network airtime sold) in terms of the Conceptual Framework.

SOLUTION 2**HOW SHOULD I APPROACH THIS QUESTION?**

First, consider whether the item complies with the definition of an asset or a liability and then test the item against the recognition criteria.

WHAT THEORY DO I NEED?

Basic theory from the Conceptual Framework regarding the definitions of assets and liabilities (Conceptual Framework *par* 4.4) and the recognition criteria (Conceptual Framework *par* 4.37–4.38) are essential knowledge before you attempt the question.

The questions here are the following:

- Can the loan be converted to an asset?
- Does a liability exist in respect of the network airtime?

Conversion of loan into asset

1. In terms of the Conceptual Framework, an asset is

- 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.

2. Test whether an asset exists (application of components of definition).

- An economic resource exists as a result of past events, being the use of network airtime by customers of Town Ltd as a result of the announcement made.
- Unless City Ltd obtains the legal right to be the sole domestic cellular network provider, control cannot be ensured. Any other cellular network provider may enter the market. It may be argued that City Ltd, in substance, obtained the sole right to sell network airtime (substance over form). However, the company does not exercise control over this right.
- Future economic benefits will flow to the entity. There is definitely an expectation that City Ltd will benefit from the increased market share and loyalty, but not necessarily to an amount of R5 million.
- It is therefore probable that future economic benefits will flow to the entity, but the value of the inflow cannot be measured reliably.

3. Conclusion

Because of the uncertainty about "control" over the asset, the definition of an asset is not met, and consequently an asset may not be recognised.



LECTURER'S COMMENT

All the criteria need to be met before an item could be classified as an asset or a liability.

Liability in respect of network airtime

1. The commitment to honour the network airtime of Town Ltd will result in costs to City Ltd: extra queries, administration costs, updating network airtime, etc.
These direct expenses should be quantified and recognised as a liability if it fits into the definition of a liability in terms of the Conceptual Framework (*par 4.4(b)*) and if it meets the recognition criteria.
2. A liability is
 - a present obligation;
 - arising from past events; and
 - the settlement of which is expected to result in an outflow from the entity of economic benefits.
3. Test whether a liability exists (application of components of definition).
 - There is a present obligation because of a past event. The past event is the public announcement that has been made. This creates a present constructive obligation that the entity cannot avoid in future.
 - It is probable that an outflow of economic benefits will be required to settle the obligation, as certain expenses, such as queries and administration costs, will have to be incurred.
 - It should be possible to make a reliable estimate of the amount of the expenses, as the cost of network airtime should be known, and it might be assumed that the majority of the customers will make use of the offer.
4. Conclusion

A liability exists in respect of the direct expenses. There is, however, uncertainty about the number of customers that will make use of the offer, as well as the point in time when the offer will be used.

Therefore, the liability should be classified as a provision, because a provision is a liability of uncertain timing or amount.



LECTURER'S COMMENT

See *IAS 37* for the difference between a liability and a provision.



ASSESSMENT CRITERIA

Are you now able to do the following?

- Define the purpose and status of the Conceptual Framework, and the objectives behind the preparation of the Conceptual Framework.
- Define the objectives and assumptions that underlie the preparation and presentation of annual financial statements.
- List the qualitative and quantitative characteristics of annual financial statements.
- Define and measure the elements of the annual financial statements.
- Identify the elements of the annual financial statements.
- Give advice on the recognition of an item in the financial statements as an asset, liability, income or expense.

LEARNING UNIT 4

**PREFACE TO
INTERNATIONAL FINANCIAL
REPORTING STANDARDS**



LEARNING OUTCOMES

Learners should understand the scope and authority of International Financial Reporting Standards as well as the accounting standard setting process.

OVERVIEW

This learning unit is divided into the following:

- 4.1 Objectives of the International Accounting Standards Board (IASB)
- 4.2 Scope and authority of International Financial Reporting Standards (IFRS)
- 4.3 Harmonisation of Statements of Generally Accepted Accounting Practice (GAAP)
- 4.4 Legal requirements for Generally Accepted Accounting Practice

STUDY

PRESCRIBED:

Descriptive accounting

Chapter 1

RECOMMENDED:

A Guide Through IFRS

Preface to International Financial Reporting Standards

OVERVIEW OF LEARNING UNIT

This preface was issued to set out the objectives and process of the International Accounting Standards Board (IASB) and to explain the scope, authority and timing of application of International Financial Reporting Standards (IFRS).

4.1 Objectives of the IASB

The objectives of the IASB are

- (a) to develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based on clearly articulated principles. These standards should require high-quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the various capital markets of the world and other users of financial information make economic decisions.
- (b) to promote the use and rigorous application of those standards;
- (c) in fulfilling the objectives associated with (a) and (b), to take account of, as appropriate, the needs of a range of sizes and types of entities in diverse economic settings; and
- (d) to promote and facilitate the adoption of IFRSs, being the standards and interpretations issued by the IASB, through the convergence of national accounting standards and IFRSs (*par .06*).

4.2 Scope and authority of International Financial Reporting Standards

The IASB achieves its objectives primarily by developing and publishing IFRSs and promoting the use of those standards in general-purpose financial statements and other financial reporting. Other financial reporting comprises information provided outside financial statements that assists in the interpretation of a complete set of financial statements or improves users' ability to make efficient economic decisions (*par .07*).

IFRSs set out recognition, measurement, presentation and disclosure requirements for transactions and events that are important in general-purpose financial statements. They may also set out such requirements for transactions and events that arise mainly in specific industries. IFRSs are based on the Conceptual Framework, which addresses the concepts underlying the information presented in general-purpose financial statements. The objective of the Conceptual Framework is to facilitate the consistent and logical formulation of IFRSs (*par .08*).

IFRSs apply to all general-purpose financial statements. Such financial statements are directed towards the common information needs of a wide range of users, for example shareholders, creditors, employees and the public at large. The objective of financial statements is to provide information about the financial position, performance and cash flows of an entity that is useful to those users in making economic decisions (*par .10*).

A complete set of financial statements includes a statement of financial position, a statement of profit or loss and other comprehensive income, a statement of changes in equity, a statement of cash flows, and accounting policies and explanatory notes. When a separate statement of profit or loss is presented in accordance with *IAS 1 – Presentation of financial statements* (as revised in 2007), it is part of that complete set (*par .11*).

4.3 Harmonisation of Statements of Generally Accepted Accounting Practice (GAAP)

The South African Accounting Practices Board (APB), who has traditionally been responsible for the setting of South African accounting standards, committed itself during 1993 to eliminating the differences between South African accounting standards and standards issued by the International Accounting Standards Board (IASB). South African standards have substantially been harmonised with international standards (the harmonisation project).

IASB standards are published in a series of pronouncements called IFRSs and IFRICs. Standards issued by the IASB are designated "IFRS", while *IASs* and *SICs*, issued by the International Accounting Standards Committee (1973 – 2001), the IASB's predecessor, continue to be designated as part of IFRSs. IFRSs therefore include IFRSs, IFRICs, *IASs*, and *SICs*.

In February 2004, the APB took a decision that it would approve the text of the International Financial Reporting Standards for issue in South Africa, without amendment. Statements of Generally Accepted Accounting Practice were, except for some effective dates, an exact replica of the relevant International Financial Reporting Standards. However, the Accounting Practice Board (APB) was dissolved and replaced by the Financial Reporting Standards Council (FRSC).

The consequences of the aforementioned discontinuation of the APB and the establishment of the FRSC included the effective withdrawal of SA GAAP effective for financial statements prepared in respect of year-ends after May 2012. Furthermore, companies currently applying SA GAAP need to prepare for conversion to IFRS, or IFRS for SMEs. The FRSC will propose changes to the regulations to include a provision to give the FRSC the power to issue Financial Reporting Pronouncements (FRPs) to take account of specific aspects that only occur in the South African context not specifically covered by IFRS or IFRS for SMEs. The first FRPs are intended to cover current South African interpretations of SA GAAP, the AC 500 series.

4.4 Legal requirements for Generally Accepted Accounting Practice

Users of financial statements, such as investors, require compliance with accounting standards in order to provide them with assurance that financial statements fairly present the affairs of the entity. In order to provide such assurance, legal backing for accounting standards will now be achieved by the Companies Act (71 of 2008).

In terms of the Companies Act (71 of 2008), two categories of companies are recognised, namely profit companies and non-profit companies.

4.4.1 Profit companies

Profit companies are defined as companies incorporated for the purpose of financial gain for their shareholders. They include the following categories of companies:

- **State-owned company (SOC Ltd)**

A company that meets the criteria for state-owned enterprises or that is owned by a municipality.

- **Private company ((Pty) Ltd)**

A company that is neither a state-owned company nor a personal liability company. Its memorandum of incorporation also prohibits it from offering its securities to the public and restricts the transferability of those securities.

- **Personal liability company (Inc)**

A private company whose memorandum of incorporation states that it is a personal liability company.

- **Public company (Ltd)**

A profit company that is not a state-owned company, a private company or a personal liability company. A public company can either be listed on the JSE Limited or be a non-listed entity.

4.4.2 Non-profit companies (NPC)

A non-profit company is incorporated for public benefit and its income and property are not distributable to its members, incorporators, directors, officers or related persons. This category of company may be regarded as a successor to the Section 21 companies.

4.4.3 Reporting of respective companies

Different financial reporting standards can be established for profit and non-profit companies, as well as for different categories of profit companies. The respective financial reporting standards applicable are the following:

| Category of profit company | Financial reporting |
|---|--|
| State-owned companies (SOCs) | IFRS, but should there be any conflict with the Public Finance Management Act (1 of 1999), the latter prevails |
| Listed public companies | IFRS |
| Public companies not listed | IFRS or IFRSs for SMEs |
| Profit companies, other than SOCs or public companies, with a public interest score (PIS) for the particular financial year of at least 350 | IFRS or IFRSs for SMEs |
| Profit companies, other than SOCs or public companies, with a PIS for the particular financial year of at least 100, but less than 350 | IFRS or IFRSs for SMEs |
| Profit companies, other than SOCs or public companies, with a PIS for the particular financial year of less than 100, and whose statements are independently compiled | IFRS or IFRSs for SMEs |
| Profit companies, other than SOCs or public companies, with a PIS for the particular year of less than 100, and whose statements are internally compiled | The financial reporting standard as determined by the company for as long as no financial reporting standards are prescribed |

The PIS (public interest score) is the sum of

- a number of points equal to the average number of employees during the financial year;
- one point for every R1 million (or portion thereof) in third-party liabilities at the end of the financial year;
- one point for every R1 million (or portion thereof) in turnover during the financial year; and
- one point for every individual who has a direct or indirect, beneficial interest in any of the profit company's issued securities at the end of the financial year.

In all cases, a company can choose to comply with a "higher" level of financial reporting standard (such as applying IFRS even if IFRSs for SMEs was allowed). Companies that may apply IFRSs for SMEs in terms of the company regulations may only do so if the company meets the scoping requirements of IFRS for SMEs.

JSE Ltd

In terms of section 8.62 of the listing requirements of the JSE, the annual financial statements of listed companies must be drawn up in accordance with the national law applicable to a listed company and be prepared in accordance with IFRSs and the AC 500 Standards as issued by the APB.



ASSESSMENT CRITERIA

Are you now able to do the following?

- Define the objectives of the IASB.
- Define the scope and authority of International Financial Reporting Standards.
- Understand the legal requirements for Generally Accepted Accounting Practice.
- Understand the harmonisation of Generally Accepted Accounting Practice.

LEARNING UNIT 5

**PRESENTATION OF
FINANCIAL STATEMENTS
(IAS 1)**



LEARNING OUTCOMES

Learners should be able to prepare general-purpose financial statements using the structure and contents of *IAS 1* in order to improve comparability with the entity's own financial statements of previous periods and with the financial statements of other entities.

OVERVIEW

This learning unit is divided into the following:

- 5.1 Purpose of financial statements
- 5.2 General features
- 5.3 Structure and content
- 5.4 Structure and content: Statement of financial position
- 5.5 Structure and content: Statement of profit or loss and other comprehensive income
- 5.6 Structure and content: Statement of changes in equity
- 5.7 Structure and content: Notes to the financial statements
- 5.8 Example: Presentation of financial statements
- 5.9 The structure of illustrative financial statements

STUDY

PRESCRIBED

Descriptive accounting

Chapter 3

RECOMMENDED:

A Guide Through IFRS

IAS 1 - Presentation of Financial Statements

OVERVIEW OF LEARNING UNIT

International Accounting Standard 1 (IAS 1) covers the presentation of financial statements. This includes the layout of general-purpose financial statements and the considerations to be taken into account when preparing the content of these financial statements.

The objective of *IAS 1* is to prescribe the basis of presentation of general-purpose financial statements in order to ensure comparability both in terms of the entity's own financial statements from one financial period to another, and with regard to the financial statements of other entities.

IAS 1 refers to general-purpose financial statements. Financial statements prepared in terms of this accounting standard form the basis or starting point for the preparation of financial statements. If another accounting standard requires additional disclosure this is in addition to that required by *IAS 1*.

IAS 1 does not apply to the preparation of condensed interim financial statements, but it does apply equally to the financial statements of individual entities and the preparation of group financial statements.

It is the responsibility of the board of directors or management of an entity to prepare and present the financial statements.

5.1 Purpose of financial statements (*IAS 1 par .09–.10*)

The financial statements are a structured representation of the financial position of the entity and the results of the operations undertaken by the entity.

The objective of preparing financial statements is to provide information about the financial position (assets, liabilities and equity), performance (income and expenses, including gains and losses), and cash flows of an entity in order to provide useful information to the users of the financial statements in making economic decisions. It also serves as proof of the results of management's stewardship of the resources of the entity.

A complete set of financial statements consists of

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

- a statement of financial position at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements or when it reclassifies items in its financial statements; and
- comparative information in respect of the preceding periods as specified in *paragraphs .38 and .38A of IAS 1*

5.2 General features

When preparing the annual financial statements, the following general features must be taken into account:

- **Fair presentation and compliance with IFRSs (*IAS 1 par .15–.23*)**

The financial statements should fairly present the financial position (referring to the statement of financial position), financial performance (referring to the statement of profit or loss and other comprehensive income) and cash flows (referring to the statement of cash flows) of an entity. If the International Financial Reporting Standards (IFRSs) are properly applied, and when in certain circumstances additional disclosure is necessary and presented, the financial statements achieve fair presentation.

If management should conclude that the compliance with a requirement in an IFRS conflict with the objective of the financial statements set out in the Framework (a rare occurrence) then management would adopt requirements that would ensure fair presentation and would disclose the following:

- (a) Management has concluded that the financial statements present fairly the entity's financial position, financial performance and cash flows.
- (b) It has complied with applicable IFRSs, except that it has departed from a particular requirement to achieve a fair presentation.
- (c) The title of the IFRS from which the entity has departed, the nature of the departure, including the treatment the IFRS would require and the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the Framework and the treatment adopted.
- (d) For each period presented, the financial effect that the departure had on each item in the financial statements that would have been reported in compliance with the requirement.

- **Going concern (*IAS 1 par .25–.26*)**

This consideration is based on the fundamental accounting concept that the entity will continue to exist in the foreseeable future.

When management assesses whether the going concern assumption is appropriate, it takes into account all the relevant information for at least 12 months from the statement of financial position reporting period.

When financial statements are not prepared on a going concern basis, that fact should be disclosed together with the basis on which the financial statements are prepared and the reason why the entity is not considered a going concern.

- **Accrual basis of accounting (IAS 1 par .27–.28)**

Financial statements, except cash flow information, are prepared using the accrual basis of accounting. When the accrual basis of accounting is used, an entity recognises the elements of the financial statements when they satisfy the definitions and recognition criteria.

- **Consistency of presentation (IAS 1 par .45–.46)**

The presentation and classification of items in the financial statements should be retained within each accounting period, and from one accounting period to the next.

Consistency consists of two important aspects, namely

- consistency over time; and
- consistency of disclosure of similar items.

- **Materiality and aggregation (IAS 1 par .29–.31)**

Each material class of similar items should be presented separately in the financial statements. Items of a dissimilar nature or function should be presented separately unless they are immaterial.

If a line item is not individually material, it is aggregated with other items either in those statements or in the notes.

- **Offsetting (IAS 1 par .32–.35)**

This consideration refers to the netting off of assets and liabilities, and income and expenses. This is not allowed unless specifically required in terms of a Standard or an Interpretation.

- **Comparative financial information (IAS 1 par .38–.44)**

Numerical information in the financial statements should be disclosed with the comparative figures for the previous period. Comparative information in respect of the previous accounting period should also be disclosed for all narrative and descriptive information. If either the presentation or the classification of items in the financial statements is amended, then the comparative amounts should be reclassified unless the reclassification is impracticable.

5.3 Structure and content

IAS 1 outlines the broad disclosure requirements for preparing financial statements. It is left to the specific International Financial Reporting Standards (IFRSs) to prescribe the specific disclosure requirements of items in the financial statements.

This accounting standard requires particular disclosures to be made in the financial statements.

- **Identification of financial statements (*IAS 1 par .49–.53*)**

The financial statements should be clearly identified. This includes information about the name of the reporting entity, whether the financial statements are for the individual entity or for a group of entities, the reporting date and currency, as well as the level of rounding of the figures (for example R'000).

- **Frequency of reporting (*IAS 1 par .36–.37*)**

It is a requirement that financial statements should be presented at least annually. In exceptional cases, in which an entity's reporting date changes, with the result that the financial statements are presented for a period shorter or longer than one year, the following additional information should be provided:

- The reason for using the longer or shorter period
- The fact that the comparative amounts of the financial statements are not entirely comparable

The financial statements must also be presented within a reasonable time from the end of the financial year; otherwise, the information will be of little or no use to the users of the financial statements.

5.4 Structure and content: Statement of financial position

- **Current/Non-current distinction (*IAS 1 par .60–.65*)**

An important classification in terms of the statement of financial position is whether an item should be disclosed as a current or as a non-current item.

- **Current assets (*IAS 1 par .66–.68*)**

An asset is classified as a current asset when it satisfies any of the following requirements:

- It is expected to be realised in, or is intended for sale or consumption in, the entity's normal operating cycle.
- It is held primarily for the purpose of being traded.

- It is expected to be realised within 12 months after the year-end date.
- It is cash or a cash equivalent.

All other assets are classified as non-current assets.

The operating cycle of an entity is the time between the acquisition for processing and the realisation of its assets for cash or cash equivalents.

- **Current liabilities (IAS 1 par .69–.70)**

A liability is classified as current when it satisfies any of the following requirements:

- It is expected to be settled in the entity's normal operating cycle.
- It is held primarily for the purpose of being traded.
- It is due to be settled within 12 months after the reporting period.
- The entity does not have an unconditional right to defer settlement of the liability for at least 12 months after the year-end date.

All other liabilities are classified as non-current liabilities.

- **Information to be presented on the statement of financial position (IAS 1 par .54–.59)**

The following line items should be included on the statement of financial position:

- (a) Property, plant and equipment
- (b) Investment property
- (c) Intangible assets
- (d) Financial assets (excluding e, h and i)
- (e) Investments accounted for using the equity method
- (f) Biological assets
- (g) Inventories
- (h) Trade and other receivables
- (i) Cash and cash equivalents
- (j) The total of assets classified as held for sale and assets included in disposal groups classified as held for sale
- (k) Trade and other payables
- (l) Provisions
- (m) Financial liabilities (excluding k and l)
- (n) Liabilities and assets for current tax
- (o) Deferred tax liabilities and deferred tax assets
- (p) Liabilities included in disposal groups classified as held for sale
- (q) Non-controlling interest presented within equity
- (r) Issued capital and reserves attributable to owners of the parent

Paragraph .54 of IAS 1 refers to information to be presented on the face of the statement of financial position. What follows is an extract of the accounting statement on financial instruments (*IAS 32*) which is not covered by this module. You need to be introduced to it to understand the statement of financial position classifications.

A financial instrument is defined as "any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity".

A **financial asset** is defined as any asset that is

- cash;
- any equity instrument of another entity;
- a contractual right
 - to receive cash or another financial asset from another financial 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.

An equity instrument is defined as any contract that evidences a residual interest in the assets of an entity after deducting all its liabilities. (This refers to an entity's investment in the equity shares of another entity.)

Examples of financial assets are

- cash;
- deposits at financial institutions;
- promissory notes receivable;
- loans receivable;
- bonds receivable;
- investments in listed companies;
- investments in unlisted companies; and
- investments in associates.

In terms of *paragraph .54 of IAS 1*, financial assets other than "investments accounted for using the equity method, trade and other receivables, and cash and cash equivalents" are grouped together under the heading "Other financial assets". This is the category for the disclosure of for example listed and unlisted investments.

The following are not examples of financial assets:

- property, plant and equipment;
- leased assets;
- inventories;
- goodwill, patents and trademarks;
- prepaid expenses (such as an insurance premium paid in advance, which is not the right to receive cash or another financial asset, but the right to the receipt of goods or services in the future); and
- income taxes that are created as a result of statutory requirements imposed by government.

A **financial liability** is defined as 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.

In the case of preference shares, they can be classified as either financial liabilities or equity.

Where the rights of a preference share

- provide for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date; or
- give the holder the right to require redemption at or after a particular date for a fixed or determinable amount, it meets the definition of a financial liability and it should be disclosed (classified) as such.

If the above does not apply, then issued preference shares will be classified as part of equity.

A preference share that provides for redemption at the option of the issuer (that is at the company's discretion) is not a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders.

These are examples of financial liabilities:

- trade and other creditors;
- promissory notes payable;
- loans payable; and
- bonds payable.

In the case of financial assets and financial liabilities, one party's contractual right to receive cash (or its obligation to pay) is matched by the other party's corresponding obligation to pay (or the right to receive).

- **Information to be presented either on the statement of financial position or in the notes (*IAS 1 par .77–.80A*)**

Further subclassifications of line items presented should be disclosed either on the face of the statement of financial position or in the notes. The disclosures vary for each item, for example:

- Property, plant and equipment are disaggregated into classes according to *IAS 16*.
- Receivables are disaggregated into amounts receivable from trade customers, receivables from related parties, prepayments and other amounts.
- Inventories are subclassified according to *IAS 2*.
- Provisions are disaggregated into provisions for employee benefits and other items.
- Equity capital and reserves are disaggregated into various classes, such as paid-up capital, share premium and reserves.

5.5 Structure and content: Statement of profit or loss and other comprehensive income (*IAS 1 par .81A–.81B*)

The statement of profit or loss and other comprehensive income presents the following in addition to profit or loss and other comprehensive income sections:

- (a) profit or loss;
- (b) total comprehensive income; and
- (c) comprehensive income for the period (the total profit or loss and other comprehensive income)

If an entity presents a separate statement of profit or loss, it does not present the profit or loss section in the statement of profit or loss and other comprehensive income.

An entity must present the following items, in addition to the profit or loss and other comprehensive income sections, as allocation of profit or loss and other comprehensive income for the period:

- (a) Profit or loss for the period attributable to
 - (i) non-controlling interests; and
 - (ii) owners of the parent.

(b) Comprehensive income for the period attributable to

- (i) non-controlling interests; and
- (ii) owners of the parent.

If an entity presents profit or loss in a separate statement, it must present (a) in that statement.

- **Information to be presented in the profit or loss section or the statement of profit or loss (IAS 1 par .82)**

In addition to items required by other IFRSs the profit or loss section or the statement of profit or loss must include line items that present the following amounts for the period:

- revenue;
- gains and losses arising from the derecognition of financial assets measured at amortised cost;
- finance costs;
- share of the profit or loss of associates and joint ventures accounted for using the equity method;
- if a financial asset is reclassified so that it is measured at fair value, any gain or loss arising from a difference between the previous carrying amount and its fair value at the reclassification date;
- tax expense; and
- a single amount for the total of discontinued operations.

An entity must not present any income or expense items as extraordinary items in the statement of profit or loss and other comprehensive income or in the notes.

- **Information to be presented in the other comprehensive income section (IAS 1 par .82A)**

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

- (a) will not be reclassified subsequently to profit or loss; and
- (b) will be reclassified subsequently to profit or loss when specific conditions are met.

- **Profit or loss for the period (IAS 1 par .88–.89)**

An entity must recognise all items of income and expense in a period in profit or loss unless an IFRS requires or permits otherwise.

- **Other comprehensive income for the period (IAS 1 par .90–.96)**

An entity must disclose the amount of income tax relating to each item of other comprehensive income, including reclassification adjustments, either in the statement of profit or loss and other comprehensive income or in the notes.


An entity may present items of other comprehensive income either

- net of related tax effects; or
 - before related tax effects with one amount shown for the aggregate amount of income tax relating to those items.
- **Information to be presented either in the statement of profit or loss and other comprehensive income or in the notes (IAS 1 par .97–.105)**

The nature and amount of all income and expense items must be disclosed separately if they are material.

The following circumstances give rise to separate disclosure of income and expense items:

- inventories written down to net realisable value and reversals of these write-downs;
- property, plant and equipment written down to recoverable amount and reversals of these write-downs;
- restructuring of an entity's activities and reversals of provisions made for the costs of restructuring;
- disposal of property, plant and equipment;
- disposal of investments;
- discontinuing operations;
- litigation settlements; and
- other reversals of provisions.

| | |
|---|---|
|  | <p>LECTURER'S COMMENT</p> <p>The statement of profit or loss and other comprehensive income can be presented in two ways: either by classifying income and expenditure in terms of the functions that give rise to them, or by classifying income and expenditure in terms of their nature.</p> <p>THIS MODULE'S PREFERENCE IS THE CLASSIFICATION OF INCOME AND EXPENSES ACCORDING TO FUNCTION.</p> |
|---|---|

When income and expenditure are classified in terms of the functions which give rise to them, additional information about the nature of the expenditure should be provided in the notes to the statement of profit or loss and other comprehensive income, including the following:

- depreciation;
- amortisation; and
- employee benefit expense.

5.6 Structure and content: Statement of changes in equity (IAS 1 par .106–.110)

A statement of changes in equity forms part of the financial statements. What is essentially required is a reconciliation of equity at the beginning of the financial year with equity at the end of the financial year.

The statement should include the following:

- total comprehensive income for the period, showing separately the total amounts attributable to owners of the parent and non-controlling interest;
- the effects of retrospective application or retrospective restatement recognised in accordance with *IAS 8* for each component of equity; and
- for each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period.

Dividends paid for the period and related dividend per share can be disclosed either in the statement of changes in equity or in the notes.

5.7 Structure and content: Notes to the financial statements (IAS 1 par .112–.138)

The notes to the annual financial statements should

- present information about the basis of preparation of the financial statements;
- present the specific accounting policies selected and applied for significant transactions and events;
- disclose information required not presented elsewhere in the financial statements; and
- provide additional information not presented elsewhere in the financial statements, but which is relevant to an understanding of any of them, for example information about contingent liabilities.

Notes to the annual financial statements should be

- presented in a systematic manner; and
- each item on the statements should be cross-referenced to the notes.

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

- the measurement basis (or bases) used in preparing the financial statements, for example, historical costs, net realisable value and fair value; and
- the other accounting policies used that are relevant to an understanding of the financial statements.

5.8 Example: Presentation of Financial Statements

The following is an example of financial statements prepared in terms of the requirements of *IAS 1*. Please note that this is a very detailed example and not all the items in this example are covered in this module.

XYZ GROUP

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20.12

| | 20.12 R'000 | 20.11 R'000 |
|-------------------------------------|----------------|----------------|
| ASSETS | | |
| Non-current assets | X | X |
| Property, plant and equipment | X | X |
| Investment property | X | X |
| Goodwill | X | X |
| Other intangible assets | X | X |
| Investments in associates | X | X |
| Investments in non-current assets | X | X |
| Deferred tax | X | X |
| Current assets | X | X |
| Inventories | X | X |
| Trade and other receivables | X | X |
| Other investments in current assets | X | X |
| Cash and cash equivalents | X | X |
| Total assets | <u>X</u> | <u>X</u> |

| | 20.12 R'000 | 20.11 R'000 |
|--|------------------------------|------------------------------|
| EQUITY AND LIABILITIES | | |
| Total equity | X | X |
| Equity attributable to owners of the parent | X | X |
| Share capital | X | X |
| Retained earnings | X | X |
| Other components of equity | X | X |
| Non-controlling interest | X | X |
| Total liabilities | X | X |
| Non-current liabilities | X | X |
| Long-term borrowings | X | X |
| Other financial liabilities | X | X |
| Long-term provisions | X | X |
| Deferred tax | X | X |
| Current liabilities | X | X |
| Trade and other payables | X | X |
| Short-term borrowings | X | X |
| Current portion of long-term borrowings | X | X |
| Short-term provisions | X | X |
| Other financial liabilities | X | X |
| Current tax payable | X | X |
| Total equity and liabilities | <u>X</u> | <u>X</u> |

XYZ GROUP

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.12

(Illustrating the classification of expenses by function – this method is preferred by Unisa)

| | 20.12 R'000 | 20.11 R'000 |
|---|----------------|----------------|
| Revenue | X | X |
| Cost of sales | (X) | (X) |
| Gross profit | <u>X</u> | <u>X</u> |
| Other income | X | X |
| Distribution costs | (X) | (X) |
| Administrative expenses | (X) | (X) |
| Other expenses | (X) | (X) |
| Finance costs | (X) | (X) |
| Share of profit of associates | X | X |
| Profit before tax | <u>X</u> | <u>X</u> |
| Income tax expense | (X) | (X) |
| PROFIT FOR THE YEAR | <u>X</u> | <u>X</u> |
| Other comprehensive income: | | |
| Items that will not be reclassified to profit or loss: | | |
| Gains on property revaluation | X | X |
| Remeasurements on defined benefit pension plans | X | X |
| Share of gain (loss) on property revaluation of associates | X | X |
| Income tax relating to items that will not be reclassified | (X) | (X) |
| | <u>X</u> | <u>X</u> |
| Items that may be reclassified subsequently to profit or loss: | | |
| Exchange differences on translating foreign operations | X | X |
| Available-for-sale financial assets | X | X |
| Cash flow hedges | X | X |
| Income tax relating to items that may be reclassified | (X) | (X) |
| | <u>X</u> | <u>X</u> |
| Other comprehensive income for the year, net of tax | <u>X</u> | <u>X</u> |
| TOTAL COMPREHENSIVE INCOME FOR THE YEAR | <u>X</u> | <u>X</u> |
| Profit attributable to | | |
| Owners of the parent | X | X |
| Non-controlling interests | X | X |
| | <u>X</u> | <u>X</u> |
| Total comprehensive income attributable to | | |
| Owners of the parent | X | X |
| Non-controlling interests | X | X |
| | <u>X</u> | <u>X</u> |

XYZ GROUP

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.12

(Illustrating the classification of expenses by nature)

| | 20.12 R'000 | 20.11 R'000 |
|---|----------------|----------------|
| Revenue | X | X |
| Other income | X | X |
| Changes in inventories of finished goods and work in progress | (X) | X |
| Work performed by the entity and capitalised | X | X |
| Raw material and consumables used | (X) | (X) |
| Employee benefits expense | (X) | (X) |
| Depreciation expense | (X) | (X) |
| Amortisation expense | (X) | (X) |
| Impairment of property, plant and equipment | (X) | (X) |
| Other expenses | (X) | (X) |
| Finance costs | (X) | (X) |
| Share of profit of associates | X | X |
| Profit before tax | <u>X</u> | <u>X</u> |
| Income tax expense | (X) | (X) |
| PROFIT FOR THE YEAR | <u>X</u> | <u>X</u> |
| Other comprehensive income: | | |
| Items that will not be reclassified to profit or loss: | | |
| Gains on property revaluation | X | X |
| Remeasurements on defined benefit pension plans | X | X |
| Share of gain (loss) on property revaluation of associates | X | X |
| Income tax relating to items that will not be reclassified | (X) | (X) |
| | <u>X</u> | <u>X</u> |
| Items that may be reclassified subsequently to profit or loss: | | |
| Exchange differences on translating foreign operations | X | X |
| Available-for-sale financial assets | X | X |
| Cash flow hedges | X | X |
| Income tax relating to items that may be reclassified | (X) | (X) |
| | <u>X</u> | <u>X</u> |
| Other comprehensive income for the year, net of tax | <u>X</u> | <u>X</u> |
| TOTAL COMPREHENSIVE INCOME FOR THE YEAR | <u>X</u> | <u>X</u> |
| Profit attributable to | | |
| Owners of the parent | X | X |
| Non-controlling interests | X | X |
| | <u>X</u> | <u>X</u> |
| Total comprehensive income attributable to | | |
| Owners of the parent | X | X |
| Non-controlling interests | X | X |
| | <u>X</u> | <u>X</u> |



LECTURER'S COMMENT

In a statement of profit or loss and other comprehensive income in which expenses are classified by nature, an impairment of property, plant and equipment is shown as a separate line item. By contrast, if expenses are classified by function, the impairment is included in the function(s) to which it relates, and separately disclosed in the note on profit before tax. The same applies to employees' costs, depreciation and amortisation.

