MO001

FAC3702

Semesters 1 & 2

DISTINCTIVE FINANCIAL REPORTING

Department of Financial Accounting
University of South Africa, Pretoria





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IMPORTANT INFORMATION:

This document contains all the tutorial matter of your learning units.

Note: *This is an online module, and therefore your module is available on myUnisa. However, in order to support you in your learning process, you will also receive some study materials in printed format.*

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INTRODUCTION

Dear Student,

Attached please find the following learning units:

- Learning unit 1 – Property, plant and equipment (IAS 16)
- Learning unit 2 – Investment property (IAS 40)
- Learning unit 3 – Impairment of assets (IAS 36)
- Learning unit 4 – Intangible assets (IAS 38)
- Learning unit 5 – Non-current assets held for sale and discontinued operations (IFRS 5)
- Learning unit 6 – Financial instruments: Presentation, Recognition and Measurement (IAS 32, IFRS 7 and IFRS 9)
- Learning unit 7 – The effects of changes in foreign exchange rates (IFRS 7 IFRS 9, IAS 21 and IAS 32)

LECTURERS AND CONTACT DETAILS

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FAC3702

LEARNING UNIT 1

PROPERTY, PLANT AND EQUIPMENT [IAS 16]



Distinctive Financial Reporting

LEARNING UNIT 1 – PROPERTY, PLANT AND EQUIPMENT

LEARNING OUTCOMES

Once you have studied and completed this course material, you should be able to:

- account for property, plant and equipment, and depreciation in the financial statements of an entity in terms of the requirements of *International Financial Reporting Standards*.
- account for revaluations of property, plant and equipment in the financial statements of an entity in terms of the requirements of *International Financial Reporting Standards*.
- account for the deferred tax and tax implications in respect of property, plant and equipment.

OVERVIEW

This learning unit will be discussed under the following sections:

A PROPERTY, PLANT AND EQUIPMENT

1.1 Objective – IAS 16.1
1.2 Scope – IAS 16.2–5
1.3 Definitions – IAS 16.6

1.4 Recognition of property, plant and equipment – IAS 16.7–14
  1.4.1 Initial costs – IAS 16.11
  1.4.2 Subsequent costs – IAS 16.12–14

1.5 Measurement at recognition – IAS 16.15–28
  1.5.1 Elements of cost – IAS 16.16–22
  1.5.2 Measurement of cost – IAS 16.23–28

1.6 Measurement after recognition – IAS 16.29–66
  1.6.1 Cost model – IAS 16.30
  1.6.2 Revaluation model – IAS 16.31–42
  1.6.3 Depreciation – IAS 16.43–62
  1.6.4 Impairment – IAS 16.63
  1.6.5 Compensation for impairment – IAS 16.65–66

1.7 Derecognition – IAS 16.67–72

B REVALUATION MODEL – IAS 16.31–42

1.8 Introduction
1.9 Frequency of revaluations

1.10 Revaluation methods
  1.10.1 Change in accounting policy
  1.10.2 Residual value
  1.10.3 Estimated useful life
  1.10.4 Determination of replacement value
  1.10.5 Alternative accounting treatments when assets are revalued
  1.10.6 Revaluation methods – schematic diagram
  1.10.7 Date of revaluation

1.11 Revalue an entire class of property, plant and equipment – IAS 16.36–38
1.12 Revaluation surplus – IAS 16.39–42
1.13 Further examples
1.14 Summary of revaluations

C DISCLOSURE – IAS 16.73–79

1.15 Disclosure requirements for the cost – and the revaluation model
1.16 Further disclosure requirements
1.17 Specific disclosure requirements for the revaluation model
1.18 Further relevant information for users of financial statements

D TAX IMPLICATIONS

1.19 Capital Gains Tax (CGT)
1.20 Deferred tax
1.21 Recovery of revalued non-depreciable assets

E COMPREHENSIVE EXAMPLES

STUDY

PRESCRIBED:
Descriptive Accounting
Chapter 9

RECOMMENDED:
A Guide through IFRS
IAS 16

A PROPERTY, PLANT AND EQUIPMENT

1.1 OBJECTIVE – IAS 16.1

IAS 16 contains prescriptions for the accounting treatment for property, plant and equipment (PPE) so that users of the financial statements can discern information about an entity's investment in its PPE and the changes in such investment. The principal issues in accounting for PPE are the following:

- the recognition of PPE as assets, and
- the determination of their carrying amounts, and
- the related depreciation charges and impairment losses.

1.2 SCOPE – IAS 16.2–5

The standard shall be applied to PPE except when another standard requires or permits a different accounting treatment.

The standard does not apply to:

(a) PPE items classified as held for sale in accordance with IFRS 5 *Non-current assets held for sale and discontinued operations* (refer to learning unit 5);
(b) biological assets related to agricultural activity (IAS 41 *Agriculture*); or
(c) the recognition and measurement of exploration and evaluation assets (see IFRS 6 *Exploration for and evaluation of mineral resources*); or
(d) mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources.

However, the standard applies to PPE used to develop or maintain the assets described in (a) and (b). The standard also applies to the following:

- where other standards may require recognition of an PPE item based on an approach different from that in the standard (eg Leases under IAS 17), other aspects of the accounting treatment for these assets, including depreciation, are prescribed by this standard;
- investment property that is being accounted for in accordance with the cost model (see learning unit 2 for investment properties).

1.3 DEFINITIONS – IAS 16.6

The following terms are used in the standard with the meanings specified:

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

Cost
Cost is the amount of cash or cash equivalents paid and the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, for instance IFRS 2 *Share-based payment*.

Depreciable amount
The cost of an asset, or other amount substituted for cost, less its residual value.

Depreciation
The systematic allocation of the depreciable amount of an asset over its useful life.

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

Fair value
The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Impairment loss
The amount by which the carrying amount of an asset exceeds its recoverable amount.

Property, plant and equipment
PPE are tangible assets that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
(b) are expected to be used during more than one period.

Recoverable amount
It is the higher of an asset's net selling price (fair value less costs to sell) and its value in use.

Residual value
The estimated amount that an entity would currently obtain from disposal of an asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Useful life
It is either:

(a) the period over which an asset is expected to be available for use by an entity; or
(b) the number of production or similar units expected to be obtained from the asset by an entity.

1.4 RECOGNITION OF PROPERTY, PLANT AND EQUIPMENT – IAS 16.7–14

The first step to take in accounting for an item of expenditure, is to decide whether the item should be recognised and accounted for as an asset or as an expense, based on the recognition criteria set out in the Framework for the Preparation and Presentation of Financial Statements. These criteria also apply to subsequent recognition.

The cost of a PPE item shall be recognised as an asset if, and only if:

- it is probable that future economic benefits associated with the item will flow to the entity (this will usually be the case where the risks and rewards of ownership have passed to the entity); and
- the cost of the item can be measured reliably.

An entity evaluates under this recognition principle all its PPE costs at the time they are incurred. These costs include costs incurred initially to acquire or construct a PPE item and costs incurred subsequently to add to, replace part of, or service it (under certain circumstances).

Spare parts and servicing equipment do not normally meet the definition of PPE as they are used in one accounting period. They are normally carried in inventory and recognised in profit and loss as and when it is used. However, major spare parts and stand-by equipment qualify as PPE when an entity expects to use them during more than one period. Similarly, if the spare parts and servicing equipment can be used only in connection with a certain PPE item, they are accounted for as PPE.

1.4.1 Initial costs

Sometimes entities are obliged to acquire certain PPE items for safety or environmental reasons. Although such assets will not directly give rise to increased future economic benefits embodied in a specific asset itself, the entity is obliged to acquire such assets for increased future economic benefits from other assets. Consequently these assets meet the general recognition criteria for assets and are therefore capitalised as assets. The resulting carrying amount of such an asset and related assets is reviewed for impairment in accordance with IAS 36 (see learning unit 3 for impairment).

EXAMPLE 1

In order to comply with environmental requirements, a manufacturer of chemical products has to install new chemical air filters to prevent the emission of toxic gasses. The relevant values at year-end, 30 April 20.10, were as follows:

	R
Existing plant	5 000 000
Accumulated depreciation	(1 250 000)
Carrying amount on 30 April 20.10	3 750 000
Cost of air filters (brought into use on 30 April 20.10)	800 000
New carrying amount on 30 April 20.10	4 550 000

1.4.2 Subsequent costs

Servicing cost

In terms of the general recognition principle described above, the normal day-to-day servicing (maintenance) costs of a PPE item are not recognised in the carrying amount of the item, but in profit or loss (an expense) as incurred. The expense is described as “repairs and maintenance” and consists mainly of the cost of labour, consumables and small (low value) spares.

Replacement at regular intervals

Parts of some PPE items may require replacement at regular intervals. For example:

- the relining of a furnace
- the seats and galleys in an aircraft
- the interior walls of a building such as an office block.

The principle (main) asset (like the furnace, aircraft and building) has a much longer useful life than the respective components (like the relining, seats and interior walls). An entity recognises in the carrying amount of a PPE item the cost of replacing part of such an item when that cost is incurred if the recognition criteria are met. The remaining carrying amount of the replaced part is then derecognised (see 1.7 for derecognition).

Regular major inspections

Certain assets need regular major inspections for faults, regardless of whether parts of the item are replaced (eg aircraft) to ensure continuing operations. When each major inspection is performed, its cost is recognised in the carrying amount of the asset as a replacement (if the recognition criteria are met) and depreciated. Any remaining carrying amount of the previous inspection (as distinct from physical parts) is derecognised. This occurs regardless of whether the cost of the previous inspection was identified in the transaction in which the item was acquired or constructed. If necessary, the estimated cost of a future similar inspection may be used as an indication of what the cost of the inspection component was when the item was acquired or constructed. In this way the depreciable amount that needs to be separately depreciated, can be estimated.

EXAMPLE 2

Deens Ltd bought a machine on 1 January 20.12 for R1 600 000. The machine has to be inspected every 6 000 hours which means that a major inspection will have to be carried out every 2 years. The estimated cost of a major inspection is R150 000. The machine has an estimated useful life of 8 years.



REQUIRED

(a) Calculate the depreciation and carrying amount of the machine for 20.12 and 20.13 if everything goes according to plan.

(b) If, due to several factors, the inspection needed to be done after 20 months instead of the planned two years and the cost of the first physical inspection amounted to R200 000, show how this matter will be disclosed in the note on property, plant and equipment for the year ended 31 December 20.13. The machine is the only asset of the entity.

SOLUTION 2

(a) Depreciation and carrying amount of the machine for 20.12 and 20.13

	Machine R	Inspection component R	Total R
Cost (1 600 000 – 150 000)	1 450 000	150 000	1 600 000
Depreciation 20.12 (1 450 000/8); (150 000/2)	(181 250)	(75 000)	(256 250)
Carrying amount on 31 December 20.12	1 268 750	75 000	1 343 750
Depreciation 20.13	(181 250)	(75 000)	(256 250)
Carrying amount on 31 December 20.13	1 087 500	–	1 087 500



LECTURER'S COMMENT

The inspection component forms a part of the machine and is not a separate asset.

(b) DEENS LTD

NOTES FOR THE YEAR ENDED 31 DECEMBER 20.13

5. Property, plant and equipment

	Machinery R
Carrying amount on 1 January 20.13	1 343 750
Gross carrying amount	1 600 000
Accumulated depreciation	(256 250)
Depreciation (calc)	(264 583)
Derecognition of initial inspection cost (75 000 – 50 000 (calc))	(25 000)
Capitalisation of inspection cost incurred	200 000
Carrying amount on 31 December 20.13	1 254 167
Gross carrying amount (1 600 000 – 150 000 + 200 000)	1 650 000
Accumulated depreciation (256 250 + 264 583 – 75 000 – 50 000)	(395 833)

CALCULATION

Depreciation – machine	181 250
Depreciation – inspection (initial) (150 000/2 x $8^{1}/12$)	50 000
Depreciation – inspection (new) (200 000/2 x $4^{1}/12$)	33 333
	264 583

1. Inspection of the machine is carried out after 20 months therefore the first 12 months falls within the 20.12 financial year and the remainder 8 months in the current financial year – 20.13.
   1 January 20.13 – 31 August 20.13 = 8 months (initial inspection cost)
   1 September 20.13 – 31 December 20.13 = 4 months (new inspection cost)

1.5 MEASUREMENT AT RECOGNITION – IAS 16.15–28

A PPE item that qualifies for recognition as an asset shall be measured at its cost.

1.5.1 Elements of cost

The cost of a PPE item comprises:

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
(b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
(c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located. This obligation can arise either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

Examples of directly attributable costs are:

(a) costs of employee benefits arising directly from the construction or acquisition of the PPE item;
(b) costs of site preparation;
(c) initial delivery and handling costs;
(d) installation and assembly costs;
(e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and
(f) professional fees.

An entity applies IAS 2 *Inventory* to the costs of obligations for dismantling, removing and restoring the site on which an item is located that are incurred during a particular period as a consequence of having used the asset to produce inventories during that period. (This implies that these costs will be capitalised to inventory and not to the PPE item.)

Examples of costs that are not costs of a PPE item are:

(a) costs of opening a new facility;
(b) costs of introducing a new product or service (including costs of advertising and promotional activities);
(c) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and
(d) administration and other general overhead costs.

Recognition of costs in the carrying amount of a PPE item ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an item are not included in the carrying amount of that item. For example:

(a) costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity;
(b) initial operating losses, such as those incurred while demand for the item's output builds up; and
(c) costs of relocating or reorganising part or all of an entity's operations.

Some operations occur in connection with the construction or development of a PPE item, but are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management. For example, income may be earned through using a building site as a car park until construction starts. Income and related expenses of such incidental operations are not included in the carrying amount of that item, but are recognised in profit or loss and included in their respective classifications.

The cost of a self-constructed asset is determined using the same principles as for an acquired asset. Any internal profits are eliminated in arriving at such costs. Similarly, the cost of abnormal amounts of wasted material, labour, or other resources incurred in self-constructing an asset is not included in the cost of the asset.

1.5.2 Measurement of cost

Abnormal credit terms

The cost of a PPE-item is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognised as interest over the period of credit (unless such interest is recognised in the carrying amount of the item in accordance with the allowed alternative treatment in IAS 23. However, capitalisation of finance costs do not form part of this module).



LECTURER'S COMMENT

Refer to:
Descriptive Accounting, example 9.8.

Exchange (swap) of PPE items (IAS 16.24)

One or more PPE items may be acquired in exchange for monetary or non-monetary asset(s) or a combination of both. The cost of the acquired item is measured at fair value unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received nor the asset given up is reliably measurable. In both cases the asset that is acquired, is measured at the carrying value of the asset given up.