An entity may choose to split the statement of profit of loss and other comprehensive income into two separate statements. The one statement, called a statement of profit or loss, then deals with the profit for the year, while the other statement, called a statement of profit or loss and other comprehensive income, shows the total profit for the year as well as the components of other comprehensive income.

XYZ GROUP

STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20.12

| | 20.12 | 20.11 |
|-------------------------------|--------------|--------------|
| | R'000 | R'000 |
| Revenue | X | X |
| Cost of sales | (X) | (X) |
| Gross profit | <u>X</u> | <u>X</u> |
| Other income | X | X |
| Distribution costs | (X) | (X) |
| Administrative expenses | (X) | (X) |
| Other expenses | (X) | (X) |
| Finance costs | (X) | (X) |
| Share of profit of associates | X | X |
| Profit before tax | <u>X</u> | <u>X</u> |
| Income tax expense | (X) | (X) |
| PROFIT FOR THE YEAR | <u>X</u> | <u>X</u> |
| Profit attributable to | | |
| Owners of the parent | X | X |
| Non-controlling interests | X | X |
| | <u>X</u> | <u>X</u> |

XYZ GROUP

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR
THE YEAR ENDED 31 DECEMBER 20.12

| | 20.12 | 20.11 |
|---|--------------|--------------|
| | R'000 | R'000 |
| Profit for the year | X | X |
| Other comprehensive income: | | |
| Items that will not be reclassified to profit or loss: | | |
| Gains on property revaluation | X | X |
| Remeasurements on defined benefit pension plans | X | X |
| Share of gain (loss) on property revaluation of associates | X | (X) |
| Income tax relating to items that will not be reclassified | (X) | (X) |
| | <u>X</u> | <u>X</u> |
| Items that may be reclassified subsequently to profit or loss: | | |
| Exchange differences on translating foreign operations | X | X |
| Available-for-sale financial assets | X | X |
| Cash flow hedges | X | X |
| Income tax relating to items that may be reclassified | (X) | (X) |
| | <u>X</u> | <u>X</u> |
| Other comprehensive income for the year, net of tax | <u>X</u> | <u>X</u> |
| TOTAL COMPREHENSIVE INCOME FOR THE YEAR | <u>X</u> | <u>X</u> |
| | | |
| Total comprehensive income attributable to | | |
| Owners of the parent | X | X |
| Non-controlling interests | X | X |
| | <u>X</u> | <u>X</u> |

XYZ GROUP
STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20.12

| | Share capital R'000 | Retained earnings R'000 | Translation of foreign operations R'000 | Investment in equity instruments R'000 | Cash flow hedges R'000 | Revaluation surplus R'000 | Total R'000 | Non-controlling interest R'000 | Total equity R'000 |
|---|---------------------|-------------------------|---|--|------------------------|---------------------------|-------------|--------------------------------|--------------------|
| Balance at 1 January 20.11 | X | X | X | X | X | - | X | X | X |
| Changes in accounting policy | - | X | - | - | - | - | X | X | X |
| Restated balance | X | X | X | X | X | X | X | X | X |
| Changes in equity for 20.11 | | | | | | | | | |
| Dividends | - | X | - | - | - | - | X | - | X |
| Total comprehensive income for the year | - | X | X | X | X | X | X | X | X |
| Balance at 31 December 20.11 | X | X | X | X | X | X | X | X | X |
| Changes in equity for 20.12 | | | | | | | | | |
| Issue of share capital | X | - | - | - | - | - | X | - | X |
| Dividends | - | X | - | - | - | - | X | - | X |
| Total comprehensive income for the year | - | X | X | X | X | X | X | X | X |
| Transfer to retained earnings | - | X | - | - | - | X | - | - | - |
| Balance at 31 December 20.12 | X | X | X | X | X | X | X | X | X |

LECTURER'S COMMENT**Statement of changes in equity**

IAS 1 requires disclosure of dividend per share in the statement of changes in equity, or alternatively in the notes.

The statement of changes in equity reflects the opening and closing balances of all the share capital and reserve accounts, the effects of changes in accounting policies/correction of prior period errors, the total comprehensive income for the period (reported as a single line item), the issue of shares, the repurchase of shares, dividends paid and transfers between reserves.

5.9 Illustrative financial statement structure

Work carefully through the appendix to *IAS 1*. Note the layout of the statement of financial position, statement of profit or loss and other comprehensive income and statement of changes in equity and the required forms of disclosure. At all times take into account what you have already learnt in this section of the study material.

The following detailed example illustrates all aspects of financial statements. The examination will not include a question of this detail and length.

Example 1

The following trial balance is available for A Ltd at 31 December 20.12:

| | Dr | Cr |
|---|----------------|----------------|
| | R | R |
| Share capital – issued and fully paid: | | |
| Ordinary shares | | 50 000 |
| 7% redeemable preference shares | | 15 000 |
| Accumulated depreciation of plant and equipment (31/12/20.11) | | 8 250 |
| Accumulated amortisation of patents and trademarks (31/12/20.11) | | 1 500 |
| Plant and equipment at cost (31/12/20.11) | 90 500 | |
| Land and buildings at fair value (cost R34 545) | 37 875 | |
| Patents and trademarks at cost (31/12/20.11) | 7 500 | |
| Investment at fair value | 16 500 | |
| Revenue (sales to customers, excluding VAT) | | 60 250 |
| Raw material purchased | 11 750 | |
| Work in progress – 31 December 20.11 | 2 000 | |
| Finished goods on hand – 31 December 20.11 | 12 000 | |
| Raw materials on hand – 31 December 20.11 (valued at cost on FIFO basis) | 1 500 | |
| Selling and distribution expenses | 3 800 | |
| Administrative expenses | 22 200 | |
| Proceeds on sale of plant and equipment | | 4 500 |
| Loss on expropriation of land | 1 000 | |
| Retained earnings – 31 December 20.11 | | 18 750 |
| Dividends received – B Ltd | | 2 700 |
| Bank overdraft | | 19 500 |
| Trade and other payables | | 71 525 |
| Trade and other receivables | 45 350 | |
| | <u>251 975</u> | <u>251 975</u> |

Additional information

1. Trade and other receivables

Includes provisional tax payments of R7 000.

2. Trade and other payables

Creditors are secured by plant to the value of R35 000 (payable within one year).
Accrued interest on debentures also forms part of creditors.

3. Administrative expenses include the following:

| | R |
|--|----------|
| Interest on bank overdraft | 1 450 |
| Auditors' remuneration – for audit | 1 000 |
| Managing director's salary – executive | 1 500 |
| Directors' remuneration – executive | 300 |
| Salaries and wages | 12 500 |
| Rent paid | 2 500 |

4. Property, plant and equipment

- Land and buildings held for capital appreciation are considered by the directors to be investment properties and are valued at fair value. Operating expenses of the investment property amounted to R2 000 for the year ended 31 December 20.12. Land with fair value of R15 000 (cost R12 000) was expropriated during the year. Land and buildings are valued by an independent valuer with a recognised and relevant qualification. There were no fair value adjustments for the year ended 31 December 20.12.
- During the year, plant which had a cost of R6 000 was sold for R4 500. The depreciation provided on this plant to 31 December 20.11 is R1 250. There were no other sales of plant and equipment during the year.
- Depreciation on plant and equipment must still be provided for the year. The details are as follows:

| | R |
|--|--------------|
| Depreciation from beginning of year to date of disposal of plant | 1 000 |
| Depreciation on remaining plant and equipment | 3 500 |
| | <u>4 500</u> |

- The tax bases and carrying amounts of property, plant and equipment were equal at the beginning of the year. Depreciation per the accounts is the same as that allowed by the SA Revenue Service.

5. Patents and trademarks

The patents and trademarks are amortised over five years according to the straight-line method. The amortisation charge for 20.12 is R1 500, which is the same as that allowed by the SA Revenue Service.

6. Authorised and issued share capital

- The authorised and issued share capital consists of

- 50 000 ordinary shares.
- 15 000 7% redeemable preference shares.

The redeemable preference shares are redeemable at the company's discretion, on or before 1 July 20.13, at a premium of 5%.

- There were no new issues of shares during the year.

7. Investment

Investment consists of 7 500 ordinary shares of R1 each in B Ltd, which is quoted on the JSE Limited (SA). The market value on 31 December 20.12 was R2,20 per share.

8. Provision must be made for the following:

- Current tax at 28%. It may be assumed that "selling and distribution expenses" and "administrative expenses" do not include any disallowable expenditure for income tax purposes.
- Annual preference dividend.
- Dividends proposed to ordinary shareholders of R7 500.

9. Inventory

The value (lower of cost or net realisable value) of inventory at 31 December 20.12 is:

| | R |
|------------------|----------|
| Raw materials | 1 500 |
| Work in progress | 3 000 |
| Finished goods | 11 250 |



REQUIRED

Prepare the annual financial statements of A Ltd for the year ended 31 December 20.12. Your answer must comply with the requirements of International Financial Reporting Standards.

Ignore the implications of capital gains tax.

Please note: The classification of financial assets and financial liabilities in this question does not form part of this module.

| |
|-------------------|
| Solution 1 |
|-------------------|

A LTD**STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20.12**

| | Notes | R |
|-------------------------------------|-------|----------------|
| ASSETS | | |
| Non-current assets | | 116 375 |
| Property, plant and equipment | 2 | 74 000 |
| Investment property | 3 | 37 875 |
| Patents and trademarks | 4 | 4 500 |
| Current assets | | 72 700 |
| Inventory | 5 | 15 750 |
| Trade and other receivables (5) | 6 | 38 350 |
| Other investments in current assets | 6 | 16 500 |
| SA Revenue Service (6) | | 2 100 |
| Total assets | | <u>189 075</u> |
| EQUITY AND LIABILITIES | | |
| Total equity | | 89 500 |
| Share capital | 7 | 65 000 |
| Retained earnings | | 24 500 |
| Total liabilities | | 99 575 |
| Current liabilities | | 99 575 |
| Trade and other payables | 8 | 71 525 |
| Dividends proposed (4) | | 8 550 |
| Bank overdraft | 8 | 19 500 |
| Total equity and liabilities | | <u>189 075</u> |

A LTD

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.12

(according to classification of expenses by function)

| | Notes | R |
|--|--------------|--------------------------|
| Revenue | 9 | 60 250 |
| Cost of sales (11 750 + 2 000 + 12 000 + 1 500 – 15 750) | | (11 500) |
| Gross profit | | <u>48 750</u> |
| Other income [4 500 (proceeds) – (6 000 (cost) – 1 250 (acc depr) – 1 000 (depr)) + 2 700 (div rec)] | | 3 450 |
| Distribution costs | | (3 800) |
| Administrative expenses (22 200 – 1 450) | | (20 750) |
| Other expenses (4 500 (depr) + 1 500 (amort) + 1 000 (loss)) | | (7 000) |
| Finance costs | | (1 450) |
| Profit before tax | 10 | <u>19 200</u> |
| Income tax expense (1) | 11 | (4 900) |
| PROFIT FOR THE YEAR | | <u><u>14 300</u></u> |
| TOTAL COMPREHENSIVE INCOME FOR THE YEAR | | <u><u>14 300</u></u> |

OR

A LTD

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.12

(according to classification of expenses by nature)

| | Notes | R |
|---|-------|---------------|
| Revenue | 9 | 60 250 |
| Other income | | 3 450 |
| [4 500 – (6 000 – 1 250 – 1 000) + 2 700] | | |
| Changes in inventories of finished goods and work in progress | | |
| [(11 250 + 3 000) – (12 000 + 2 000)] | | 250 |
| Raw material consumed | | (11 750) |
| Employee benefits expense | | (12 500) |
| Depreciation and amortisation expense (4 500 + 1 500) | | (6 000) |
| Other expenses (3) | | (13 050) |
| Finance costs | | (1 450) |
| Profit before tax | 10 | <u>19 200</u> |
| Income tax expense (1) | 11 | (4 900) |
| PROFIT FOR THE YEAR | | <u>14 300</u> |
| TOTAL COMPREHENSIVE INCOME FOR THE YEAR | | <u>14 300</u> |

(**Note:** If this classification is used, employee benefits expense and depreciation would not be disclosed in the note dealing with the components of profit before tax.)

**LECTURER'S COMMENT**

Please note that the line item "other income" in the statement of profit or loss and other comprehensive income includes both investment income and operating income.

A LTD

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20.12

| | Share capital R | Retained earnings R | Total Equity R |
|---|-----------------------|---------------------------|----------------------|
| Balance at 1 January 20.12 | 65 000 | 18 750 | 83 750 |
| Changes in equity for 20.12 | | | |
| Total comprehensive income for the year | | 14 300 | 14 300 |
| Dividends paid | | | |
| – ordinary (1) | | (7 500) | (7 500) |
| – preference (2) | | (1 050) | (1 050) |
| Balance at 31 December 20.12 | 65 000 | 24 500 | 89 500 |

(1) Given

(2) 15 000 x 7%

A LTD

NOTES FOR THE YEAR ENDED 31 DECEMBER 20.12

1. Accounting policy

The financial statements have been prepared in accordance with International Financial Reporting Standards.

The financial statements have been prepared on the historical cost basis, as modified by the revaluation of land and buildings, investment property, financial assets and financial liabilities at fair value through profit or loss, financial assets at fair value through other comprehensive income and financial assets and financial liabilities at amortised cost.

They incorporate the following principal accounting policies that are consistent with the policies applied in previous years, except where otherwise stated.



LECTURER'S COMMENT

IAS 1.16 requires disclosure of the fact that IFRSs have been complied with.

1.1 Property, plant and equipment

Property, plant and equipment are initially recognised at cost price. Plant and equipment are subsequently measured at historical cost less accumulated depreciation and accumulated impairment losses. Plant and equipment are depreciated according to the straight-line method over their estimated useful lives, which were as follows on 1 January 20.12:

Plant and equipment – x years

The residual values and useful lives of all items of property, plant and equipment are reviewed and adjusted, if necessary, in each reporting period.

1.2 Investment property

Investment property is land and buildings held to earn rentals, for capital appreciation, or for both reasons. Investment property is initially recognised at cost and subsequently measured at fair value, with fair-value adjustments recognised in profit or loss for the period. The fair value of investment property is determined at the reporting period by an independent sworn appraiser based on market evidence of the most recent prices obtained in arm's length transactions of similar properties in the same area.

1.3 Patents and trademarks

Patents and trademarks acquired are initially recognised at cost. Patents and trademarks have a finite useful life and they are carried at cost less accumulated amortisation and accumulated impairment losses. Amortisation on patents and trademarks is calculated using the straight-line method over a period of five years.

1.4 Inventory

Inventory and work in progress are stated at the lower of cost or net realisable value. Cost is determined according to the following methods pertaining to each class:

Raw materials – at actual cost calculated using the FIFO method

Work in progress – at manufacturing cost including overheads

Finished goods – at manufacturing cost including overheads

1.5 Financial assets

Financial assets are recognised in the entity's statement of financial position when the entity becomes a party to the contractual provisions of an instrument.

Financial instruments are initially measured at fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, the transaction costs directly attributable to the acquisition or issue of the financial asset or financial liability.

The entity classifies its financial assets in the following categories: at amortised cost; at fair value through profit or loss; or at fair value through other comprehensive income. The entity's classification depends on the substance of the contractual arrangement and the definition of a financial asset.

1.6 Financial liabilities

Financial liabilities are recognised in the entity's statement of financial position when the entity becomes a party to the contractual provisions of the instrument. The classification depends on the substance of the contractual arrangement and the definition of a financial liability.

1.7 Revenue

Revenue is measured at the fair value of the consideration received or receivable. Revenue represents the transfer of promised goods and services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. Revenue is recognised from contracts with customers when performance obligations are satisfied.

2. Property, plant and equipment

| | R |
|---|-----------------|
| Carrying amount at the beginning of the year | 82 250 |
| Cost | 90 500 |
| Accumulated depreciation | (8 250) |
| Depreciation | (4 500) |
| Disposals | (3 750) |
| Carrying amount at end of the year | <u>74 000</u> |
| Cost (90 500 – 6 000) | 84 500 |
| Accumulated depreciation (2) | <u>(10 500)</u> |

Plant to the value of R35 000 serves as security for creditors.

3. Investment property

| | R |
|--|---------------|
| Carrying amount at fair value – 31 December 20.11 | 52 875 |
| Cost (34 545 + 12 000) | 46 545 |
| Fair value adjustments [(15 000 – 12 000) + (37 875 – 34 545)] | 6 330 |
| Expropriation of land | (15 000) |
| Carrying amount at fair value – 31 December 20.12 | <u>37 875</u> |
| Cost | 34 545 |
| Fair value adjustments (37 875 – 34 545) | <u>3 330</u> |

Land and buildings are valued by an independent valuer with a recognised and relevant qualification.

4. Patents and trademarks

| | R |
|---|----------------|
| Carrying amount at the beginning of the year | 6 000 |
| Cost | 7 500 |
| Accumulated amortisation | (1 500) |
| Amortisation for the year | (1 500) |
| Carrying amount at end of the year | <u>4 500</u> |
| Cost | 7 500 |
| Accumulated amortisation | <u>(3 000)</u> |

5. Inventory

Inventory consists of

| | R |
|------------------|---------------|
| Raw materials | 1 500 |
| Work in progress | 3 000 |
| Finished goods | 11 250 |
| | <u>15 750</u> |

6. Financial assets

| | R |
|--|----------|
| Current financial assets | |
| Trade receivables | 38 350 |
| Other investments in current assets | |
| Financial assets at fair value through profit and loss | |
| Listed investment: 7 500 shares in B Ltd at fair value | 16 500 |

7. Share capital

R

Authorised

| | |
|--|---------------|
| 50 000 ordinary shares | 50 000 |
| 15 000 7% redeemable preference shares | 15 000 |
| | <u>65 000</u> |

Issued

R

| | |
|--|---------------|
| 50 000 ordinary shares | 50 000 |
| 15 000 7% redeemable preference shares | 15 000 |
| | <u>65 000</u> |

The 7% redeemable preference shares are redeemable at the company's discretion at a premium of 5% on or before 1 July 20.13.

LECTURER'S COMMENT



Redeemable preference shares

Preference shares may be issued with various rights. In classifying a preference share as a liability or equity, an entity assesses the particular rights attaching to the share to determine whether or not it exhibits the fundamental characteristic of a financial liability. For example, a preference share that provides for redemption on a specific date or at the option of the holder meets the definition of a financial liability if the issuer has an obligation to transfer financial assets to the holder of the share. An option of the issuer to redeem the share does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders. Redemption of the shares is solely at the discretion of the issuer. When preference shares are non-redeemable, the appropriate classification is determined by the other rights that may attach to them. When distributions to holders of the preference shares are at the discretion of the issuer, the shares are equity instruments (*IAS 32 paragraphs 15–20*).

8. Financial liabilities

Current financial liabilities

R

| | |
|------------------------------|--------|
| Trade and other payables | 71 525 |
| Other financial liabilities: | |
| Bank overdraft | 19 500 |

9. Revenue**R**

| | |
|--------------------|---------------|
| Sales to customers | <u>60 250</u> |
|--------------------|---------------|

10. Profit before tax

Profit before tax is stated after charging the following:

R**Income**

| | |
|--|-------|
| Other income – profit on sale of plant | 750 |
| Income from investments – dividends received from listed investments | 2 700 |

Expenses

| | |
|--|--------|
| Finance costs – interest paid on bank overdraft | 1 450 |
| Auditors' remuneration – for audit | 1 000 |
| Directors' remuneration – executive directors | 1 800 |
| As director | 300 |
| Other services | 1 500 |
| Depreciation on property, plant and equipment | 4 500 |
| Amortisation – patents and trademarks | 1 500 |
| Employee benefits expenses | 12 500 |
| Rent paid | 2 500 |
| Operating expenses relating to investment property which does not generate rental income | 2 000 |

**LECTURER'S COMMENT**

Note that *IAS 1.104* requires that when expenses are classified by function, additional information on the nature of total depreciation, amortisation and staff costs should be disclosed in a note.

11. Income tax expense

R

Major components of tax expense

Current tax expense – current year

4 900

Tax rate reconciliation

| | R | OR | % |
|--|--------------|----|-------------|
| Standard rate of tax (19 200 x 28%) | 5 376 | | 28,0 |
| Adjusted for exempt differences: | | | |
| Loss on expropriation of land (capital) (1 000 x 28%); [((1 000 x 28%) ÷ 19 200) x 100] | 280 | | 1,4 |
| Dividends received (2 700 x 28%); [((2 700 x 28%) ÷ 19 200) x 100] | (756) | | (3,9) |
| Effective rate of tax [(4 900 ÷ 19 200) x 100] | <u>4 900</u> | | <u>25,5</u> |

Calculations

1. Taxable income and tax payable

R

| | |
|----------------------------------|---------------|
| Profit before tax | 19 200 |
| Dividends received (not taxable) | (2 700) |
| Loss on expropriation of land | 1 000 |
| Taxable income | <u>17 500</u> |
| Tax payable at 28% | <u>4 900</u> |

2. Depreciation

R

| | |
|--|---------------|
| Accumulated depreciation per trial balance | 8 250 |
| Accumulated depreciation in respect of plant sold | (1 250) |
| | <u>7 000</u> |
| Depreciation for the year | 4 500 |
| Depreciation for the year in respect of plant sold | (1 000) |
| Accumulated depreciation at 31 December 20.12 | <u>10 500</u> |

3. Other expenses (nature)

| | Total | Nature |
|---|---------------|---------------|
| | R | R |
| Auditors' remuneration | 1 000 | 1 000 |
| Managing director's salary | 1 500 | 1 500 |
| Directors' remuneration | 300 | 300 |
| Interest on bank overdraft* | 1 450 | – |
| Staff costs* | 12 500 | – |
| Rent paid | 2 500 | 2 500 |
| Other (balancing figure) | 2 950 | 2 950 |
| Administrative expenses per trial balance | <u>22 200</u> | |
| Selling and distribution costs | | 3 800 |
| Loss on expropriation of land | | 1 000 |
| Other expenses | | <u>13 050</u> |

*Disclosed separately

4. Dividends proposed

| | R |
|---------------------------------|--------------|
| Ordinary shares (50 000 x 15%) | 7 500 |
| Preference shares (15 000 x 7%) | 1 050 |
| | <u>8 550</u> |

5. Trade and other receivables

| | R |
|---------------------------|---------------|
| Balance per trial balance | 45 350 |
| Provisional tax payments | (7 000) |
| | <u>38 350</u> |

6. SA Revenue Service

| | R |
|----------------------------------|--------------|
| Provisional tax payments | 7 000 |
| Current tax expense for the year | (4 900) |
| | <u>2 100</u> |

Example 2

The following list of balances of Door Ltd for the year ended 31 December 20.12 is available:

| | 20.12 | 20.11 |
|--|------------------|------------------|
| | R'000 | R'000 |
| Credits | | |
| Share capital | 147 834 | 147 834 |
| Revaluation surplus (net after tax) | 7 200 | – |
| Retained earnings at beginning of year | 29 446 | 33 802 |
| Long-term loans | 277 425 | 140 297 |
| Deferred taxation | 28 875 | 23 100 |
| Sales | 1 287 052 | 902 052 |
| Trade and other payables | 35 990 | 20 145 |
| Current portion of long-term loans | 83 042 | 24 639 |
| Shareholders for dividends | 17 409 | 11 606 |
| Bank overdraft | 1 652 | – |
| | <u>1 915 925</u> | <u>1 303 475</u> |
| Debits | | |
| Property, plant and equipment | 33 269 | 21 496 |
| Inventories | 187 391 | 151 273 |
| Trade and other receivables | 427 536 | 222 833 |
| Bank balances and cash | – | 1 465 |
| Cost of sales | 1 098 187 | 819 939 |
| Operating costs | 103 435 | 46 592 |
| Interest paid | 39 264 | 20 862 |
| Income tax expense | 5 621 | 3 877 |
| Dividends paid | 21 222 | 15 138 |
| | <u>1 915 925</u> | <u>1 303 475</u> |

Additional information

1. Operating costs comprise out of the following items:

| | 20.12 | 20.11 |
|--------------------------------|----------------|---------------|
| | R'000 | R'000 |
| Depreciation | 3 002 | 2 237 |
| Loss on scrapping of equipment | 500 | – |
| Distribution costs | 25 741 | 14 010 |
| Administrative expenses | 28 813 | 10 345 |
| Staff costs | 45 379 | 20 000 |
| | <u>103 435</u> | <u>46 592</u> |

2. Assume that the SA normal tax rate is 28%. The income tax expense as per list of balances (assume correct) comprised of the following:

| | R'000 | R'000 |
|---------------|--------------|--------------|
| SA normal tax | 5 621 | 3 877 |
| – current | 1 721 | 777 |
| – deferred | 3 900 | 3 100 |

3. The revaluation surplus relates to land which was revalued during the year by an independent sworn appraiser.
4. Dividends amounting to R21 222 (20.11: R15 138) were paid to shareholders during the year.
5. Ignore earnings and dividend per share.
6. The long-term loans are interest bearing.
7. Door Ltd classifies expenses by function in a single statement of profit or loss and other comprehensive income.



REQUIRED

Prepare the annual financial statements of Door Ltd for the year ended 31 December 20.12. Your answer must comply with International Financial Reporting Standards. The tax rate reconciliation is not required.

Solution 2

DOOR LTD

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20.12

| | 20.12 R'000 | 20.11 R'000 |
|---|----------------|----------------|
| ASSETS | | |
| Non-current assets | | |
| Property, plant and equipment | 33 269 | 21 496 |
| Current assets | 614 927 | 375 571 |
| Inventories | 187 391 | 151 273 |
| Trade and other receivables | 427 536 | 222 833 |
| Cash and cash equivalents | – | 1 465 |
| Total assets | <u>648 196</u> | <u>397 067</u> |
| EQUITY AND LIABILITIES | | |
| Total equity | 203 803 | 177 280 |
| Issued capital | 147 834 | 147 834 |
| Revaluation surplus | 7 200 | – |
| Retained earnings | 48 769 | 29 446 |
| Total liabilities | 444 393 | 219 787 |
| Non-current liabilities | 306 300 | 163 397 |
| Long-term borrowings | 277 425 | 140 297 |
| Deferred taxation | 28 875 | 23 100 |
| Current liabilities | 138 093 | 56 390 |
| Trade and other payables | 35 990 | 20 145 |
| Current portion of long-term borrowings | 83 042 | 24 639 |
| Shareholders for dividends | 17 409 | 11 606 |
| Bank overdraft | 1 652 | – |
| Total equity and liabilities | <u>648 196</u> | <u>397 067</u> |

DOOR LTD

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20.12

| | Attributable to equity holders of parent | | | |
|---|--|---------------------|-------------------|----------------|
| | Share capital | Revaluation-surplus | Retained earnings | Total equity |
| | R'000 | R'000 | R'000 | R'000 |
| Balance at 1 January 20.11 | 147 834 | – | 33 802 | 181 636 |
| Changes in equity for 20.11 | | | | |
| Total comprehensive income for the year | – | – | 10 782 | 10 782 |
| Dividends | – | – | (15 138) | (15 138) |
| Balance at 31 December 20.11 | <u>147 834</u> | <u>–</u> | <u>29 446</u> | <u>177 280</u> |
| Changes in equity for 20.12 | | | | |
| Total comprehensive income for the year | – | 7 200 | 40 545 | 47 745 |
| Dividends | – | – | (21 222) | (21 222) |
| Balance at 31 December 20.12 | <u>147 834</u> | <u>7 200</u> | <u>48 769</u> | <u>203 803</u> |

DOOR LTD

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.12

| | Notes | 20.12 R'000 | 20.11 R'000 |
|---|-------|----------------|----------------|
| Revenue | | 1 287 052 | 902 052 |
| Cost of sales | | (1 098 187) | (819 939) |
| Gross profit | | 188 865 | 82 113 |
| Distribution costs | | (25 741) | (14 010) |
| Administrative expenses | | (28 813) | (10 345) |
| Other expenses (3 002 + 500 + 45 379);(2 237 + 20 000) | | (48 881) | (22 237) |
| Finance cost | | (39 264) | (20 862) |
| Profit before tax | | 46 166 | 14 659 |
| Income tax expense | 3 | (5 621) | (3 877) |
| PROFIT FOR THE YEAR | 2 | 40 545 | 10 782 |
| Other comprehensive income for the year, after tax: | | | |
| Items that will not be reclassified to profit or loss: | | | |
| Gains on property revaluation | 4,5 | 7 200 | – |
| Other comprehensive income for the year, net of tax | | 7 200 | – |
| TOTAL COMPREHENSIVE INCOME FOR THE YEAR | | <u>47 745</u> | <u>10 782</u> |

DOOR LTD

NOTES FOR THE YEAR ENDED 31 DECEMBER 20.12

1. Accounting policy

1.1 Basis of preparation

The financial statements have been prepared in accordance with International Financial Reporting Standards.

The financial statements have been prepared on the historical cost basis, except for land that is revalued.

[Now provide the accounting policy for every transaction type. Note that you do not have enough information to do it here.]



LECTURER'S COMMENT

IAS 1.16 requires disclosure of the fact that IFRSs have been complied with.

2. Profit before tax

Included in profit before tax are the following:

| | 20.12 | 20.11 |
|--------------------------------|--------------|--------------|
| | R'000 | R'000 |
| Depreciation | 3 002 | 2 237 |
| Loss on scrapping of equipment | 500 | – |
| Staff costs | 45 379 | 20 000 |

LECTURER'S COMMENT

1. Note that when expenses are classified according to function, the following should be disclosed in the profit before tax note (*IAS 1.104*):
 - total depreciation
 - total amortisation
 - employee benefit expense
2. The loss on scrapping of equipment qualifies as a separately disclosable item (*IAS 1.98*). Only the nature thereof and the amount should be disclosed.

3. Income tax expense

| | 20.12 | 20.11 |
|---|--------------|--------------|
| | R'000 | R'000 |
| Major components of tax expense: | | |
| Current tax expense – current year | 1 721 | 777 |
| Deferred tax expense – current | 3 900 | 3 100 |
| | <u>5 621</u> | <u>3 877</u> |

Income tax relating to the components of other comprehensive income

| | 20.12 | 20.11 |
|---|--------------|--------------|
| | R'000 | R'000 |
| Deferred tax relating to gain on property revaluation | <u>2 800</u> | <u>–</u> |

4. Disclosure of components of other comprehensive income

| | 20.12 | 20.11 |
|---|--------------|--------------|
| | R'000 | R'000 |
| Gains on property revaluation | 7 200 | – |
| Other comprehensive income for the year | <u>7 200</u> | <u>–</u> |

5. Disclosure of tax effects relating to each component of other comprehensive income

| | 20.12 | | | 20.11 | | |
|------------------------------------|--------------------------|-------------------------------|--------------------------|--------------------------|-------------------------------|--------------------------|
| | Before tax amount | Tax (expense)/ benefit | Net of tax amount | Before tax amount | Tax (expense) /benefit | Net of tax amount |
| | R'000 | R'000 | R'000 | R'000 | R'000 | R'000 |
| Gains on pro- perty revaluation | 10 000 | (2 800) | 7 200 | – | – | – |
| Other compre- hensive income | 10 000 | (2 800) | 7 200 | – | – | – |



ASSESSMENT CRITERIA

Are you now able to do the following?

- State the purpose of preparing financial statements and name the person responsible for this.
- Explain and describe the overall considerations to be taken into account during the preparation of the financial statements.
- Prepare a comprehensive set of financial statements from given information in accordance with the requirements of *IAS 1*.

LEARNING UNIT 6

**EVENTS AFTER THE
REPORTING PERIOD
(IAS 10)**



LEARNING OUTCOMES

The learner should be able to identify events after the reporting period and disclose them in the financial statements of the company in terms of the requirements of International Financial Reporting Standards.

OVERVIEW

This learning unit is divided into the following:

- 6.1 Definitions
- 6.2 Recognition and measurement
 - 6.2.1 Adjusting events after the reporting period
 - 6.2.2 Non-adjusting events after the reporting period
 - 6.2.3 Dividends
 - 6.2.4 Going concern
- 6.3 Disclosure
 - 6.3.1 Date of authorisation for issue
 - 6.3.2 Updating of disclosure about conditions at the reporting period
 - 6.3.3 Non-adjusting events after the reporting period
- 6.4 Schematic presentation of events after the reporting period

STUDY

PRESCRIBED

Descriptive accounting
Chapter 7

RECOMMENDED:

A Guide Through IFRS
IAS 10 – Events after the reporting period

OVERVIEW OF THE LEARNING UNIT

This standard should be applied in the accounting for and disclosure of events after the reporting period.

The objective of this standard is to prescribe

- (a) when an entity should adjust its financial statements for events after the reporting period; and
- (b) What an entity should disclose about the date when the financial statements were authorised for issue and about events after the reporting period.

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

6.1 DEFINITIONS (IAS 10.3)

The following term is used in the standard with the meaning specified:

Events after the reporting period are those events, both favourable and unfavourable, that occur between the reporting date and the date when the financial statements are authorised for issue. Two types of events can be identified:

- (a) those that provide evidence of conditions that existed at the end of the reporting period (adjusting events after the reporting period); and
- (b) those that are indicative of conditions that arose after the reporting period (non-adjusting events after the reporting period).

The process involved in authorising the financial statements for issue varies depending on the management structure, statutory requirements and procedures followed in preparing and finalising the financial statements.

In some cases, an entity is required to submit its financial statements to its shareholders for approval after the financial statements have already been issued. In such cases, the financial statements are authorised for issue on the date of original issuance, not on the date when shareholders approve the financial statements.

EXAMPLE 1

The management of an entity completes draft financial statements for the year ended 31 December 20.11 on 29 February 20.12. On 18 March 20.12, the board of directors reviews the financial statements and authorises them for issue. The entity announces its profit and selected other financial information on 19 March 20.12. The financial statements are made available to shareholders and others on 1 April 20.12. The annual meeting of shareholders approves the financial statements on 15 May 20.12 and the approved financial statements are then filed with the regulatory body on 17 May 20.12.

The financial statements are authorised for issue on 18 March 20.12 (date when the Board of directors authorised it for issue). Events after the reporting period will therefore include those events that occur between the reporting date and 18 March 20.12.

In some cases, the management of an entity is required to issue its financial statements to a supervisory board (made up solely of non-executives) for approval. In such cases, the financial statements are authorised for issue when the management authorises them for issue to the supervisory board.

EXAMPLE 2

On 18 March 20.12, the management of an entity authorises financial statements for issue to its supervisory board. The supervisory board is made up solely of non-executives and may include representatives of employees and other outside interest groups. The supervisory board approves the financial statements on 26 March 20.12. The financial statements are made available to shareholders and others on 1 April 20.12. The annual meeting of shareholders receives the financial statements on 15 May 20.12 and the financial statements are then filed with the regulatory body on 17 May 20.12.

The financial statements are authorised for issue on 18 March 20.12 (date of authorisation for issue to the supervisory board). Events after the reporting period will therefore include those events that occur between the reporting date and 18 March 20.12.

Events after the reporting date include all events up to the date when the financial statements are authorised for issue, even if those events occur after the publication of a profit announcement or of other selected financial information.

6.2 RECOGNITION AND MEASUREMENT

6.2.1 Adjusting events after the reporting period (IAS 10 par .08–.09)

An entity must adjust the amounts recognised in its financial statements to reflect adjusting events after the reporting period.

The following are examples of **adjusting events after the reporting period** that require an entity to **adjust the amounts recognised in its financial statements, or to recognise items that were not previously recognised**:

- (a) The resolution after the reporting period of a court case which, because it confirms that an entity already had a present obligation at the reporting period, requires the entity to adjust a provision already recognised, or to recognise a provision instead of merely disclosing a contingent liability.
- (b) The receipt of information after the reporting period indicating that an asset was impaired at the reporting date, or that the amount of a previously recognised impairment loss for that asset needs to be adjusted. For example:
 - (i) The bankruptcy of a customer which occurs after the reporting period usually confirms that a loss already existed at the reporting date on a trade receivable account and that the entity needs to adjust the carrying amount of the trade receivable account.
 - (ii) The sale of inventories after the reporting period may give evidence about their net realisable value at the end of the reporting period.
- (c) The determination after the reporting period of the cost of assets purchased or the proceeds from assets sold before the reporting period.
- (d) 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 reporting date to make such payments as a result of events before that date. (According to the statement on Employee Benefits – not part of this module).
- (e) The discovery of fraud or errors that show that the financial statements were incorrect.

EXAMPLE 3

The financial year end of Beta Ltd is 31 December 20.11 and the financial statements are authorised for issue on 30 March 20.12.

On 5 January 20.12, the employees of the construction division of Beta Ltd found rock formations at one of the company's construction projects that would delay construction to such an extent that additional costs amounting to R500 000 would be incurred. This event refers to a condition that existed at the reporting period, because the rock formations existed at 31 December 20.11. The additional cost of R500 000 should therefore be accounted for in the financial year ended 31 December 20.11.

6.2.2 Non-adjusting events after the reporting period (IAS 10 par .10–.11)

An entity must not adjust the amounts recognised in its financial statements to reflect non-adjusting events after the reporting period.

An example of a non-adjusting event after the reporting period is a decline in market value of investments between the reporting period and the date when the financial statements are authorised for issue. The decline in fair value does not normally relate to the condition of the investments at the reporting period, but reflects circumstances that have arisen subsequently. Therefore, an entity does not adjust the amounts recognised in its financial statements for the investments. Similarly, the entity does not update the amounts disclosed for the investments as at the reporting date, although it may need to give additional disclosure (see the paragraph dealing with disclosure).

The following are examples of **non-adjusting events after the reporting period** that may be of such importance that non-disclosure would affect the ability of the users of the financial statements to make proper evaluation and decisions (IAS 10.22):

- (a) a major business combination after the reporting period (paragraph 59(b) and B66 of *IFRS 3 – Business combinations*, requires specific disclosures in such cases – not part of this module) or disposing of major subsidiary;
- (b) announcing a plan to discontinue operation, disposing of assets or settling liabilities attributable to a discontinuing operation or entering into binding agreements to sell such assets or settle such liabilities;
- (c) major purchases and disposals of assets, or expropriation of major assets by government;
- (d) the destruction of a major production plant by a fire after the reporting period;
- (e) announcing, or commencing the implementation of, a major restructuring (see *IAS 37 – Provisions, contingent liabilities and contingent assets*);
- (f) major ordinary share transactions and potential ordinary share transactions after the reporting period (*IAS 33 – Earnings per share*, encourages an entity to disclose a description of such transactions, other than capitalisation issues and share splits – not part of this module);
- (g) abnormally large changes after the reporting period in asset prices or foreign exchange rates;

- (h) changes in tax rates or tax laws enacted or announced after the reporting period that have a significant effect on current and deferred tax assets and liabilities (see *IAS 12 – Income taxes*);
- (i) entering into significant commitments or contingent liabilities, for example, by issuing significant guarantees; and
- (j) commencing major litigation arising solely out of events that occurred after the reporting period.

6.2.3 Dividends (IAS 10.12–.13)

If dividends to holders of equity instruments (as defined in the statement on Financial Instruments: Disclosure and Presentation – not part of this module) are **proposed or declared after the reporting period**, an entity must **not recognise** those dividends as a liability at the reporting period, as they do not meet the criteria of a present obligation. It is important to note that an entity's past practice of paying dividends does not give rise to a constructive obligation and therefore still does not warrant the recognition of a liability. (See learning unit 7.)

6.2.4 Going concern (IAS 10.14–.16)

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

Deterioration in operating results and financial position after the reporting period may indicate a need to consider whether the going concern assumption is still appropriate. If the going concern assumption is no longer appropriate, the effect is so pervasive that this standard requires a fundamental change in the basis of accounting, rather than an adjustment to the amounts recognised within the original basis of accounting.

Paragraph .25 of the statement on the Presentation of Financial Statements (*IAS 1*), requires certain disclosures if

- (a) the financial statements are not prepared on a going concern basis; or
- (b) 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. (The events or conditions requiring disclosure may arise after the reporting period.)

The following disclosure is necessary in terms of paragraph .25 of *IAS 1* when the financial statements are not prepared on the going-concern basis:

- (a) the fact that the statements are not prepared on the going-concern basis;
- (b) the basis on which the financial statements have been prepared; and
- (c) the reason why the entity is not considered to be a going concern.

6.3 DISCLOSURE (IAS 10.17–.22)

6.3.1 Date of authorisation for issue (IAS 10.17–.18)

An entity must disclose the date when the financial statements were authorised for issue and who gave that authorisation. If the entity's owners or others have the power to amend the financial statements after issuance, the entity must disclose that fact.

It is important for users to know when the financial statements were authorised for issue, as the financial statements do not reflect events after this date.

6.3.2 Updating of disclosure about conditions at the reporting date (IAS 10.19–.20)

If an entity receives information after the reporting period about conditions that existed at the reporting date, the entity must update disclosures that relate to these conditions, in the light of the new information.

In some cases, an entity needs to update the disclosures in its financial statements to reflect information received after the reporting period, even when the information does not affect the amounts that the entity recognises in its financial statements. One example of the need to update disclosures is when evidence becomes available after the reporting period about a contingent liability that existed at the reporting date. In addition to considering whether it should now recognise a provision in terms of *IAS 37 – Provisions, contingent liabilities and contingent assets*, an entity updates its disclosures about the contingent liability in the light of that evidence.

6.3.3 Non-adjusting events after the reporting period (IAS 10.21–.22)

Where non-adjusting events after the reporting period are of such importance that non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions, an entity must disclose the following information for each significant category of non-adjusting event after the reporting period:

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



LECTURER'S COMMENT

Work through example 7.1 of *Descriptive accounting*.

EXAMPLE 4

Busy Bees Ltd is a manufacturer of computer equipment. The company's year-end is 31 December 20.11 and the following came to your attention before the financial statements were finalised on 16 February 20.12:

1. The market value of a listed investment decreased in January 20.12 to R600 000. Investments are stated at market value. Assume that the company does not speculate with shares.
2. A debtor with an outstanding balance of R71 500 on 31 December 20.11, was declared insolvent and placed under liquidation on 20 January 20.12. The liquidator indicated that creditors will receive 30 cents in the rand. No allowance for credit losses was made at reporting date.
3. On 15 January 20.12 the directors declared a dividend of 10 cents per share for the year ended 31 December 20.11. There is 100 000 issued ordinary shares.
4. In January 20.12 inventory with a value of R20 000 was destroyed when a store was burnt down during political unrest.

Assume a tax rate of 28%, that all amounts are material and that the company is a going concern.



REQUIRED

- (a) Define events occurring after the reporting period according to *IAS 10*.
- (b) In each of the above events, do the following:
 - (i) Discuss briefly how the event will affect assets and liabilities in the financial statements, that is, must the assets and/or liabilities be adjusted or not?
 - (ii) Disclose this in the notes to the financial statements if required.

SOLUTION 4

- (a) **Events after the reporting period** are those events, both favourable and unfavourable, that occur between the reporting date and the date when the financial statements are authorised for issue. Two types of events can be identified:
 - (i) those that provide evidence of conditions that existed at the end of the reporting period (adjusting events after the reporting period); and
 - (ii) those that are indicative of conditions that arose after the reporting date (non-adjusting events after the reporting period).
- (b) 1. The decrease in market value in January 20.12 does not normally relate to the condition of investments at the reporting period, but reflects circumstances that have arisen subsequently. Therefore, an entity does not adjust the amounts recognised in its financial statements for the investments. Thus, additional disclosure will be required as non-disclosure would affect the ability of the users of financial statements to make proper evaluations and decisions.

*Disclosure***BUSY BEES LTD
NOTES FOR THE YEAR ENDED 31 DECEMBER 20.11****Event after the reporting period**

The market value of the listed investment decreased to R600 000 in January 20.12.

- The bankruptcy of a client which occurs after the reporting period usually confirms that a loss already existed at the reporting date. Thus the carrying amount of the debtor needs to be adjusted in the financial statements for the year ended 31 December 20.11

Journal

| | Dr R | Cr R |
|--|-----------------|-----------------|
| Allowance for credit losses | 50 050 | |
| Accounts receivable | | 50 050 |
| <i>Correction of debtor placed under liquidation</i> | | |
| 71 500 – (71 500 x 0.30) | | |

- If dividends are declared after the reporting period, an entity should not recognise those dividends as a liability as they do not meet the criteria of a present obligation. Thus disclose in a note as non-disclosure would affect the ability of the users of financial statements to make proper evaluations and decisions.

*Disclosure***BUSY BEES LTD
NOTES FOR THE YEAR ENDED 31 DECEMBER 20.11****Event after the reporting period**

In 15 January 20.12 the directors declared a dividend of R10 000 for the year ended 31 December 20.11.

- The inventory that was destroyed during January 20.12 in a fire is an event that took place after the reporting period. There was no liability at the reporting date, thus disclosure will be required as non-disclosure would affect the ability of the users of financial statements to make proper evaluations and decisions.

Disclosure

BUSY BEES LTD

NOTES FOR THE YEAR ENDED 31 DECEMBER 20.11

Event after the reporting period

In January 20.12 inventory with a value of R20 000 was destroyed when a store was burnt down during a political unrest.

EXAMPLE 5

As the auditor of the under-mentioned companies, you are provided with the following independent situations. The directors of these companies have asked your assistance in deciding on the most appropriate method for the accounting treatment of the under mentioned problem at the end of the 20.11 financial year in order to comply with the requirements of International Financial Reporting Standards.

Alaska Ltd is a listed food preparation company with a 31 December year end. The vast majority of Alaska Ltd's business includes the preparation of meals for airline companies. On 15 February 20.12 one of the airlines, which was responsible for 80% of Alaska Ltd's profit and 70% of Alaska Ltd's sales, announced that it is not going to renew its contract with Alaska Ltd for the provision of food on its flights. The renewal date of the contract is 30 June 20.12. Alaska Ltd is in the process of finalising its financial statements for the year ended 31 December 20.11. Stock exchange regulations require that the financial statements should be published on or before 31 March 20.12.



REQUIRED

Discuss the appropriate accounting treatment in accordance with International Financial Reporting Standards of the abovementioned problem for the year ended 31 December 20.11.

SOLUTION 5

The loss on the contract represents an event after the reporting date, as events after the reporting date are those events, both favourable and unfavourable, that occur between the reporting date and the date when the financial statements are authorised for issue.

The loss of the contract represents a non-adjusting event after the reporting period, because the event is indicative of conditions that arose after the reporting date. Therefore, it will not be necessary to adjust assets and liabilities.

The following information about non-adjusting events after the reporting period should be disclosed:

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

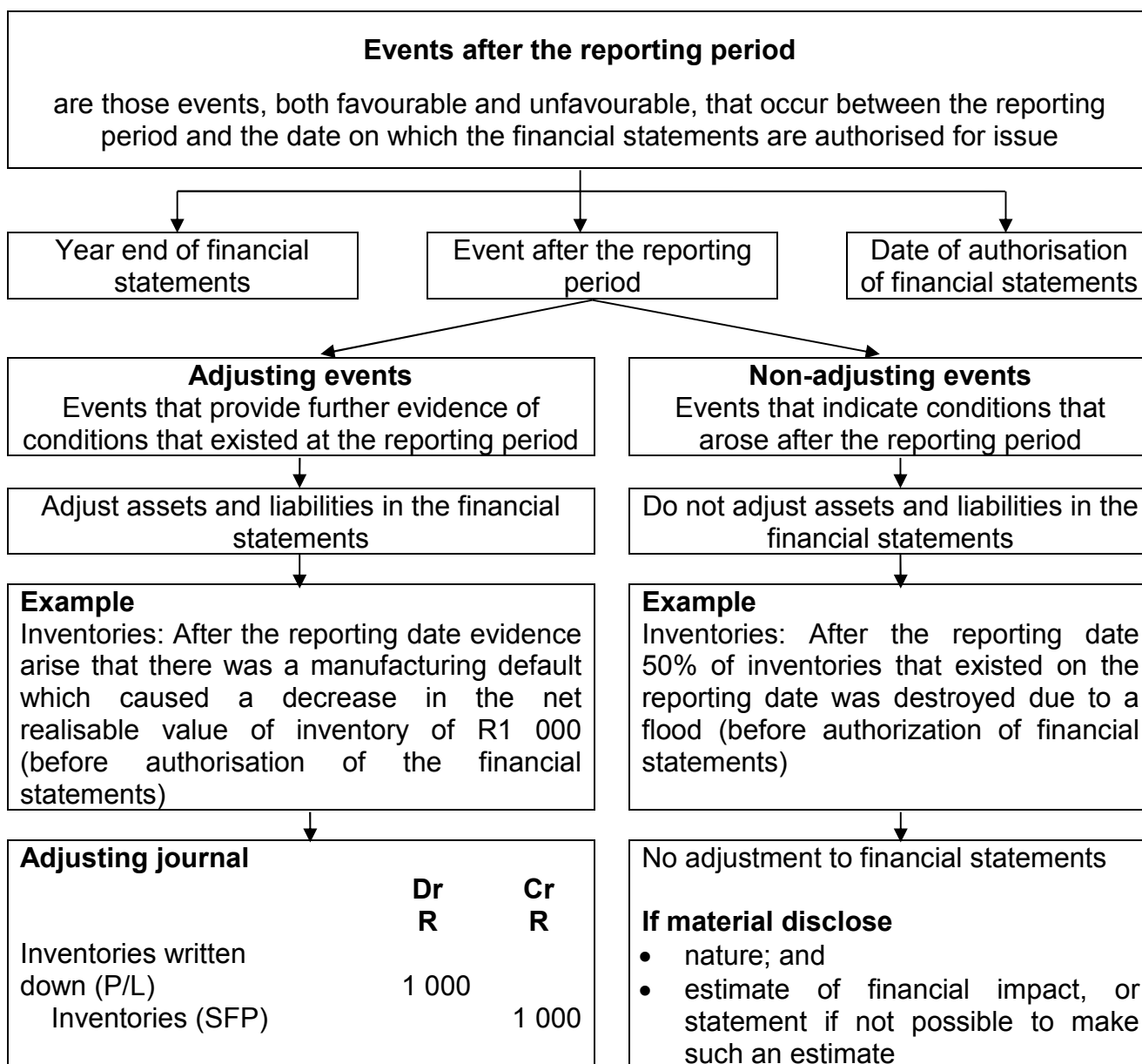
Consideration must be given to whether the going concern assumption is still appropriate.

An entity should not prepare its financial statements on a going concern basis if events after the reporting period indicate that the going concern assumption is no longer appropriate.

Current information indicates that a fundamental part of the enterprise's profit and sales is generated by the contract.

This is sufficient information to draw up the financial statements according to the expected liquidation values. The shareholders should be informed about the current state of affairs. The above can only be avoided if there is a possibility of new contracts that can replace the profit and sales.

6.4 SCHEMATIC PRESENTATION OF EVENTS AFTER THE REPORTING PERIOD





ASSESSMENT CRITERIA

Are you now able to do the following?

- Identify events after the reporting period.
- Record events after the reporting period accurately in the annual financial statements according to International Financial Reporting Standards.
- Determine when to adjust financial statements for events after the reporting period.

LEARNING UNIT 7

**PROVISIONS, CONTINGENT
LIABILITIES AND
CONTINGENT ASSETS
(IAS 37)**



LEARNING OUTCOMES

Learners should be able to recognise, measure and disclose provisions, contingent liabilities and contingent assets in the annual financial statements of a company.

OVERVIEW

This learning unit is divided into the following:

- 7.1 Scope
- 7.2 Definitions
- 7.3 Provisions and other liabilities
- 7.4 Recognition
 - 7.4.1 Provisions
 - 7.4.2 Contingent liabilities
 - 7.4.3 Distinction between provisions and contingent liabilities
 - 7.4.4 Contingent assets
- 7.5 Measurement
 - 7.5.1 Best estimate
 - 7.5.2 Risks and uncertainties
 - 7.5.3 Present value
 - 7.5.4 Future events
 - 7.5.5 Expected disposal of assets
 - 7.5.6 Reimbursements
 - 7.5.7 Changes in and uses of provisions
- 7.6 Application of the recognition and measurement rules
 - 7.6.1 Future operating losses
 - 7.6.2 Onerous contracts
 - 7.6.3 Staff retraining
 - 7.6.4 Warranties
 - 7.6.5 Constructive obligation
 - 7.6.6 Leave pay provision
 - 7.6.7 Possible legal liability
- 7.7 Disclosure
 - 7.7.1 Provisions
 - 7.7.2 Contingent liability
 - 7.7.3 Contingent asset
- 7.8 Transitional provisions
- 7.9 Summary – IAS 37
- 7.10 Tax implications

| STUDY |
|---|
| <p>PRESCRIBED <i>Descriptive accounting</i> Chapter 19.</p> <p>RECOMMENDED: <i>A Guide Through IFRS Standards</i> IAS 37 – Provisions, Contingent liabilities and Contingent assets</p> |

| OVERVIEW OF THE LEARNING UNIT |
|---|
| <p>The objective of the standard is to ensure</p> <ul style="list-style-type: none"> • proper recognition and measurement of provisions, contingent liabilities and contingent assets; and • sufficient disclosure of information about <ul style="list-style-type: none"> – provisions: nature, timing and amount; and – contingent liabilities and assets: nature, amount and uncertainties. |

7.1 SCOPE OF IAS 37

The statement should be applied by all entities in accounting for provisions, contingent liabilities and contingent assets, except

- those resulting from executory contracts, except where the contract is onerous; and
- those covered by another International Accounting Standard. (*IAS 37.01*).

This standard does not apply to financial instruments (including guarantees) that are within the scope of IFRS 9 – *Financial instruments: recognition and measurement*.

Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. The statement does not apply to executory contracts unless they are onerous. (*IAS 37.03*)

When another Standard of International Financial Reporting Standards deals with a specific type of provision, contingent liability or contingent asset, an entity applies that Standard instead of this Standard. For example, certain types of provisions are also addressed in statements on

- (a) income taxes; and
- (b) leases.

However, as the statement on leases contains **no specific** requirements to deal with operating leases that have become onerous, this statement applies to such cases.

- (c) Employee benefits (*IAS 37.05*).

Some amounts treated as provisions may relate to the recognition of revenue, for example where an entity gives guarantees in exchange for a fee. The statement does not address the recognition of revenue which is covered in *IFRS 15*.

7.2 DEFINITIONS

Provision

A provision is a liability of uncertain timing or amount.

Liability

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

Obligating event

An event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

Legal obligation

It is an obligation that derives from

- (a) a contract (through its explicit or implicit terms);
- (b) legislation; or
- (c) other operation of law

Constructive obligation

It is an obligation that derives from an entity's actions where

- (a) 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
- (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

Contingent liability

A contingent liability is

- (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- (b) a present obligation that arises from past events but is not recognised because
 - (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
 - (ii) the amount of the obligation cannot be measured with sufficient reliability.

In a general sense, all provisions are contingent because they are uncertain in timing or amount. The difference between a provision and contingent liability is that there is more uncertainty about a contingent liability with regard to the possibility of an outflow of economic resources or the estimate of the amount of the outflow of the economic resources. (*IAS 37.12*)

Contingent asset

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

Onerous contract

A contract that causes the unavoidable costs of meeting the obligations under the contract exceed the economic benefits to be received under it.

7.3 PROVISIONS AND OTHER LIABILITIES

Provisions can be distinguished from other liabilities such as trade payables and accruals because there is uncertainty about the timing or amount of the future expenditure required in settlement. By contrast

- (a) trade payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier; and
- (b) accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees or electricity bills. (Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions.)

Accruals are often reported as part of trade and other payables, whereas provisions are reported separately (*IAS 37.11*).

7.4 RECOGNITION

7.4.1 Provisions

A provision must be recognised when

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

If not all these conditions are met, no provision should be recognised (*IAS 37.14*).

(a) Present obligation

In rare cases it is not clear whether or not there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the end of the reporting date. (*IAS 37.15*)

In almost all cases it will be clear whether a past event has given rise to a present obligation. In rare cases, for example, in a law suit, it may be disputed either whether or not certain events have occurred or whether or not those events result in a present obligation. In such a case, an entity determines whether or not a present obligation exists at the reporting date by taking account of all available evidence including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the reporting period. On the basis of such evidence

- (a) where it is more likely than not that a present obligation exists at the reporting date, the entity recognises a provision (if the recognition criteria are met); and
- (b) where it is more likely that no present obligation exists at the reporting date, the entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (*IAS 37.16*).

An obligation always involves another party to whom the obligation is owed. However it is not necessary, to know the identity of the party to whom the obligation is owed – indeed the obligation may be to the public at large. Because an obligation always involves a commitment to another party, it follows that a management or board decision does not give rise to a constructive obligation at the reporting date unless the decision has been communicated before the reporting date to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will discharge its responsibilities (*IAS 37.20*).

(b) Past event

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

- (a) where the settlement of the obligation can be enforced by law; or
- (b) in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation (*IAS 37.17*).

Provisions are divided into two categories, namely

- legal obligations; and
- constructive obligations.

- **Legal obligations**

This category of obligations means that another party has the right to summons the entity to perform. Such obligations are applicable, for example, when warranties are given to customers, when such result from litigation and when self-insurance is applied, and in the case of onerous contracts. The essential element in such cases is therefore an obligation that can be enforced by law.

- **Constructive obligations**

Constructive obligations are those obligations that are not legally enforceable, but are inescapable as a result of external factors or management policy and decisions. This means that the entity is left no other realistic alternative than to incur the obligation; constructive obligations therefore emanate from circumstances, in contrast to legal obligations that arise from the operation of the law. If it is the policy of a trader to exchange products within three days of the sale thereof if the customer is not completely satisfied, this policy brings about a constructive obligation for the entity, because its name can be brought into disrepute by the non-fulfilment of the undertaking. Although the customer cannot necessarily institute a legal action for the enforcement of the policy, and in this sense no legal obligation can therefore arise, the obligation is nevertheless such that the entity will want to fulfil it: it is therefore a constructive obligation. Another example of a constructive obligation is that of contaminated ground around a factory plant. Public opposition to such contamination may be such that it is obligatory for the entity to incur costs to remove the contamination, even if it does not necessarily have a legal obligation to do so. The mere presence of environmental pollution does not, however, give rise to an obligation, even if it is caused by the entity's activities. Only when there is no realistic alternative to rehabilitation does the obligation arise. This can be on the date that the board makes a public announcement that cleaning up will take place, or when production is inhibited by the pollution to such an extent that cleaning up can no longer be postponed.

Financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an entity's statement of financial position are those that exist at the end of the reporting period (*IAS 37.18*).

For example: A machine used by a company in its production process needs to be overhauled every 5 years for technical reasons. At the reporting date, the machine has been in use for three years. No provision must be made for the cost of the overhaul since there is no present obligation as a result of a past obligating event. The future cost of overhauling the machine can be avoided by the future actions of the company, for example by selling the machine. Even if the company has the intention to incur the expenditure, it still depends on what happens in the future.

It is only those obligations arising from past events existing independently of an entity's future actions (i.e. the future conduct of its business) that are recognised as provisions. An example of such an obligation is penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the entity (*IAS 37.19*).

In contrast, because of commercial pressures or legal requirements, an entity may intend or need to carry out expenditure to operate in a particular way in the future, for example by fitting smoke filters in a certain type of factory. The entity can avoid the future expenditure by its future actions, for example by changing its method of operation; it has no present obligations for that future expenditure and no provision is recognised (*IAS 37.19*).

An event that does not give rise to an obligation immediately may do so at a later date because of changes in the law or because an act (for example a sufficiently specific public statement) by the entity gives rise to a constructive obligation. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified or when the entity publicly accepts responsibility for rectification in a way that creates a constructive obligation (*IAS 37.21*).

Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted as drafted (*IAS 37.22*).

(c) Probable outflow of resources embodying economic benefits

For the purpose of the statement, an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, that is the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (*IAS 37.23*).

Where there are a number of similar obligations, for example, product warranties or similar contracts the probability that an outflow will be required in settlement is determined by considering the class of obligation as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision is recognised (if the other recognition criteria are met) (*IAS 37.24*).

(d) Reliable estimate of the obligation

The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature are more uncertain than most other statement of financial position items. Except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision (*IAS 37.25*).

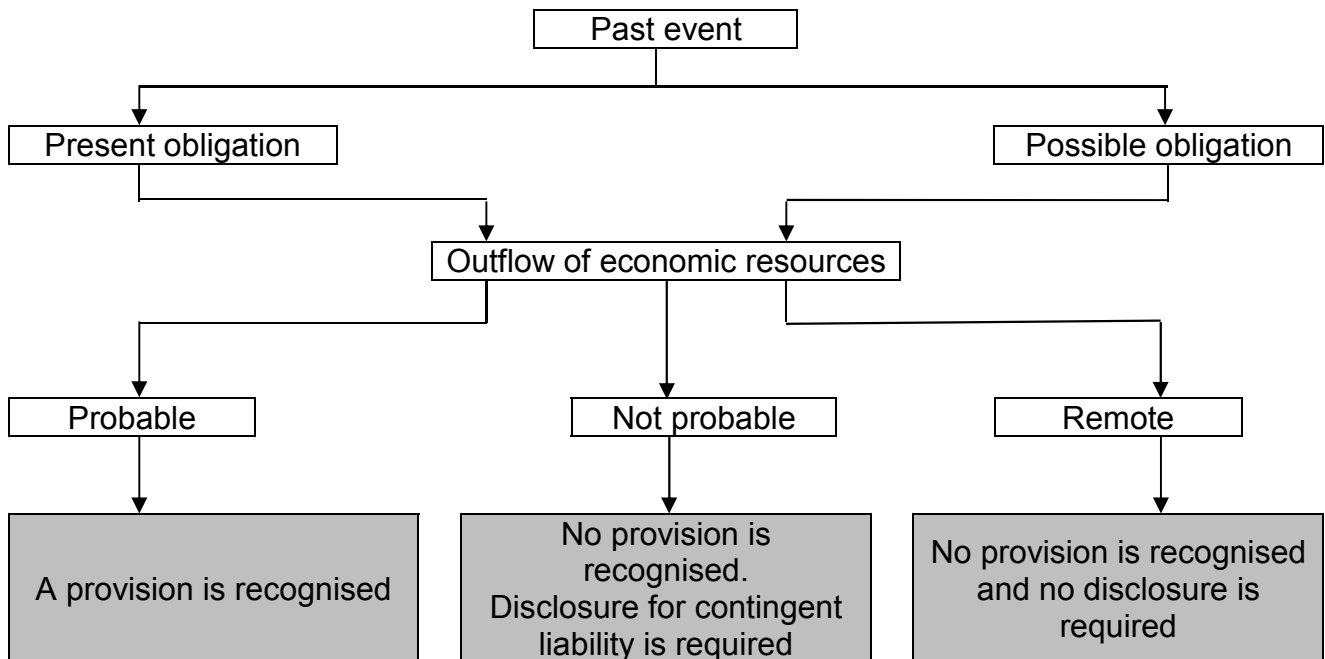
In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is disclosed as a contingent liability (*IAS 37.26*).

7.4.2 Contingent liabilities

An entity must not recognise a contingent liability (*IAS 37.27*). However, a contingent liability should be disclosed unless the possibility of an outflow of resources embodying economic benefits is remote (*IAS 37.28*).