An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows (after tax) are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

(a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or
(b) the entity-specific value of the portion of the entity's operations affected by the transaction (after tax cash flows) changes as a result of the exchange; and
(c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

When the fair values of both the acquired asset and the asset given up can be measured reliably, then the fair value of the asset given up is used to measure the cost of the asset received unless the fair value of the asset received is more evident, in which case it can be used.

EXAMPLE 3

Bob Ltd entered into the following exchange transactions during the year ended 30 June 20.10:

Transaction 1
A motor vehicle with a carrying amount of R100 000 in the records of Bob Ltd and a fair value of R120 000 was exchanged for a light delivery vehicle of Zaz Ltd with a fair value of R125 000. The fair values of both vehicles can readily be determined since there is an active market for used vehicles.

Transaction 2
A machine of Bob Ltd with a carrying amount of R90 000 was exchanged for a machine of Yk Ltd which is carried in Yk's records at R80 000. The fair values of neither of the machines could be readily determined.

Transaction 3
A computer network system of Bob Ltd with a carrying amount of R160 000 was exchanged for furniture with a carrying amount of R170 000 in the records of Xi! Ltd. The fair value of the network system cannot be determined readily as this item is seldom sold in its entirety, but based on probabilities the fair value is estimated at R150 000. The fair value of the furniture is R165 000 and is readily determinable because an active market exists for these used assets.

Transaction 4
Bob Ltd exchanged a truck with a carrying value of R200 000 for a similar truck with the same age and condition of WOW Ltd. The truck of Bob Ltd has blue stripes painted on the sides and the other truck has silver stripes which is more to the liking of the managing director of Bob Ltd. The fair value of the blue striped truck is R210 000 and that of the silver striped truck is R220 000, which indicates that the silver striped truck is more popular.



REQUIRED

Calculate for each transaction the amount at which the new asset acquired from the exchange should be measured in the financial statements of Bob Ltd according to the requirements of *International Financial Reporting Standards*.

Motivate your answer by reference to *IAS 16*.

SOLUTION 3

Transaction 1
The delivery vehicle will be measured at R120 000. (IAS 16.26)

Transaction 2
The acquired machine will be measured at R90 000, the carrying amount of the machine given up. (IAS 16.24)

Transaction 3
The furniture will be measured at R165 000, its fair value, since it is more readily determinable than the fair value of the asset given up. (IAS 16.26, last part)

Tra**nsaction 4**
The silver stripe truck will be measured at R200 000. This transaction is without commercial substance and the carrying amount of the blue stripe truck given up is used as the cost of the acquired truck. (IAS 16.24, 25)

1.6 MEASUREMENT AFTER RECOGNITION – IAS 16.29–66

An entity shall choose, after the initial recognition of a PPE item, either

- the cost model or
- the revaluation model

as its accounting policy and shall apply that policy to an entire class of property, plant and equipment.

1.6.1 Cost model

After recognition as an asset, a PPE item shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses.

1.6.2 Revaluation model – IAS 16.31–42 (refer to part B of this learning unit)

1.6.3 Depreciation – IAS 16.43–62

Traditionally there are different points of departure regarding the nature of depreciation within the context of historical cost. The three most important views regard depreciation as a process of:

- valuation, or
- capital maintenance, or
- cost allocation.

IAS 16 follows the point of view that depreciation is a process of **cost allocation**. IAS 16.6 and 16.50 states that depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. The standard also allows a revaluation amount to be the depreciable amount (see PART B below for revaluations).

Depreciable items of property, plant and equipment

Each part of a PPE item with a cost that is significant in relation to the total cost of the item shall be depreciated separately.

An entity allocates the amount initially recognised in respect of a PPE item to its significant parts and depreciates separately each such part. For example, it may be appropriate to depreciate separately the airframe and engines of an aircraft.

A significant part of a PPE item may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that same item. Such parts may be grouped in determining the depreciation charge.

To the extent that an entity depreciates separately some parts of a PPE item, it also depreciates separately the remainder of the item. The remainder consists of the parts of the item that are individually not significant. If an entity has varying expectations for these parts, approximation techniques may be necessary to depreciate the remainder in a manner that faithfully represents the consumption pattern and/or useful life of its parts.

An entity may choose to depreciate separately the parts of an item that do not have a cost that is significant in relation to the total cost of the item.

Where is depreciation recorded?

The depreciation charge for each period shall be recognised in **profit or loss** unless it is included in the **carrying amount** of another asset.

The depreciation charge for a period is usually recognised in profit or loss. However, sometimes, the future economic benefits embodied in an asset are absorbed in producing other assets. In this case, the depreciation charge constitutes part of the cost of the other asset and is included in its carrying amount. For example, the depreciation of manufacturing plant and equipment is included in the costs of conversion of inventories. Similarly, depreciation of PPE for development activities may be included in the cost of an intangible asset (refer to learning unit 4 of this module).

Depreciable amount

The depreciable amount of an asset shall be allocated on a systematic basis over its useful life.

The residual value and the useful life of an asset shall be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) shall be accounted for as a change in an accounting estimate in accordance with IAS 8.

Depreciation is recognised even if the fair value of the asset exceeds its carrying amount, as long as the asset's residual value does not exceed its carrying amount. Repair and maintenance of an asset do not negate the need to depreciate it.

The depreciable amount of an asset is determined after deducting its residual value. In practice, the residual value of an asset is often insignificant and therefore immaterial in the calculation of the depreciable amount.

The residual value of an asset may increase to an amount equal to or greater than the asset's carrying amount. If it does, the asset's depreciation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount.

Period of depreciation

Depreciation of an asset begins when it is available for use, that is, when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Depreciation of an asset ceases at the earlier of the date that the asset is classified as held for sale and the date that the asset is derecognised. Therefore, depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero while there is no production.

Useful life

The future economic benefits embodied in an asset are consumed by an entity principally through its use. However, other factors, such as technical or commercial obsolescence and tax allowance while an asset remains idle, often result in the diminution of the economic benefits that might have been obtained from the asset. Consequently, all the following factors are considered in determining the useful life of an asset:

(a) expected usage of the asset. Usage is assessed by reference to the asset's expected capacity or physical output.
(b) expected physical tax allowance. This depends on (i) operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance program, and (ii) the care and maintenance of the asset while idle.
(c) technical or commercial obsolescence. This arises (i) from changes or improvements in production, (ii) or from a change in the market demand for the product or service output of the asset.
(d) legal or similar limits on the use of the asset, such as the expiry dates of related leases.

The useful life of an asset is defined in terms of the asset's expected utility to the entity. The asset management policy of the entity may involve the disposal of assets after a specified time or after consumption of a specified portion of the future economic benefits embodied in the asset. Therefore, the useful life of an asset may be shorter than its economic life. The estimation of the useful life of the asset is a matter of judgement based on the experience of the entity with similar assets.

Useful life of land and buildings

Land and buildings are separable assets and are accounted for separately, even when they are acquired together. With some exceptions, such as quarries and sites used for landfill, land has an unlimited useful life and therefore is not depreciated. Buildings have a limited useful life and therefore are depreciable assets. An increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building.

If the cost of land includes the costs of site dismantlement, removal and restoration, the restoration cost portion of the land asset is depreciated over the period of benefits obtained by incurring those costs. In some cases, the land itself may have a limited useful life, in which case it is depreciated in a manner that reflects the benefits to be derived from it.

Depreciation methods and their recognition – IAS 16.60–62

The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

The depreciation method applied to an asset shall be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method shall be changed to reflect the changed pattern. Such a change shall be accounted for as a change in an accounting estimate in accordance with IAS 8.

A variety of depreciation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life, namely:

- The straight-line method: depreciation results in a constant charge over the useful life if the asset's residual value does not change. This allocation of depreciation in fixed instalments is usually adopted where the income produced by the asset or part of it is a function of time rather than usage and where the repair and maintenance charges are fairly constant.
- The diminishing balance method: depreciation results in a decreasing charge over the useful life of the asset. The allocated amount of depreciation declines on an annual basis. The method is usually used where there is uncertainty as to the amount of income that will be derived from the asset, especially in subsequent years, and where the effectiveness of the asset is expected to gradually decline. The repair and maintenance costs will usually increase as an asset ages. The total debit for the cost of the asset will therefore remain fairly constant.
- The units of production method (or: sum of the units method): depreciation is a charge based on the expected use or output of the asset.

The entity selects the method that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. That method is applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits.

EXAMPLE 4

Cost of equipment (1 March 20.13)	R500 000
Residual value (remains unchanged)	R20 000
Useful life	4 years
The year-end is on 28 February	



REQUIRED

Calculate the depreciation charge according to:

- the straight-line method
- the diminishing balance method
- the sum of the units method.

SOLUTION 4

	Annual depreciation R	Carrying amount on 28 February R
Straight-line method: (500 000 – 20 000)/4 = 120 000 annually		
Year 1:	120 000	380 000
Year 2:	120 000	260 000
Year 3:	120 000	140 000
Year 4:	120 000	20 000

(i) Diminishing balance method (assume an annual rate of 25%)

Year 1:	(500 000 – 20 000) x 25%	120 000	380 000
Year 2:	(500 000 – 20 000) x 75% x 25% or: (380 000 – 20 000) x 25%	90 000	290 000
Year 3:	(500 000 – 20 000) x 75% x 75% x 25% or: (290 000 – 20 000) x 25%	67 500	222 500
Year 4:	(500 000 – 20 000) x 75% (3 times) x 25 or: (222 500 – 20 000) x 25%	50 625	171 875
Year 5:	(500 000 – 20 000) x 75% (4 times) x 25% or: (171 875 – 20 000) x 25%	37 969	133 906

(ii) Sum of the units method: total number of years or number of units = 4 + 3 + 2 + 1 = 10

Year 1: 4/10 x (500 000 – 20 000)	192 000	308 000
Year 2: 3/10 x (500 000 – 20 000)	144 000	164 000
Year 3: 2/10 x (500 000 – 20 000)	96 000	68 000
Year 4: 1/10 x (500 000 – 20 000)	48 000	20 000

In all three the above methods the figures or amounts shall be reviewed at least at each financial year-end and if expectations differ significantly from previous estimates, the changes shall be accounted for as a change in an accounting estimate. Thus the depreciation charge for the current year and future periods will change. In the year of change disclosure of the nature and amount of the change in estimate is required in terms of IAS 8.39–40 as well as the effect on the current and future periods.

EXAMPLE 5

The details of the property, plant and equipment of Manufac Ltd are as follows:

On 1 July 20.11, the date of incorporation of the company, Manufac Ltd bought office furniture for R80 000. At that date the estimated useful life of the furniture was 5 years, with no residual value.

On 31 December 20.11, Manufac Ltd bought a machine for R423 000. At that date the estimated useful life of the machine was 6 years, with a residual value of R32 000 at the end of its useful life. The following costs were incurred to bring the machine to the location and working condition for its intended use:

- installation costs R10 000
- transport costs R7 000

On 1 April 20.13 a main water pipe burst causing the office to be flooded. Extensive damage to the office furniture that was bought on 1 July 20.11 resulted in a reduction of the recoverable amount to R20 000. This estimate was based on the net selling price in an arm's length transaction. The remaining useful life was determined at that date to be 2 years and the residual value remained unchanged at Rnil.

The company depreciates its assets on the straight-line basis over the useful life of the assets.

The income tax rate is 28%.



REQUIRED

Show how the above-mentioned transactions should be disclosed in the notes to the financial statements of Manufac Ltd for the year ended 30 June 20.13.

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

Comparative figures are required.

SOLUTION 5

MANUFAC LTD

ANNUAL FINANCIAL STATEMENTS

NOTES FOR THE YEAR ENDED 30 JUNE 20.13

1. Accounting policy

The financial statements are presented on the historical cost basis, conforming with *International Financial Reporting Standards*. It incorporates the following principal accounting policy which is consistent with that applied in previous years:

1.1 Property, plant and equipment

Initially property, plant and equipment are recognised at cost price.

Subsequently property, plant and equipment are measured at historical cost less accumulated depreciation and accumulated impairment losses.

Property, plant and equipment are depreciated over the assets expected useful lives on the straight-line basis. The expected useful lives of the assets are as follows:

Office furniture	– 2 years
Machinery	– 6 years

The residual value and useful life of all items of property, plant and equipment are reviewed, and adjusted if necessary at each reporting date.

Depreciation is charged to profit or loss. Gains or losses on disposal are determined by comparing the proceeds with the carrying amount of the asset. The net amount is included in profit or loss for the period.

2. Property, plant and equipment

20.13

	Office furniture R	Machinery R	Total R
Carrying amount beginning of year	64 000	406 000	470 000
Cost	80 000	440 000	520 000
Accumulated depreciation	(16 000)	(34 000)	(50 000)
Impairment loss through profit or loss (included in other expenses) (calc 1)	(32 000)	–	(32 000)
Depreciation (calc 1) (calc 3)	(14 500)	(68 000)	(82 500)
Carrying amount end of year	17 500	338 000	355 500
Cost	80 000	440 000	520 000
Accumulated depreciation and impairment loss	(62 500)	(102 000)	(164 500)

The impairment loss of R32 000 on office furniture was caused by flooding. The recoverable amount is the fair value less costs to sell based on an arm's length transaction.

20.12

	Office furniture R	Machinery R	Total R
Carrying amount beginning of year	–	–	–
Cost	–	–	–
Accumulated depreciation	–	–	–
Additions	80 000	440 000	520 000
Depreciation (calc 1) (calc 3)	(16 000)	(34 000)	(50 000)
Carrying amount end of year	64 000	406 000	470 000
Cost	80 000	440 000	520 000
Accumulated depreciation	(16 000)	(34 000)	(50 000)

3. Profit before tax

Profit before tax includes the following:

	20.13	20.12
Expenses	R	R
Depreciation (calc 1) (calc 3)	82 500	50 000
Impairment loss	32 000	–

Change in estimate

Included in depreciation for 20.13 is a change in estimate to the amount of R2 500. This increase in depreciation is the result of a decrease in the useful life of office furniture. The cumulative effect of the change in future periods is a decrease in depreciation of R2 500 (calc 2).