Where an entity is jointly and severally liable for an obligation, the part of the obligation, which is expected to be met by other parties, is treated as a contingent liability (*IAS 37.29*).

Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether or not an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made) (*IAS 37.30*).



7.4.3 Distinction between provisions and contingent liabilities

Refer to the decision tree in the appendix B to *IAS 37*. The purpose of this decision tree is to summarise the main recognition requirements of the statement on provisions and contingent liabilities.

| | |
|---|---|
|  | <p>LECTURER'S COMMENT</p> <p>Work through examples 19.1 and 19.3 of <i>Descriptive accounting</i>.</p> |
|---|---|

EXAMPLE 1

Fun-in-the Sun Ltd is an exclusive holiday resort situated on the KwaZulu-Natal North Coast.

During the 20.11 financial year, the board of directors decided to reduce the maintenance personnel of the company significantly. On 28 February 20.11 the balance of the provision raised for the severance packages for these redundant employees amounted to R45 000. During the current financial year severance packages amounting to R76 000 have been paid to these redundant employees according to their service contracts.

On 15 January 20.12 a holidaymaker instituted a claim of R250 000 against Fun-in-the-Sun Ltd after she was injured by a volleyball while strolling on the beach. There are various billboards on the premises warning holidaymakers to be aware of flying volleyballs. The legal advisors of Fun-in-the-Sun Ltd are of the opinion that the claim will be unsuccessful. The legal costs to defend the claim are estimated at R25 000.

During January 20.11 various chalets in the resort were damaged as a result of heavy rainstorms. The holidaymakers had to evacuate the damaged chalets. At the time management estimated that R80 000 would have to be paid to these holidaymakers to compensate them for the inconvenience, and accounted for it in the financial statements for the year ended 28 February 20.11. During the financial years ended 28 February 20.11 and 29 February 20.12 amounts of R5 000 and R60 000 respectively, were paid to these holidaymakers. On 29 February 20.12 the financial director established that no further payments were due to these holidaymakers.



REQUIRED

Disclose the above-mentioned in the notes to the annual financial statements of Fun-in-the-Sun Ltd for the year ended 29 February 20.12 according to the requirements of IAS 37 – *Provisions, contingent liabilities and contingent assets*.

SOLUTION 1

FUN-IN-THE-SUN LTD

NOTES FOR THE YEAR ENDED 29 FEBRUARY 20.12

1. Accounting policy

1.1 Provisions

The company recognises a provision when it has a present obligation because of a past event and it is probable that the company will be required to settle the obligation. Provisions are measured based on the best estimate of the expenditure required to settle the present obligation at the reporting date.

Where the effect of the time value of money is material the amount of the provision is discounted to present value using a pre-tax rate that reflects current assessments of the

time value of money. The increase in the amount of the provision as a result of the passage of time is recorded in profit or loss for the year.

2. Contingent liability

On 15 January 20.12 a holidaymaker, instituted a claim of R250 000 against Fun-in-the-Sun Ltd after she was injured by a volleyball. The legal advisors of Fun-in-the-Sun Ltd are of the opinion that the claim will be unsuccessful. The legal costs to defend the claim are estimated at R25 000.

3. Provisions

3.1 Provision for holidaymakers – inconvenience

| | |
|--|-----------------|
| | R |
| Carrying amount at beginning of the year (80 000 – 5 000) | 75 000 |
| Amount used during the year | (60 000) |
| Unused amounts transferred to the statement of profit or loss and other comprehensive income during the year | <u>(15 000)</u> |
| Carrying amount at end of year | <u><u>–</u></u> |

During January 20.11 various chalets of the resort were damaged as a result of heavy rainstorms which resulted in the evacuation and relocation of holidaymakers. The financial director established that no further payments are due to these holidaymakers at 29 February 20.12.

3.2 Provision for severance packages – redundant employees

| | |
|--|-----------------|
| | R |
| Carrying amount beginning of the year | 45 000 |
| Amount used during the year | <u>(45 000)</u> |
| Carrying amount end of year | <u><u>–</u></u> |

During the 20.11 financial year the board of directors decided to reduce the maintenance personnel of the company significantly and paid severance packages to these redundant employees according to their service contracts.

LECTURER'S COMMENT

To summarise, a provision is defined in *IAS 37.10* as a liability of which the amount or timing are uncertain. A contingent liability is

- a **possible** obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- a **present** obligation that arises from past events but is not recognised because
 - it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
 - the amount of the obligation cannot be measured with sufficient reliability.

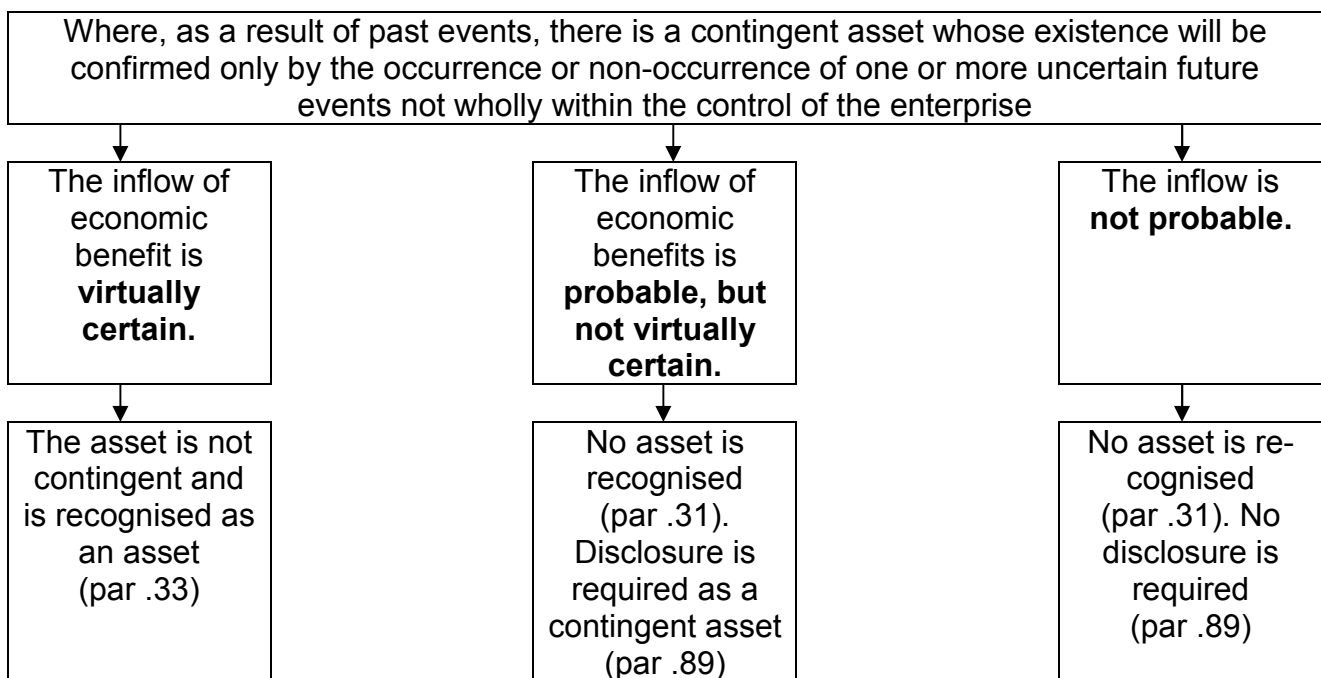


7.4.4 Contingent assets

An entity must not recognise a contingent asset (*IAS 37.31*). A contingent asset is disclosed where an inflow of economic benefits is probable (*IAS 37.34*). However, when the realisation of income is virtually certain, the related asset is not a contingent asset and its recognition is appropriate (*IAS 37.33*).

Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the entity. An example is a claim that an entity is pursuing through legal processes, where the outcome is uncertain (*IAS 37.32*).

Contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs (*IAS 37.35*).




LECTURER'S COMMENT



Work through example 19.12 of *Descriptive accounting*.

EXAMPLE 2

Fun-in-the-Sun Ltd is an exclusive holiday resort situated on the KwaZulu-Natal North Coast. On 17 January 20.12 Fun-in-the-Sun Ltd instituted a claim of R100 000 against Holidays Galore Ltd. They gained unauthorised access to Fun-in-the-Sun Ltd's database of holidaymakers to promote their own resorts. At year-end on 29 February 20.12 the court case is in process and the lawyers of Fun-in-the-Sun Ltd are of the opinion that the claim will probably succeed, but they are not virtually certain.

| | |
|---|--|
|  | <p>REQUIRED</p> <p>Disclose the above-mentioned in the notes to the annual financial statements of Fun-in-the-Sun Ltd for the year ended 29 February 20.12 according to the requirements of <i>IAS 37 – Provisions, contingent liabilities and contingent assets</i>.</p> |
|---|--|

SOLUTION 2

FUN-IN-THE-SUN LTD

NOTES FOR THE YEAR ENDED 29 FEBRUARY 20.12

1. Contingent asset

A claim was instituted against a company for gaining unauthorised access to Fun-in-the-Sun Ltd's database of holidaymakers for promoting their own resorts. According to the company's legal advisors it is probable that the claim will be successful but the realisation of income is not virtually certain. If the claim were to succeed, Fun-in-the-Sun Ltd would receive R100 000 before tax.

7.5 Measurement

7.5.1 Best estimate

The amount recognised as a provision must be the best estimate of the expenditure required to settle the present obligation at the end of the reporting date (*IAS 37.36*).

It will often be impossible or prohibitively expensive to settle or transfer an obligation at the reporting date. However, the estimate of the amount than an entity would rationally pay to settle or transfer the obligation gives the best estimate of the expenditure required to settle the present obligation at the reporting date (*IAS 37.37*).

The estimate of outcome and financial effect are determined by the judgement of the management of the entity, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The evidence considered includes any additional evidence provided by events after the reporting period (*IAS 37.38*).

Risks and uncertainties surrounding the amount to be recognised as a provision must be taken into account and are dealt with by various means according to the circumstances. For example:

- (a) Where the provision being measured involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities. The name for this statistical method of estimation is "expected value" (*IAS 37.39*).
- (b) Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability. However, even in such a case, the entity considers other possible outcomes. For example, if an entity has to rectify a serious fault in a major plant that it has constructed for a customer, the individual most likely outcome may be for the repair to succeed at the first attempt at a cost of R1 000, but a provision for a larger amount is made if there is a significant chance that further attempts will be necessary (*IAS 37.40*).

7.5.2 Risks and uncertainties

The risks and uncertainties that inevitably surround many events and circumstances must be taken into account in reaching the best estimate of a provision.

Risk therefore describes variability of outcome. A risk adjustment may increase the amount at which liability is measured. Caution is needed in making judgements under conditions of uncertainty, so that income or assets are not overstated and expenses or liabilities are not understated.

However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case. Care is needed to avoid duplicating adjustments for risk and uncertainty, with the consequent overstatement of a provision (*IAS 37.43*).

The provision is measured before tax, as the tax consequences of the provision, and changes in it, are dealt with in the Statement on Income Taxes. (*IAS 37.41*) The deductibility of the provision for income tax purposes is determined by the requirements of section 11(a) of the Income Tax Act, No. 58 of 1962 namely that it should constitute a cost/expense actually incurred during the year.

7.5.3 Present value

Where the effect of the time value of money is material, the amount of a provision must be the present value of the expenditure expected to be required to settle the obligation (*IAS 37.45*).

The effect of time value of money is greater where cash outflows of the same amount arise later. Provisions are therefore discounted, where the effect is material.

The discount rate(s) should be a pre-tax rate(s) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) must not reflect risks for which future cash flow estimates have been adjusted (*IAS 37.47*).

EXAMPLE 3

Acid MineWater Ltd is a large mining company that operates in South Africa and other parts of Africa. The increased importance of nature conservation in South Africa has made the company conscious of costs to be incurred to preserve the areas in which the company operates.


Legislation stipulates that a mining company must repair all damage caused by their operations to the environment at their own cost as soon as mining activities have ceased.

It was determined that damage has been caused evenly over the period of the mines activity.

Acid MineWater Ltd is currently in the process of commissioning a new mine close to the Benoni Lake. The total damage to the surrounding area was reliably estimated during commencement of activities at a future amount of R100 000. The mining activities commenced on 1 January 20.11 and the estimated date when activities will cease is 31 December 20.14.

The market-related interest rate for calculation purposes is 12%.

The effect of the time value of money is seen as material for the financial statements of the company.

| | |
|---|--|
|  | <p>REQUIRED</p> <p>Disclose the above information in the relevant note to the financial statements of Acid MineWater Ltd for the year ended 31 December 20.12 according to the requirements of IAS 37.</p> <p>Ignore accounting policy notes.</p> |
|---|--|

SOLUTION 3

ACID MINEWATER LTD

NOTES FOR THE YEAR ENDED 31 DECEMBER 20.12

1. Provision for environmental repair costs

| | 20.12 R | 20.11 R |
|--|---------------------------|---------------------------|
| Carrying amount at beginning of year | 71 178 ¹ | - |
| Initial recognition | - | 63 552 ¹ |
| Increase in provision due to time value of money | 8 541 ⁴ | 7 626 ² |
| Carrying amount at end of the year | <u>79 719³</u> | <u>71 178¹</u> |

The provision is related to future environmental repair costs payable with the ceasing of mining activities at the Benoni Lake Mine. The mining activities will in all probability cease on 31 December 20.14. The future expense is estimated on the best available information at the end of the financial year.

There are certain uncertainties regarding the estimation of the rehabilitation costs as certain information only becomes available when mining operations start. (These uncertainties mainly comprise assumptions.)

1. $(100\ 000 \times 1/(1.12)^3) = R71\ 178$; $(100\ 000 \times 1/(1.12)^4) = R63\ 552$ (refer to lecturer's comment)

2. $(100\ 000 \times 1/(1.12)^3) - (100\ 000 \times 1/(1.12)^4)$ or $71\ 178 - 63\ 552$

3. $(100\ 000 \times 1/(1.12)^2) = R79\ 719$ (refer to lecturer's comment)

4. $(100\ 000 \times 1/(1.12)^2) - (100\ 000 \times 1/(1.12)^3)$ or $79\ 719 - 71\ 178$

LECTURER'S COMMENT

IAS 37.45 states that if the effect of discounting is significant, the provision must be measured at the present value of the expected future outflow of resources. This applies to the liabilities that have an effect over the long term, as often occurs in the case of environmental costs, for example, rehabilitation of disturbed land in the mining industry. The discount rate and the cash flows must both be expressed in either nominal terms (including the effect of inflation) or in real terms (excluding the effect of inflation) AND on a before tax basis.

When discounting is used in the measurement of a provision, the carrying amount will increase on an annual basis over time. The debit entry as a result of the increase in provision is recognised as finance costs in the profit or loss section of the Statement of profit or loss and other comprehensive income. The following formulas are used for calculations:

Formulas for the calculation of time value of money

1. Future value

= Original amount x (1 + interest rate per period)^{Number of periods}

OR

= PV x (1 + i)ⁿ

2. Present value

= FV x (1 + i)⁻ⁿ

3. When using a financial calculator (a Hewlett Packard 10BII financial calculator was used for the following calculations)

| Calculation 1 | 20.11 | 20.11 |
|-------------------------|--------------------|--------------------|
| Future value (FV) | R100 000 | R100 000 |
| Periods (N) | 3 | 4 |
| P/YR | 1 payment per year | 1 payment per year |
| Interest rate (I) | 12% | 12% |
| Payment (PMT) | R0,00 | R0,00 |
| Comp present value (PV) | R71 178 | R63 552 |

| Calculation 3 | 20.12 |
|-------------------------|--------------------|
| Future Value (FV) | R100 000 |
| Periods (N) | 2 |
| P/YR | 1 payment per year |
| Interest rate (I) | 12% |
| Payment (PMT) | R0,00 |
| Comp present value (PV) | R79 719 |





LECTURER'S COMMENT

Work through examples 19.8 and 19.9 of *Descriptive accounting*.

7.5.4 Future events

Future events that may affect the amount required to settle an obligation must be reflected in the amount of a provision where there is sufficient objective evidence that they will occur (*IAS 37.48*).

For example, an entity may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology. Thus it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation that has previously been carried out. However, an entity does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence (*IAS 37.49*).

The effect of possible new legislation is taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted. The variety of circumstances that arise in practice makes it impossible to specify a single event that will provide sufficient objective evidence in every case. In many cases, sufficient objective evidence will not exist until the new legislation is enacted (*IAS 37.50*).

7.5.5 Expected disposal of assets

Gains from the expected disposal of assets are not taken into account in measuring a provision (*IAS 37.51*).

Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an entity recognises gains on expected disposals of assets at the time specified by the statement of International Financial Reporting Standards dealing with the assets concerned (*IAS 37.52*).

7.5.6 Reimbursements

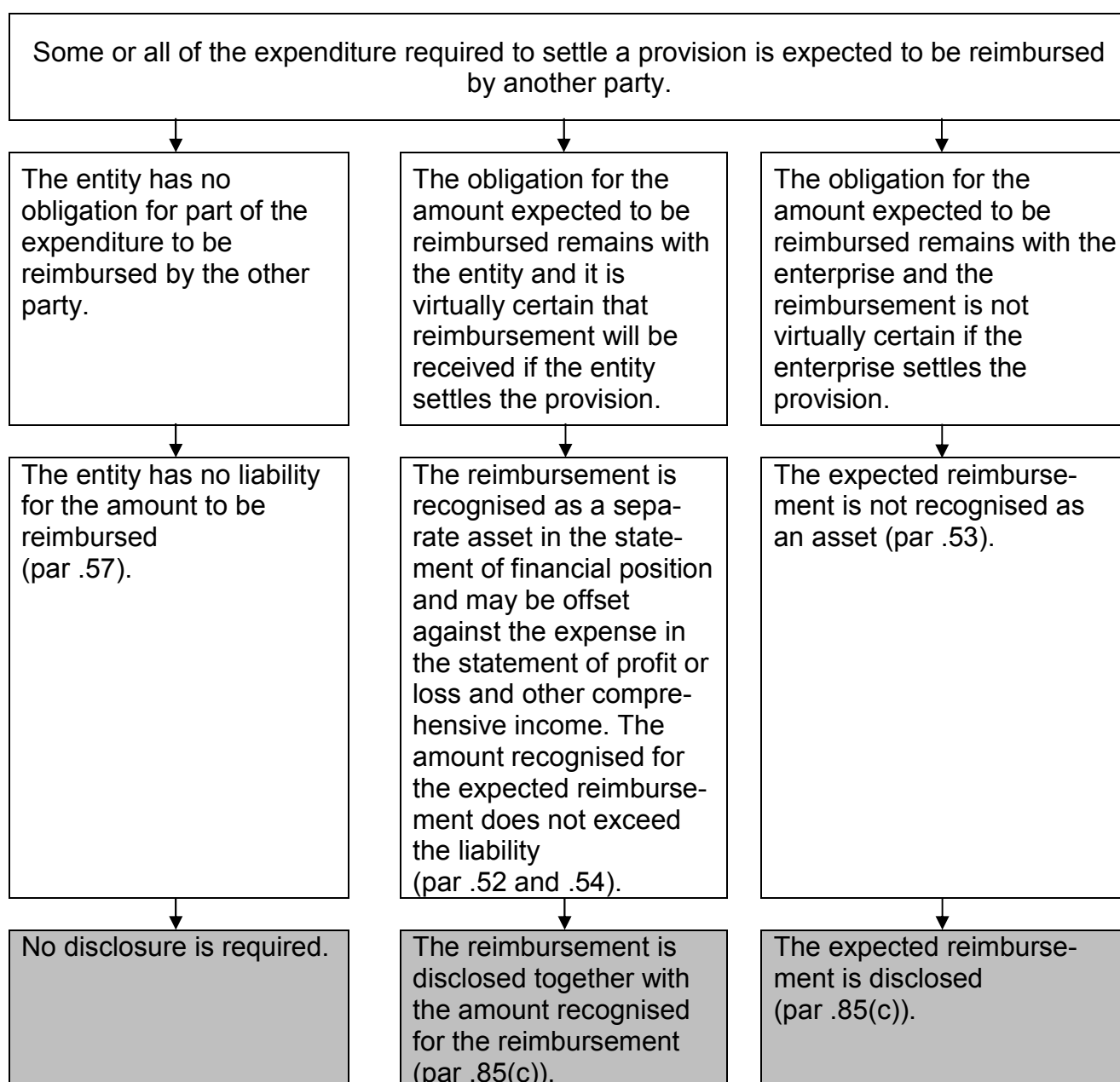
Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement is recognised when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation. The reimbursement is treated as a separate asset. The amount recognised for the reimbursement may not exceed the amount of the provision (*IAS 37.53*).

In the statement of profit or loss and other comprehensive income, the expense relating to a provision may be presented net of the amount recognised for a reimbursement (*IAS 37.54*).

The other party may either reimburse amounts paid by the entity or pay the amounts directly (*IAS 37.55*).

In most cases, for example insurance contracts, suppliers' warranties, etc, the entity will be liable for the whole of the amount in question so that the entity would have to settle the full amount if the third party failed to pay for any reason. However, the entity may be able to look to another party to pay part or all of the expenditure. In this situation, a provision is recognised for the full amount of the liability, and a separate asset for the expected reimbursement is recognised when it is virtually certain that reimbursement will be received if the entity settles the liability (*IAS 37.56*).

As noted in paragraph .29, an obligation for which an entity is jointly and severally liable is a contingent liability to the extent that it is expected that the obligation will be settled by the other parties (*IAS 37.58*).



7.5.7 Changes in and uses of provisions

Provisions must be reviewed at each reporting date and must be adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed. The reason for the reversal being that a provision must be used only for expenditures for which the provision was originally recognised (*IAS 37.59*).

Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognised as a borrowing cost (*IAS 37.60*).

7.6 APPLICATION OF THE RECOGNITION AND MEASUREMENT RULES

7.6.1 Future operating losses

Provisions must not be recognised for future operating losses (*IAS 37.63*).

Future operating losses do not meet the definition of a liability and the general recognition criteria set out for provisions; therefore, it is not a present obligation.

7.6.2 Onerous contracts

If an entity has a contract that is onerous, the present obligation under the contract must be recognised and measured as a provision (*IAS 37.66*).

Some contracts establish both rights and obligations for each of the contracting parties. Where events make such a contract onerous, the contract falls within the scope of the statement and a liability exists which is recognised (*IAS 37.67*).

The statement defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it (*IAS 37.68*).


Before a separate provision for an onerous contract is established, an entity recognises any impairment loss that has occurred on assets dedicated to that contract (see the statement on impairment of assets not part of this module) (*IAS 37.69*).

An example of an onerous contract is an entity operating a profitable business in a factory that it has leased from another party. The directors have decided to relocate the operations of the company to a safer area. It is not possible to cancel the existing lease. The old lease will therefore continue for the next three years. The directors of the company are not able to find other tenants to sublease the factory.

A provision is recognised for the best estimate of the amount of the future lease repayments.

The reasons for the recognition are as follows:

- (a) The lease is a present obligation because of the signing of a lease contract in the past. This is a legal obligating lease.
- (b) The lease payments for the next three years is probable.
- (c) The cost of the contract is unavoidable and no economic benefits arise from them.

| | |
|---|---|
|  | LECTURER'S COMMENT Work through example 19.5 of <i>Descriptive accounting</i> . |
|---|---|

7.6.3 Staff retraining

A company has to incur training cost for its financial personnel after government has announced changes to the Income Tax Act. These changes were significant and led to the necessity of training the personnel in these new requirements to ensure continued compliance with the Income Tax Act. At the reporting date, no training of staff had taken place.

There are two reasons why provisions will not be provided:

- (a) There is not a present obligation because of a past event. The changes to the Income Tax Act represent the past event but the company has no fixed obligation to retrain the staff.
- (b) The retraining will lead to an outflow of economic resources in the future but at the reporting date, the obligating event has not taken place.

7.6.4 Warranties

A company sells its products with a warranty attached to it. The warranty undertakes to make good, by repair or replacement, manufacturing defects that become apparent within years from the date of sale. From previous years' experience, it is probable that there will be about 7% of the sales returned with a claim against the warranty.

The company provides a provision for the following reasons:

- (a) There is a present obligation because of a past event. The obligation is as a result of a sale of the products with a warranty. A defect product leads to a legal obligation.
- (b) The claims under the warranty will result in an outflow of resources embodying economic benefits in settlement.
- (c) A reasonable estimate of the expenditure required to settle the present obligation at the reporting date could be made. Previous experience will be used as a guideline for the estimate.

7.6.5 Constructive obligation

A company mines coal in an opencast mine. There is no environmental policy on the rehabilitation of a matured opencast mine. However, the entity has a widely published environmental policy in which it undertakes to clean up and rehabilitate the mine. The company has a history of honouring this published policy.

A provision will be provided because of the following:

- (a) There is a constructive obligation to rehabilitate the land on which the company has mined. The past event is the mining of coal on the land. The constructive obligation has been created by the expectation created with the public with the widely published environmental policy of the company to rehabilitate land.
- (b) It is probable that an outflow of resources embodying economic benefits will result from rehabilitating the land.
- (c) The company would be able to estimate the costs involved in rehabilitating the land.

7.6.6 Leave pay provision

The employees of a company are entitled to twenty working days leave per annum. The policy is that an employee must take at least ten days leave per annum. The unused leave will be accumulated and paid out on retirement or resignation.

A provision will be provided because of the following:

- (a) There is a present obligation as a result of a past event. The past event is the fact that the employee's leave is accumulating while working for a company. The present obligation exists because the employee is entitled to the accumulated leave being paid out upon resignation or retirement.
- (b) There is an outflow of resources embodying economic benefits when paying the accumulated leave to the employee.
- (c) It is possible to reliably estimate the amount of unpaid leave pay that the company will be liable for by referring to the accumulated leave days per employee and the rate of pay of an employee.

7.6.7 Possible legal liability

A hotel-owning company has had legal proceeding brought in against it. A guest has slipped on a wet floor in one of its hotels and injured his back. The guest is seeking compensation from the hotel for his hospital bills and discomfort to the amount of R500 000. Up to the date of approval of the financial statements for the year ended 31 December 20.11, the company's lawyer advised that it is probable that the entity would not be found liable. However when the company prepared the financial statements for the year ended 31 December 20.12, the lawyers advised that due to new evidence in the case, it is probable that the company would be found liable.

At 31 December 20.11

No provision will be provided because on the basis of the evidence available it appears that there is no present obligation as a result of a past event. The past event is the guest falling and injuring his back.


These are the reasons why a contingent liability will be disclosed:

- (a) A possible obligation arose from a past event and whose existence will be confirmed by the outcome of future events not wholly within the control of the entity.
- (b) The amount of the possible obligation can be measured sufficiently.
- (c) The probability of an outflow is not remote.

At 31 December 20.12

These are the reasons why a provision is provided:

- (a) There is a present obligation because of a past event.
- (b) It is possible that an outflow of resources embodying economic benefits in settlement exists.
- (c) A reliable estimate of the amount to settle the obligation is available.

| | |
|--|--|
|  | LECTURER'S COMMENT Work through the appendix of <i>IAS 37</i> for additional examples. |
|--|--|

7.7 DISCLOSURE

7.7.1 Provisions

Provisions are disclosed as a separate line item on the face of the statement of financial position.

The following must be disclosed for each category of provisions in the notes to the financial statements:

- A brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits (*IAS 37.85*).
- An indication of the uncertainties about the amount or timing of these outflows. Where necessary to provide adequate information an entity must disclose the major assumptions made concerning future events, as addressed in par .48 (*IAS 37.85*).
- The amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement (*IAS 37.85*).
- The carrying amount at the beginning and the end of the period (*IAS 37.84*).
- Movements in each category of provisions must be reflected separately, with an indication of
 - additional provisions made in the period and increases to existing provisions;
 - amounts incurred (utilised) 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 (*IAS 37.84*).

7.7.2 Contingent liability

The following disclosure requirements apply in the case of contingent liabilities:

For each class of contingent liability, a brief description of its nature is given, as well as, 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 (*IAS 37.86*).
- Where a provision and a contingent liability arise to the same set of circumstances, the disclosure for the contingent liability is cross-referenced to the disclosure for the provision to clearly illustrate the relationship (*IAS 37.88*).
 - Where the disclosure of the above information does not take place as it would be impracticable and is not disclosed for this reason, the fact must be stated (*IAS 37.91*).
 - The above disclosure requirements do not apply when the possibility of any outflow of resources is remote – then no disclosure is required.
 - No specific disclosure is required in cases where the disclosure of information, as set out above, can prejudice the position of the entity in negotiations with other parties in respect of the matter to which the contingency relates, however *IAS 37.92* does, indicate that these circumstances are extremely rare. The general nature of the circumstances and the fact that the information is not disclosed, as well as the reason why it is not disclosed, should be stated. See *IAS 37*, Appendix D, example 3, for an illustration.

EXAMPLE 4

1. On 31 January 20.12, the marketing director of Orange Ltd informed management of the possibility that the new logo of the company appearing on all its aircraft would have to be changed after complaints had been received from its main competitor, Mango Ltd. The competitor claimed that the new logo was similar to its own logo and it started legal proceedings against Orange Ltd. However, on 29 February 20.12, the legal advisors of Orange Ltd are of the opinion that it is not probable that Mango Ltd will be successful with their legal claim against the company.
2. After a review of the company's insurance policy covering possible claims from passengers for damaged or lost baggage and flight delays, the financial director of Orange Ltd recommended that the company cancel their current insurance policy with Quicksure Ltd on 1 March 20.10 and self-insure in future. Based on previous years' records, the financial director estimated that these claims from passengers amounted to approximately R240 000 a year. For the year ended 28 February 20.11, 25 claims amounting to R185 000 in total were submitted by passengers. On 28 February 20.11, it was possible that these claims of R185 000 would be successful. On 15 April 20.11, the court ruled that an amount of R178 000 should be paid for all the claims submitted during the previous financial year, which was subsequently paid out. Claims amounting to R260 000 in total were submitted by passengers during the year ended 29 February 20.12. The final outcome of these claims will be determined during the court hearings scheduled for April 20.12. On 29 February 20.12, the legal advisors of

Orange Ltd advised the company that the possibility is remote that the company will be found liable for R65 000 of the claims submitted during the current financial year due to incomplete records.



REQUIRED

1. Prepare the journal entries for the above-mentioned transactions in the books of Orange Ltd for the year ended 29 February 20.12.
2. Disclose the above transactions in the notes to the annual financial statements of Orange Ltd for the year ended 29 February 20.12 according to the requirements of IAS 37 – *Provisions, contingent liabilities and contingent assets*.

Ignore accounting policy notes.

SOLUTION 4

1. Journals

| | Debit R | Credit R |
|---|------------|-------------|
| Provision for claims (SFP) | 178 000 | |
| Bank (SFP) | | 178 000 |
| <i>Payment of claims iro 20.11</i> | | |
| <hr/> | | |
| Provision for claims (SFP) (185 000 – 178 000) | 7 000 | |
| Claims (P/L) | | 7 000 |
| <i>Reversal of unused provision of claims iro 20.11</i> | | |
| <hr/> | | |
| Claims (P/L) (260 000 – 65 000) | 195 000 | |
| Provisions for claims (SFP) | | 195 000 |
| <i>Recording of provisions for claims iro 20.12</i> | | |
| <hr/> | | |

2. Disclosure

ORANGE LTD

NOTES FOR THE YEAR ENDED 29 FEBRUARY 20.12

1. Contingent liability

On 31 January 20.12, the marketing director informed management that the new logo of the company appearing on all its aircraft would have to change after complaints had been received from its main competitor, Mango Ltd and they started legal proceedings against the company. It claimed that the new logo was very similar to its own logo. On 29 February 20.12, the legal advisors of Orange Ltd is of the opinion that it is not probable that Mango Ltd will win their legal action.

2. Provision for claims

| | R |
|---|----------------|
| Carrying amount at beginning of year | 185 000 |
| Provision used during the year | (178 000) |
| Unused provision reversed during the year (185 000 – 178 000) | (7 000) |
| Provision created for the year (260 000 – 65 000) | 195 000 |
| Carrying amount at the end of the year | <u>195 000</u> |

After a review of the company's insurance policy covering possible claims from passengers for damaged or lost baggage and flight delays, the financial director of Orange Ltd recommended that the company cancel their current insurance policy with Quicksure Ltd on 1 March 20.10 and self-insure in future. The final outcome of claims submitted by passengers during the year ended 29 February 20.12 will be determined during the court hearings scheduled for April 20.12.

7.7.3 Contingent asset

Should an inflow of economic benefits be probable, the following disclosure requirements apply to contingent assets:

- A brief description of the nature of the contingent asset at the end of the reporting period (*IAS 37.89*).
- An estimate of the financial effect of the contingent asset, measured according to the same principles that apply to provisions and contingent liabilities, provided it is practicable to obtain this information (*IAS 37.89*).
- Where the disclosure of the above information does not take place, as it would be impracticable, and is not disclosed for this reason, the fact must be disclosed (*IAS 37.91*).
- No specific disclosure is required in cases in where the disclosure of information, as set out above, can prejudice the position of the entity in negotiations with other parties in respect of the matter to which the contingency relates. However *IAS 37.92* does, indicate that these circumstances are extremely rare. The general nature of the circumstances and the fact that the information is not disclosed, as well as the reason why it is not disclosed, must be stated.

EXAMPLE 5

Herselman Ltd is a building contractor of shopping centres in Gauteng. During May 20.12, the roof of a shopping centre in Sandton, erected by Herselman Ltd, collapsed and five people were injured. After numerous investigations it was determined that the cause of the accident was the inferior-quality building materials used by Herselman Ltd. The injured started legal proceedings against Herselman Ltd seeking damages of R120 000, but the company disputed the claim. At year end, on 31 December 20.12 the company's lawyers advised the directors of Herselman Ltd that it was probable that the company would be found liable. As a result of this, Herselman Ltd instituted a claim of R100 000 against Cemento Ltd, the supplier of the inferior building materials used for the shopping centre. On 31 December 20.12, Herselman Ltd's legal advisors are of the opinion that the claim against Cemento Ltd will probably succeed but they are not virtually certain.

As a result of the negative publicity after the accident at the shopping centre in Sandton, the directors of Herselman Ltd estimated that the operating loss for the next financial year would probably amount to R240 000. At a board meeting held on 30 November 20.12, the board of directors decided to take precautions and to reduce its workforce by twenty-five employees. Employees were notified and severance packages amounting to a total of R225 000 would be paid to these redundant employees according to their service contracts.

On 30 September 20.12, Herselman Ltd decided to replace the Bowmag machine it currently leases in terms of an operating lease agreement from Machines Galore with the latest model. However, the current lease agreement expires on 31 March 20.13 only and cannot be cancelled or sub-leased to another user. The monthly lease instalment of this Bowmag machine amounts to R12 250. The operating lease instalments of this Bowmag machine were up to date until 31 December 20.12.

During 20.11, Herselman Ltd reviewed its insurance arrangements for its liability for accidents sustained by its construction workers on site and decided to cancel its policy with an insurance broker and self-insure from 1 July 20.11. Based on experience, the directors estimated that the costs of these accidents amount to approximately R120 000 per annum. Four claims amounting to R65 000 in total were submitted during 20.11 by construction workers being injured on site.

On 31 December 20.11, it was probable that these claims of R65 000 would be successful.

The court ruled on 14 January 20.12 that an amount of R54 000 should be paid for these claims submitted during 20.11. Three claims amounting to R25 000 in total were submitted during 20.12 by construction workers being injured on site. The outcome of these claims would be decided during the court hearing in January 20.13. At year end on 31 December 20.12, the legal advisors of Herselman Ltd advised the company that it is probable that the company will not be found liable for the claims submitted during the current financial year.

On 1 June 20.12 Herselman Ltd purchased an imported bulldozer from Germany. Owing to the nature of the recent construction contracts it is being used for, the company expects to replace component parts of the bulldozer at regular intervals. The directors estimated that a provision of R5 000 per month to cover the costs of replacing the component parts of the bulldozer would be adequate. No replacements of the component parts for the bulldozer were required for the current financial year.

On 1 November 20.12, Herselman Ltd gave a guarantee to Loanshark Bank for a personal overdraft facility of R500 000 for the managing director, Mr Liberace. On 31 December 20.12, the financial position of the managing director is considered to be doubtful as he has filed for protection from his creditors.



REQUIRED

Disclose the above-mentioned information relating to provisions, contingent liabilities and contingent assets **only** in the notes to the statement of financial position of Herselman Ltd for the year ended 31 December 20.12. Your answer must comply with the requirements of International Financial Reporting Standards.

Ignore any tax implications.

Ignore accounting policy notes.

| | |
|--|---|
| | Comparative figures are not required. Assume that all amounts are material. |
|--|---|

SOLUTION 5

HERSELMAN LTD

NOTES FOR THE YEAR ENDED 31 DECEMBER 20.12

1. Contingent asset

A claim for R100 000 has been instituted against a supplier, Cemento Ltd, for building material delivering of an inferior quality. This was the cause of a roof of a shopping centre in Sandton, erected by Herselman Ltd, collapsing during May 20.12, injuring five people. The claim receivable by Herselman Ltd will be taxable.

2. Provisions

2.1 Provision for legal claims

| | R |
|--------------------------------------|----------|
| Carrying amount at 1 January 20.12 | – |
| Provision created during the year | 120 000 |
| Carrying amount at 31 December 20.12 | 120 000 |

During May 20.12 the roof of a shopping centre in Sandton, erected by Herselman Ltd, collapsed because Herselman Ltd used building materials of an inferior quality and five people were injured. The injured started legal proceedings against Herselman Ltd seeking damages, but the company disputes the claim. The company's lawyers advised the directors of Herselman Ltd that it is probable that the company will be found liable.

2.2 Provision for severance packages

| | R |
|--------------------------------------|----------|
| Carrying amount at 1 January 20.12 | – |
| Provision created during the year | 225 000 |
| Carrying amount at 31 December 20.12 | 225 000 |

At a board meeting held on 30 November 20.12, the board of directors decided to take precautions and to reduce its workforce by 25 employees. Severance packages will be paid to the redundant employees according to their service contracts.

2.3 Provision for onerous contract

| | R |
|---|----------|
| Carrying amount at 1 January 20.12 | – |
| Provision created during the year (3 x R12 250) | 36 750 |
| Carrying amount at 31 December 20.12 | 36 750 |

Herselman Ltd decided to replace the Bowmag it currently leases from Machines Galore in terms of an operating lease agreement with the latest model. However, the current lease agreement only expires on 31 March 20.13 and cannot be cancelled or subleased to another user.

2.4 Provision for claims of employees injured on site

| | R |
|---|-----------------|
| Carrying amount at 1 January 20.12 | 65 000 |
| Amount used during the year | (54 000) |
| Unused amounts reversed during the year | <u>(11 000)</u> |
| Carrying amount at 31 December 20.12 | <u><u>-</u></u> |

During 20.11, Herselman Ltd decided to cancel its insurance policy for its possible liability in the case of accidents sustained by its employees on site and to self-insure from 1 July 20.11. Provision of R65 000 was made for claims of employees injured on the construction site during 20.11. However, the court ruled on 14 January 20.12 that only an amount of R54 000 had to be paid for these claims submitted during 20.11.

2.5 Provision for guarantee given

| | R |
|--------------------------------------|-----------------------|
| Carrying amount at 1 January 20.12 | - |
| Provision created during the year | <u>500 000</u> |
| Carrying amount at 31 December 20.12 | <u><u>500 000</u></u> |

Herselman Ltd gave a guarantee to Loanshark Bank for a personal loan of R500 000 of the managing director, Mr Liberace, on 1 November 20.12. At year end, the financial position of the managing director is considered to be doubtful as he has filed for protection from his creditors.

3 Contingent liability

Three claims amounting to R25 000 in total were submitted during the year by construction workers being injured on site. The outcome would be decided during the court hearing in January 20.13. The legal advisors of Herselman Ltd advised the company that it was probable that the company would not be found liable.



LECTURER'S COMMENT

No provision should be made for the future operating loss of R240 000 and future replacement costs of component parts of R5 000 per month, as a present obligation does not exist at year end.

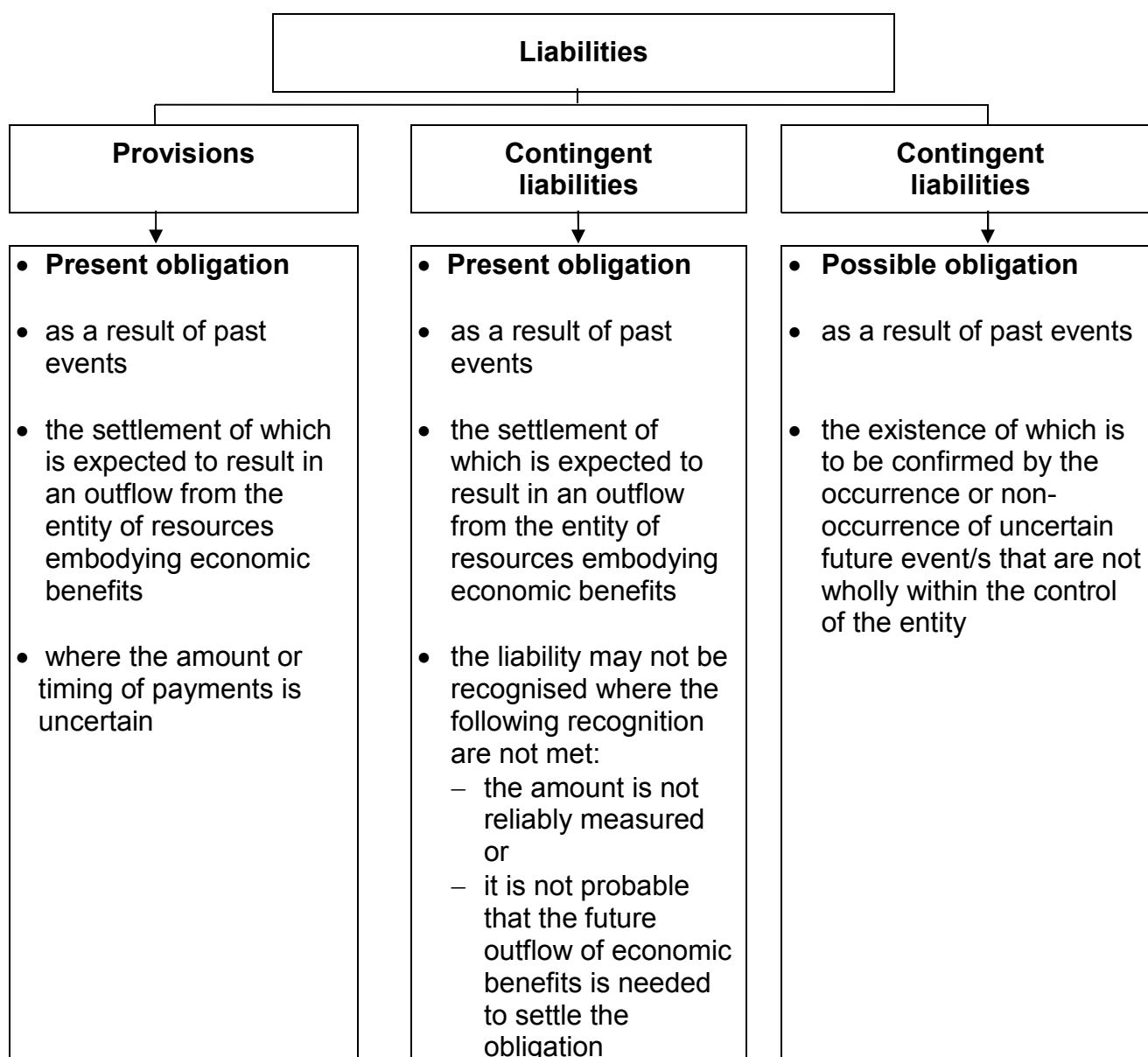
7.8 TRANSITIONAL PROVISIONS

The effect of adopting this statement on its effective date (or earlier) must be reported as an adjustment to the opening balance of retained earnings for the period in which the statement is first adopted.

Entities are encouraged, but not required, to adjust the opening balance of retained earnings for the earliest period presented and to restate comparative information. If comparative information is not restated, this fact must be disclosed (*IAS 37.93*).

7.9 SUMMARY – IAS 37

Liabilities under different levels of uncertainty may be summarised as follows:



7.10 TAX IMPLICATIONS

This only gives an overview of the most important aspects of tax related to provisions, contingent liabilities and contingent assets.

It is only provisions that will have any tax implications, as it will result in an expense in the statement of profit or loss and other comprehensive income and a credit balance in the statement of financial position.

Contingent liabilities and contingent assets will only be disclosed in a note to the annual financial statements and will **not** result in any accounting entries; therefore, it will **not** have any tax implications.

For tax purposes, an expense is not deductible until the expense is actually paid or incurred. In terms of section 23(e) of the Income Tax Act a taxpayer may not claim a deduction when determining taxable income if this deduction originates from a reserve transfer or any other capitalisation of income (raising a provision). This section is in line with the general deduction formula in section 11(a), which determines that expenses can only be deducted for tax purposes when actually incurred, unless the Income Tax Act provides otherwise.

EXAMPLE 6

Dot Ltd has raised a provision of R100 000 for warranty claims during the current financial year. For accounting purposes, the following journal entry is processed:

| | Debit R | Credit R |
|-------------------------------------|------------|-------------|
| Warranty claims (P/L) | 100 000 | |
| Provision for warranty claims (SFP) | | 100 000 |

Calculation of deferred tax

| | Carrying amount R | Tax base R | Temporary difference R | Deferred tax asset @ 28% R |
|-------------------------------|-------------------------|------------------|------------------------------|-------------------------------------|
| Provision for warranty claims | 100 000 | —* | 100 000 | 28 000 |

* The tax base of the provision is the carrying amount less the amount that will be deductible for tax purposes in future. Owing to the deductibility of actual expenses incurred, the tax base will be nil because the claim will only be deductible for tax purposes when it is settled.



ASSESSMENT CRITERIA

Are you now able to do the following?

- Define provisions, contingent assets and contingent liabilities in detail.
- Determine if an item should be accounted for as a provision, contingent liability or as a contingent asset.
- Record a provision, contingent liability and contingent asset accurately in the annual financial statements to enable users to understand the nature, timing and amounts of provisions, contingent liabilities and contingent assets.

LEARNING UNIT 8

**FAIR VALUE
MEASUREMENT (IFRS 13)**



LEARNING UNIT 8: FAIR VALUE MEASUREMENT

LEARNING OUTCOMES

Learners should be able to measure fair value for financial reporting according to the framework set out in IFRS 13.

OVERVIEW

This learning unit is divided into the following:

A. INTRODUCTION

8.1 Objectives and scope

B. MEASUREMENT

8.2 Definitions

8.3 The elements of fair value measurement

8.3.1 The asset or liability

8.3.2 Orderly transaction

8.3.3 Market participants

8.3.4 Price

8.4 Applications of fair value measurement

8.4.1 Application to non-financial assets

8.4.2 Application to liabilities and the entity's own equity instruments

8.4.3 Application to financial assets and liabilities with offsetting positions in market risks or counterparty credit risk

8.5 Fair value at initial recognition

8.6 Valuation techniques

8.6.1 General remarks

8.6.2 Application guidance: valuation techniques

8.7 Inputs to valuation techniques

8.7.1 General principles

8.7.2 Inputs based on bid and ask prices

8.8 Fair value hierarchy

8.8.1 Introduction

8.8.2 Level 1 inputs: quoted prices in active markets for identical assets or liabilities

8.8.3 Level 2 inputs: other than quoted prices in active markets for assets or liabilities

8.8.4 Level 3 inputs: unobservable inputs for assets or liabilities

C. DISCLOSURE

8.9 Disclosure

8.9.1 Disclosure requirements

8.9.2 Disclosure example

STUDY

PRESCRIBED

Descriptive Accounting

Chapter 26.

RECOMMENDED

A Guide Through IFRS Standards

IFRS 13 – Fair value measurement

A. INTRODUCTION

IFRS 13 explains how to measure fair value for financial reporting. It does not require fair value measurements in addition to those already required or permitted by other IFRSs and is not intended to establish valuation standards or affect valuation practices outside financial reporting (IFRS 13: IN4).

Some IFRSs require or permit entities to measure or disclose the fair value of assets, liabilities or their own equity instruments. Because those IFRSs were developed over many years, the requirements for measuring fair value and for disclosing information about fair value measurements were dispersed and in many cases did not articulate a clear measurement or disclosure objective (IFRS 13: IN5).

As a result, some of those IFRSs contained limited guidance about how to measure fair value, whereas others contained extensive guidance and that guidance was not always consistent across those IFRSs that refer to fair value. Inconsistencies in the requirements for measuring fair value and for disclosing information about fair value measurements have contributed to diversity in practice and have reduced the comparability of information reported in financial statements. IFRS 13 remedies that situation (IFRS 13: IN6).

Main features of IFRS 13

IFRS 13 defines fair value as the *price* that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (i.e. an exit price) (IFRS 13.9).

The definition of fair value emphasises that fair value is a *market-based* measurement, not an entity-specific measurement. When measuring fair value, an entity uses the *assumptions* that market participants would use when pricing the asset or liability under current market conditions, including assumptions about risk. As a result, an entity's intention to hold an asset or to settle or otherwise fulfill a liability is not relevant when measuring fair value.

8.1 OBJECTIVES AND SCOPE (IFRS 13.1 – 8)

The purpose of IFRS 13 is to:

- define fair value;
- set out in a single IFRS a framework for measuring fair value; and
- describe disclosure requirements about fair value measurements.

The objective of a fair value measurement is:

- to estimate the **price** at which an **orderly transaction** (to sell an **asset** or to transfer a **liability**) would take place;
- between **market participants**;
- at the **measurement date**; and
- under current market conditions.

Fair value is a market-based measurement and not one that is only specific to the entity. Market transactions or market information for some assets and liabilities might or might not be observable (available). When a price is unobservable, an entity measures fair value using another valuation technique that maximises the use of relevant observable inputs and minimises the use of unobservable inputs. As a market-based measurement, the fair value is measured using the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. The intention of the entity (to hold the asset or settle the liability) is therefore not relevant in fair value measurement.

The definition of fair value focuses on assets or liabilities, as they are primary subjects of accounting measurements. IFRS 13 also applies to an entity's own equity instruments measured at fair value.

IFRS 13 applies to IFRSs that require or permit fair value measurements or disclosures about fair value measurements. It also applies to measurements such as fair value less costs to sell, which are based on fair values and their disclosures. The fair value measurement framework applies to both the initial and the subsequent measurement.

IFRS 13 does not apply in the following circumstances:

- The measurement and disclosure requirements do not apply to IFRS 2 (share-based payment transactions), IFRS 16 (leasing transactions), IAS 2 (the net realisable value of inventories) and IAS 36 (the value in use of impairment assets).
- The disclosure requirements do not apply to IAS 19 (plan assets measured at fair value), IAS 26 (retirement benefit plan investments measured at fair value) and IAS 36 (assets for which the recoverable amount is fair value less costs of disposal).

B. MEASUREMENT

8.2 DEFINITIONS (IFRS 13 appendix A)

Active market is a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

Cost approach is a valuation technique that reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).

Entry price is the price paid to acquire an asset or received to assume a liability in an exchange transaction.

Exit price is the price that would be received to sell an asset or paid to transfer a liability.

Expected cash flow is the probability-weighted average (i.e. mean of the distribution) of possible future cash flows.

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

Highest and best use is the use of a non-financial asset by market participants that would maximise the value of the asset or the group of assets and liabilities (e.g. a business) within which the asset would be used.

Income approach is valuation techniques that convert future amounts (e.g. cash flows or income and expenses) to a single current (i.e. discounted) amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts.

Inputs are the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk, such as:

- (a) the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model); and
- (b) the risk inherent in the inputs to the valuation technique.

Inputs may be observable or unobservable.

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.

Level 2 inputs are inputs (other than quoted prices included within Level 1) that are observable for the asset or liability, either directly or indirectly.

Level 3 inputs are unobservable inputs for the asset or liability.

Market approach is a valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable (i.e. similar) assets, liabilities or a group of assets and liabilities, such as a business.

Market-corroborated inputs are inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics.

- (a) They are independent of each other, although the price in a related party transaction may be used as an input to a fair value measurement if the entity has evidence that the transaction was entered into at market terms.
- (b) They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary.
- (c) They are able to enter into a transaction for the asset or liability.

(d) They are willing to enter into a transaction for the asset or liability, in other words they are motivated but not forced or otherwise compelled to do so.

Most advantageous market is the market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs.

Non-performance risk is the risk that an entity will not fulfill an obligation. Non-performance risk includes, but may not be limited to, the entity's own credit risk.

Observable inputs are inputs that are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability.

Orderly transaction is a transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (e.g. a forced liquidation or distress sale).

Principal market is the market with the greatest volume and level of activity for the asset or liability.

Risk premium is compensation sought by risk-averse market participants for bearing the uncertainty inherent in the cash flows of an asset or a liability. It is also referred to as a risk adjustment.

Transaction costs are the costs to sell an asset or transfer a liability in the principal (or most advantageous) market for the asset or liability that are directly attributable to the disposal of the asset or the transfer of the liability and meet both of the following criteria:

- (a) They result directly from and are essential to that transaction.
- (b) They would not have been incurred by the entity had the decision to sell the asset or transfer the liability not been made.

Transport costs are the costs that would be incurred to transport an asset from its current location to its principal (or most advantageous) market.

Unit of account is the level at which an asset or a liability is aggregated or disaggregated in an IFRS for recognition purposes.

Unobservable inputs are inputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability.

The following definitions, which do not form part of this statement, are given as these terms are used in the statement:

A **financial instrument** is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

A **financial asset** is any asset that is:

- (a) cash;
- (b) any equity instrument of another entity;
- (c) 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
- (d) 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) 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
- (b) 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.

A **business combination** is a transaction or other event in which an acquirer obtains control of one or more businesses.

An **intangible asset** is an identifiable non-monetary asset without physical substance.

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.

Investment property is property 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.

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

8.3 THE ELEMENTS OF FAIR VALUE MEASUREMENT

8.3.1 The asset or liability (IFRS 13.11–14)

A fair value measurement is for a particular asset or liability. The entity must therefore take into account what the characteristics of the asset or liability are if the market participants would take those characteristics into account when the asset or liability is priced on the measurement date. Characteristics include the following:

- The condition and location of the asset.
- Any restrictions on the sale or use of the asset.

The effect on the measurement arising from a particular characteristic will differ depending on how that characteristic would be taken into account by market participants.

The asset or liability measured at fair value might be either of the following:

- (a) A *stand-alone* asset or liability (e.g. a financial instrument or a non-financial asset).
- (b) A *group* of assets, or group of liabilities or a group of assets and liabilities (e.g. a cash-generating unit or a business).

8.3.2 Orderly transaction (IFRS 13.15–21)

A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date under current market conditions.

A fair value measurement assumes that such a transaction takes place either:

- (a) in the principal market for the asset or liability; or
- (b) in the absence of a principal market, in the most advantageous market for the asset or liability.

An entity need not undertake an exhaustive search of all possible markets to identify the principal market or the most advantageous market, but it shall take into account all information that is reasonably available. In the absence of evidence to the contrary, the market in which the entity would normally enter into a transaction to sell the asset or to transfer the liability is presumed to be the principal market or, if absent, the most advantageous market.

8.3.3 Market participants (IFRS 13.22–23)

An entity shall measure the fair value of an asset or a liability using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest.

In developing those assumptions, an entity need not identify specific market participants. Rather, the entity shall identify characteristics that distinguish market participants generally, considering factors specific to:

- (a) the asset or liability;
- (b) the principal (or most advantageous) market for the asset or liability; and
- (c) market participants with whom the entity would enter into a transaction in that market.

8.3.4 Price (IFRS 13.24–26)

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (i.e. an **exit price**) regardless of whether that price is directly observable or estimated using another valuation technique.

The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for *transaction costs*. Transaction costs shall be accounted for in accordance with other IFRSs. Transaction costs are not a characteristic of an asset or a liability. Rather, they are specific to a transaction and will differ depending on how an entity enters into a transaction for the asset or liability.

Transaction costs do not include *transport costs*. If location is a characteristic of the asset (as might be the case, for example, for a commodity), the price in the principal (or most advantageous) market shall be adjusted for the costs, if any, that would be incurred to transport the asset from its current location to that market.



LECTURER'S COMMENT

Work through example 26.1 of *Descriptive Accounting*

8.4 APPLICATIONS OF FAIR VALUE MEASUREMENT

A fair value measurement requires an entity to determine:

- (a) the particular *asset or liability* being measured;
- (b) for a non-financial asset, the *highest and best use* of the asset and whether the asset is used in combination with other assets or on a stand-alone basis;
- (c) the *market* in which an orderly transaction would take place for the asset or liability; and

- (d) the appropriate *valuation technique(s)* to use when measuring fair value. The valuation technique(s) used should maximise the use of relevant observable inputs and minimise unobservable inputs. Those inputs should be consistent with the inputs a market participant would use when pricing the asset or liability (IFRS 13 IN8–10).


8.4.1 Application to non-financial assets (IFRS 13.27–.33)

(a) Highest and best use for non-financial assets

A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its *highest and best* use or by selling it to another market participant that would use the asset in its highest and best use. Examples of non-financial assets are property, plant and equipment and investment properties. The highest and best use of a non-financial asset takes into account the use of the asset that is physically possible, legally permissible and financially feasible, as follows:

- (a) **A use that is *physically possible*** takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset (e.g. the location or size of a property).
- (b) **A use that is *legally permissible*** takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (e.g. the zoning regulations applicable to a property).
- (c) **A use that is *financially feasible*** takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment if that asset is put to that use.

The highest and best use is determined *from the perspective of market participants*, even if the entity intends a different use. However, an entity's current use of a non-financial asset is presumed to be its highest and best use unless market or other factors suggest that a different use by market participants would maximise the value of the asset.

| | |
|---|---------------------------|
|  | LECTURER'S COMMENT |
| Work through example 26.3 of <i>Descriptive Accounting</i> and IFRS 13 <i>Fair Value Measurement</i> : Illustrative Examples 2, 4 and 9 | |

8.4.2 Application to liabilities and an entity's own equity instruments (IFRS 13.34–.47)

(a) General principles

A fair value measurement assumes that a financial or non-financial liability or an entity's own equity instrument (e.g. equity interests issued as consideration in a business combination) is transferred to a market participant at the measurement date. The transfer of a liability or an entity's own equity instrument assumes the following:

- (a) A *liability* would remain outstanding and the market participant transferee would be required to fulfill the obligation. The liability would not be settled with the counterparty or otherwise extinguished on the measurement date.
- (b) An entity's *own equity instrument* would remain outstanding and the market participant transferee would take on the rights and responsibilities associated with the instrument. The instrument would not be cancelled or otherwise extinguished on the measurement date.

Even when there is no observable market to provide pricing information about the transfer of a liability or an entity's own equity instrument (e.g. because contractual or other legal restrictions prevent the transfer of such items), there might be an observable market for such items if they are held by other parties as assets (e.g. a corporate bond or a call option on an entity's shares).

In all cases, an entity shall maximise the use of relevant observable inputs and minimise the use of unobservable inputs to meet the objective of a fair value measurement, which is to estimate the price at which an orderly transaction to transfer the liability or equity instrument would take place between market participants at the measurement date under current market conditions.

Liabilities and equity instruments held by other parties as assets

When a quoted price for the transfer of an identical or a similar liability or entity's own equity instrument is not available and the identical item is held by another party as an asset, an entity shall measure the fair value of the liability or equity instrument from the perspective of a market participant that holds the identical item as an asset at the measurement date.

In such cases, an entity shall measure the fair value of the liability or equity instrument as follows:

- (a) Using the quoted price in an *active market* for the identical item held by another party as an asset, if that price is available
- (b) If that price is not available, using other observable inputs, such as the quoted price in a market that is not active for the identical item held by another party as an asset
- (c) If the observable prices in (a) and (b) are not available, using another valuation technique, such as:
 - (i) an income approach (e.g. a present value technique that takes into account the future cash flows that a market participant would expect to receive from holding the liability or equity instrument as an asset; refer Application guidance B10 and B11);
 - (ii) a market approach (e.g. using quoted prices for similar liabilities or equity instruments held by other parties as assets; refer Application guidance B5–B7)




LECTURER'S COMMENT

Work through example 26.5 and example 26.6 in *Descriptive Accounting*

Liabilities and equity instruments not held by other parties as assets

When a quoted price for the transfer of an identical or a similar liability or entity's own equity instrument is not available and the identical item is not held by another party as an asset, an entity shall measure the fair value of the liability or equity instrument using a valuation technique from the perspective of a market participant that owes the liability or has issued the claim on equity. For example, when applying a present value technique an entity might take into account either of the following:

- (a) The future cash outflows that a market participant would expect to incur in fulfilling the obligation, including the compensation that a market participant would require for taking on the obligation (refer Application Guidance paragraphs B31–B33 for examples)
- (b) The amount that a market participant would receive to enter into or issue an identical liability or equity instrument, using the assumptions that market participants would use when pricing the identical item (e.g. having the same credit characteristics) in the principal (or most advantageous) market for issuing a liability or an equity instrument with the same contractual terms

| | |
|--|--|
|  | <p>LECTURER'S COMMENT</p> <p>Work through example 26.7 in <i>Descriptive Accounting</i></p> |
|--|--|

8.4.3 Application to financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk (IFRS 13.48–.56)

This section of the statement does **not** form part of this module.


8.5 FAIR VALUE AT INITIAL RECOGNITION (IFRS 13.57–.60)

When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the **transaction price** is the price paid to acquire the asset or received to assume the liability (an entry price). In contrast, the **fair value** of the asset or liability is the price that would be received to sell the asset or paid to transfer the liability (an exit price). Entities do not necessarily sell assets at the prices paid to acquire them. Similarly, entities do not necessarily transfer liabilities at the prices received to assume them.

In many cases the transaction price will equal the fair value (e.g. that might be the case when on the transaction date the transaction to buy an asset takes place in the market in which the asset would be sold).

When determining whether fair value at initial recognition equals the transaction price, an entity shall take into account factors specific to the transaction and to the asset or liability. For example, the transaction price might not represent the fair value of an asset or a liability at initial recognition if any of the following conditions exist:

- (a) The transaction is between *related parties*, although the price in a related party transaction may be used as an input into a fair value measurement if the entity has evidence that the transaction was entered into at market terms.
- (b) The transaction takes place under *duress* or the seller is forced to accept the price in the transaction. That might be the case if the seller is experiencing financial difficulty.
- (c) The *unit of account* represented by the transaction price is different from the unit of account for the asset or liability measured at fair value. For example, that might be the case if the asset or liability measured at fair value is only one of the elements in the transaction (e.g. in a business combination), the transaction includes unstated rights and privileges that are measured separately in accordance with another IFRS, or the transaction price includes transaction costs.
- (d) The *market* in which the transaction takes place is different from the principal market (or most advantageous market). For example, those markets might be different if the entity is a dealer that enters into transactions with customers in the retail market, but the principal (or most advantageous) market for the exit transaction is with other dealers in the dealer market.

| | |
|---|--|
|  | <p>LECTURER'S COMMENT</p> <p>Work through example 26.8 in <i>Descriptive Accounting</i></p> |
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8.6 VALUATION TECHNIQUES (IFRS 13.61–.66)

8.6.1 General remarks

An entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs.

The objective of using a valuation technique is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions. **Three widely used valuation techniques are the market approach, the cost approach and the income approach.** The main aspects of those approaches are summarised in Application Guidance paragraphs B5–B11.

Valuation techniques used to measure fair value shall be applied consistently. However, a change in a valuation technique or its application (e.g. a change in its weighting when multiple valuation techniques are used or a change in an adjustment applied to a valuation technique) is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. That might be the case if, for example, any of the following events take place:

- (a) new markets develop;
- (b) new information becomes available;

- (c) information previously used is no longer available;
- (d) valuation techniques improve; or
- (e) market conditions change.