CALCULATIONS

1. Depreciation and carrying amount of office furniture

	R
Cost at 1 July 20.11	80 000
Depreciation to 30 June 20.12 (80 000/5)	(16 000)
Carrying amount at 30 June 20.12	64 000
Depreciation to 1 April 20.13 (80 000/5 x 9/12)	(12 000)
Carrying amount before impairment loss	52 000
Impairment loss – reduction to recoverable amount	(32 000)
Carrying amount at 1 April 20.13	20 000
Depreciation (20 000/2 x 3/12)	(2 500)
Carrying amount at 30 June 20.13	17 500
Depreciation for the year ended 30 June 20.13 (12 000 + 2 500)	14 500

2. Change in estimate

Depreciation as previously

	R
Depreciation on office furniture before impairment (1)	12 000
Depreciation on carrying amount before impairment, and effect of impairment	–
On carrying amount [(64 000 – 12 000)/39 (months left)	
x 3 (months for rest of year)]	4 000
On impairment amount [32 000/24 (months after impairment) x 3]	(4 000)
Depreciation as previously – office furniture	12 000
Depreciation – machinery (3)	68 000
Depreciation for 20.13	80 000
Depreciation for 20.12 [16 000 (1) + 34 000 (3)]	50 000

Depreciation because of change in estimate

Depreciation on carrying amount before impairment, and effect of useful life	
On carrying amount after change in useful life (52 000/24 x 3)	6 500
On carrying amount before change in useful life (52 000/39 x 3)	(4 000)
Effect of change in estimate	2 500

Effect of change in estimate on depreciation in future periods

Depreciation on carrying amount before impairment, and remaining useful life	
Carrying amount in proportion to remaining useful life after change	
(52 000 x 21/24)	45 500
Carrying amount in proportion to remaining useful life before change	
(52 000 x 36/39)	(48 000)
Effect of change in estimate on future periods – decrease	(2 500)

3. Depreciation and carrying amount of machinery

	R
Purchase price on 31 December 20.11	423 000
Installation costs	10 000
Transport costs	7 000
Cost at 31 December 20.11	440 000
Depreciation to 30 June 20.12 ((440 000 – 32 000)/6 x 6/12)	(34 000)
Carrying amount at 30 June 20.12	406 000
Depreciation to 30 June 20.13 ((440 000 – 32 000)/6)	(68 000)
Carrying amount at 30 June 20.13	338 000

1.6.4 Impairment – IAS 16.63–64

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount (IAS 16.6).

To determine whether a PPE item is impaired, an entity applies IAS 36 Impairment of Assets. That standard explains how an entity reviews the carrying amount of its assets, how it determines the recoverable amount of an asset, and when it recognises, or reverses the recognition of, an impairment loss.

1.6.5 Compensation for impairment – IAS 16.65–66

Compensation from third parties for PPE items that were impaired, lost or given up shall be included in profit or loss when the compensation becomes receivable.

Monetary or non-monetary compensation that an enterprise may receive from third parties may include:

- reimbursement by insurance companies after an impairment or loss of PPE items, for instance due to natural disasters, theft or mishandling;
- indemnities by the government for PPE items that were expropriated;
- compensation related to the involuntary conversion of PPE items, for instance the relocation of facilities from a designated urban area to a non-urban area in accordance with a national land policy; or
- physical replacement in whole or in part of an impaired or lost asset.

The following are separate economic events that are accounted for separately:

- impairments or losses of PPE items;
- related compensation from third parties;
- subsequent purchase or construction of assets.

The separate accounting treatments are as follows:

(a) impairments of PPE items are recognised in accordance with IAS 36;
(b) derecognition of PPE items retired or disposed of is determined in accordance with IAS 16;
(c) compensation from third parties for PPE items that were impaired, lost or given up is included in determining profit or loss when it becomes receivable; and
(d) the cost of PPE items restored, purchased or constructed as replacements is determined in accordance with IAS 16.

1.7 DERECOGNITION – IAS 16.67–72

The carrying amount of a PPE item shall be **derecognised**:

(a) on disposal; or
(b) when no future economic benefits are expected from its use or disposal.

The gain or loss arising from the derecognition of a PPE item shall be included in profit or loss when the item is derecognised. Gains shall not be classified as revenue from the sale of goods and services.

The disposal of a PPE item may occur in a variety of ways (eg by sale, by entering into a finance lease or by donation). In determining the date of disposal of an item, an entity applies the criteria in IFRS 15 *Revenue from contracts with customers* for recognising revenue from the sale of goods, which are as follows:

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

All the conditions should be satisfied before a disposal can be recognised.

If, under the recognition principle (see 1.4 above), an entity recognises in the carrying amount of a PPE item the cost of a replacement for part of the item, then it derecognises the carrying amount of the replaced part regardless of whether the replaced part had been depreciated separately. If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or constructed.

The gain or loss arising from the derecognition of a PPE item shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the item.

The consideration receivable on disposal of a PPE item is recognised initially at its fair value. If payment for the item is deferred, the consideration received is recognised initially at the cash price equivalent. The difference between the nominal amount of the consideration (the amount actually received) and the cash price equivalent is recognised as interest revenue in accordance with IFRS 15, reflecting the effective yield on the receivable.

EXAMPLE 6

A Ltd entered into the following two transactions in respect of PPE items during the year ended 31 December 20.12:

1. Machine 1, with an original cost price of R300 000 on 1 January 20.10, a residual value of nil and a carrying amount of R180 000 on 1 January 20.12, was sold on 30 June 20.12 for R210 000. The payment will only be received on 30 June 20.13 from the buyer.

2. Machine 2, with an original cost price of R500 000 on 1 January 20.9, a residual value of nil and a carrying amount of R200 000 on 1 January 20.12, was withdrawn from use on 30 April 20.12 after health inspectors prohibited the further use of the asset due to irreparable pollution problems. The asset cannot be adjusted to secure further use thereof which makes its resale impossible.

Both machines are depreciated at 20% per annum on the straight-line basis. The current interest rate for asset financing is 12% per annum.



REQUIRED

Calculate the profit or loss with derecognition of the two assets to be shown in the statement of profit and loss and other comprehensive income, and any other relevant items.

SOLUTION 6

Machine 1

	R
Proceed on disposal	187 500
(n=1; FV = R210 000; i = 12%; compute PV = ? = R187 500)	
Carrying amount on date of disposal [180 000 – (300 000 x 20% x 6/12)]	(150 000)
Profit on sale of machine 1 (P/L)	37 500
Interest received (P/L) (187 500 x 12% x 6/12) or [(210 000 – 187 500) x 6/12]	11 250



LECTURER'S COMMENT

The total interest that will be recognised as income on the deferred payment is R22 500 (year 20.12 = R11 250 and year 20.13 = R11 250). The proceeds of R187 500 plus the interest of R22 500 equals the selling price of R210 000.

Machine 2

	R
Proceed on withdrawal from use	NIL
Carrying amount on date of withdrawal [200 000 – (500 000 x 20% x 4/12)]	(166 667)
Loss on withdrawal (P/L)	(166 667)

B REVALUATION MODEL – IAS 16.31–42

1.8 INTRODUCTION

In terms of the alternative accounting treatment provided for in IAS 16 *Property, plant and equipment* may be revalued. The revaluation of PPE is widely used in practice due to the limitation of the historical cost basis to present a true and fair reflection of the results and position of the entity. PPE that has a long useful life will be significantly undervalued if only the historical cost basis is used.

After recognition as an asset, a PPE item whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.

The fair value of land and buildings is usually determined from market-based evidence by appraisal that is normally undertaken by professional qualified valuers. The fair value of plant and equipment is usually their market value determined by appraisal.

If there is no market-based evidence of fair value because of the specialised nature of the PPE item and the item is rarely sold (except as part of a continuing business), an entity may need to estimate fair value using an income or a depreciated replacement cost approach.

1.9 FREQUENCY OF REVALUATIONS

The frequency of revaluations depends upon the changes in fair values of the PPE items being revalued. When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is required. Some PPE items experience significant and volatile changes in fair value, thus necessitating annual revaluation. Such frequent revaluations are unnecessary for PPE items with only insignificant changes in fair value. Instead, it may be necessary to revalue the item only every three or five years.

1.10 REVALUATION METHODS

Points to be considered are:

1.10.1 Change in accounting policy

When an item of PPE is revalued for the first time it is considered to be a change in accounting policy. The specific requirement of IAS 8.17 is that the initial adoption of the policy to carry PPE at revalued amounts should be dealt with in terms of IAS 16 and IAS 38 rather than in accordance with IAS 8.19–31. IAS 16 does not specify disclosure requirements for the change in accounting policy. It is therefore treated as a normal revaluation.

Only the effect of the change on the figures for the current year is shown, as replacement values applicable to previous years are not readily available.

1.10.2 Residual value

Residual values of assets should be reviewed at least at each *financial year-end*. If necessary the residual values should be adjusted and the disclosure requirements in IAS 8.39 with regard to a change in accounting estimate should be complied with (IAS 16.51).

1.10.3 Estimated useful life

If necessary, the amended remaining useful life should be used and the disclosure requirements in IAS 8.39 with regard to a change in accounting estimate should be complied with (IAS 16.51).

1.10.4 Determination of replacement value

Assets can be revalued according to the net replacement value or the gross replacement value.

Gross replacement value is the replacement cost (market value) of a similar, new asset.

Net replacement value is the equivalent fair market value of a similar asset of the same age and/or condition.

1.10.5 Alternative accounting treatments when an asset is revalued

When a PPE item is revalued, any accumulated depreciation at the date of the revaluation is treated in one of the following ways:

(a) restated proportionately with the change in the gross carrying amount of the asset so that the carrying amount of the asset after revaluation equals its revalued amount (this method is on the gross replacement value basis). This method is often used when an asset is revalued by means of applying an index to its depreciated replacement cost.
(b) eliminated against the gross carrying amount of the asset and the net amount restated to the revalued amount of the asset (this method is on the net replacement value basis). This method is often used for buildings.

The amount of the adjustment arising on the restatement or elimination of accumulated depreciation forms part of the increase or decrease in the carrying amount (see 1.12 below).

The following example illustrates the alternative accounting treatments when an asset is revalued:

EXAMPLE 7

The following information applies to the machinery of X Ltd:

Cost price of equipment (purchased 1 January 20.9)	R100 000
Accumulated depreciation on 31 December 20.10	R20 000
Expected useful life (straight-line method)	10 years
Financial year-end	31 December

At the beginning of 20.11 the equipment was revalued at a net replacement value of R120 000.



REQUIRED

Journalise the revaluation of the machinery according to the two allowed alternative methods in accordance with IAS 16.35.

SOLUTION 7

Alternative (a): proportional restatement (increase) in accumulated depreciation (gross replacement value basis)

	Revalued amount	Carrying amount	Revaluation
	R	R	R
Cost	150 000[1]	100 000	50 000
Accumulated depreciation	(30 000)[2]	(20 000)	(10 000)
Carrying amount	120 000	80 000	40 000

[1] 120 000 x 10/8
[2] 150 000/10 x 2 years

Journal

	Dr	Cr
	R	R
Equipment (150 000 – 100 000) (SFP)	50 000	
Accumulated depreciation (30 000 – 20 000) (SFP)		10 000
Revaluation surplus (other comprehensive income – OCI)		40 000
Revaluation of equipment on the gross replacement value basis		

Alternative (b): elimination of depreciation (net replacement value basis)

	R
Carrying amount end of 20.10	80 000
Net replacement value	120 000
Revaluation surplus	40 000

Journal

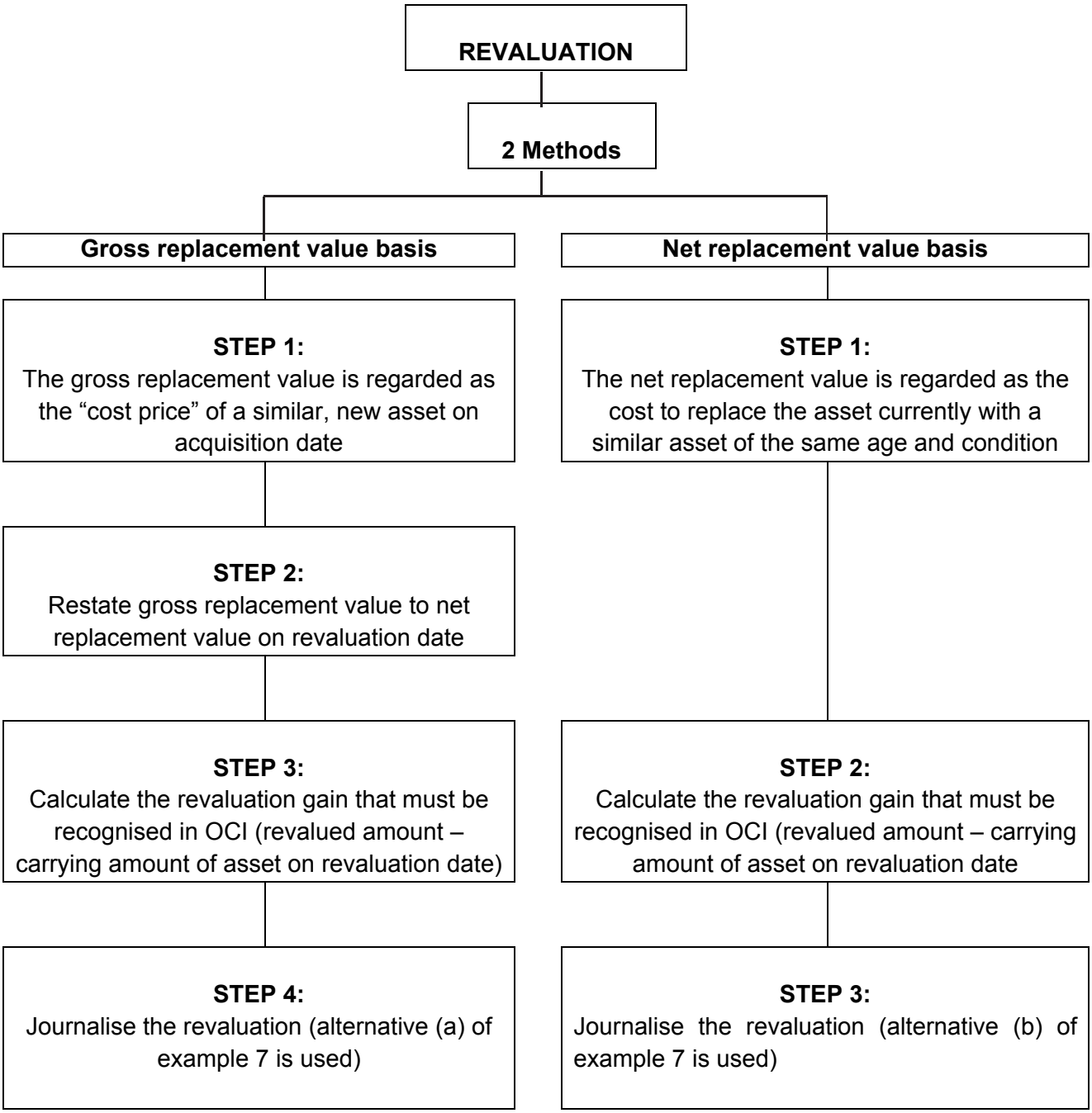
	Dr	Cr
	R	R
Accumulated depreciation (SFP)	20 000	
Equipment at cost (SFP)		100 000
Equipment at revaluation (SFP)	120 000	
Revaluation surplus (OCI)		40 000
Revaluation of equipment on the net replacement value basis		



LECTURER'S COMMENT

Both alternative (a) and (b) show the correct surplus, but (b) is preferable because (a) reflects an amount of accumulated depreciation that has not been debited to the statement of profit or loss and other comprehensive income.

1.10.6 Revaluation methods – schematic diagram



The following example illustrates the two methods of revaluation:

EXAMPLE 8

	R
Cost of machine (purchased 01/01/20.9)	100 000
Accumulated depreciation on 31/12/20.12	(40 000)
Carrying amount 31/12/20.12	60 000

Expected useful life (straight-line method) 10 years

The net replacement value is R90 000
The gross replacement value is R150 000
It is company policy to revalue machinery on the:

(a) net replacement value basis
(b) gross replacement value basis.



REQUIRED

Journalise the revaluation of the asset according to the two allowed alternatives in accordance with IAS 16.35.

SOLUTION 8

(a) Net replacement value basis

Step 1: The net replacement value of R90 000 is regarded as the cost to replace the machine currently with a similar machine of the same age and condition.

Step 2: Calculate the amount that must be transferred to the revaluation surplus (revalued amount – carrying amount of machine on revaluation date).

	R
Net replacement value	90 000
Carrying amount	60 000
Revaluation surplus	30 000

Step 3: Journalise the revaluation (alternative (b) [refer example 7] is used).

Journals	**Dr**	**Cr**
	R	**R**
Machine at revaluation (SFP)	90 000	
Machine at cost (SFP)		100 000
Accumulated depreciation (SFP)	40 000	
Revaluation surplus (OCI)		30 000
Revaluation of machine on net replacement value basis		
Depreciation (90 000/6) (P/L)	15 000	
Accumulated depreciation (SFP)		15 000
Depreciation for the year based on revalued amount		

(b) Gross replacement value basis

Step 1: The gross replacement value of R150 000 is regarded as the cost of a similar, new asset on original acquisition date.

Step 2: Restate the gross replacement value to the net replacement value on revaluation date.

	R	
Gross replacement value	150 000	(10 years)
Accumulated depreciation (150 000/10 x 4 years)	(60 000)	(4 years)
Net replacement value (150 000/10 x 6 years)	90 000	(6 years)

Step 3: Calculate the amount that must be recognised in other comprehensive income as a revaluation surplus (revalued amount – carrying amount of asset on revaluation date).

	R
Net replacement value	90 000
Carrying amount	60 000
Revaluation surplus	30 000

	Revalued amount	**Carrying amount**	**Revaluation**
	R	**R**	**R**
Cost	150 000	100 000	50 000
Accumulated depreciation	(60 000)	(40 000)	(20 000)
Carrying amount	90 000	60 000	30 000

Step 4: Journalise the revaluation (alternative (a) [refer example 7] is used).

Journals	**Dr**	**Cr**
	R	**R**
Machine at cost (SFP)	50 000	
Accumulated depreciation (SFP)		20 000
Revaluation surplus (OCI)		30 000
Revaluation of asset on the gross replacement value basis		
Depreciation (90 000/6) (P/L)	15 000	
Accumulated depreciation (SFP)		15 000
Depreciation for the year based on the revalued amount		



LECTURER'S COMMENT

Refer to:
Descriptive accounting, example 9.14 for an illustrative example on the gross and net replacement value methods.

1.10.7 Date of revaluation

IAS 16 does not specify the date that the revaluation of the asset should take place. If the asset should be revalued in the middle of the financial year, it implies that the depreciation for the current year will be based on different amounts: an amount before the revaluation and then a different amount after the revaluation has taken place. As this is not a desirable practice, it is recommended that the revaluation should be performed either at the beginning or at the end of the financial year.

If the revaluation is performed at the end of the financial year, the revalued amount is worked back to the beginning of the year and the depreciation for the current year is based on the recalculated, revalued amount. This practice must be stipulated in the accounting policy of the company.

1.11 REVALUE AN ENTIRE CLASS OF PROPERTY, PLANT AND EQUIPMENT – IAS 16.36–38

If a PPE item is revalued, the entire class of PPE to which that asset belongs shall be revalued.

A class of PPE is a grouping of assets of a similar nature and use in an entity's operations. The following are examples of separate classes:

(a) land
(b) land and buildings
(c) machinery
(d) ships
(e) aircraft
(f) motor vehicles
(g) furniture and fixtures
(h) office equipment

The items within a class of PPE are revalued simultaneously to avoid selective revaluation of assets and the reporting of amounts in the financial statements that are a mixture of costs and values as at different dates. However, a class of assets may be revalued on a rolling basis provided revaluation of the class of assets is completed within a short period and provided the revaluations are kept up to date.

1.12 REVALUATION SURPLUS – IAS 16.39–42

If an asset's carrying amount is increased as a result of a revaluation, the increase shall be recognised in **other comprehensive income** accumulated in **equity** under the heading of **revaluation surplus**. However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.

If an asset's carrying amount is **decreased** as a result of a revaluation, the decrease shall be recognised in **profit or loss.** However, the decrease shall be recognised in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset. The decrease recognised in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus.

The revaluation surplus is unrealised and should be disclosed as part of equity. It should be considered to be a non-distributable reserve. The reserve should only be used for subsequent write-downs of revaluations or it may be used for a capitalisation share issue.

The revaluation surplus included in equity in respect of a PPE item may be transferred directly to retained earnings when the asset is derecognised. This may involve transferring the whole of the surplus when the asset is retired or disposed of. However, some of the surplus may be transferred as the asset is used by an entity. In such a case, the amount of the surplus transferred would be the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on the asset's original cost. Transfers from revaluation surplus to retained earnings are not made through profit or loss, ie not through the statement of profit or loss and other comprehensive income, but directly on the face of the statement of changes in equity. The transfer to retained earnings should be net of tax (see section E).

The revaluation surplus is disclosed in the statement of changes in equity and indicates

- the change for the period (surplus created on a revaluation during the current period and realisations due to disposals or through the gradual use of the valued asset), and
- any restrictions on the distribution of the balance of the revaluation surplus to shareholders (for example, when it is the policy of the entity to keep the surplus intact as a capital maintenance reserve or to transfer it to an asset replacement reserve).

1.13 FURTHER EXAMPLES

EXAMPLE 9

	R
Cost of machine (purchased 01/01/20.10)	180 000
Accumulated depreciation (31/12/20.11)	60 000
Net replacement value at date of revaluation (01/01/20.12)	150 000

The machine is depreciated on the straight-line basis over 6 years.



REQUIRED

Calculate the revaluation amount if the gross carrying amount and accumulated depreciation are restated in proportion to the revalued amount (gross replacement value basis). Journalise the revaluation.

SOLUTION 9

	Revalued amount	Carrying amount	Revaluation
	R	R	R
Gross carrying amount (150 000 x $6^{1}/4^{2}$) or cost price	225 000	180 000	45 000
Accumulated depreciation	(75 000)	(60 000)	(15 000)
Carrying amount	150 000	120 000	30 000

[1]Original useful life of 6 years
[2]Age of machine at date of revaluation is 2 years. Therefore, the remaining useful life is 4 years which is the number of years on which the revaluation is based.

Journal	**Dr**	**Cr**
	R	**R**
Machinery (SFP)	45 000	
Accumulated depreciation (SFP)		15 000
Revaluation surplus (OCI)		30 000
Revaluation of asset on the gross replacement value basis		

The machine will be shown in the **statement of financial position** at:

	R
Gross carrying amount (180 000 + 45 000)	225 000
Accumulated depreciation (60 000 + 15 000)	(75 000)
Carrying amount	150 000

EXAMPLE 10

	R
Cost of machine (purchased 01/01/20.10)	180 000
Accumulated depreciation (31/12/20.11)	60 000
Net replacement value at date of revaluation (01/01/20.12)	150 000

The machine is depreciated on the straight-line basis over 6 years.



REQUIRED

Journalise the revaluation if the original cost and accumulated depreciation are written back and the asset is stated at the **revalued amount** (net replacement value basis).

SOLUTION 10

Journal	**Dr**	**Cr**
	R	**R**
Accumulated depreciation (SFP)	60 000	
Machine at revaluation (SFP)	150 000	
Machine at cost (SFP)		180 000
Revaluation surplus (OCI) [150 000 – (180 000 – 60 000)]		30 000
Revaluation of machine on the net replacement value basis		

The machine will be shown in the **statement of financial position** at:

	R
Gross carrying amount	150 000
Accumulated depreciation	–
Carrying amount	150 000



LECTURER'S COMMENT

Unisa prefers the **net replacement value basis for revaluing**. If the gross replacement value basis is used, accumulated depreciation will include depreciation which has never been debited against income.

EXAMPLE 11

The **net replacement value** of the machine is given on **revaluation date (at financial year-end)** and the **net replacement value basis** is required.

The machine was originally purchased for R180 000 on 1 January 20.12.
Accumulated depreciation on the date of revaluation is R60 000.
The machine is depreciated on the straight-line basis over the expected useful life of 6 years.
The net replacement value of the machine on 31 December 20.13 is R160 000.
The machine must be **disclosed on the net replacement value basis**.

SOLUTION 11

Revaluation date: 31 December 20.13
Net replacement value: R160 000
The machine is 2 years old at 31 December 20.13.
(180 000/6 = 30 000; 60 000/30 000 = 2 years) or 1 January 20.12–31 December 20.13 = 2 years
At 1 January 20.13, the beginning of the financial year, the machine is therefore 1 year old.

The revaluation surplus at this date is:

	R
Net replacement value at 31 December 20.13	160 000
Depreciation for the year (160 000/4) (remaining useful life at 31 December 20.13)	40 000
Net replacement value at 1 January 20.13	200 000
Carrying amount at 1 January 20.13 (180 000 – 30 000)	(150 000)
Revaluation surplus at 31 December 20.13	50 000

The accumulated depreciation and cost of the machine is **written back** and the machine is shown at the revalued amount.

Journal	**Dr**	**Cr**
	R	**R**
Accumulated depreciation (SFP)	30 000	
Machine at revaluation (SFP)	200 000	
Machine at cost (SFP)		180 000
Revaluation surplus (OCI)		50 000
Revaluation of machine on the net replacement value basis		
Depreciation (200 000/5) (P/L)	40 000	
Accumulated depreciation (SFP)		40 000
Depreciation for the year based on the revalued amount		



LECTURER'S COMMENT

NRV = Net replacement value = Cost of a similar asset - same age and condition

FURTHER EXPLANATION ON EXAMPLE 11:

	R
Cost price (given) purchase date 01/01/20.12	180 000
Accumulated depreciation (given) 31/12/20.13	(60 000)
Carrying amount 31/12/20.13	120 000

Depreciation is calculated on a straight line basis over 6 years.
The depreciation per year amounts to (180 000/6) 30 000

2 years have passed since purchase date:

- 01/01/20.12 – 31/12/20.13 = 2 years OR
- If accumulated depreciation is R60 000 and the depreciation per year amounts to R30 000 it means that 2 years have passed since purchase date (30 000 x 2 = 60 000)

If 2 years have passed since purchase date it means that the machine has a remaining useful life of 4 years on 31/12/20.13 (total useful life of 6 years – 2 years already passed).

NRV is given on 31/12/20.13
Cost of a similar machine with a remaining useful life of 4 years. 160 000

The NRV is given at the end of the financial year. A NRV at the beginning of the financial year should however be calculated since the revaluation calculation must be performed at the beginning of the financial year.

At 01/01/20.13 the machine has a remaining useful life of 5 years.
Calculation of NRV at 01/01/20.13:
160 000/4 (value of a machine with remaining useful life of 4 years) x 5 (remaining useful life of existing asset is 5 years). 200 000

Carrying amount of machine at 01/01/20.13 (180 000 – 30 000) 150 000
Revaluation surplus [200 000 (NRV calculated) – 150 000] **50 000**

Depreciation charge for the 20.13 financial year:

Gross carrying amount/remaining useful life = (200 000/5) 40 000

Carrying amount as at 31/12/20.13 (200 000 – 40 000) 160 000
TEST: This should be the NRV as given by the question at the end of the financial year.

EXAMPLE 12

If the **net replacement value** of the machine is given on **revaluation date (at beginning of financial year)** and the **net replacement value basis** is required.

The machine was originally purchased for R180 000 on 1 January 20.12.
Accumulated depreciation on the date of revaluation is R30 000.
The machine is depreciated on the straight-line basis over the expected useful life of 6 years.
The net replacement value of the machine on 1 January 20.13 is R160 000.
The machine must be disclosed on the net replacement value basis.

SOLUTION 12

Revaluation date: 1 January 20.13
Net replacement value: R160 000
The machine is 1 year old at 1 January 20.13.
(180 000/6 = 30 000; 30 000/30 000 = 1 year) or 1 January 20.12 – 1 January 20.13 = 1 year

The revaluation surplus at this date is:

	R
Cost	180 000
Accumulated depreciation	(30 000)
Carrying amount at 1 January 20.13	150 000
Net replacement value 1 January 20.13	(160 000)
Revaluation surplus at 1 January 20.13	10 000

The accumulated depreciation and cost of the machine is **written back** and the machine is shown at the revalued amount.

Journals	**Dr**	**Cr**
	R	**R**
Accumulated depreciation (SFP)	30 000	
Machine at revaluation (SFP)	160 000	
Machine at cost (SFP)		180 000
Revaluation surplus (OCI)		10 000
Revaluation of machine on the net replacement value basis		
Depreciation (160 000/5) (P/L)	32 000	
Accumulated depreciation (SFP)		32 000
Depreciation for the year based on the revalued amount		



LECTURER'S COMMENT

NRV = Net replacement value = Cost of a similar asset - same age and condition

FURTHER EXPLANATION ON EXAMPLE 12

	R
Cost price (given) Purchase date 01/01/20.12	180 000
Accumulated depreciation (given) 01/01/20.13	(30 000)
Carrying amount 31/12/20.13	150 000

Depreciation is calculated on a straight line basis over 6 years.
The depreciation per year amounts to (180 000/6) 30 000
1 year has passed since purchase date

- 01/01/20.12 – 31/12/20.12 = 1 year OR
- If accumulated depreciation is R30 000 and the depreciation per year is R30 000, it means that 1 year has passed since purchase date

If 1 year has passed since purchase date it means that the machine has a remaining useful life of 5 years on 01/01/20.13 (total useful life of 6 years – 1 year already passed)

Since the NRV is given at the beginning of the financial year, the revaluation surplus can be easily determined by comparing the carrying amount at that date with the NRV given.
Revaluation surplus (160 000 – 150 000) **10 000**

EXAMPLE 13

If the **gross replacement value** of the machine is given on **revaluation date (at beginning of financial year)** and the **gross replacement value basis** is required.