Revisions resulting from a change in the valuation technique or its application shall be accounted for as a **change in accounting estimate** in accordance with *IAS 8*. However, the disclosures in *IAS 8* for a change in accounting estimate are not required for revisions resulting from a change in a valuation technique or its application.

8.6.2 Application guidance: valuation techniques

(a) Market approach (*IFRS 13 .B5–.B6*)

The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (i.e. similar) assets, liabilities or a group of assets and liabilities, such as a business.

For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might be in ranges with a different multiple for each comparable. The selection of the appropriate multiple within the range requires judgement, considering qualitative and quantitative factors specific to the measurement.

| | |
|---|--|
|  | <p>LECTURER'S COMMENT</p> <p>Work through example 26.9 in <i>Descriptive Accounting</i></p> |
|---|--|

(b) Cost approach (*IFRS 13 .B8–.B9*)

The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).

From the perspective of a market participant seller, the price that would be received for the asset is based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. That is because a market participant buyer would not pay more for an asset than the amount for which it could replace the service capacity of that asset. Obsolescence encompasses physical deterioration, functional (technological) obsolescence and economic (external) obsolescence, and is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (using specified service lives). In many cases the current replacement cost method is used to measure the fair value of tangible assets that are used in combination with other assets or with other assets and liabilities.



LECTURER'S COMMENT

Work through example 26.10 in *Descriptive Accounting*

(c) **Income approach** (IFRS 13 .B10–.B11)

The income approach converts future amounts (e.g. cash flows or income and expenses) to a single current (i.e. discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts.

Those valuation techniques include, for example:

- (a) present value techniques;
- (b) option pricing models, such as the Black-Scholes-Merton formula or a binomial model (i.e. a lattice model), that incorporate present value techniques and reflect both the time value and the intrinsic value of an option; and
- (c) the multi-period excess earnings method, which is used to measure the fair value of some intangible assets.

8.7 **INPUTS TO VALUATION TECHNIQUES** (IFRS 13 .67–.71)

8.7.1 **General principles**

Valuation techniques used to measure fair value shall maximise the use of relevant observable inputs and minimise the use of unobservable inputs.

Examples of markets in which inputs might be observable for some assets and liabilities (e.g. financial instruments) include exchange markets, dealer markets, brokered markets and principal-to-principal markets.

8.7.2 **Inputs based on bid and ask prices**

If an asset or a liability measured at fair value has a bid price and an ask price (e.g. an input from a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value regardless of where the input is categorised within the fair value hierarchy. The use of bid prices for asset positions and ask prices for liability positions is permitted but not required.

This IFRS does not preclude the use of mid-market pricing or other pricing conventions that are used by market participants as a practical expedient for fair value measurements within a bid-ask spread.

8.8 Fair value hierarchy (IFRS 13 .72–.90)

8.8.1 Introduction

To increase consistency and comparability in fair value measurements and related disclosures, this IFRS establishes a fair value hierarchy that categorises into three levels the inputs to valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (Level 3 inputs).

8.8.2 Level 1 inputs: quoted prices in active markets for identical assets or liabilities

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date. A quoted price in an active market provides the most reliable evidence of fair value and shall be used without adjustment to measure fair value whenever available, except as specified in paragraph 13.79 of IFRS 13.

A Level 1 input will be available for many financial assets and financial liabilities, some of which might be exchanged in multiple active markets (e.g. on different exchanges). Therefore, the emphasis within Level 1 is on determining both of the following:

- (a) the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability; and
- (b) whether the entity can enter into a transaction for the asset or liability at the price in that market at the measurement date.

EXAMPLE 1: Principle (or most advantageous) market: Level 1

This example illustrates the use of Level 1 inputs to measure the fair value of an asset that trades in different active markets at different prices.

An asset is sold in two different active markets at different prices. An entity enters into transactions in both markets and can access the price in those markets for the asset at the measurement date. In Market A, the price that would be received is R26, transaction costs in that market are R3; and the costs to transport the asset to that market are R2 (i.e. the net amount that would be received is R21). In Market B, the price that would be received is R25; transaction costs in that market are R1; and the costs to transport the asset to that market are R2 (i.e. the net amount that would be received in Market B is R22).

If Market A is the principal market for the asset (i.e. the market with the greatest volume and level of activity for the asset), the fair value of the asset would be measured using the price that would be received in that market, after taking into account transport costs (R24).

If neither market is the principal market for the asset, the fair value of the asset would be measured using the price in the most advantageous market. The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account transaction costs and transport costs (i.e. the net amount that would be received in the respective markets).

Because the entity would maximise the net amount that would be received for the asset in Market B (R22), the fair value of the asset would be measured using the price in that market (R25), less transport costs (R2), resulting in a fair value measurement of R23.

Although transaction costs are taken into account when determining which market is the most advantageous market, the price used to measure the fair value of the asset is not adjusted for those costs (although it is adjusted for transport costs).

8.8.3 Level 2 inputs: other than quoted prices for assets or liabilities

Level 2 inputs are inputs other than quoted prices included at Level 1 that are observable for the asset or liability, either directly or indirectly.

If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

- (a) quoted prices for similar assets or liabilities in active markets;
- (b) quoted prices for identical or similar assets or liabilities in markets that are not active;
- (c) inputs other than quoted prices that is observable for the asset or liability, for example:
 - (i) interest rates and yield curves observable at commonly quoted intervals;
 - (ii) implied volatilities;
 - (iii) credit spreads; and
- (d) market-corroborated inputs.

Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the following:

- (a) the condition or location of the asset;
- (b) the extent to which inputs relate to items that are comparable to the asset or liability (including those factors described in IFRS 13.39); and
- (c) the volume or level of activity in the markets within which the inputs are observed.

An adjustment to a Level 2 input that is significant to the entire measurement might result in a fair value measurement categorised within Level 3 of the fair value hierarchy if the adjustment uses significant unobservable inputs.

8.8.4 Level 3 inputs: unobservable inputs for assets or liabilities

Level 3 inputs are unobservable inputs for the asset or liability.

Unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same (an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability).

Therefore unobservable inputs shall reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk.

Assumptions about risk include the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and the risk inherent in the inputs to the valuation technique. A measurement that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one when pricing the asset or liability. For example, it might be necessary to include a risk adjustment when there is significant measurement uncertainty (e.g. when there has been a significant decrease in the volume or level of activity when compared with normal market activity for the asset or liability, or similar assets or liabilities, and the entity has determined that the transaction price or quoted price does not represent fair value, as described in Application Guidance B37–B47).

An entity shall develop unobservable inputs using the best information available in the circumstances, which might include the entity's own data. In developing unobservable inputs, an entity may begin with its own data, but it shall adjust those data if reasonably available information indicates that other market participants would use different data or there is something particular to the entity that is not available to other market participants (e.g. an entity-specific synergy). An entity need not undertake exhaustive efforts to obtain information about market participant assumptions. However, an entity shall take into account all information about market participant assumptions that is reasonably available. Unobservable inputs developed in the manner described above are considered market participant assumptions and meet the objective of a fair value measurement.

Identifying transactions that are not orderly

To determine whether a transaction is orderly or not is more difficult if there has been a significant decrease in the volume or level of activity for the asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities). In such circumstances it is not appropriate to conclude that all transactions in that market are not orderly (i.e. forced liquidations or distress sales). Circumstances that may indicate that a transaction is not orderly include the following:

- (a) There was not adequate exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities under current market conditions.
- (b) There was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant.
- (c) The seller is in or near bankruptcy or receivership (i.e. the seller is distressed).
- (d) The seller was required to sell to meet regulatory or legal requirements (i.e. the seller was forced).
- (e) The transaction price is an outlier when compared with other recent transactions for the same or a similar asset or liability. An entity shall evaluate the circumstances to determine whether, on the weight of the evidence available, the transaction is orderly.

An entity shall consider all the following when measuring fair value or estimating market risk premiums:

- (a) If the evidence indicates that a transaction is not orderly, an entity shall place little, if any, weight (compared with other indications of fair value) on that transaction price.
- (b) If the evidence indicates that a transaction is orderly, an entity shall take into account that transaction price. The amount of weight placed on that transaction price when compared with other indications of fair value will depend on the facts and circumstances, such as the following:
 - (i) the volume of the transaction;
 - (ii) the comparability of the transaction to the asset or liability being measured;
 - (iii) the proximity of the transaction to the measurement date.
- (c) If an entity does not have sufficient information to conclude whether a transaction is orderly, it shall take into account the transaction price. However, that transaction price may not represent fair value (i.e. the transaction price is not necessarily the sole or primary basis for measuring fair value or estimating market risk premiums). When an entity does not have sufficient information to conclude whether particular transactions are orderly, the entity shall place less weight on those transactions when compared with other transactions that are known to be orderly.

Using quoted prices provided by third parties

IFRS 13 does not preclude the use of quoted prices provided by third parties, such as pricing services or brokers, if an entity has determined that the quoted prices provided by those parties are developed in accordance with this IFRS.

If there has been a significant decrease in the volume or level of activity for the asset or liability, an entity shall evaluate whether the quoted prices provided by third parties are developed using current information that reflects orderly transactions or a valuation technique that reflects market participant assumptions (including assumptions about risk). In weighting a quoted price as an input to a fair value measurement, an entity places less weight (when compared with other indications of fair value that reflect the results of transactions) on quotes that do not reflect the result of transactions.

Furthermore, the nature of a quote (e.g. whether the quote is an indicative price or a binding offer) shall be taken into account when weighting the available evidence, with more weight given to quotes provided by third parties that represent binding offers.

C. DISCLOSURE

8.9 DISCLOSURE

8.9.1 Disclosure requirements

- An entity shall disclose information that helps users of its financial statements assess both of the following:

- (a) For assets and liabilities that are measured at fair value on a recurring or non-recurring basis in the statement of financial position after initial recognition, the valuation techniques and inputs used to develop those measurements.
- (b) For recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period (IFRS 13.91).

To meet the objectives in (a) and (b) above, an entity shall consider all the following:

- (a) The level of detail necessary to satisfy the disclosure requirements
- (b) How much emphasis to place on each of the various requirements
- (c) How much aggregation or disaggregation to undertake
- (d) Whether users of financial statements need additional information to evaluate the quantitative information disclosed.

If the disclosures provided in accordance with this IFRS and other IFRSs are insufficient to meet the objectives in paragraph 91, an entity shall disclose additional information necessary to meet those objectives (IFRS 13.92).

- Statement of financial position. To meet the objectives in IFRS 13.91, an entity shall disclose, at a minimum, the following information for each class of assets and liabilities (see paragraph 94 for information on determining appropriate classes of assets and liabilities) measured at fair value (including measurements based on fair value within the scope of this IFRS) in the statement of financial position after initial recognition:
 - (a) For recurring and non-recurring fair value measurements, the fair value measurement at the end of the reporting period, and for non-recurring fair value measurements, the reasons for the measurement. Recurring fair value measurements of assets or liabilities are those that other IFRSs require or permit in the statement of financial position at the end of each reporting period. Non-recurring fair value measurements of assets or liabilities are those that other IFRSs require or permit in the statement of financial position in particular circumstances.
 - (b) For recurring and non-recurring fair value measurements, the level of the fair value hierarchy within which the fair value measurements are categorised in their entirety (Level 1, 2 or 3).
 - (c) For assets and liabilities held at the end of the reporting period that are measured at fair value on a recurring basis, the amounts of any transfers between Level 1 and Level 2 of the fair value hierarchy, the reasons for those transfers and the entity's policy for determining when transfers between levels are deemed to have occurred (see paragraph 95). Transfers into each level shall be disclosed and discussed separately from transfers out of each level.

- (d) For recurring and non-recurring fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique(s) and the inputs used in the fair value measurement. If there has been a change in valuation technique (e.g. changing from a market approach to an income approach or the use of an additional valuation technique), the entity shall disclose that change and the reason(s) for making it. For fair value measurements categorised within Level 3 of the fair value hierarchy, an entity shall provide quantitative information about the significant unobservable inputs used in the fair value measurement. An entity is not required to create quantitative information to comply with this disclosure requirement if quantitative unobservable inputs are not developed by the entity when measuring fair value (e.g. when an entity uses prices from prior transactions or third-party pricing information without adjustment). However, when providing this disclosure an entity cannot ignore quantitative unobservable inputs that are significant to the fair value measurement and are reasonably available to the entity.
- (e) For recurring fair value measurements categorised within Level 3 of the fair value hierarchy, a reconciliation from the opening balances to the closing balances, disclosing separately changes during the period attributable to the following:
- (i) Total gains or losses for the period recognized in profit or loss, and the line item(s) in profit or loss in which those gains or losses are recognised.
 - (ii) Total gains or losses for the period recognised in other comprehensive income, and the line item(s) in other comprehensive income in which those gains or losses are recognised.
 - (iii) Purchases, sales, issues and settlements (each of those types of changes must be disclosed separately).
 - (iv) The amounts of any transfers into or out of Level 3 of the fair value hierarchy, the reasons for those transfers and the entity's policy for determining when transfers between levels are deemed to have occurred. Transfers into Level 3 shall be disclosed and discussed separately from transfers out of Level 3.
- (f) For recurring fair value measurements categorised within Level 3 of the fair value hierarchy, the amount of the total gains or losses for the period in (e)(i) included in profit or loss that is attributable to the change in unrealized gains or losses relating to those assets and liabilities held at the end of the reporting period, and the line item(s) in profit or loss in which those unrealised gains or losses are recognized.
- (g) For recurring and non-recurring fair value measurements categorised within Level 3 of the fair value hierarchy, a description of the valuation processes used by the entity (including, for example, how an entity decides its valuation policies and procedures and analyses changes in fair value measurements from period to period).
- (h) For recurring fair value measurements categorised within Level 3 of the fair value hierarchy:

- (i) For all such measurements, a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement. If there are interrelationships between those inputs and other unobservable inputs used in the fair value measurement, an entity shall also provide a description of those interrelationships and of how they might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement. To comply with that disclosure requirement, the narrative description of the sensitivity to changes in unobservable inputs shall include, at a minimum, the unobservable inputs disclosed when complying with (d).
 - (ii) For financial assets and financial liabilities, if changing one or more of the unobservable inputs to reflect reasonably possible alternative assumptions would change fair value significantly, an entity shall state that fact and disclose the effect of those changes. The entity shall disclose how the effect of a change to reflect a reasonably possible alternative assumption was calculated. For that purpose, significance shall be judged with respect to profit or loss, and total assets or total liabilities, or, when changes in fair value are recognized in other comprehensive income, total equity.
- (i) For recurring and non-recurring fair value measurements, if the highest and best use of a non-financial asset differs from its current use, an entity shall disclose that fact and why the non-financial asset is being used in a manner that differs from its highest and best use (IFRS 13.93).
- Classes of assets and liabilities. An entity shall determine appropriate classes of assets and liabilities on the basis of the following:
 - (a) The nature, characteristics and risks of the asset or liability; and
 - (b) The level of the fair value hierarchy within which the fair value measurement is categorised.
 - Policy for transfers. An entity shall disclose and consistently follow its policy for determining when transfers between levels of the fair value hierarchy are deemed to have occurred in accordance with paragraph 93(c) and (e)(iv). The policy about the timing of recognising transfers shall be the same for transfers into the levels as for transfers out of the levels. Examples of policies for determining the timing of transfers include the following:
 - (a) the date of the event or change in circumstances that caused the transfer;
 - (b) the beginning of the reporting period; and
 - (c) the end of the reporting period (IFRS 13.95).
 - An entity shall present the quantitative disclosures required by this IFRS in a tabular format unless another format is more appropriate (IFRS 13.99).

8.9.2 Disclosure example

EXAMPLE 2: Disclosure: assets measured at fair value

For assets and liabilities measured at fair value at the end of the reporting period, the IFRS requires quantitative disclosures about the fair value measurements for each class of assets and liabilities. An entity might disclose the following for *assets* to comply with paragraphs 93(a) and (b) of the IFRS:

| (R in millions) | Fair value measurements at the end of the reporting period using | | | | |
|--|--|--|---|---|----------------------|
| | | Quoted prices in active markets for identical assets (Level 1) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) | Total gains (losses) |
| Description | 31/12/20.11 | (Level 1) | (Level 2) | (Level 3) | (losses) |
| Recurring fair value measurements | | | | | |
| Trading equity securities ^(a) : | | | | | |
| Real estate industry | 93 | 70 | 23 | | |
| Oil and gas industry | 45 | 45 | | | |
| Other | 15 | 15 | | | |
| Total trading equity securities | 153 | 130 | 23 | | |
| Other equity securities ^(a) : | | | | | |
| Financial services Industry | 150 | 150 | | | |
| Health care industry | 163 | 110 | | | |
| Private equity fund investments ^(b) | 57 | | | 53 | |
| Other | 15 | 15 | | 57 | |
| Total other equity securities | 385 | 275 | | 110 | |
| Debt securities: | | | | | |
| Residential mortgage-backed securities | 149 | | 24 | 125 | |
| Commercial mortgage-backed securities | 50 | | | 50 | |
| Risk-free Government securities | 120 | 120 | | | |
| Corporate bonds | 93 | 9 | 84 | | |
| Total debt securities | 412 | 129 | 108 | 175 | |

| (R in millions) | Fair value measurements at the end of the reporting period using | | | | |
|---|--|--|---|---|----------------------|
| | | Quoted prices in active markets for identical assets (Level 1) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) | Total gains (losses) |
| Description | 31/12/20.11 | | | | |
| Investment properties: | | | | | |
| Commercial | | | | | |
| – Africa | 31 | | | 31 | |
| Commercial | | | | | |
| – Europe | 27 | | | 27 | |
| Total investment properties | 58 | | | 58 | |
| Total recurring fair value measurements | 1,008 | 534 | 131 | 343 | |

| Non-recurring fair value measurements | | | | |
|---|----|--|----|------|
| Assets held for sale ^(c) : | 26 | | 26 | (15) |
| Total non-recurring fair value measurements | 26 | | 26 | (15) |
| <p>(a) On the basis of its analysis of the nature, characteristics and risks of the securities, the entity has determined that presenting them by industry is appropriate.</p> <p>(b) On the basis of its analysis of the nature, characteristics and risks of the investments, the entity has determined that presenting them as a single class is appropriate.</p> <p>(c) In accordance with IFRS 5, assets held for sale with a carrying amount of R35 million were written down to their fair value of R26 million, less costs to sell of R6 million (or R20 million), resulting in a loss of R15 million, which was included in profit or loss for the period.</p> <p>(Note: A similar table would be presented for liabilities unless another format is deemed more appropriate by the entity.)</p> | | | | |



LECTURER'S COMMENT

Work through comprehensive example in section 26.9 in *Descriptive Accounting* and IFRS 13 *Fair Value Measurement: Illustrative Examples*.



ASSESSMENT CRITERIA

Are you now able to:

- define fair value and related concepts in detail?
- describe and apply all the aspects of fair value measurement of an asset, liability or an equity instrument?
- Disclose a fair value measurements of assets, liabilities and equity instruments in the annual financial statements of an entity?

LEARNING UNIT 9

**REVENUE FROM
CONTRACTS WITH
CUSTOMERS (IFRS 15)**



LEARNING UNIT 9: REVENUE FROM CONTRACTS WITH CUSTOMERS

LEARNING OUTCOME

Learners should be able to recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services and to disclose revenue properly in accordance with the requirements of International Financial Reporting Standards.

OVERVIEW

This learning unit is divided into the following sections:

- 9.1 Definitions
- 9.2 Five steps for revenue recognition
 - 9.2.1 Step 1 – Identify the contract(s) with a customer
 - 9.2.2 Step 2 – Identify the performance obligations in the contract
 - 9.2.3 Step 3 – Determine the transaction price
 - 9.2.4 Step 4 – Allocate the transaction price to the performance obligations in the contract
 - 9.2.5 Step 5 – Recognise revenue when (or as) the entity satisfies a performance obligation
- 9.4 Contract costs
 - 9.4.1 Costs of fulfilling a contract
 - 9.4.2 Incremental costs of obtaining a contract
 - 9.4.3 Amortisation and impairment
- 9.5 Appendix B: Application guidance
- 9.6 Presentation
- 9.7 Disclosure

STUDY

PRESCRIBED

Descriptive accounting

Chapter 27

RECOMMENDED

A Guide Through IFRS Standards

IFRS 15 – Revenue from contracts with customers

OVERVIEW OF LEARNING UNIT

This Standard establishes the principles that an entity must apply to report useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

9.1 DEFINITIONS

The following terms are used in this Standard with the meanings specified (the defined terms appear in Appendix A of this Standard):

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

A **contract asset** is an entity's right to consideration in exchange for goods or services, which the entity has transferred to a customer when that right is subject to something other than the passage of time (for example, the entity's future performance).

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

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

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 an increase in equity, other than those relating to contributions from equity participants.

A **performance obligation** is a promise in a contract with a customer to transfer either a good or a service (or a bundle of goods or services) that is distinct or a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

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

The **stand-alone selling price** (of a good or service) is the price at which an entity would sell a promised good or service separately to a customer.

The **transaction price** (for a contract with a customer) is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, VAT).



LECTURER'S COMMENT

The above definitions must be studied. They are also provided for ease of reference when working through the examples in both *Descriptive accounting* and this learning unit.

9.2 FIVE STEPS FOR REVENUE RECOGNITION

The core principle of *IFRS 15 – Revenue from contracts with customers* is that an entity recognises revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services (*IFRS 15 .02*). To be able to apply this core principle an entity performs the following five steps for revenue recognition:

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

Each of the five steps will be discussed separately in this learning unit.

9.2.1 Step 1 – Identify the contract(s) with a customer

A contract is an agreement between two or more parties that creates (legally) enforceable rights and obligations. Contracts can be in a written or oral format or can be implied by an entity's customary business practices (*IFRS 15 .10*). An entity accounts for a contract with a customer only when all of the following criteria are met:

- (a) The parties to the contract have approved the contract (in writing, orally or in accordance with other customary business practices) and they are committed to perform their respective obligations.
- (b) The entity can identify each party's rights regarding the goods or services to be transferred.
- (c) The entity can identify the payment terms for the goods or services to be transferred.
- (d) The contract has commercial substance (the risk, timing or amount of the entity's future cash flows is expected to change because of the contract).
- (e) It is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that it will transfer to the customer (*IFRS 15 .09*).

A contract does not exist if each party to the contract exercises their unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (or parties). A contract is wholly unperformed if both of the following criteria are met:

- (a) The entity has not yet transferred any promised goods or services to the customer.
- (b) The entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promised goods or services (*IFRS 15 .12*).

Combination of contracts

The Standard specifies the accounting for individual contracts with customers, except in the following two instances, where an entity may combine two or more contracts and apply this Standard to a combination of contracts:

- (a) The entity has a portfolio of contracts (or performance obligations) with similar characteristics, and it reasonably expects that the effects on the financial statements of applying this Standard to the portfolio would not differ materially from applying this Standard to the individual contracts (or performance obligations) within that portfolio (*IFRS 15 .04*).
- (b) The entity entered into two or more contracts at or near the same time with the same customer (or related parties of the customer) and one or more of the following criteria are met:
 - (i) The contracts are negotiated as a package with a single commercial objective.
 - (ii) The amount of consideration to be paid in one contract depends on the price or performance of the other contract.
 - (iii) The goods or services promised in the contracts (or some goods or services promised in each of the contracts) constitute a single performance (*IFRS 15 .17*).

Contract modifications

A contract may be modified after its inception. A contract modification is a change in the scope or price (or both) of a contract that is approved by the parties to the contract. A contract modification exists when the parties to a contract approve (in writing, orally or implied) a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract. If the parties to the contract have not approved a contract modification, an entity must continue to apply this Standard to the existing contract until the contract modification has been approved (*IFRS 15 .18*).

An entity accounts for a contract modification as a separate contract if both of the following conditions are present:

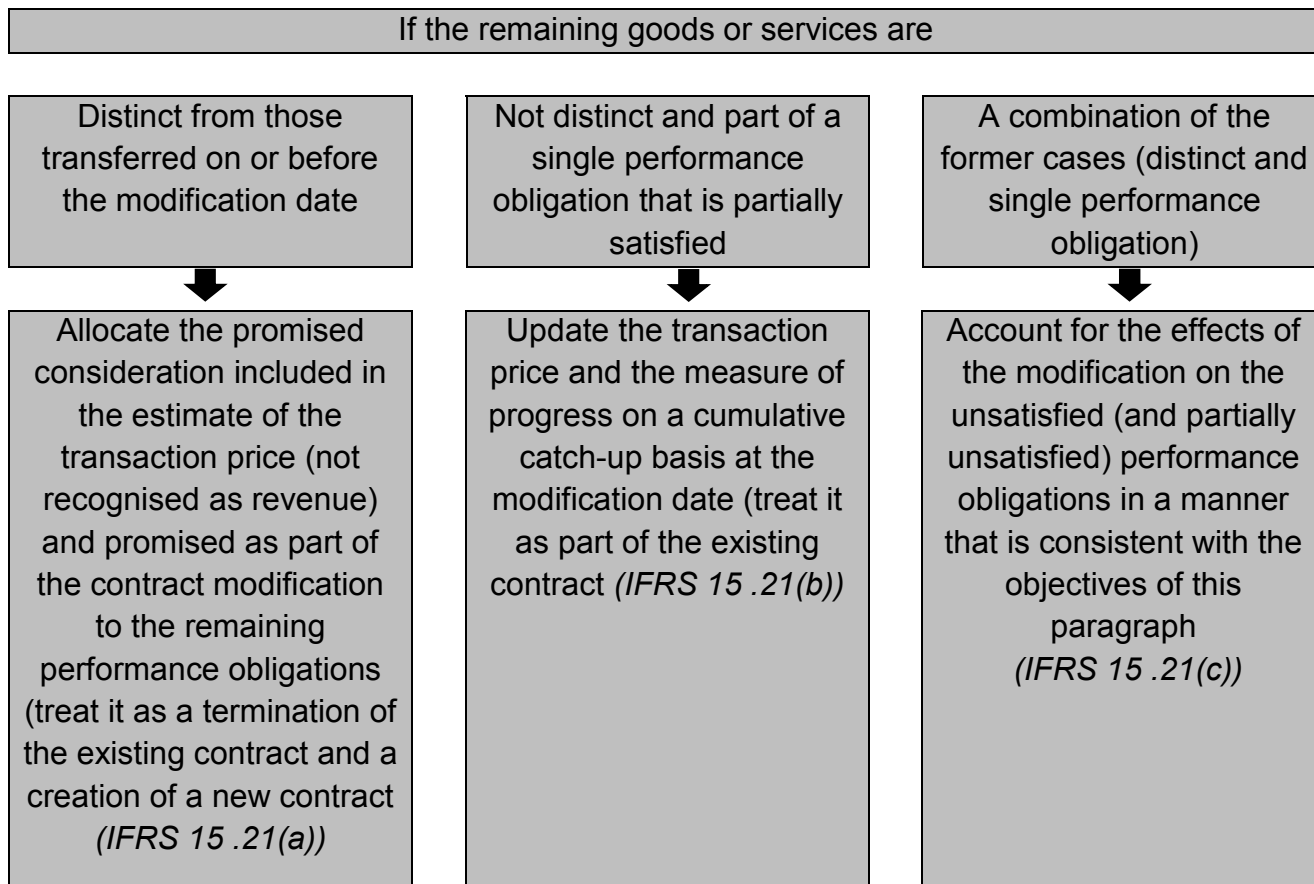
- (a) the scope of the contract increases because of the addition of promised goods or services that are distinct
- (b) the price of the contract increases by an amount of consideration that reflects the entity's stand-alone selling prices of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract (*IFRS 15 .20*)



LECTURER'S COMMENT

Work through examples 27.1 to 27.4 of *Descriptive accounting*, which deal with contract modifications.

For a contract modification that is not accounted for as a separate contract in accordance with requirements above, an entity accounts for the promised goods or services not yet transferred at the date of the contract modification (the remaining promised goods or services) as follows:



EXAMPLE 1 – MODIFICATION RESULTING IN A CUMULATIVE CATCH-UP ADJUSTMENT TO REVENUE

A construction company enters into a contract to construct a commercial building for a customer on customer-owned land for a promised consideration of R1 million and a bonus of R200 000 if the building is completed within 24 months. The entity accounts for the promised bundle of goods and services as a single performance obligation satisfied over time because the customer controls the building during construction. At the inception of the contract, the entity expects the following:

| | |
|-----------------------|----------------|
| | R |
| Transaction price | 1 000 000 |
| Expected costs | 700 000 |
| Expected profit (30%) | <u>300 000</u> |

At contract inception, the entity excludes the R200 000 bonus from the transaction price because it cannot conclude that it is highly probable that a significant reversal of the amount of cumulative revenue recognised will not occur. Completion of the building is highly subject to factors outside the entity's influence, including weather and regulatory approvals. In addition, the entity has limited experience with similar types of contracts.

The entity determines that the input measure, based on costs incurred, provides an appropriate measure of progress towards complete satisfaction of the performance obligation. By the end of the first year, the entity has satisfied 60% of its performance obligation based on costs incurred to date (R420 000) relative to total expected costs (R700 000). The entity reassesses the variable consideration and concludes that the amount is still constrained in accordance with paragraphs 56 to 58 of IFRS 15. Consequently, the cumulative revenue and costs recognised for the first year are as follows:

| | R |
|---------------------------------------|----------------|
| Revenue (420 000/700 000 x 1 000 000) | 600 000 |
| Costs | 420 000 |
| Gross profit | <u>180 000</u> |

In the first quarter of the second year, the parties to the contract agree to modify the contract by changing the floor plan of the building. As a result, the fixed consideration and expected costs increase by R150 000 and R120 000, respectively. Total potential consideration after the modification is R1 350 000 (R1 150 000 fixed consideration + R200 000 completion bonus). In addition, the allowable time for achieving the R200 000 bonus is extended by 6 months to 30 months from the original contract inception date. At the date of the modification, based on its experience and the remaining work to be performed – which is primarily inside the building and not subject to weather conditions – the entity concludes that it is highly probable that including the bonus in the transaction price will not result in a significant reversal of the amount of cumulative revenue recognised. Therefore, it includes the R200 000 in the transaction price. In assessing the contract modification, the entity evaluates and concludes that the remaining goods and services to be provided using the modified contract are not distinct from the goods and services transferred on or before the date of contract modification; that is, the contract remains a single performance obligation.

Consequently, the entity accounts for the contract modification as if it were part of the original contract. The entity updates its measure of progress and estimates that it has satisfied 51,2% of its performance obligation (R420 000 actual costs incurred ÷ R820 000 total expected costs). The entity recognises additional revenue of R91 200 ((51,2% complete × R1 350 000 modified transaction price) – R600 000 revenue recognised to date) at the date of the modification as a cumulative catch-up adjustment.

9.2.2 Step 2 – Identify the performance obligations in the contract

The next step is to identify the performance obligations in the contract at its inception by assessing the goods or services promised in a contract with a customer and identifying as a performance obligation each promise to transfer to the customer, either

- (a) a good or service (or a bundle of goods or services) that is distinct; or
- (b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer (*IFRS 15 .22*)

A good or service that is promised to a customer is distinct if both of the following are met:

- (a) The customer can benefit from the good or service either on their own or together with other resources that are readily available to the customer.
- (b) The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e. the good or service is distinct within the context of the contract) (*IFRS 15 .27*).

Factors indicating that an entity's promise to transfer a good or service to a customer is separately identifiable include, but are not limited to, the following:

- (a) The entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract into a bundle of goods or services that represent the combined output for which the customer has contracted (the good or service is not used as an input to produce or deliver the combined output).
- (b) The good or service does not significantly modify or customise another good or service promised in the contract.
- (c) The good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract. The fact that a customer could decide not to purchase the good or service without significantly affecting the other goods or services promised in the contract might indicate that the good or service is not highly dependent on, or highly interrelated with, those other promised goods or services (*IFRS 15 .29*).

If a promised good or service is not distinct, that good or service should be combined with other promised goods or services until the entity identifies a bundle of goods or services that is distinct (*IFRS 15 .30*).

Performance obligations do not include activities that an entity must undertake to fulfil a contract, unless those activities transfer a good or service to a customer. For example, a services provider may need to perform various administrative tasks to set up a contract. The performance of these tasks does not transfer a service to the customer and therefore, these setup activities are not a performance obligation (*IFRS 15 .25*). Depending on the contract, promised goods or services may include, but are not limited to

- (a) sale of goods produced by an entity (inventory of a manufacturer);
- (b) resale of goods purchased by an entity (merchandise of a retailer);

- (c) resale of rights to goods or services purchased by an entity (a ticket resold by an entity acting as a principal);
- (d) performing a contractually agreed-upon task (or tasks) for a customer;
- (e) providing a service of being ready to provide goods or services (unspecified updates to software that are provided on a when-and-if-available basis) or of making goods or services available to a customer for use as and when the customer decides;
- (f) providing a service of arranging for another party to transfer goods or services to a customer (acting as an agent of another party);
- (g) granting rights to goods or services, to be provided in the future, which a customer can resell or provide to its customer (an entity selling a product to a retailer promises to transfer an additional good or service to an individual who purchases the product from the retailer);
- (h) constructing, manufacturing or developing an asset on behalf of a customer;
- (i) granting licences; and
- (j) granting options to purchase additional goods or services (when those options provide a customer with a material right) (*IFRS 15 .26*).



LECTURER'S COMMENT

Work through examples 27.5 and 27.6 of *Descriptive accounting*, which deal with performance obligations.

EXAMPLE 2 – DETERMINING WHETHER GOODS OR SERVICES ARE DISTINCT

HiLo Ltd, a software developer, enters into a contract with Flow Ltd to transfer a software licence, perform an installation service and provide unspecified software updates and technical (online and telephonic) support for a two-year period. HiLo Ltd sells the licence, installation service and technical support separately. The installation service includes changing the web screen for each type of user (for example, marketing, inventory management, and information technology). The installation service is routinely performed by other entities and it does not significantly modify the software. The software remains functional without the updates and the technical support.

HiLo Ltd assesses the goods and services promised to Flow Ltd to determine which goods and services are distinct (refer to *IFRS 15 .27*). HiLo Ltd observes that the software is delivered before the other goods and services and remains functional without the updates and the technical support. Thus, HiLo Ltd concludes that Flow Ltd can benefit from each of the goods and services either on their own or together with the other goods and services that are readily available (refer *IFRS 15 .27(a)*).

HiLo Ltd also considers the factors in paragraph 29 of IFRS 15 and determines that the promise to transfer each good and service to Flow Ltd is separately identifiable from each of the other promises (refer *IFRS 15 .27(b)*). In particular, HiLo Ltd observes that the installation service does not significantly modify or customise the software itself and, as such, the software and the installation service are separate outputs promised by HiLo Ltd instead of inputs used to produce a combined output.

Based on the above assessment, HiLo Ltd identifies four performance obligations in the contract for the following goods or services:

- (a) the software licence;
- (b) an installation service;
- (c) software updates; and
- (d) technical support.

EXAMPLE 3 – GOODS AND SERVICES ARE NOT DISTINCT

A contractor enters into a contract to build a hospital for a customer. The entity is responsible for the overall management of the project and identifies various goods and services to be provided, including engineering, site clearance, foundation, procurement, construction of the structure, piping and wiring, installation of equipment, and finishing.

The promised goods and services are capable of being distinct, as the customer can benefit from the goods and services either on their own or together with other readily available resources. This is evidenced by the fact that the entity, or competitors of the entity, regularly sells many of these goods and services separately to other customers. In addition, the customer could generate economic benefit from the individual goods and services by using, consuming, selling or holding those goods or services.

However, the goods and services are not distinct within the context of the contract, as the entity's promise to transfer individual goods and services in the contract is not separately identifiable from other promises in the contract. This is evidenced by the fact that the entity provides a significant service of integrating the goods and services (the inputs) into the hospital (the combined output) for which the customer has contracted.

Because both criteria in paragraph .27 of *IFRS 15* are not met, the goods and services are not distinct. The entity accounts for all of the goods and services in the contract as a single performance obligation.



LECTURER'S COMMENT

The identification of performance obligations and if they are to be accounted for separately is a key judgement in applying *IFRS 15 – Revenue from contracts with customers*.

9.2.3 Step 3 – Determine the transaction price

The next step is to determine the transaction price for the contract, which is the amount of consideration to which an entity expects to be entitled (in terms of both the contract and its customary business practices) in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (VAT). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both (*IFRS 15 .47*).

The nature, timing and amount of consideration promised by a customer will affect the estimate of the transaction price, and an entity considers the effects of all of the following (*IFRS 15 .48*):

a) Variable consideration

If the consideration promised includes a variable amount, an entity estimates (and updates the estimate at each reporting date (*IFRS 15 .59*)) the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer (*IFRS 15 .50*). An amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items or because the entity's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event. For example, an amount of consideration would be variable if either a product was sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone (*IFRS 15 .51*). An entity estimates an amount of variable consideration by using either of the following methods consistently throughout the contract, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

- (i) The **expected value** is the sum of probability-weighted amounts in a range of possible consideration amounts. This method may be appropriate if an entity has a large number of contracts with similar characteristics.
- (ii) The **most likely amount** is the single most likely amount in a range of possible consideration amounts. This method may be appropriate if the contract has two possible outcomes only (an entity either achieves a performance bonus or does not) (*IFRS 15 .53–54*).



LECTURER'S COMMENT

Work through examples 27.7 and 27.9 of *Descriptive accounting*, which deal with variable consideration.

b) Constraining estimates of variable consideration

The estimated amount of variable consideration should only be included in the transaction price to the extent that it is highly probable that a significant reversal of the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved (*IFRS 15 .56*). Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, any of the following:

- (i) The amount of consideration is highly susceptible to factors outside the entity's sphere of influence (volatility in a market, the judgement or actions of third parties, weather conditions and a high risk of obsolescence of the promised good or service).
- (ii) The uncertainty about the amount of consideration is not expected to be resolved for a long time.
- (iii) The entity's experience (or other evidence) with similar types of contracts is limited or that experience has limited predictive value.
- (iv) The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.

- (v) The contract has a large number and broad range of possible consideration amounts (*IFRS 15 .57*).



LECTURER'S COMMENT

Work through example 27.11 of *Descriptive accounting*, which deals with constraining the amount of revenue.

c) The existence of a financing component in the contract

The promised amount of consideration is adjusted for the effects of the **time value of money** if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer (*IFRS 15 .60*).

The objective of the adjustment is for an entity to recognise revenue at an amount that reflects the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services (cash selling price). An entity considers all relevant facts and circumstances in assessing whether a contract contains a significant financing component, including both of the following:

- (i) the difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services
- (ii) the combined effect of both of the following:
 - the expected length of time between transferring the promised goods or services to the customer and payment
 - the prevailing interest rates in the relevant market (*IFRS 15 .61*)

An entity uses the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. That rate would reflect the credit characteristics of the party receiving financing and any collateral or security provided by the customer or the entity. The rate may be the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services when (or as) they are transferred to the customer (*IFRS 15 .64*).


A contract with a customer does not have a significant financing component if any of the following factors exist:

- (i) The customer paid for the goods or services in advance and the timing of the transfer is at the discretion of the customer.

- (ii) A substantial amount of the consideration promised by the customer is variable and the amount or timing of that consideration varies based on the occurrence or non-occurrence of a future event that is not substantially within the control of the customer or the entity (sales-based royalty).
- (iii) The difference between the promised consideration and the cash-selling price arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference. The payment terms might provide the entity or the customer with protection from the other party failing to fulfil some or all of its obligations under the contract adequately (*IFRS 15 .62*).

As a practical expedient, an entity does not have to adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between transfer of a promised good or service to a customer and payment by the customer for that good or service will be one year or less (*IFRS 15 .63*).

The effects of financing (interest revenue or interest expense) are presented separately from revenue from contracts with customers in the statement of profit or loss and other comprehensive income. Interest revenue or interest expense is recognised only to the extent that a contract asset (or receivable) or a contract liability is recognised in accounting for a contract with a customer (*IFRS 15 .65*).

| | |
|---|---|
|  | <p>LECTURER'S COMMENT</p> <p>Work through example 27.8 of <i>Descriptive accounting</i>, which deals with the time value of money.</p> |
|---|---|

d) Non-cash consideration

The transaction price for contracts in which a customer promises consideration in a form other than cash is measured at fair value of the non-cash consideration. If an entity cannot reasonably estimate the fair value of the non-cash consideration, the entity measures the consideration indirectly by reference to the stand-alone selling price of the goods or services promised to the customer in exchange for the consideration (*IFRS 15 .66–67*).

e) Consideration payable to a customer

Consideration payable to a customer includes cash amounts that an entity pays, or expects to pay, to the customer. Consideration payable to a customer also includes credit or other items (a coupon or voucher) that can be applied against amounts owed to the entity. An entity accounts for consideration payable to a customer as a reduction of the

transaction price and, therefore, of revenue, unless payment to the customer is in exchange for a distinct good or service that the customer transfers to the entity (*IFRS 15. 70*). If consideration payable to a customer is payment for a distinct good or service, then an entity accounts for the purchase of the good or service in the same way that it accounts for other purchases from suppliers. If the amount of consideration payable to the customer exceeds the fair value of the distinct good or service that the entity receives from the customer, then the entity accounts for such an excess as a reduction of the transaction price. If the entity cannot reasonably estimate the fair value of the good or service received, it accounts for all of the consideration payable to the customer as a reduction of the transaction price (*IFRS 15.71*).

If consideration payable to a customer is accounted for as a reduction of the transaction price, an entity recognises the reduction of revenue when (or as) the later of either of the following events occur:

- (i) the entity recognises revenue for the transfer of the related goods or services to the customer; or
- (ii) the entity pays or promises to pay the consideration (even if the payment is conditional on a future event) (*IFRS 15.72*).

EXAMPLE 4 – SIGNIFICANT FINANCING COMPONENT AND RIGHT OF RETURN

XYZ Ltd sells a trailer to a customer for R121 000 that is payable 24 months after delivery. The customer obtains control of the product at contract inception. The contract permits the customer to return the trailer within 90 days. The trailer is new, and XYZ Ltd has no relevant historical evidence of product returns or other available market evidence.

The cash-selling price of the trailer is R100 000, which represents the amount that the customer would pay upon delivery for the same product sold under otherwise identical terms and conditions as at contract inception. XYZ Ltd's cost of the trailer is R80 000.



REQUIRED

Discuss when revenue should be recognised and prepare the journal entries in the accounting records of XYZ Ltd to recognise the revenue transaction according to *IFRS 15 – Revenue from contracts with customers*.

| |
|-------------------|
| SOLUTION 4 |
|-------------------|

XYZ Ltd does not recognise revenue when control of the product transfers to the customer. This is because the existence of the right of return and the lack of relevant historical evidence mean that the entity cannot conclude that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur (*IFRS 15 .56–.58*). Consequently, revenue is recognised only after 90 days, when the right of return lapses.

The contract includes a significant financing component (*IFRS 15 .60–.62*). This is evident from the difference between the amount of promised consideration of R121 000 and the cash-selling price of R100 000 at the date at which the goods are transferred to the customer. The contract includes an implicit interest rate of 10% (the interest rate that discounts the promised consideration of R121 000 to the cash selling price of R100 000 over 24 months). XYZ Ltd evaluates the rate and concludes that it is commensurate with the rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception.

The following journal entries illustrate how XYZ Ltd accounts for this contract:

| | Dr | Cr |
|---|---------|---------|
| | R | R |
| Asset for right to recover trailer to be returned ¹ | 80 000 | |
| Inventory | | 80 000 |
| <i>Recognise asset for right to recover the trailer to be returned when the trailer is transferred.</i> | | |
| <hr/> | | |
| Receivable | 100 000 | |
| Revenue | | 100 000 |
| <i>Recognise revenue for the transfer of the trailer when the right of return lapses, as the product is not returned.</i> | | |
| <hr/> | | |
| Cost of sales | 80 000 | |
| Asset for right to recover trailer to be returned | | 80 000 |
| <i>Recognise cost of sales for the transfer of the trailer when the right of return lapses, as the product is not returned.</i> | | |
| <hr/> | | |

¹ Take note that this example does not consider the expected costs to recover the trailer.



LECTURER'S COMMENT

- No interest is recognised during the three-month right of return period, because no contract asset or receivable has been recognised (*IFRS 15 .65*).
- The receivable recognised is measured in accordance with IFRS 9. This example assumes there is no material difference between the fair value of the receivable at contract inception and the fair value of the receivable when it is recognised at the time the right of return lapses. This example does not consider the impairment accounting for the receivable.

EXAMPLE 5 – VOLUME DISCOUNT INCENTIVE

LOL Ltd enters into a contract with CHAT Ltd on 1 January 20.14 to sell cellular phone devices for R100 per device. If CHAT Ltd purchases more than 1 000 cellular phone devices in a calendar year, the contract specifies that the price per device be reduced retrospectively to R90 per device. Consequently, the consideration in the contract is variable.

For the first quarter ended 31 March 20.14, LOL Ltd sells 75 cellular phone devices to CHAT Ltd. LOL Ltd estimates that CHAT Ltd's purchases will not exceed the 1 000-unit threshold required for the volume discount in the calendar year. LOL Ltd considers the requirements for constraining estimates of variable consideration. LOL Ltd determines that it has significant experience with this product and with the purchasing pattern of CHAT Ltd. Thus, LOL Ltd concludes that it is highly probable that a significant reversal in the cumulative amount of revenue recognised (R100 per device) will not occur when the uncertainty is resolved (namely, when the total amount of purchases is known). Consequently, LOL Ltd recognises revenue of R7 500 (75 devices x R100 per device) for the quarter ended 31 March 20.14.

In May 20.14, CHAT Ltd acquires another company and in the second quarter ended 30 June 20.14, LOL Ltd sells an additional 500 units of cellular phone devices to CHAT Ltd. In the light of this new fact, LOL Ltd estimates that CHAT Ltd's purchases will exceed the 1 000-unit threshold for the calendar year and therefore, it will be required to reduce the price per device to R90 retrospectively. Consequently, LOL Ltd recognises revenue of R44 250 for the quarter ended 30 June 20.14. That amount is calculated based on R45 000 for the sale of 500 devices (500 devices x R90 per device) less the change in transaction price of R750 (75 devices x R10 price reduction) for the reduction of revenue relating to devices sold for the quarter ended 31 March 20.14.

9.2.4 Step 4 – Allocate the transaction price to the performance obligations in the contract

The next step is to allocate the transaction price to the performance obligations identified earlier. An entity allocates the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer (*IFRS 15 .73*). An entity allocates the transaction price to each performance obligation on a relative stand-alone selling price basis, taking into account discounts and variable amounts (*IFRS 15 .74*).

The stand-alone selling price of the distinct good or service underlying each performance obligation in the contract is determined at contract inception, and the transaction price is allocated in proportion to those stand-alone selling prices (*IFRS 15 .76*). The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. The best evidence of a stand-alone selling price is the observable price when the entity sells that good or service separately in similar circumstances and to similar customers (*IFRS 15 .77*).

If a stand-alone selling price is not directly observable, an entity estimates the stand-alone selling price by considering all information (market conditions, entity-specific factors and information about the customer or class of customer) that is reasonably available to the entity. An entity maximises the use of observable inputs and applies estimation methods consistently in similar circumstances (*IFRS 15 .78*).

Suitable methods for estimating the stand-alone selling price of a good or service include the following:

- (a) *Adjusted market assessment approach*. An entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. That approach might also include referring to prices of the entity's competitors of similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.
- (b) *Expected cost plus a margin approach*. An entity forecasts its expected costs of satisfying a performance obligation and adds an appropriate margin for that good or service.
- (c) *Residual approach*. An entity may estimate the stand-alone selling price by referring to the total transaction price less the sum of the observable stand-alone selling prices of other goods or services promised in the contract. However, an entity may use a residual approach to estimate the stand-alone selling price of a good or service, only if one of the following criteria is met:
 - (i) The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts.
 - (ii) The entity has not yet established a price for that good or service and the good or service has not been sold previously on a stand-alone basis (*IFRS 15 .79*).

A customer receives a discount for purchasing a bundle of goods or services if the sum of the stand-alone selling prices of those goods or services promised in the contract exceeds the promised consideration in the contract. Except when an entity has observable evidence to allocate the entire discount to only one or more, but not all, performance obligations in a contract, the entity allocates a discount proportionately to all performance obligations in the contract (*IFRS 15 .81*).



LECTURER'S COMMENT

Work through example 27.12 of *Descriptive accounting*, which deals with the allocation of the transaction price.

An entity allocates a discount entirely to one or more, but not all, performance obligations in the contract if all of the following criteria are met:

- (a) The entity regularly sells each distinct good or service (or each bundle) in the contract on a stand-alone basis.
- (b) The entity also regularly sells on a stand-alone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the stand-alone selling prices of the goods or services in each bundle.
- (c) The discount attributable to each bundle of goods or services described in (b) above is substantially the same as the discount mentioned in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation to which the entire discount in the contract belongs (*IFRS 15 .82*).

If a discount is allocated entirely to one or more performance obligations in the contract in accordance with paragraph 82 above, an entity allocates the discount before using the residual approach to estimate the stand-alone selling price of a good or service in accordance with paragraph 79(c) (*IFRS 15 .83*).

Similarly, variable consideration that is promised in a contract may be attributable to the entire contract or to a specific part of the contract, such as either

- (a) one or more, but not all, performance obligations in the contract (a bonus may be contingent on an entity transferring a promised good or service within a specified period); or
- (b) one or more, but not all, distinct goods or services promised in a series of distinct goods or services that form part of a single performance obligation (the consideration promised for the second year of a two-year cleaning service contract will increase, based on movements in a specified inflation index) (*IFRS 15 .84*).

An entity allocates a variable amount (and subsequent changes to that amount) entirely to a performance obligation if both of the following criteria are met:

- (a) The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service.
- (b) Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective in paragraph 73 when considering all of the performance obligations and payment terms in the contract (*IFRS 15 .85*).

The allocation requirements in paragraphs 73 to 83 are applied to allocate the remaining amount of the transaction price that does not meet the criteria in paragraph 85 above (*IFRS 15 .86*).

After contract inception, the transaction price may change for various reasons (*IFRS 15 .87*). An entity allocates to the performance obligations in the contract any subsequent changes in the transaction price on the same basis as at contract inception. Amounts allocated to a satisfied performance obligation are recognised as revenue, or as a reduction of revenue, in the period in which the transaction price changes (*IFRS 15 .88*).

An entity accounts for a change in the transaction price that arises from a contract modification in accordance with paragraphs 18 to 21. However, for a change in the transaction price that occurs after a contract modification, an entity applies paragraphs 87 to 89 to allocate the change in the transaction price in whichever of the following ways that is applicable:

- (a) An entity allocates the change in the transaction price to the performance obligations identified in the contract before the modification if, and to the extent that, the change in the transaction price is attributable to an amount of variable consideration promised before the modification and the modification is accounted for in accordance with paragraph 21(a).
- (b) In all other cases, in which the modification was not accounted for as a separate contract in accordance with paragraph 20, an entity allocates the change in the transaction price to the performance obligations in the modified contract (*IFRS 15 .90*).

EXAMPLE 6 – ALLOCATING A DISCOUNT AND VARIABLE CONSIDERATION

An entity regularly sells products A, B and C individually, thereby establishing the following stand-alone selling prices:

| Product | Stand-alone selling price |
|----------------|----------------------------------|
| | R |
| Product A | 40 |
| Product B | 55 |
| Product C | 45 |
| | 140 |

In addition, the entity regularly sells products B and C together for R60.

Case A – Allocating a discount to one or more performance obligations

The entity enters into a contract with a customer to sell products A, B and C in exchange for R100. The entity will satisfy the performance obligations for each of the products at different points in time. The contract includes a discount of R40 on the overall transaction, which would be allocated proportionately to all three performance obligations when allocating the transaction price, using the relative stand-alone selling price method (*IFRS 15 par .81*). However, because the entity regularly sells products B and C together for R60 and product A for R40, it has evidence that the entire discount should be allocated to the promises to transfer products B and C (*IFRS 15 .82*).

If the entity transfers control of products B and C at the same point in time, then the entity could, as a practical matter, account for the transfer of those products as a single performance obligation. The entity could, in other words, allocate R60 of the transaction price to the single performance obligation and recognise revenue of R60 when products B and C are simultaneously transferred to the customer.

If the contract requires the entity to transfer control of products B and C at different points in time, then the allocated amount of R60 is individually allocated to the promises to transfer product B (stand-alone selling price of R55) and product C (stand-alone selling price of R45) as follows:

| Product | Allocated transaction price |
|----------------|--|
| Product B | R 33 ¹ |
| Product C | 27 ² |
| Total | <hr/> 60 <hr/> |

¹ $R55/R100$ (total stand-alone selling price) x R60

² $R45/R100$ (total stand-alone selling price) x R60

Case B – Residual approach is appropriate

The entity enters into a contract with a customer to sell products A, B and C as described in case A. The contract also includes a promise to transfer product D. Total consideration in the contract is R130. The stand-alone selling price for product D is highly variable (*IFRS 15 .79(c)*) because the entity sells product D to different customers at a broad range of amounts (R15–R45). Consequently, the entity decides to estimate the stand-alone selling price of product D using the residual approach.

Before estimating the stand-alone selling price of product D using the residual approach, the entity determines whether any discount should be allocated to the other performance obligations in the contract (*IFRS 15 .82 –.83*).

As in case A, because the entity regularly sells products B and C together for R60 and product A for R40, the entity has observable evidence that R100 should be allocated to those three products and a R40 discount should be allocated to the promises to transfer products B and C (*IFRS 15 .82*). Using the residual approach, the entity estimates the stand-alone selling price of product D to be R30 as follows:

| Product | Stand-alone selling price |
|---|----------------------------------|
| | R |
| Product A (the stand-alone selling price is directly observable) | 40 |
| Products B & C (the stand-alone selling price is directly observable with a discount) | 60 |
| Product D (the stand-alone selling price is estimated using the residual approach) | 30 |
| | <u>130</u> |

The entity observes that the resulting R30 allocated to product D is within the range of its observable selling prices (R15–R45). Therefore, the resulting allocation is consistent with the allocation objective (*IFRS 15 .73 and .78*).

Case C – Residual approach is inappropriate

The same facts as in case B apply to case C, except for the transaction price, which is R105 instead of R130. Consequently, the application of the residual approach would result in a stand-alone selling price of R5 for product D (R105 transaction price less R100 allocated to products A, B and C). The entity concludes that R5 would not faithfully depict the amount of consideration to which the entity expects to be entitled in exchange for satisfying its performance obligation to transfer product D because R5 does not approximate the stand-alone selling price of product D, which ranges from R15 to R45. Consequently, the entity reviews its observable data, including its sales and margin reports, to estimate the stand-alone selling price of product D using another suitable method. The entity allocates the transaction price of R105 to products A, B, C and D using the relative stand-alone selling prices of those products (*IFRS 15 .73– 80*).



LECTURER'S COMMENT

The above example illustrates the considerations and process followed to allocate a discount and variable consideration in different scenarios.

9.2.5 Step 5 – Recognise revenue when (or as) the entity satisfies a performance obligation

The next step is to recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (for example an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset (*IFRS 15 .31*). For each performance obligation identified, an entity determines at contract inception whether it satisfies the performance obligation **over time** or **at a point in time**. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time (*IFRS 15 .32*).

Goods and services are assets, even if only momentarily, when they are received and used. Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by

- (a) using the asset to produce goods or provide services (including public services);
- (b) using the asset to enhance the value of other assets;
- (c) using the asset to settle liabilities or reduce expenses;
- (d) selling or exchanging the asset;
- (e) pledging the asset to secure a loan; and
- (f) holding the asset (*IFRS 15 .33*).

Control may be transferred either over time or at a point in time.

Performance obligations satisfied over time

An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if one of the following criteria is met:

- (a) The entity simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
- (b) The entity's performance creates or enhances an asset (work in progress) that the customer controls as the asset is created or enhanced.

- (c) The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date (*IFRS 15 .35*).

An asset created by an entity's performance does not have an alternative use to an entity if the entity is either restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset or limited practically from readily directing the asset in its completed state for another use. The assessment of whether an asset has an alternative use to the entity is made at contract inception. After contract inception, an entity does not update the assessment of the alternative use of an asset unless the parties to the contract approve a contract modification that substantively changes the performance obligation (*IFRS 15 .36*).

An entity considers the terms of the contract, as well as any laws applying to the contract, when evaluating whether it has an enforceable right to payment for performance completed to date in accordance with paragraph 35(c). The right to payment for performance completed to date does not need to be for a fixed amount. However, at all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates it for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised (*IFRS 15 .37*).

Performance obligations satisfied at a point in time

If a performance obligation is not satisfied over time, an entity satisfies the performance obligation at a point in time. To determine the point in time at which a customer obtains control of a promised asset and the entity satisfies a performance obligation, the entity considers the requirements for control and the indicators of the transfer of control, which include, but are not limited to, the following:

- (a) The entity has a present right to payment for the asset.
- (b) The customer has legal title to the asset.
- (c) The entity has transferred physical possession of the asset.
- (d) The customer has the significant risks and rewards of ownership of the asset.
- (e) The customer has accepted the asset (*IFRS 15 .38*).



LECTURER'S COMMENT


Work through example 27.15 of *Descriptive accounting*, which deals with performance obligations satisfied at a point in time.

Measuring progress towards complete satisfaction of a performance obligation

For each performance obligation satisfied over time, an entity recognises revenue over time by measuring the progress towards complete satisfaction of that performance obligation to depict the transfer of control of goods or services promised (*IFRS 15 .39*).

A single method of measuring progress for each performance obligation satisfied over time should be applied consistently to similar performance obligations and in similar circumstances. Progress towards complete satisfaction of a performance obligation satisfied over time is remeasured at the end of each reporting period (*IFRS 15 .40*).

Appropriate methods of measuring progress include output methods and input methods (*IFRS 15 .41*).

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|  | <p>LECTURER'S COMMENT</p> <p>Work through example 27.16 of <i>Descriptive accounting</i>, which illustrates the input method.</p> |
|---|--|

When applying a method for measuring progress, an entity excludes from the measure of progress any goods or services for which it does not transfer control to a customer. Conversely, an entity includes in the measure of progress any goods or services for which it does transfer control to a customer when satisfying that performance obligation (*IFRS 15 .42*).

As circumstances change over time, an entity updates its measure of progress to reflect any changes in the outcome of the performance obligation. Such changes to an entity's measure of progress are accounted for as a change in the accounting estimates in accordance with *IAS 8 – Accounting policies, changes in accounting estimates and errors* (*IFRS 15 .43*).

An entity recognises revenue for a performance obligation satisfied over time only if it can reasonably measure its progress towards complete satisfaction of the performance obligation (*IFRS 15 .44*). In some circumstances (early stages of a contract), an entity may not be able to measure the outcome of a performance obligation reasonably, but it may still expect to recover the costs incurred in satisfying the performance obligation. In these circumstances, the entity recognises revenue only to the extent of the costs incurred until such time that it can reasonably measure the outcome of the performance obligation (*IFRS 15 .45*).

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| EXAMPLE 7 – MEASURING PROGRESS WHEN MAKING GOODS OR SERVICES AVAILABLE |
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Italiano Ltd, an owner and manager of health clubs, enters into a contract with a customer for one year of access to any of its health clubs. The customer has unlimited use of the health clubs and he promises to pay R100 per month. Italiano Ltd determines that its promise to the customer is to provide a service of making the health clubs available for the customer's use as and when the customer wishes. This is because the extent to which the customer uses the health clubs does not affect the number of the remaining goods and services to which the customer is entitled. The entity concludes that the customer simultaneously receives and consumes the benefits of the entity's performance in making the health clubs available. Consequently, the entity's performance obligation is satisfied over time in terms of paragraph 35(a).

Italiano Ltd also determines that the customer benefits from the entity's service of making the health clubs available evenly throughout the year (that is, the customer benefits from the health clubs being available, regardless of whether the customer uses them or not). Consequently, the entity concludes that the best measure of progress towards complete satisfaction of the performance obligation over time is a time-based measure and it recognises revenue on a straight-line basis throughout the year at R100 per month.

9.4 CONTRACT COSTS

9.4.1 Costs of fulfilling a contract

If the costs incurred in fulfilling a contract with a customer are not within the scope of another Standard (*IAS 2 – Inventories, IAS 16 – Property, plant and equipment* or *IAS 38 – Intangible assets*), an entity recognises an asset from the costs incurred to fulfil a contract only if those costs meet all of the following criteria:

- (a) The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify.
- (b) The costs generate or enhance resources of the entity, which will be used in satisfying performance obligations in the future.
- (c) The costs are expected to be recovered (*IFRS 15 .95*).

Costs that relate directly to a contract include any of the following:

- (a) direct labour;
- (b) direct materials;
- (c) allocations of costs that relate directly to the contract or to contract activities (costs of contract management and supervision, insurance and depreciation of tools and equipment used in fulfilling the contract);
- (d) costs that are explicitly chargeable to the customer under the contract; and
- (e) other costs that are incurred only because an entity entered into the contract (payments to subcontractors) (*IFRS 15 .97*).

An entity recognises the following costs as expenses when incurred:

- (a) general and administrative costs;
- (b) costs of wasted materials, labour or other resources to fulfil the contract, which were not reflected in the price of the contract;
- (c) costs that relate to satisfied performance obligations in the contract; and
- (d) costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations (*IFRS 15 .98*).

9.4.2 Incremental costs of obtaining a contract

An entity recognises as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs (*IFRS 15 .91*). **The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained, for example, sales commissions (*IFRS 15 .92*).**

9.4.3 Amortisation and impairment

Contract costs recognised as an asset is amortised on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates (*IFRS 15 .99*).

An entity updates the amortisation to reflect a significant change in the entity's expected timing of transfer to the customer of the goods or services to which the asset relates as a change in the accounting estimates in accordance with IAS 8 (*IFRS 15 .100*).

An entity recognises an impairment loss in profit or loss to the extent that the carrying amount of an asset recognised exceeds

- (a) the remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates less
- (b) the costs that relate directly to providing those goods or services and that have not been recognised as expenses (*IFRS 15 .101*).

To determine the amount of consideration that an entity expects to receive, the entity uses the principles of determining the transaction price (except for the requirements for constraining estimates of variable consideration) and adjusts that amount to reflect the effects of the customer's credit risk (*IFRS 15 .102*).

Before an entity recognises an impairment loss for an asset recognised in accordance with the above requirements, it recognises any impairment loss for assets related to the contract, which are recognised in accordance with another Standard (IAS 2, IAS 16 and IAS 38) (*IFRS 15 .103*).

An entity recognises in profit or loss a reversal of some or all of an impairment loss previously recognised when the impairment conditions no longer exist or have improved. The increased carrying amount of the asset must not exceed the amount that would have been determined (net of amortisation) if no impairment loss had been recognised previously (*IFRS 15 .104*).



LECTURER'S COMMENT

Work through example 27.10 of *Descriptive accounting*, which deals with the collectability of the consideration that the entity expects to receive. Also, please work through example 27.17 of *Descriptive accounting*, which deals with contract costs.

EXAMPLE 8 – COSTS THAT GIVE RISE TO AN ASSET

An entity enters into a service contract to manage a customer's information-technology data centre for five years. The contract is renewable for subsequent one-year periods. The average customer term is seven years. The entity pays an employee a R10 000 sales commission upon the customer signing the contract. Before providing the services, the entity designs and builds a technology platform for its internal use, which interfaces with the customer's systems. This platform is not transferred to the customer, but it will be used to deliver services to the customer. The initial setup costs relate primarily to activities to fulfil the contract but they do not relate to transferring goods or services to the customer.

The initial costs incurred to set up the technology platform are as follows:

| | R |
|--------------------------------------|----------------|
| Design services | 40 000 |
| Hardware | 120 000 |
| Software | 90 000 |
| Migration and testing of data centre | 100 000 |
| Total costs | <u>350 000</u> |



REQUIRED

Discuss the accounting treatment of the costs incurred to obtain and fulfil the contract according to the requirements of *IFRS 15 – Revenue from contracts with customers*.