The machine was originally purchased for R180 000 on 1 January 20.12.
Accumulated depreciation on the date of revaluation is R30 000.
The machine is depreciated on the straight-line basis over the expected useful life of 6 years.
The gross replacement value of the machine on 1 January 20.13 is R240 000.
The machine must be disclosed on the gross replacement value basis.

SOLUTION 13

Revaluation date: 1 January 20.13
Gross replacement value: R240 000
At 1 January 20.13, the beginning of the financial year, the asset is 1 year old.
(180 000/6 = 30 000; 30 000/30 000 = 1 year) or 1 January 20.12 – 31 December 20.12 = 1 year

The revaluation surplus at this date is:

	R
Gross replacement value at 1 January 20.13	240 000
Accumulated depreciation (240 000/180 000 x 30 000) or (240 000/6)	(40 000)
Net replacement value at 1 January 20.13	200 000
Carrying amount at 1 January 20.13 (180 000 – 30 000)	(150 000)
Revaluation surplus at 1 January 20.13	50 000

Journals	**Dr**	**Cr**
	R	**R**
Masjien (240 000 - 180 000) (SFP)	60 000	
Accumulated depreciation (40 000 - 30 000) (SFP)		10 000
Revaluation surplus (OCI)		50 000
Revaluation of machine on gross replacement value basis		
Depreciation (200 000/5) (P/L)	40 000	
Accumulated depreciation (SFP)		40 000
Depreciation for the year based on the revalued amount		



LECTURER'S COMMENT

GRV = Gross Replacement Value = Cost of a similar NEW asset

FURTHER EXPLANATION ON EXAMPLE 13:

	R
Cost price (given) Purchase date 01/01/20.12	180 000
Accumulated depreciation (given) 01/01/20.13	(30 000)
Carrying amount 31/12/20.13	150 000
Depreciation is calculated on a straight line basis over 6 years.	
The depreciation per year amounts to (180 000/6)	30 000

1 year has passed since purchase date:

- 01/01/20.12 – 31/12/20.12 = 1 year OR
- If accumulated depreciation is R30 000 and the depreciation per year is R30 000, it means that 1 year has passed since purchase date.

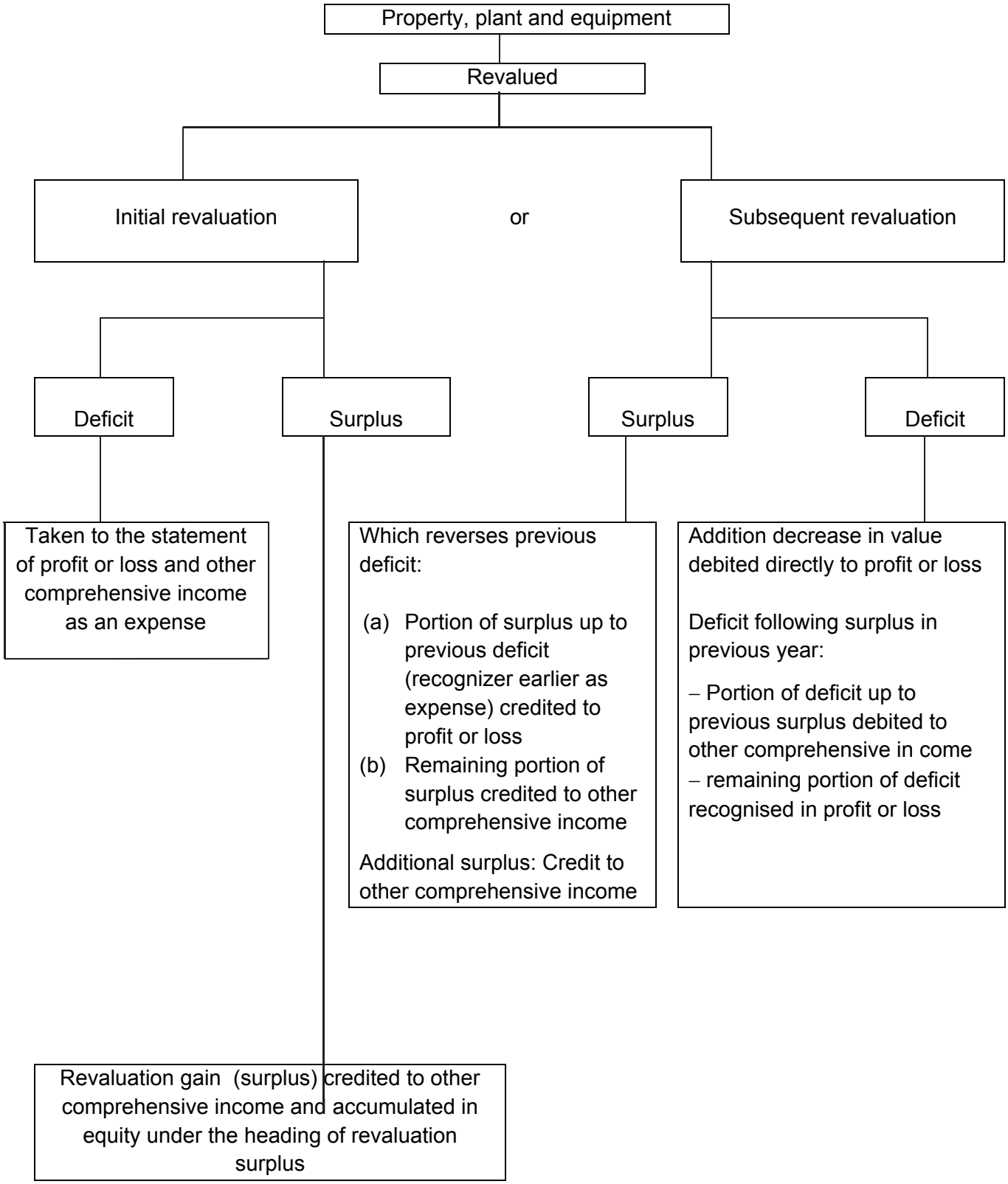
If 1 year has passed since purchase date, it means that the machine has a remaining useful life of 5 years on 01/01/20.13 (total useful life of 6 years – 1 year already passed)

The GRV is given in this question to be R240 000. This is then the cost to buy a new machine.

A replacement value at 01/01/20.13 of a machine of a similar age and condition is needed. The GRV thus has to be recalculated to a net replacement value.

Net replacement value as at 01/01/20.13:	
240 000/6 x 5 = 200 000 (value of a machine with a useful life of 6 years. The 5 represents the remaining useful life of our current machine as at 01/01/20.13)	200 000
Revaluation surplus at 01/01/20.13 (200 000 – 150 000)	**50 000**

1.14 SUMMARY OF REVALUATIONS



C DISCLOSURE – IAS 16.73–79

1.15 DISCLOSURE REQUIREMENTS FOR THE COST AND REVALUATION MODEL

The financial statements shall disclose, for each class of PPE:

(a) the measurement bases used for determining the gross carrying amount;
(b) the depreciation methods used;
(c) the useful lives or the depreciation rates used;
(d) the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period; and
(e) a reconciliation of the carrying amount at the beginning and end of the period showing:

   (i) additions;
   (ii) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with IFRS 5 (see learning unit 5) and other disposals;
   (iii) acquisitions through business combinations;
   (iv) increases or decreases resulting from revaluations under paragraphs 31, 39 and 40 and from impairment losses recognised or reversed directly in other comprehensive income in accordance with IAS 36;
   (v) impairment losses recognised in profit or loss in accordance with IAS 36;
   (vi) impairment losses reversed in profit or loss in accordance with IAS 36;
   (vii) depreciation;
   (viii) the net exchange differences arising on the translation of the financial statements from the functional currency into a different presentation currency, including the translation of a foreign operation into the presentation currency of the reporting entity **(translation of financial statements and of a foreign operation do not form part of this module);** and
   (ix) other changes.

1.16 FURTHER DISCLOSURE REQUIREMENTS

The financial statements shall also disclose:

(a) the existence and amounts of

   – restrictions on title, and
   – PPE pledged as security for liabilities;

(b) the amount of expenditures recognised in the carrying amounts of a PPE item in the course of its construction;
(c) the amount of contractual commitments for the acquisition of PPE; and
(d) if it is not disclosed separately in the statement of profit or loss and other comprehensive income, the amount of compensation from third parties for PPE items that were impaired, lost or given up that is included in profit or loss.

Selection of the depreciation method and estimation of the useful life of assets are matters of judgement. Therefore, disclosure of the methods adopted and the estimated useful lives or depreciation rates provides users of financial statements with information that allows them to review the policies selected by management and enables comparisons to be made with other entities. For similar reasons, it is necessary to disclose:

(a) depreciation, whether recognised in profit or loss or as a part of the cost of other assets, during a period; and
(b) accumulated depreciation at the end of the period.

In accordance with IAS 8 an enity discloses the nature and effect of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in subsequent periods. For PPE, such disclosure may arise from changes in estimates with respect to:

(a) residual values;
(b) the estimated costs of dismantling, removing or restoring PPE items;
(c) useful lives; and
(d) depreciation methods.

1.17 SPECIFIC DISCLOSURE REQUIREMENTS FOR THE REVALUATION MODEL

If PPE items are stated at revalued amounts, the following shall be disclosed:

(a) the effective date of the revaluation;
(b) whether an independent valuer was involved;
(c) for each revalued class of PPE, the carrying amount that would have been recognised had the assets been carried under the cost model (cost price minus accumulated depreciation and impairment losses); and
(d) the revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders (ie whether it is considered non-distributable or not).

In accordance with IAS 36 an entity discloses information on impaired PPE in addition to the information required mentioned above (1.15(e) (iv)–(vi)).

1.18 FURTHER RELEVANT INFORMATION FOR USERS OF FINANCIAL STATEMENTS

Users of financial statements may also find the following information relevant to their needs:

(a) the carrying amount of temporarily idle PPE;
(b) the gross carrying amount of any fully depreciated PPE that is still in use;
(c) the carrying amount of PPE retired from active use and held for disposal in accordance with IFRS 5 (refer to learning unit 5); and
(d) when the cost model is used, the fair value of PPE when this is materially different from the carrying amount.

D TAX IMPLICATIONS

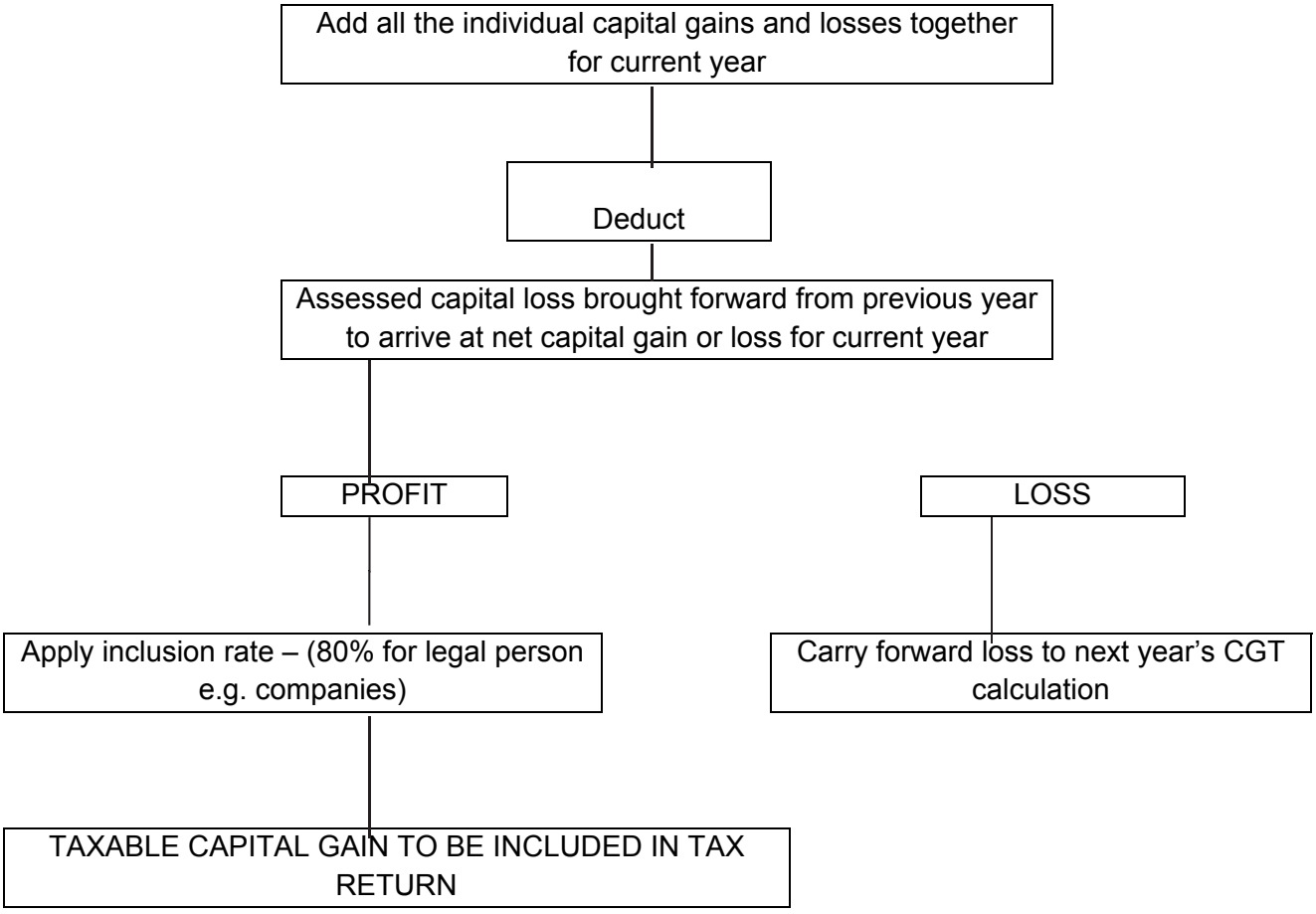
1.19 CAPITAL GAINS TAX (CGT)

Introduction

All capital gains and losses made on the disposal of assets will be subject to CGT unless excluded by specific provisions (eighth schedule – Income Tax Act). The schedule determines a taxable gain or loss and section 26A of the principal Act provides that the taxable gain be included in taxable income. Capital gains will be taxed from 1 October 2001.