SOLUTION 8

Incremental costs of obtaining a contract

The entity recognises an asset for the R10 000 incremental costs of obtaining the contract for the sales commission because it expects to recover those costs through future fees for the services to be provided (IFRS 15 .91). The entity amortises the asset over seven years because the asset relates to the services transferred to the customer during the contract term of five years, and the entity anticipates that the contract will be renewed for two subsequent one-year periods in accordance with paragraph .99.

Costs to fulfil a contract

The entity accounts for the initial setup costs as follows:

- (a) *Hardware costs* – accounted for in accordance with IAS 16 – *Property, plant and equipment*.
- (b) *Software costs* – accounted for in accordance with IAS 38 – *Intangible assets*.
- (c) *Costs of the design, migration and testing of the data centre* – assess to determine whether an asset can be recognised for the costs of fulfilling the contract (IFRS 15 .95). Any resulting asset would be amortised on a systematic basis over the seven-year period (the five-year contract term and two anticipated one-year renewal periods) in which the entity expects to provide services related to the data centre.

9.5 APPENDIX B: APPLICATION GUIDANCE

The application guidance appears in **Appendix B** of *IFRS 15 – Revenue from contracts with customers*. It describes the application of the paragraphs in this Standard. The following is a summary of revenue recognition criteria for certain transactions.

Performance obligations satisfied over time

- *Simultaneous receipt and consumption of the benefits of the entity's performance*

Assessing whether a customer receives the benefits and simultaneously consumes those benefits as they are received may be straightforward and may include routine or recurring services (such as a cleaning service) (IFRS 15 .B3). However, if an entity is not able to readily identify whether a customer simultaneously receives and consumes the benefits from the entity's performance as the entity performs, then a performance obligation is satisfied over time if an entity determines that another entity would not need to substantially re-perform the work that the entity has completed to date, if that other entity were to fulfil the remaining performance obligation to the customer (IFRS 15 .B4).

- *An entity's performance does not create an asset with an alternative use*

In assessing whether an asset has an alternative use to an entity, an entity considers the effects of substantive contractual restrictions and practical limitations on its ability to readily direct that asset for another use, such as selling it to a different customer (IFRS 15 .B6). A contractual restriction is substantive if a customer could enforce its rights to the promised asset if the entity sought to direct the asset for another use. A contractual restriction is not substantive if an asset is largely interchangeable with other assets that

the entity could transfer to another customer without breaching the contract and without incurring significant costs (*IFRS 15 .B7*).

A practical limitation on an entity's ability to direct an asset for another use exists if an entity would incur significant economic losses to direct the asset for another use (significant costs to rework the asset or selling the asset at a significant loss). Practical limitations may include design specifications that are unique to a customer or remote locations (*IFRS 15 .B8*).

- *Right to payment for performance completed to date*

An entity has a right to payment for performance completed to date if it would be entitled to an amount that at least compensates it for its performance completed to date in the event that the customer or another party terminates the contract for reasons other than the entity's failure to perform as promised. An amount that would compensate an entity for performance completed to date would be an amount that approximated the selling price of the goods or services transferred to date (recovery of the costs incurred by an entity in satisfying the performance obligation plus a reasonable profit margin) rather than compensation for the entity's potential loss of profit only, if the contract were to be terminated. An entity should be entitled to compensation for either of the following amounts:

- (a) a proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination by the customer; or
- (b) a reasonable return on the entity's cost of capital for similar contracts (or the entity's typical operating margin for similar contracts) if the contract-specific margin is higher than the return the entity usually generates from similar contracts (*IFRS 15 .B9*).

Methods for measuring progress towards complete satisfaction of a performance obligation

An entity may use either output methods or input methods to measure progress towards complete satisfaction (*IFRS 15 .B14*):

Output methods

Output methods recognise revenue based on direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract. Output methods include methods such as surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, and units produced or units delivered (*IFRS 15 .B15*).

The disadvantages of output methods to measure progress are that the outputs used may not be directly observable and the information required to apply them may not be available to an entity without undue cost (*IFRS 15 .B17*).

Input methods

Input methods recognise revenue based on the entity's efforts or inputs to the satisfaction of a performance obligation (resources consumed, labour hours expended, costs incurred, time elapsed or machine hours used) relative to the total expected inputs to the satisfaction of that performance obligation. If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for the entity to recognise revenue on a straight-line basis (*IFRS 15 .B18*).

A shortcoming of input methods is that there may not be a direct relationship between an entity's inputs and the transfer of control of goods or services to a customer. An entity should therefore exclude the effects of any inputs that do not depict the entity's performance in transferring control of goods or services to the customer (costs of unexpected amounts of wasted materials, labour or other resources).

Sale with a right of return

Some contracts also grant the customer the right to return the product for various reasons (such as dissatisfaction with the product) and to receive any combination of the following:

- (a) a full or partial refund of any consideration paid;
- (b) a credit that can be applied against amounts owed, or that will be owed, to the entity;
- (c) another product in exchange (*IFRS 15 .B20*).

To account for the transfer of products with a right of return (and for some services that are provided, subject to a refund), an entity recognises all of the following:

- (a) revenue for the transferred products in the amount of consideration to which the entity expects to be entitled (therefore, revenue would not be recognised for the products expected to be returned);
- (b) a refund liability;
- (c) an asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability (*IFRS 15 .B21*).

For any amounts received (or receivable), to which an entity does not expect to be entitled, the entity does not recognise revenue when it transfers products to customers, as a refund liability is recognised. Subsequently, at the end of each reporting period, the entity updates its assessment of amounts, to which it expects to be entitled, in exchange for the transferred products and makes a corresponding change to the transaction price and, therefore, in the amount of revenue recognised (*IFRS 15 .B23*).

An asset recognised for an entity's right to recover products from a customer on settling a refund liability is initially measured by reference to the former carrying amount of the product (inventory) less any expected costs to recover those products (including potential decreases in the value to the entity of returned products). At the end of each reporting period, an entity must update the measurement of the asset arising from changes in expectations about products to be returned. An entity must present the asset separately from the refund liability (*IFRS 15 .B25*).

Exchanges by customers of one product for another of the same type, quality, condition and price (one colour or size for another) are not considered returns (*IFRS 15 .B26*).

Warranties

An entity may provide (in accordance with the contract, the law or customary business practices) a warranty in connection with the sale of a product (good or service). Some warranties provide a customer with assurance that the related product will function as the parties intended because it complies with agreed-upon specifications. Other warranties provide the customer with a service in addition to the assurance that the product complies with agreed-upon specifications (*IFRS 15 .B28*).

If a customer has the option to purchase a warranty separately (the warranty is priced or negotiated separately), the warranty is a distinct service because the entity promises to provide the service to the customer in addition to the product that has the functionality described in the contract. The promised warranty is accounted for as a performance obligation, and a portion of the transaction price is allocated to that performance obligation (*IFRS 15 .B29*).

If a customer does not have the option to purchase a warranty separately, an entity accounts for the warranty in accordance with *IAS 37 – Provisions, contingent liabilities and contingent assets*, unless the promised warranty provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications (*IFRS 15 .B30*).

In assessing whether a warranty provides a customer with a service in addition to assurance, an entity considers factors such as the following:

- (a) *Whether the warranty is required by law.* If the warranty is required by law, the existence of that law indicates that the promised warranty is not a performance obligation.
- (b) *The length of the warranty coverage period.* The longer the coverage period, the more likely it is that the promised warranty is a performance obligation.
- (c) *The nature of the tasks that the entity promises to perform.* If it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (a return shipping service for a defective product), then those tasks are not likely to give rise to a performance obligation (*IFRS 15 .B31*).

If a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, the promised service is a performance obligation and the transaction price should be allocated to the product and the service (*IFRS 15 .B32*).

Principal versus agent considerations

When another party is involved in providing goods or services to a customer, the entity

must determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (a principal) or to arrange for the other party to provide those goods or services (an agent) (IFRS 15 .B34).

An entity is a principal if it controls a promised good or service before it transfers the good or service to a customer. When an entity, which is a principal, satisfies a performance obligation, it recognises revenue in the gross amount of consideration, to which it expects to be entitled, in exchange for those goods or services transferred (*IFRS 15 .B35*).

An entity is an agent if its performance obligation is to arrange for the provision of goods or services by another party. When an entity that is an agent satisfies a performance obligation, it recognises revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the other party to provide its goods or services (*IFRS 15 .B36*).

Indicators that an entity is an agent include the following:

- (a) another party is primarily responsible for fulfilling the contract;
- (b) the entity does not have inventory risk before or after the goods have been ordered by a customer, during shipping or on return;
- (c) the entity does not have discretion in establishing prices for the other party's goods or services and, therefore, the benefit that the entity can receive from those goods or services is limited;
- (d) the entity's consideration is in the form of a commission; and
- (e) the entity is not exposed to credit risk for the amount receivable from a customer in exchange for the other party's goods or services (*IFRS 15 .B37*).

Customer options for additional goods or services

Customer options to acquire additional goods or services for free or at a discount take on many forms, such as sales incentives, customer award credits (or points), contract renewal options or other discounts on future goods or services (*IFRS 15 .B39*).

An option granted to the customer to acquire additional goods or services is accounted for as a performance obligation in the contract only if the option provides a material right to the customer that it would not receive without entering into that contract. If the option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services, and the entity recognises revenue when those future goods or services are transferred or when the option expires (*IFRS 15 .B40*).

An entity allocates the transaction price to performance obligations on a relative stand-alone selling price basis. If the stand-alone selling price for a customer's option to acquire additional goods or services is not directly observable, an entity estimates it. That estimate reflects the discount that the customer would obtain when exercising the option, adjusted for both of the following:

- (a) any discount that the customer could receive without exercising the option; and
- (b) the likelihood that the option will be exercised (*IFRS 15 .B42*).

Customers' unexercised rights

Upon receipt of a prepayment from a customer, an entity recognises a contract liability in the amount of the prepayment for its performance obligation to transfer, or to be ready to transfer, goods or services in the future. An entity derecognises that contract liability (and recognises revenue) when it satisfies its performance obligation (*IFRS 15 .B44*).

A customer's non-refundable prepayment to an entity gives the customer a right to receive a good or service in the future. However, customers may not exercise all of their contractual rights, which are often referred to as breakage (*IFRS 15 .B45*). If an entity expects to be entitled to a breakage amount in a contract liability, the entity recognises the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer (*IFRS 15 .B46*).

Non-refundable upfront fees (and some related costs)

In some contracts, an entity charges a customer a non-refundable upfront fee at or near contract inception. Examples include joining fees in health-club membership contracts, activation fees in telecommunication contracts, setup fees in some services contracts, and initial fees in some supply contracts (*IFRS 15 .B48*).

To identify performance obligations in such contracts, an entity assesses whether the fee relates to the transfer of a promised good or service. In many cases, even though a non-refundable upfront fee relates to an activity that the entity is required to undertake at or near contract inception to fulfil the contract, that activity does not result in the transfer of a promised good or service to the customer. Instead, the upfront fee is an advance payment for future goods or services and, therefore, it would be recognised as revenue when those future goods or services are provided. The revenue recognition period would extend beyond the initial contractual period if the entity grants the customer the option to renew the contract and that option provides the customer with a material right (*IFRS 15 .B49*).

If the non-refundable upfront fee relates to a good or service, the entity evaluates whether to account for the good or service as a separate performance obligation (*IFRS 15 .B50*).

Licensing

A licence establishes a customer's rights to the intellectual property of an entity. Licences of intellectual property may include, but are not limited to

- (a) software and technology;
- (b) motion pictures, music and other forms of media and entertainment;
- (c) franchises; and
- (d) patents, trademarks and copyrights (*IFRS 15 .B52*).

In addition to a promise to grant a licence to a customer, an entity may promise to transfer other goods or services to the customer. As in other types of contracts, an entity identifies

each of the performance obligations in the contract (*IFRS 15 .B53*).

If the promise to grant a licence is not distinct from other goods or services promised in the contract, an entity accounts for the promise to grant a licence and those other promised goods or services together as a single performance obligation. Examples of licences that are not distinct from other goods or services promised in the contract include the following:

- (a) a licence that forms a component of a tangible good and that is integral to the functionality of the good; and
- (b) a licence from which the customer can benefit only in conjunction with a related service (such as an online service provided by the entity that, by granting a licence, enables the customer to access content) (*IFRS 15 .B54*).

If the licence is not distinct, an entity determines whether the single performance obligation is a performance obligation that is satisfied over time or satisfied at a point in time (*IFRS 15 .B55*).

If the promise to grant the licence is distinct from the other goods or services promised in the contract, an entity determines whether the licence transfers to a customer either at a point in time or over time. An entity considers whether the nature of the entity's promise in granting the licence to a customer is to provide the customer with either

- (a) a right to access the entity's intellectual property as it exists throughout the licence period; or
- (b) a right to use the entity's intellectual property as it exists at the point in time at which the licence is granted (*IFRS 15 .B56*).

To determine the nature of its promise, an entity considers whether a customer can direct the use of, and obtain substantially all of the remaining benefits from, a licence at the point in time at which the licence is granted. A customer cannot direct the use of, and obtain substantially all of the remaining benefits from, a licence at the point in time at which the licence is granted if the intellectual property, to which the customer has rights, changes throughout the licence period. The intellectual property will change when the entity continues to be involved with its intellectual property and undertakes activities that significantly affect the intellectual property to which the customer has rights. In these cases, the licence provides the customer with a right to access the entity's intellectual property. In contrast, a customer can direct the use of, and obtain substantially all of the remaining benefits from, the licence at the point in time at which the licence is granted if the intellectual property, to which the customer has rights, will not change. In those cases, any activities undertaken by the entity merely change its own asset (i.e. the underlying intellectual property), which may affect its ability to provide future licences. However, those activities would not affect the determination of what the licence provides or what the customer controls (*IFRS 15 .B57*).

The nature of an entity's promise is to provide a right to access the entity's intellectual property if all of the following criteria are met:

- (a) The contract requires, or the customer reasonably expects, that the entity will

undertake activities that significantly affect the intellectual property to which the customer has rights.

- (b) The rights granted by the licence directly expose the customer to any positive or negative effects of the entity's activities identified.
- (c) Those activities do not result in the transfer of a good or a service to the customer as those activities occur (*IFRS 15 .B58*).

If the above criteria are met, an entity accounts for the promise to grant a licence as a performance obligation satisfied over time because the customer will simultaneously receive and consume the benefit from the entity's performance of providing access to its intellectual property as the performance occurs (*IFRS 15 .B60*).

If the above criteria are not met, the nature of an entity's promise is to provide a right to use the entity's intellectual property as that intellectual property exists at the point in time at which the licence is granted to the customer. It means that the customer can direct the use of, and obtain substantially all of the remaining benefits from, the licence at the point in time at which the licence transfers. The performance obligation is satisfied at a point in time (*IFRS 15 .B61*).

Sales based or usage based

An entity recognises revenue for a sales-based or usage-based royalty promised in exchange for a licence of intellectual property only when (or as) the later of the following events occurs:

- (a) the subsequent sale or usage occurs; and
- (b) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated is satisfied (or partially satisfied) (*IFRS 15 .B63*).

Repurchase agreements

A repurchase agreement is a contract in which an entity sells an asset and also promises, or has the option, to repurchase the asset (*IFRS 15 .B64*).

Consignment arrangements

When an entity delivers a product to another party (such as a dealer or a distributor) for sale to end customers, the entity evaluates whether that other party has obtained control of the product at that point in time. A product that has been delivered to another party may be held in a consignment arrangement if that other party has not obtained control of the product. Accordingly, an entity does not recognise revenue upon delivery of a product to another party if the delivered product is held on consignment (*IFRS 15 .B77*). Indicators that an arrangement is a consignment arrangement include the following:

- (a) The product is controlled by the entity until a specified event occurs, such as the sale of the product to a customer of the dealer or until a specified period expires.
- (b) The entity is able to require the return of the product or to transfer the product to a third

party (such as another dealer).

(c) The dealer does not have an unconditional obligation to pay for the product (IFRS 15 .B78).

Bill-and-hold arrangements

A bill-and-hold arrangement is a contract under which an entity bills a customer for a product but the entity retains physical possession of the product until it is transferred to the customer at a point in time in the future. A customer may request an entity to enter into such a contract because of the customer's lack of available space for the product or because of delays in the customer's production schedules (*IFRS 15 .B79*).

An entity determines when it has satisfied its performance obligation to transfer a product by evaluating when a customer obtains control of that product. For some contracts, control is transferred either when the product is delivered to the customer's site or when the product is shipped, depending on the terms of the contract (including delivery and shipping terms). However, for some contracts, a customer may obtain control of a product even though that product remains in an entity's physical possession. In that case, the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the product, even though the customer has decided not to exercise its right to take physical possession of that product. Consequently, the entity does not control the product. Instead, the entity provides custodial services to the customer in respect of the customer's asset (*IFRS 15 .B80*).

All of the following criteria must be met for a customer to have obtained control of a product in a bill-and-hold arrangement:

- (a) The reason for the bill-and-hold arrangement must be substantive (the customer has requested the arrangement).
- (b) The product must be identified separately as belonging to the customer.
- (c) The product currently must be ready for physical transfer to the customer.
- (d) The entity cannot have the ability to use the product or to direct it to another customer (*IFRS 15 .B81*).

If an entity recognises revenue for the sale of a product on a bill-and-hold basis, it considers whether it has remaining performance obligations (custodial services), to which it allocates a portion of the transaction price (*IFRS 15 .B82*).

Customer acceptance

Customer acceptance clauses allow a customer to cancel a contract or require an entity to take remedial action if a good or service does not meet agreed-upon specifications. An entity considers such clauses when evaluating when a customer obtains control of a good or service (*IFRS 15 .B83*).

If an entity can objectively determine that control of a good or service has been transferred to the customer in accordance with the agreed-upon specifications in the contract, then

customer acceptance is a formality that would not affect the entity's determination of when the customer has obtained control of the good or service. If the customer acceptance clause were based on meeting specified size and weight characteristics, an entity would be able to determine whether those criteria have been met before receiving confirmation of the customer's acceptance (*IFRS 15 .B84*).

However, if an entity cannot determine objectively that the good or service provided to the customer is in accordance with the agreed-upon specifications in the contract, then the entity would not be able to conclude that the customer has obtained control until the entity receives the customer's acceptance (*IFRS 15 .B85*).



LECTURER'S COMMENT

Work through example 27.18 of *Descriptive accounting*, which deals with customer incentives.

9.6 PRESENTATION

When either party to a contract has performed, an entity presents the contract in the statement of financial position as a contract asset or a contract liability, depending on the relationship between the entity's performance and the customer's payment. An entity presents any unconditional rights to consideration separately as a receivable (*IFRS 15 .105*).

If a customer pays consideration, or an entity has a right to an amount of consideration that is unconditional (a receivable), before the entity transfers a good or service to the customer, the entity presents the contract as a contract liability when payment is made or payment is due (whichever is earlier). A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or consideration is due) from the customer (*IFRS 15 .106*).

If an entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due, the entity presents the contract as a contract asset, excluding any amounts presented as a receivable. A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer (*IFRS 15 .107*).

A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due (*IFRS 15 .108*).

EXAMPLE 9 – CONTRACT LIABILITY AND RECEIVABLE

Case A – Cancellable contract

On 1 January 20.14, an entity enters into a cancellable contract to transfer a product to a customer on 31 March 20.14. The contract requires the customer to pay consideration of R1 000 in advance on 31 January 20.14. The customer pays the consideration on 1 March 20.14. The entity transfers the product on 31 March 20.14. The following journal entries illustrate how the entity accounts for the contract:

| | Dr | Cr |
|---|-----------|-----------|
| | R | R |
| <i>Cash received on 1 March 20.14 (cash is received in advance of performance):</i> | | |
| Cash | 1 000 | |
| Contract liability | | 1 000 |
| <hr/> | | |
| <i>The entity satisfies the performance obligation on 31 March 20.14:</i> | | |
| Contract liability | 1 000 | |
| Revenue | | 1 000 |
| <hr/> | | |

Case B – Non-cancellable contract

The same facts as in case A apply to case B, except that the contract is non-cancellable. The following journal entries illustrate how the entity accounts for the contract:

| | Dr | Cr |
|--|-----------|-----------|
| | R | R |
| <i>The amount of consideration is due on 31 January 20.14 (which is when a receivable is recognised because it has an unconditional right to consideration)¹:</i> | | |
| Receivable | 1 000 | |
| Contract liability | | 1 000 |
| <hr/> | | |
| <i>Cash received on 1 March 20.14:</i> | | |
| Cash | 1 000 | |
| Receivable | | 1 000 |
| <hr/> | | |
| <i>Performance obligation satisfied on 31 March 20.14:</i> | | |
| Contract liability | 1 000 | |
| Revenue | | 1 000 |
| <hr/> | | |

¹ If the entity issued the invoice before 31 January 20.14 (the due date of the consideration), the entity would not present the receivable and the contract liability on a gross basis in the statement of financial position because it does not yet have a right to consideration that is unconditional.

EXAMPLE 10 – CONTRACT ASSET AND RECEIVABLE RECOGNISED FOR THE ENTITY'S PERFORMANCE

a) Contract asset recognised for the entity's performance

On 1 January 20.14, an entity enters into a contract to transfer products A and B to a customer in exchange for R1 000. The contract requires product A to be delivered first and states that payment for delivery of product A is conditional on delivery of product B. In other words, the consideration of R1 000 is due only after the entity has transferred both products A and B to the customer. Consequently, the entity does not have a right to consideration that is unconditional (a receivable) until both products A and B are transferred to the customer. The entity identifies the promises to transfer products A and B as performance obligations and allocates R400 to the performance obligation to transfer product A, and R600 to the performance obligation to transfer product B, based on their relative stand-alone selling prices. The entity recognises revenue for each respective performance obligation when control of the product is transferred to the customer.

b) Receivable recognised for the entity's performance

An entity enters into a contract with a customer on 1 January 20.14 to transfer products to the customer for R150 per product. If the customer purchases more than 1 million products in a calendar year, the contract indicates that the price per unit is reduced retrospectively to R125 per product. Consideration is due when control of the products is transferred to the customer. Therefore, the entity has an unconditional right to consideration (a receivable) for R150 per product until the retrospective price reduction applies after 1 million products have been shipped.

In determining the transaction price, the entity concludes at contract inception that the customer will meet the one million products threshold and therefore, estimates that the transaction price is R125 per product.



REQUIRED

Provide the journal entries to recognise the revenue transaction in a) and b) above according to *IFRS 15 – Revenue from contracts with customers*.

SOLUTION 10

a) Contract asset recognised for the entity's performance

| | Dr | Cr |
|---|-------|-----|
| | R | R |
| <i>The entity satisfies the performance obligation to transfer product A:</i> | | |
| Contract asset | 400 | |
| Revenue | | 400 |
| <hr/> | | |
| <i>The entity satisfies the performance obligation to transfer product B and to recognise the unconditional right to consideration:</i> | | |
| Receivable | 1 000 | |
| Contract asset | | 400 |
| Revenue | | 600 |
| <hr/> | | |

b) Receivable recognised for the entity's performance

Upon the first shipment to the customer of 100 products, the entity recognises the following:

| | Dr | Cr |
|---|--------|--------|
| | R | R |
| <i>The entity satisfies the performance obligation to transfer product B and to recognise the unconditional right to consideration:</i> | | |
| Receivable (R150 per product x 100 products) | 15 000 | |
| Revenue (R125 transaction price per product x 100 products) | | 12 500 |
| Refund liability (contract liability) | | 2 500 |



LECTURER'S COMMENT

The refund liability (*IFRS 15 .55*) represents a refund of R25 per product, which is expected to be provided to the customer for the volume-based rebate (the difference between the R150 price stated in the contract that the entity has an unconditional right to receive and the R125 estimated transaction price).

9.7 DISCLOSURE

The objective of the disclosure requirements is to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective, an entity discloses qualitative and quantitative information about all of the following:

- its contracts with customers;
- the significant judgements, and changes in the judgements, made in applying this Standard to those contracts; and
- any assets recognised from the costs to obtain or to fulfil a contract with a customer (*IFRS 15 .110*).

The level of detail and the amount of emphasis placed on each of the various requirements will vary, and an entity appropriately aggregates or disaggregates disclosures to disclose useful information that satisfies the disclosure objective (*IFRS 15 .111*).

Contracts with customers

An entity discloses all of the following amounts for the reporting period unless those amounts are presented separately in the statement of comprehensive income in accordance with other Standards:

- (a) revenue recognised from contracts with customers, which the entity discloses separately from its other sources of revenue; and
- (b) any impairment losses recognised on any receivables or contract assets arising from an entity's contracts with customers, which the entity discloses separately from impairment losses from other contracts (*IFRS 15 .113*).

Disaggregation of revenue

An entity disaggregates revenue recognised from contracts with customers into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors (*IFRS 15 .114*).

Disclosure of disaggregated revenue

Examples of categories that might be appropriate include, but are not limited to, all of the following:

- (a) type of good or service (major product lines);
- (b) geographical region (country or region);
- (c) market or type of customer (government and non-government customers);
- (d) type of contract (fixed-price and time-and-materials contracts);
- (e) contract duration (short-term and long-term contracts);
- (f) timing of transfer of goods or services (revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred over time); and
- (g) sales channels (goods sold directly to consumers and goods sold through intermediaries) (*IFRS 15 .B89*).

Contract balances

An entity discloses all of the following:

- (a) the opening and closing balances of receivables, contract assets and contract liabilities from contracts with customers, if not otherwise presented or disclosed separately;
- (b) revenue recognised in the reporting period that was included in the contract liability balance at the beginning of the period; and
- (c) revenue recognised in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (changes in transaction price) (*IFRS 15 .116*).

An entity explains how the timing of satisfaction of its performance obligations relates to the typical timing of payment and the effect of those factors on the contract asset and the contract liability balances. The explanation provided may contain qualitative information (*IFRS 15 .117*).

An entity provides an explanation of the significant changes in the contract asset and the contract liability balances during the reporting period. The explanation includes qualitative and quantitative information. Examples of changes in the entity's balances of contract assets and contract liabilities include any of the following:

- (a) changes due to business combinations;
- (b) cumulative catch-up adjustments to revenue affecting the corresponding contract asset or contract liability, including adjustments arising from a change in the measure of progress, a change in an estimate of the transaction price (including any changes in the assessment of whether an estimate of variable consideration is constrained) or a contract modification;
- (c) impairment of a contract asset;
- (d) a change in the time frame for a right to consideration to become unconditional (for a contract asset to be reclassified to a receivable); and
- (e) a change in the time frame for a performance obligation to be satisfied (for the recognition of revenue arising from a contract liability) (*IFRS 15 .118*).

EXAMPLE 11 – DISAGGREGATION OF REVENUE: QUANTITATIVE DISCLOSURE

In accordance with *IFRS 8 – Operating segments*, Camel Ltd reports on the following segments: consumer products, transportation and energy. **Take note that *IFRS 8 – Operating segments* does not form part of this module. The purpose of this example is to illustrate to you the disaggregation of revenue for disclosure requirements.** When the entity prepares its investor presentations, it disaggregates revenue into primary geographical markets, major product lines and timing of revenue recognition (goods transferred at a point in time or services transferred over time).

Camel Ltd determines that the categories used in the investor presentations can be used to meet the objective of the disaggregation disclosure requirement (*IFRS 15 .114*), which is to disaggregate revenue from contracts with customers into categories depicting how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. The following table illustrates the disaggregation disclosure by primary geographical market, major product line and timing of revenue recognition, including a reconciliation of how the disaggregated revenue ties in with the consumer products, transportation and energy segments (*IFRS 15 .115*).

| Segments | Consumer products | Transport | Energy | Total |
|--------------------------------------|-------------------|--------------|--------------|---------------|
| | R | R | R | R |
| Primary geographical markets | | | | |
| North America | 990 | 2 250 | 5 250 | 8 490 |
| Europe | 300 | 750 | 1 000 | 2 050 |
| Asia | 700 | 260 | - | 960 |
| | 1 990 | 3 260 | 6 250 | 11 500 |
| Major goods/service lines | | | | |
| Office supplies | 600 | - | - | 600 |
| Appliances | 990 | - | - | 990 |
| Clothing | 400 | - | - | 400 |
| Motorcycles | - | 500 | - | 500 |
| Automobiles | - | 2 760 | - | 2 760 |
| Solar panels | - | - | 1 000 | 1 000 |
| Power plant | - | - | 5 250 | 5 250 |
| | 1 990 | 3 260 | 6 250 | 11 500 |
| | R | R | R | R |
| Timing of revenue recognition | | | | |
| Goods transferred at a point in time | 1 990 | 3 260 | 1 000 | 6 250 |
| Services transferred over time | - | - | 5 250 | 5 250 |
| | 1 990 | 3 260 | 6 250 | 11 500 |

Performance obligations

An entity discloses information about its performance obligations in contracts with customers, including a description of all of the following:

- (a) when the entity typically satisfies its performance obligations (upon shipment, upon delivery, as services are rendered or upon completion of service), including when performance obligations are satisfied in a bill-and-hold arrangement;
- (b) the significant terms of payment (when payment is typically due, whether the contract has a significant financing component, whether the consideration amount is variable and whether the estimate of variable consideration is typically constrained);
- (c) the nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (if the entity is acting as an agent);
- (d) obligations for returns, refunds and other similar obligations; and
- (e) types of warranties and related obligations (*IFRS 15 .119*).

Transaction price allocated to the remaining performance obligations

An entity discloses the following information about its remaining performance obligations:

- (a) the aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period;
- (b) an explanation of when the entity expects to recognise as revenue the amount disclosed in (a) above, which the entity discloses in one of the following ways:

- (i) on a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations; or
- (ii) by using qualitative information (*IFRS 15 .120*).

Significant judgements in the application of this Standard

An entity discloses the judgements, and changes in the judgements, made in applying this Standard that significantly affect the determination of the amount and timing of revenue from contracts with customers. In particular, an entity explains the judgements, and changes in the judgements, used in determining both of the following:

- (a) the timing of satisfaction of performance obligations; and
- (b) the transaction price and the amounts allocated to performance obligations (*IFRS 15 .123*).

Determining the timing of satisfaction of performance obligations

For performance obligations that an entity satisfies over time, an entity discloses both of the following:

- (a) the methods used to recognise revenue (a description of the output methods or input methods used and how those methods are applied); and
- (b) an explanation of why the methods used provide a faithful depiction of the transfer of goods or services (*IFRS 15 .124*).

For performance obligations satisfied at a point in time, an entity discloses the significant judgements made in evaluating when a customer obtains control of promised goods or services (*IFRS 15 .125*).

Determining the transaction price and the amounts allocated to performance obligations

An entity discloses information about the methods, inputs and assumptions used for

- (a) determining the transaction price, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of the time value of money and measuring non-cash consideration;
- (b) assessing whether an estimate of variable consideration is constrained;
- (c) allocating the transaction price, including estimating stand-alone selling prices of promised goods or services and allocating discounts and variable considerations to a specific part of the contract (if applicable); and
- (d) measuring obligations for returns and refunds and other similar obligations (*IFRS 15 .126*).


Assets recognised from the costs to obtain or to fulfil a contract with a customer

An entity describes both of the following:

- (a) the judgements it makes in determining the amount of the costs incurred to obtain or to fulfil a contract with a customer; and
- (b) the method it uses to determine the amortisation for each reporting period (*IFRS 15 .127*).

An entity discloses all of the following:

- (a) the closing balances of assets recognised from the costs incurred to obtain or to fulfil a contract with a customer, by main category of asset (costs to obtain contracts with customers, pre-contract costs and setup costs); and
- (b) the amount of amortisation and any impairment losses recognised in the reporting period (*IFRS 15 .128*).

| | |
|--|--|
|  | <p>ASSESSMENT CRITERIA</p> <p>Are you now able to do the following?</p> <ul style="list-style-type: none"> • Measure revenue accurately and determine when revenue should be recognised in the annual financial statements. • Record revenue in the annual financial statements of companies according to the requirements of the International Financial Reporting Standards. |
|--|--|

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