CGT will only be triggered on the disposal of an asset. The taxable gain will then form part of taxable income and must be included in the Income Tax return for the year of assessment in which the disposal occurred.

Framework for capital gains tax



What is meant by a disposal?

A wide meaning has been given to the concept of disposal. The following are examples of events that will be regarded as disposals:

- a sale of an asset;
- donation of an asset; or
- the loss or destruction of an asset.

Capital gain or loss

A capital gain in respect of an asset disposed of is the amount by which the proceeds exceed the base cost of that asset. A capital loss is equal to the amount by which the base cost of the asset exceeds the proceeds.

Base cost

The base cost of an asset is generally the expenditure actually incurred in acquiring the asset together with other expenditure directly related to the acquisition or disposal of an asset or to improve the asset. The base cost does not include any amount otherwise allowed as a deduction for income tax purposes.

Some of the main costs that may form part of the base cost of an asset are:

- expenditure incurred to acquire the asset;
- costs incurred directly in the acquisition, creation or disposal of the asset i.e transfer costs, stamp duties, valuation fees, advertising costs or fees paid to a surveyor, auctioneer, accountant or legal advisor;
- cost of improvements to an asset;
- VAT paid and not claimed or refunded on an asset;
- cost of establishing, maintaining or defending a legal title or right in that asset;
- cost of moving assets from one location to another (on acquisition); and
- cost of installation of that asset, including the cost of foundations and supporting structures.

Costs that are excluded from base costs are:

- holding costs such as interest, repairs and maintenance, and insurance costs;
- all recoverable expenses and expenses deductible for income tax purposes; and
- any adjustments for inflation.

What is the base cost of assets held before 1 October 2001?

Capital gains are taxable after 1 October 2001. In order to exclude the portion of the capital gain relating to the period before 1 October 2001, any one of the following options can be used to calculate the valuation date value of an asset (choose the biggest amount as the valuation date value):

(a) 20% of the proceeds upon realisation can be deemed to be the base cost (if no records have been kept);

(b) the market value of the asset as at 1 October 2001, which is called the valuation date (the valuation must have taken place on or before 30 September 2004);
(c) the time apportionment method (calculated by means of specific formulae).

Basic concepts of base costs

- The base cost of an asset purchased before 01/10/2001 and which was sold on 01/10/2001 is the valuation date value as calculated (option (a)–(c) as discussed above) on 01/10/2001.

  Thus: base cost of asset on 01/10/2001 = valuation date value

- The base cost of an asset purchased before 01/10/2001 and which was sold after 01/10/2001 is the valuation date value as calculated on 01/10/2001, plus costs capitalised after 01/10/2001.

  Thus: base cost = valuation date value + costs capitalised after 01/10/2001

- Base cost of an asset purchased after 01/10/2001 is the cost price of that asset.

  Thus: base cost = cost price



IMPORTANT

It will not be expected of you to apply the formulas, but it is important that you understand the basic concepts of base costs.

Rules applicable when capital gains tax is calculated

- The proceeds up to the cost price of an asset are taxed at 28%.
- The proceeds above the cost price up to the base cost of the asset are not taxed at all.
- 80% of the proceeds above the base cost of the asset (capital gain) is taxed at 28%.

1.20 DEFERRED TAX

Revaluing an asset increases the carrying amount of the asset but since it does not affect taxable profit, the tax base of the asset is not adjusted. IAS 12.20 *Income taxes* specifically states that the difference between the carrying amount of a revalued asset and its tax base is a temporary difference which gives rise to a deferred tax liability or asset. According to IAS 12.20 this is true even if the entity does not intend to dispose of the asset and explains that in such cases the revalued carrying amount of the asset will be recovered through use and this will generate taxable income that exceeds the depreciation (tax allowance) that will be allowed for tax purposes in future periods.

Is there an actual liability for deferred tax on the revaluation surplus in excess of historical cost if an entity intends to dispose of an asset? As from 1 October 2001 50% of the capital gain arising on the sale of the asset will be subject to capital gains tax at the normal tax rate (currently 28%). The CGT inclusion rate increased to 66,6% from 1 March 2012 and to 80% from 1 March 2016.

Therefore, any revaluation surplus in excess of historical cost (or base cost if different, that is the greater of the two) of an asset that will be disposed of in the near future represents a potential capital gain that will be taxed as soon as the asset is sold. Deferred tax liabilities are defined in IAS 12.05 as the amounts of income taxes payable in future periods in respect of taxable temporary differences. Therefore, this potential capital gains tax should form part of the deferred tax liability.
In conclusion, the revaluation of PPE influences the provision for deferred tax as follows:

If **land** is revalued, deferred tax should be provided for on the total surplus above base cost at **80% x 28%**, irrespective of whether or not there is any intention to dispose of the land, as the carrying amount of the land (a non-depreciable asset) can only be recovered by means of sale – refer to discussion below in 1.21).

(a) Where **no decision** has been made **to sell a depreciable asset**, deferred tax should be provided for at **28%** on the total revaluation surplus (including the amount in excess of historical cost). This is done because the carrying amount of the asset will be realised through the use of the asset.
(b) If a **decision** has been made **to sell a depreciable asset**, deferred tax should be provided for as follows: on the revaluation surplus up to the original cost at **28% and** on the excess above base cost at **80% x 28%**.

Deferred tax relating to the revaluation should be recognised in other comprehensive income. (IAS 12.61A)

1.21 RECOVERY OF REVALUED NON-DEPRECIABLE ASSETS

In terms of IAS 12.51 the measurement of deferred tax liabilities and assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of those assets and liabilities that give rise to temporary differences.

IAS 12.20 notes that the revaluation of an asset does not always affect taxable profit/(tax loss) in the period of the revaluation and that the tax base of the asset may not be adjusted as a result of the revaluation. If the future recovery of the carrying amount will be taxable, any difference between the carrying amount of the revalued asset and its tax base is a temporary difference and gives rise to a deferred tax liability or asset. The issue is how to interpret the term "recovery" in relation to an asset that is not depreciated (non-depreciable asset) and is revalued in terms of IAS16.31.

The deferred tax liability or asset that arises from the revaluation of a non-depreciable asset shall be measured based on the basis of the tax consequences that would follow from recovery of the carrying amount of that asset through sale, regardless of the basis of measuring the carrying amount of that asset. Accordingly, if the tax law specifies a tax rate applicable to the taxable amount derived from the sale of an asset that differs from the tax rate applicable to the taxable amount derived from using an asset, the former rate is applied in measuring the deferred tax liability or asset relating to a non-depreciable asset. (In South Africa the tax rate applicable on the sale of such non-depreciable assets, is the capital gains tax rate which is effectively 80% x 28% for companies – see 1.19 for capital gains tax.)

The framework indicates that an entity recognises an asset if it is probable that the future economic benefits associated with the asset will flow to the entity. Generally, those future economic benefits will be derived (and therefore the carrying amount of an asset will be recovered) through sale, through use, or through use and subsequent sale. Recognition of depreciation implies that the carrying amount of a depreciable asset is expected to be recovered through use to the extent of its depreciable amount, and through sale at its residual value. Consistent with this, the carrying amount of a non-depreciable asset, such as land having an unlimited life, will be recovered only through sale. That is, because the asset is not depreciated, no part of its carrying amount is expected to be recovered (that is, consumed) through use. Deferred taxes associated with the non-depreciable asset reflect the tax consequences of selling the asset.

The expected manner of recovery is not predicated on the basis of measuring the carrying amount of the asset. For example, if the carrying amount of a non-depreciable asset is measured at its value in use, the basis of measurement does not imply that the carrying amount of the asset is expected to be recovered through use, but through its residual value upon ultimate disposal.



LECTURER'S COMMENT

Refer to:
Descriptive Accounting, examples 9.20 – 9.22 for illustrative examples on the deferred tax implications of the cost model.

EXAMPLE 14

Bata Ltd bought a machine for R1 000 000 on 1 April 20.10. The machine is depreciated on the straight-line method at 20% per year. The machine was revalued at the beginning of the third year at a net replacement value of R1 100 000. The South African Revenue Service allows a tax allowance on the machine at R250 000 per annum.

The tax rate is 28%. 80% of all capital gains are taxable.



REQUIRED

Calculate the deferred tax balance of Bata Ltd at 31 March 20.13. Round off all calculations to the nearest rand.

SOLUTION 14

Machine	Carrying amount R	Tax base R	Tempora-ry differ-rence R	Deferred tax (asset)/ liability @ 28% R
Cost	1 000 000	1 000 000	–	
Depreciation	(200 000)	(250 000)	50 000	
Carrying amount – 31 March 20.11	800 000	750 000	50 000	14 000
Depreciation	(200 000)	(250 000)	50 000	
Carrying amount – 31 March 20.12	600 000	500 000	100 000	28 000
Revaluation – 1 April 20.12	500 000	–	500 000	
	1 100 000	500 000	600 000	
Depreciation (1 100 000/3)	(366 667)	(250 000)	(116 667)	
Carrying amount at 31 March 20.13	733 333	250 000	483 333	135 333



LECTURER'S COMMENT

Deferred tax is provided for on the revaluation surplus of machinery at a rate of 28%. According to IAS 12.20(a) the difference between the carrying amount of a revalued asset and its tax base is a temporary difference even if the entity does not intend to dispose of the asset. If no decision was taken to sell the asset, the revalued carrying amount is regarded as reflecting the value of future economic benefits to be obtained through the use of the asset. Therefore deferred tax is calculated at a rate of 28% on the total revaluation surplus, including the portion above cost.

EXAMPLE 15

Mike Ltd owns an asset with a cost price and base cost of R30 000 and a carrying amount of R24 000 which was revalued to a net replacement value of R40 000. The South African Revenue Service allowed a tax allowance of R7 500 on the asset and the tax rate is 28%. 80% of all capital gains are taxable.



REQUIRED

Calculate the deferred tax implications of the revaluation of the asset of Mike Ltd if:

(a) the asset is used; and
(b) the entity sold/is of the intention to sell the asset.

Do the journal entries for both cases.

Round off all calculations to the nearest rand.

SOLUTION 15

(a) If the asset is used:

	Carrying amount R	Tax base R	Tempora-ry differ-rence R	Deferred tax (asset)/ liability @ 28% R
Asset – carrying amount	24 000	22 500	1 500	420
Revaluation	16 000	–	16 000	4 480
	40 000	22 500	17 500	4 900



LECTURER'S COMMENT

Carrying amount of asset > tax base of asset, therefore it results in a deferred tax liability.

The carrying amount of R40 000 will be recovered during the use of the asset. The carrying amount that will be written off over the remaining useful life is R40 000, while only R22 500 will be deductible as tax allowances. Therefore the deferred tax liability is R4 900 [28% x (R40 000 – R22 500)].

Journals

	Dr R	Cr R
Asset (SFP)	30 000	
Bank/Creditor (SFP)		30 000
Acquisition of asset		
Depreciation (P/L)	6 000	
Accumulated depreciation (SFP)		6 000
Depreciation provided for the year		
Deferred tax (P/L) [(7 500 – 6 000) x 28%]	420	
Deferred tax (SFP)		420
Deferred tax on temporary differences (depreciation and tax allowance)		
Asset @ cost (SFP)		30 000
Accumulated depreciation (SFP)	6 000	
Asset @ revalued amount (SFP)	40 000	
Revaluation surplus (OCI)		16 000
Revaluation of asset on net replacement value basis		

	Dr R	Cr R
Revaluation surplus (OCI) (16 000 x 28%)	4 480	
Deferred tax (SFP)		4 480[1]
Deferred tax on a revaluation gain taken out		

[1] Deferred tax is provided for on the full revaluation surplus at 28%, because the company does not have the intention to sell the asset.

(b) If the asset is sold for R40 000 or if it is the company's intention to sell the asset (decision has been made):

	Carrying amount R	Tax base R	Tempora-ry differ-rence R	Deferred tax (asset)/ liability R
Asset – carrying amount	24 000	22 500	1 500	420
Accumulated depreciation/tax allowance	6 000	–	6 000	1 680
Capital gain	10 000	–	10 000[1]	2 240[2]
	40 000	22 500	17 500	4 340

[1] 40 000 – 30 000 = 10 000
[2] (40 000 – 30 000) x 80% x 28% = 2 240



LECTURER'S COMMENT

The carrying amount of R40 000 will be recovered when the asset is sold. The asset will generate income of R40 000 of which R7 500 will be taxable as a recoupment of tax allowances and R10 000 is a capital gain on which capital gains tax is payable.

Journals

	Dr R	Cr R
Asset (SFP)	30 000	
Bank/Creditor (SFP)		30 000
Acquisition of asset		
Depreciation (P/L)	6 000	
Accumulated depreciation (SFP)		6 000
Depreciation for the year		

	Dr R	Cr R
Deferred tax (P/L)	420	
Deferred tax (SFP)		420
Deferred tax provided for on temporary differences (depreciation and tax allowance)		
Asset @ cost (SFP)		30 000
Accumulated depreciation (SFP)	6 000	
Asset @ revalued amount (SFP)	40 000	
Revaluation surplus (OCI)		16 000
Revaluation of asset on net replacement value basis		
Revaluation surplus (OCI) (1 680 + 2 240)	3 920	
Deferred tax (SFP)		3 920
Deferred tax on a revaluation gain taken out		



LECTURER'S COMMENT

Refer to:

Descriptive Accounting, example 9.23 for an illustrative example on the deferred tax on revalued land.

Descriptive Accounting, example 9.26 for an illustrative example on deferred tax on a depreciable asset if the asset has a residual value.

Descriptive Accounting, example 8.26 for an illustrative example on the measurement of deferred tax in case of a change in tax rate.

EXAMPLE 16

Mellox Ltd purchased a piece of land on 1 April 20.13 for R1 500 000. The land will be used in the construction of the company's new headquarters. The company accounts for all property according to the revaluation model. On 31 December 20.13 the net replacement value of the land was determined to be R1 700 000.

The tax rate is 28%. 80% of all capital gains are taxable.



REQUIRED

Calculate the deferred tax balance relating to the land of Mellox Ltd at 31 December 20.13. Round off all calculations to the nearest rand.

SOLUTION 16

Land	Carrying amount R	Tax base R	Exempt diffe-rence R	Tempora-ry diffe-rence R	Deferred tax (asset)/ liability @ 80% x 28% R
Cost – 1 April 20.13	1 500 000	–	1 500 000		
Revaluation – 31 December 20.13	200 000	–	–		
Carrying amount at 31 December 20.13	1 700 000	–	1 500 000	200 000	44 800



LECTURER'S COMMENT

According to IAS 12.51(b) the carrying amount of a non-depreciable asset will be recovered only by means of sale. Deferred tax is provided for on the revaluation surplus of the land at a rate of 80% x 28%.

EXAMPLE 17

On 31 December 20.13 Zenel Ltd revalued a depreciable item of property, plant and equipment, with an original cost of R355 000 and a carrying amount of R210 000 to a net replacement value of R390 000. On acquisition date a residual value of R370 000 was allocated to the item. On 31 December 20.13 the tax base of the item amounts to R300 000.

The tax rate is 28%. 80% of all capital gains are taxable.



REQUIRED

Calculate the deferred tax balance relating to the depreciable item of property, plant and equipment of Zenel Ltd at 31 December 20.13. Round off all calculations to the nearest rand.

SOLUTION 17

Depreciable item (residual value higher than cost)	Carrying amount R	Tax base R	Temporary difference R	Deferred tax (asset)/ liability R
Carrying amount at 31 December 20.13	390 000	300 000	90 000	24 360[1]

[1] [(20 000 + 55 000) x 28%] + (15 000 x 80% x 28%) = 21 000 + 3 360 = R24 360

The manner of recovery of the asset can be illustrated as follows:

Revalued carrying amount	R390 000	
		Through use R20 000 x 28%
Residual value	R370 000	
		Through sale R15 000 x 80% x 28%
Original cost	R355 000	
		Through recoupment at sale R55 000 x 28%
Tax base	R300 000	



LECTURER'S COMMENT

When an entity allocates a residual value to a depreciable item, the entity is effectively confirming that it expects to recover the depreciable amount of that asset through use and the allocated residual value through sale. The portion of the temporary difference that is recovered through use will be taxed at 28% and the portion that is recovered through sale at 80% x 28%.

EXAMPLE 18

On 31 December 20.13 Detoks Ltd revalued a depreciable item of property, plant and equipment, with an original cost of R355 000 and a carrying amount of R210 000 to a net replacement value of R390 000. On acquisition date a residual value of R310 000 was allocated to the item. On 31 December 20.13 the tax base of the item amounts to R300 000.

The tax rate is 28%. 80% of all capital gains are taxable.



REQUIRED

Calculate the deferred tax balance relating to the depreciable item of property, plant and equipment of Detoks Ltd at 31 December 20.13. Round off all calculations to the nearest rand.

SOLUTION 18

Depreciable item (residual value lower than cost)	**Carrying amount R**	**Tax base R**	**Temporary difference R**	**Deferred tax (asset)/ liability R**
Carrying amount at 31 December 20.13	390 000	300 000	90 000	25 200

The manner of recovery of the asset can be illustrated as follows:

Revalued carrying amount	R390 000	
		Through use R35 000 x 28%
Original cost	R355 000	
		Through use R45 000 x 28%
Residual value	R310 000	
		Through recoupment at sale R10 000 x 28%
Tax base	R300 000	

EXAMPLE 19

On 1 November 20.10, Proplink Ltd purchased an administration property at a cost of R750 000 (land: R150 000; building: R600 000). The building was available for use, as intended by management, on acquisition date. On acquisition date an expected useful life of 25 years and a residual value of R50 000 was allocated to the building.

Property was revalued for the first time during the 20.13 financial year. On 31 March 20.13, the net replacement value of the property was determined to be R1 865 000 (land: R650 000; building: R1 215 000). On the date of the revaluation the building had an estimated remaining useful life of 15 years and a residual value of Rnil.

Property is accounted for using the revaluation model. Depreciation is provided according to the straight-line method over the expected useful life of the building. Depreciation is calculated on the most recent revalued amounts.

According to section 13quin of the Income Tax Act, the South African Revenue Service allows an annual tax allowance of 5%, on the straight-line method, on the building. This allowance is not apportioned for part of a year.

The tax rate is 28%. 80% of all capital gains are taxable.



REQUIRED

Calculate the deferred tax balance relating to the administration property of Proplink Ltd at 31 March 20.13. Round off all calculations to the nearest rand.

SOLUTION 19

Land	Carrying amount R	Exempt difference R	Temporary difference R	Deferred tax asset /(liability) R
Cost 1 November 20.10	150 000	150 000		
Revaluation	500 000[1]	-		
Carrying amount 31 March 20.13	650 000	150 000	500 000	(112 000)[2]

1. 650 000 – 150 000 = 500 000
2. (650 000 – 150 000) x 80% x 28% = 112 000

Building	Carrying amount R	Tax base R	Temporary difference R	Deferred tax asset/(liability) R
Cost 1 November 20.10	600 000	600 000		
Accumulated depreciation/ Tax allowances	(31 167)[1]	(60 000)[2]		
Carrying amount 31 March 20.12	568 833	540 000	28 833	(8 073)
Revaluation	727 167[4]	-		
Net replacement value at beginning of year	1 296 000[3]	540 000		
Depreciation/ Tax allowance	(81 000)[5]	(30 000)[6]		
Carrying amount 31 March 20.13	1 215 000	510 000	705 000	(197 400)[7]

1. (600 000 cost price – 50 000 residual value)/total useful life of 300 months x 17 months from acquisition date until year-end 20.12 = 31 167
2. 600 000 x 5% x 2 = 60 000
3. 1 215 000/180 remaining useful life at end of 20.13 financial year x 192 remaining useful life at beginning of 20.13 financial year = 1 296 000
4. 1 296 000 – 568 833 = 727 167
5. 1 296 000/16 = 81 000
6. 600 000 x 5% = 30 000
7. (1 215 000 – 510 000) x 28% = 197 400

Deferred tax balance relating to the administration property of Proplink Ltd at 31 March 20.13:

	R
Land	112 000
Building	197 400
Total deferred tax liability	309 400



LECTURER'S COMMENT

The property was revalued on 31 March 20.13 to a net replacement value. In order to perform the calculation of the revaluation surplus the given net replacement value should be restated to a net replacement value on 1 March 20.12. Your revaluation surplus will be calculated as the difference between the carrying amount on this date and the restated net replacement value.

Steps to follow in the calculation of the revaluation surplus:

1. Calculate the carrying amount on 1 March 20.12
2. Calculate the restated net replacement value on 1 March 20.12
3. Calculate the revaluation surplus on 1 March 20.12

Deferred tax will be calculated according to the statement of financial position approach at every year-end date. This entails that the carrying amount of an item will be compared to the tax base of that specific item at every year-end date. The difference between these two amounts will equal the temporary difference after any exempt difference is taken into account. Multiply the calculated temporary difference with the applicable tax rate.

The carrying amount of a non-depreciable asset will be recovered only by means of sale. Deferred tax is thus provided for on the revaluation surplus of the land at a rate of 80% x 28%.

The carrying amount of a depreciable asset will be recovered by means of use. Deferred tax is thus provided for on the building at a rate of 28%.

E COMPREHENSIVE EXAMPLES

EXAMPLE 20

Noy Ltd purchased machinery on 1 January 20.10 and the machinery is written off over its estimated useful life (at that stage six years). It is the policy of the enterprise to revalue machinery every two years. On 1 January 20.12 machinery was revalued for the first time by Mr X, an independent sworn appraiser, on a depreciated (net) replacement value basis with reference to recent market transactions on arm's length. On that date the remaining useful life of all the machinery was estimated to be five years. The residual value of all machinery remains Rnil despite the fact that the useful lives have changed. The following information is available:

	Machinery		
	A **R**	**B** **R**	**C** **R**
Cost	480 000	540 000	600 000
Accumulated depreciation – 1 January 20.12	(160 000)	(180 000)	(200 000)
Carrying amount	320 000	360 000	400 000
Net replacement value – 1 January 20.12	500 000	330 000	450 000

Additional information

1. The entity realises revaluation surpluses as the assets are used.
2. The entity discloses all revalued property, plant and equipment on the net replacement value basis.
3. The reduction in the replacement value of machine B is permanent.
4. According to section 11(e) of the Income Tax Act, the South African Revenue Service allows a tax allowance on the machinery on the straight-line method over 5 years. This allowance is apportioned for part of a year.
5. The income tax rate is 28%. 80% of all capital gains are taxable.
6. No decision has in principle been taken to sell the machinery.
7. Assume that all the dates mentioned above are after 1 October 2001.



REQUIRED

Disclose all the notes to the financial statements of Noy Ltd for the year ended 31 December 20.12 which relate to the above-mentioned information. Your answer must comply with *International Financial Reporting Standards*.

Ignore comparative figures.

Also disclose the revaluation surplus in the statement of changes in equity.

SOLUTION 20

NOY LTD

NOTES FOR THE YEAR ENDED 31 DECEMBER 20.12

1. Accounting policy

1.1 Property, plant and equipment

Initially property, plant and equipment are recognised at cost price.

Subsequently revalued property, plant and equipment are stated at revalued amounts, being the fair value at the date of revaluation less any subsequent accumulated depreciation and impairment losses.

Revaluations are performed with regularity. An increase in the revaluation surplus is recognised in other comprehensive income and accumulated in equity, except to the extent that it relates to a reversal of a previous revaluation deficit for the same asset that was previously recognised in profit or loss. A decrease in the carrying amount of an asset arising on revaluation is firstly charged to the available balance in equity, and any excess is subsequently recognised in profit or loss. Any accumulated depreciation at the date of the revaluation is eliminated against the gross carrying amount of the asset and the net amount is restated to the revalued amount of the asset. The revaluation surpluses are realised as the assets are used.

Property, plant and equipment are depreciated on the straight-line basis over the assets estimated useful life which is as follows:

Machinery – 5 years

The residual value and useful life of all items of property, plant and equipment are reviewed, and adjusted if necessary at each reporting date.

Depreciation is charged to profit or loss. Gains or losses on disposal are determined by comparing the proceeds with the carrying amount of the asset. The net amount is included in profit or loss for the period.

2. Property, plant and equipment

	R
Machinery [IAS 16.73(d)–(e)]	
Carrying amount at beginning of year (320 000 + 360 000 + 400 000)	1 080 000
Cost (480 000 + 540 000 + 600 000)	1 620 000
Accumulated depreciation (160 000 + 180 000 + 200 000)	(540 000)
Revaluation (180 000 + 50 000) (calc 1)	230 000
Devaluation (calc 1)	(30 000)
Depreciation (100 000 + 66 000 + 90 000) (calc 1)	(256 000)
Carrying amount at end of year	1 024 000
Gross carrying amount (500 000 + 330 000 + 450 000)	1 280 000
Accumulated depreciation (100 000 + 66 000 + 90 000)	(256 000)

Machinery was revalued on 1 January 20.12 by an independent sworn appraiser.

If the assets had been carried at cost less accumulated depreciation, the carrying amount would have amounted to R840 000 (256 000 + 264 000 + 320 000) (refer to comment after calculation). [IAS 16.77(a)–(e)]

3. Revaluation surplus (in SCE) [IAS 16.77(f)]

	R
Gain on revaluation of machinery (other comprehensive income)	
[(180 000 + 50 000) – 64 400 (deferred tax)]	165 600
Transferred to retained earnings [(10 000 + 36 000) x 72%]	(33 120)
	132 480



LECTURER'S COMMENT

The R30 000 devaluation is recognised as an expense in profit or loss, as this asset does not have an existing revaluation surplus.

This adjustment is regarded as a downward revaluation (revaluation deficit) and not as an impairment loss, because it was identified during the normal revaluation process of the enterprise. If the loss is identified outside of the normal revaluation cycle (ie at a stage when other similar assets are not revalued), it will be treated as an impairment loss.

4. Deferred tax

	R
Analysis of temporary differences:	
Accelerated tax allowance	
[(256 000 – 192 000 + 264 000 – 216 000 + 320 000 – 240 000) x 28%]	53 760
Revaluation [(144 000 + 40 000) x 28%]	51 520
	105 280

OR

	R
Machinery	
[(400 000 – 192 000) + (264 000 – 216 000) + (360 000 – 240 000)] x 28%	105 280

5. Profit before tax

Profit before tax includes the following:

Expense	R
Depreciation of machinery [IAS 1.93]	256 000

Change in estimate

Included in depreciation for 20.12 is a change in estimate to the amount of R54 000[1]. This decrease in depreciation is a result of a change in useful life regarding revaluation of machinery. The cumulative effect of the change in future periods is an increase in depreciation of R54 000[1].

[1] [(320 000 + 360 000 + 400 000)/5] – [(320 000 + 360 000 + 400 000)/4] = 54 000; or
[(320 000 + 360 000 + 400 000) x 3/4] – [(320 000 + 360 000 + 400 000) x 4/5] = 54 000



LECTURER'S COMMENT

The change in estimate is based on the carrying amounts before revaluation, since the net replacement values (revalued amounts) provided in the question would already have taken the revised useful lives into consideration and would therefore not be affected by the change in useful lives.

6. Tax expense

	R
Major components of tax expense	
Deferred [– 4 000 (A) – 30 000 (B) + 42 000 (B) + 30 000 (C)] x 28%	10 640
Tax expense	10 640

Income tax relating to the components of other comprehensive income	
Deferred tax relating to revaluation of machinery	64 400

CALCULATIONS

1. Deferred tax

Machine A	Total R	Revaluation R	Historical R	Tax base R	Temporary difference R
Cost price	480 000	–	480 000	480 000	
Accumulated depreciation 31/12/20.11	(160 000)	–	(160 000)	(192 000)	
Carrying amount 31/12/20.11	320 000	–	320 000	288 000	32 000
Revaluation	180 000	180 000	–	–	
	500 000	180 000	320 000	288 000	
Depreciation	(100 000)	(36 000)	(64 000)	(96 000)	(4 000)
Carrying amount 31/12/20.12	400 000	144 000	256 000	192 000	208 000

Machine B	Total R	Revaluation R	Historical R	Tax base R	Temporary difference R
Cost price	540 000	-	540 000	540 000	
Accumulated depreciation 31/12/20.11	(180 000)	–	(180 000)	(216 000)	
Carrying amount 31/12/20.11	360 000	–	360 000	324 000	36 000
Devaluation	(30 000)	–	(30 000)	–	(30 000)
	330 000	–	330 000	324 000	
Depreciation	(66 000)	–	(66 000)	(108 000)	42 000
Carrying amount 31/12/20.12	264 000	–	264 000	216 000	48 000

Machine C	Total R	Revaluation R	Historical R	Tax base R	Temporary difference R
Cost price	600 000	–	600 000	600 000	
Accumulated depreciation 31/12/20.11	(200 000)	–	(200 000)	(240 000)	
Carrying amount 31/12/20.11	400 000	–	400 000	360 000	40 000
Revaluation	50 000	50 000	–	–	
	450 000	50 000	400 000	360 000	
Depreciation	(90 000)	(10 000)	(80 000)	(120 000)	30 000
Carrying amount 31/12/20.12	360 000	40 000	320 000	240 000	120 000
Total					**376 000**



LECTURER'S COMMENT

Even if the company does not follow a policy of revaluation, they still have to adjust machine B as the decline in replacement cost is permanent. In terms of IAS 16.77(e) the carrying amount of each class of asset, if the asset had been carried at cost less accumulated depreciation, has to be disclosed. The permanent decline of R30 000 should thus be taken into account when calculating this amount. Refer to note 2.

Journals

	Dr R	Cr R
Machine A @ cost (SFP)		480 000
Accumulated depreciation (SFP)	160 000	
Machine A @ revalued amount (SFP)	500 000	
Revaluation surplus (OCI)		180 000
Revaluation of machine A on 1 January 20.12		
Machine B @ cost (SFP)		540 000
Accumulated depreciation (SFP)	180 000	
Machine B @ revalued amount (SFP)	330 000	
Devaluation (P/L)	30 000	
Revaluation of machine B on 1 January 20.12		
Machine C @ cost (SFP)		600 000
Accumulated depreciation (SFP)	200 000	
Machine C @ revalued amount (SFP)	450 000	
Revaluation surplus (OCI)		50 000
Revaluation of machine C on 1 January 20.12		

	Dr	Cr
	R	R
Revaluation surplus (OCI) [(180 000 + 50 000) x 28%]	64 400	
Deferred tax (SFP)		64 400
Transfer to deferred tax		
Depreciation A (P/L)	100 000	
Depreciation B (P/L)	66 000	
Depreciation C (P/L)	90 000	
Accumulated depreciation A (SFP)		100 000
Accumulated depreciation B (SFP)		66 000
Accumulated depreciation C (SFP)		90 000
Depreciation for the year ended 31 December 20.12		
Revaluation surplus (SCE) [(36 000 + 10 000) x 72%]	33 120	
Retained earnings (SCE)		33 120
Realisation of revaluation surplus (a portion) through the use of the asset		

EXAMPLE 21

Black Ltd owns a single machine which it acquired at a cost of R384 000 and which had a carrying amount of R268 800 on 31 December 20.10. The tax value at that date was R153 600. Depreciation is written off on the straight-line method over the estimated remaining useful life of the machine, assuming no residual value which will remain at Rnil until the machine is derecognised despite the annual review. According to section 11(e) of the Income Tax Act, the South African Revenue Service allows a tax allowance on the machine on the straight-line method over 5 years. This allowance is apportioned for part of a year.

The directors decided to revalue the machine on 1 January 20.11. Mr Blue, a sworn appraiser, valued the machine at gross replacement value (undepreciated replacement value) of R740 880 with reference to prices in an active market for new machinery. The total life of the asset is now estimated to be 1 year less than the original estimate.

Profit before depreciation for the financial years ended 31 December 20.10 and 31 December 20.11 were both R280 000. There are no non-taxable/non-deductible or temporary differences other than those evident from the above-mentioned information.

The income tax rate is 28%. Capital gains tax is in accordance with current legislation and the assets were acquired after 1 October 2001. 80% of all gains are taxable

The company regards a revaluation surplus as realised when the underlying asset is sold or withdrawn from use.

It is the policy of Black Ltd to disclose machinery on the net (depreciated) replacement value. No decision was made to dispose of the machine.



REQUIRED

By applying the principles of IAS 16:

(a) give the journal entries in respect of the revaluation of the asset and the other entries and adjustments which are related thereto for the year ended 31 December 20.11; and

(b) prepare the statement of profit or loss and other comprehensive income of Black Ltd for the year ended 31 December 20.11 and all applicable notes to the statement of profit or loss and other comprehensive income and statement of financial position, and the disclosure in the statement of changes in equity in respect of the revaluation. Confine your answer to the available information. Comparative figures are required.

SOLUTION 21

(a) Journals

	Dr	Cr
	R	R
01/01/20.11		
Accumulated depreciation (384 000 - 268 800) (SFP)	115 200	
Machinery at revaluation (calc 1)	493 920	
Machinery at cost (SFP)		384 000
Revaluation surplus (OCI) (calc 1)		225 120
Revaluation of machine		
Revaluation surplus (OCI)	63 034	
Deferred tax - SFP @ 28% (calc 2)		63 034
Provide deferred tax on revaluation surplus		
31/12/20.11		
Depreciation (493 920/6) (P/L)	82 320	
Accumulated depreciation (SFP)		82 320
Provision for depreciation for the year		
Deferred tax (SFP)	1 546	
Deferred tax (P/L)		1 546
Provision for deferred tax for the year		

(b) BLACK LTD

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.11

	Notes	20.11 R	20.10 R
Profit before tax (calc 3)	2	197 680	241 600
Income tax expense	3	(55 350)	(67 648)
Profit for the period		142 330	173 952
Other comprehensive income:			
Gains on property revaluation		225 120	–
Tax expense		(63 034)	–
Other comprehensive income for the year, net of tax		162 086	–
TOTAL COMPREHENSIVE INCOME FOR THE YEAR		304 416	173 952

BLACK LTD

NOTES FOR THE YEAR ENDED 31 DECEMBER 20.11

1. Accounting policy

1.1 Property, plant and equipment

Initially property, plant and equipment are recognised at cost price.

Subsequently revalued property, plant and equipment are stated at revalued amounts, being the fair value at the date of revaluation less any subsequent accumulated depreciation and impairment losses.

This represents a change in accounting policy since the cost model was previously applied. In terms of *International Financial Reporting Standards* the change in accounting policy was accounted for as a normal revaluation.

Revaluations are performed with regularity. An increase in the revaluation surplus is recognised in other comprehensive income and accumulated in equity, except to the extent that it relates to a reversal of a previous revaluation deficit for the same asset that was previously recognised in profit or loss. A decrease in the carrying amount of an asset arising on revaluation is firstly charged to the available balance in equity, and any excess is subsequently recognised in profit or loss. Any accumulated depreciation at the date of the revaluation is eliminated against the gross carrying amount of the asset and the net amount is restated to the revalued amount of the asset. The net revaluation surplus is transferred to retained earnings on disposal of the assets.

Property, plant and equipment are depreciated on the straight-line basis over the estimated useful life which is as follows:

Machinery – 9 years

The residual value and useful life of all items of property, plant and equipment are reviewed, and adjusted if necessary at each reporting date.

Depreciation is charged to profit or loss. Gains or losses on disposal are determined by comparing the proceeds with the carrying amount of the asset. The net amount is included in profit or loss for the period.

1.2 Deferred tax

Deferred tax is recognised for all temporary differences by using the statement of financial position approach and based on tax rates that have been 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 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 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).

The carrying amount of deferred tax assets is reviewed at each reporting date and is reduced to the extent that it is no longer probable that sufficient taxable profit will be available to utilise the benefit.

Deferred tax assets and liabilities are offset when there is a legally enforceable right to offset current tax assets and liabilities and when they relate to income taxes levied by the same taxation authority on either the same taxable entity or different taxable entities (when the taxable entities intends to settle current tax assets and liabilities on a net basis).



LECTURER'S COMMENT

If an entity has always carried its assets at historical cost and later decides to revalue the assets, it represents a change in accounting policy, as in this question. However, if it is the policy of the entity to revalue its assets every x-years from the start, the first revaluation performed will not constitute a change in accounting policy (as in the previous question), even though the assets were previously carried at cost.

2. Profit before tax

	20.11	20.10
Expenses	R	R
Depreciation – machinery	82 320	38 400

Change in estimate

Included in depreciation for 20.11 is a change in estimate to the amount of R6 400[1]. This increase in depreciation is a result of a change in useful life regarding revaluation of machinery. The cumulative effect of the change in future periods is a decrease in depreciation of R6 400[1].

[1] (268 800/6) – (268 800/7) = 6 400; or
(268 800 x 6/7) – (268 800 x 5/6) = 6 400

3. Income tax expense

	20.11	20.10
	R	R
Major components of tax expense		
– Current tax (calc 4)	56 896	56 896
– Deferred tax (calc 2)	(1 546)[3]	10 752
Tax expense	55 350	67 648
Income tax relating to the components of other comprehensive income		
Deferred tax relating to revaluation of machinery	63 034[2]	–

[2] 225 120 x 28% = 63 034
[3] 93 744 – 32 256 – 63 034 = (1 546)

4. Revaluation surplus (in SCE)

	20.11	20.10
	R	R
Gain on revaluation of machinery (other comprehensive income) [225 120 – 63 034 (deferred tax)]	162 086	–
Balance at the end of the year	162 086	–

5. Deferred tax

Analysis of temporary differences:	20.11 R	20.10 R
Accelerated tax allowance		
[(224 000 –76 800) x 28%](calc 2)	41 216	32 256
Revaluation [225 120 – 37 520 = 187 600 x 28%]	52 528	–
	93 744	32 256
OR		
Machinery [(411 600 – 76 800) x 28%]	93 744	32 256

6. Property, plant and equipment

Machinery	20.11 R	20.10 R
Carrying amount at beginning of year	268 000	307 200
Cost	384 000	384 000
Accumulated depreciation	(115 200)	(76 800)
Revaluation	225 120	–
Depreciation	(82 320)	(38 400)
Carrying amount at end of year	411 600	268 800
Gross carrying amount	493 920	384 000
Accumulated depreciation	(82 320)	(115 200)

Machinery was revalued on 01/01/20.11 by an independent sworn appraiser.

If the machinery had been carried at cost less accumulated depreciation, the carrying amount would have been R224 000 (calc 2) (20.10 – R268 800).

CALCULATIONS

1. Net replacement value

	R
Period already in use	
Original cost	384 000
Accumulated tax allowances (384 000 – 153 600)	230 400
Tax allowance per annum (384 000/5)	76 800
Period in use (230 400/76 800)	3 years

Depreciation on historical cost

	R
Accumulated depreciation (384 000 – 268 800)	115 200
Depreciation per annum (115 200/3)	38 400
Original expected life (384 000/38 400)	10 years[1]
Remaining life : previously	7 years
: revised	6 years
Depreciation per annum on historical cost from 20.11 (268 800/6)	R44 800
Revaluation surplus	
New useful life	9 years
Period lapsed	3 years

	R
Gross replacement value	740 880
Depreciated replacement value (740 880 x 6/9)	493 920
Historical carrying amount	(268 800)
Revaluation surplus	225 120

1. Depreciation per annum = cost/useful life. Therefore useful life = cost/depreciation per annum. Cost = 384 000 (given). Depreciation per annum = 38 400 (calculated). Therefore useful life = 384 000/38 400 = 10 years



LECTURER'S COMMENT

The net replacement value is calculated using the most recent estimate of the useful life of the asset in order to state the value of the asset in the statement of financial position as accurately as possible.

2. Deferred tax

	Total R	Revaluation R	Historical cost R	Tax base R	Temporary difference R	Deferred tax asset/ (liability) R
Cost	384 000	–	384 000	384 000		
Accumulated depreciation to 31/12/20.10	(115 200)	–	(115 200)	(230 400)		
Carrying amount 01/01/20.11	268 800	–	268 800	153 600	115 200	(32 256)
Revaluation	225 120	225 120	–	–		
Gross carrying amount	493 920	225 120	268 800	153 600		
Depreciation	(82 320)[1]	(37 520)	(44 800)[2]	(76 800)		
Carrying amount 31/12/20.11	411 600	187 600	224 000	76 800	334 800	(93 744)

[1] 493 920/6 years = 82 320
[2] 268 800/6 years = 44 800

3. Profit before tax

	20.11 R	20.10 R
Profit before depreciation – given	280 000	280 000
Depreciation (calc 2);(493 920/6);(384 000/10)	(82 320)	(38 400)
	197 680	241 600

4. Current tax

	20.11 R	20.10 R
Profit before tax and depreciation	280 000	280 000
Tax allowance	(76 800)	(76 800)
Taxable income	203 200	203 200
Current tax @ 28%	56 896	56 896

5. Deferred tax

	20.11 R	20.10 R
Accelerated tax allowance	76 800	76 800
Depreciation	(82 320)	(38 400)
Temporary difference	(5 520)	38 400
Deferred tax @ 28%	(1 546)	10 752



LECTURER'S COMMENT

1. Where a company decides to revalue its PPE for the first time, this represents a change in accounting policy, but the change in policy is not accounted for as such – IAS 8.17
2. If PPE is revalued and the question does not indicate which method of disclosure is required, both the gross and the net methods for disclosure is accepted, although the net method is recommended. In this question it was specifically indicated that disclosure is done on the depreciated replacement value basis and consequently the gross carrying amount in note 6 at year-end amounts to R493 920 and accumulated depreciation to R82 320. If the question indicated that disclosure is done on the gross replacement value basis, then the gross carrying amount would have been R740 880 and the accumulated depreciation R329 280 (740 880/9 x 4) at year-end. If PPE is revalued at net replacement values, PPE should be disclosed at net replacement values (the gross replacement values will not be available).

EXAMPLE 22

Universal Ltd is a company listed on the JSE Security Exchange with a 31 March year-end.

Machinery was purchased on 1 April 20.9 for R1 200 000 and depreciation is written off on a straight-line basis over 12 years, the estimated useful life. During the current financial year the directors decided that because of the increase in the gross replacement value, the machinery should in the future be disclosed at net replacement value. The net replacement value will be determined bi-annually by an independent sworn valuer, Mr Expert. On 31 March 20.12 Mr Expert valued machinery at a net replacement value of R981 000 based on prices of new assets in an active market. The remaining useful life remained unchanged at this date. There will be no residual value until derecognition of the assets.

On revaluation the accumulated depreciation is set off against gross amounts. Depreciation is calculated on the most recent revaluation. The revaluation surplus realises as machinery is used in the production process.

Profit before tax for the year ended 31 March 20.12 is R200 000, including the implications of the above-mentioned information.

According to section 11(e) of the Income Tax Act, the South African Revenue Service allows a tax allowance on the machinery on the straight-line method over 5 years. This allowance is apportioned for part of a year.

The income tax rate is 28%. 80% of all capital gains are taxable. Deferred tax is provided for on all temporary differences by using the statement of financial position approach. There are no other temporary differences or deferred tax balances, except for those which are evident from the question. No decision has been taken to sell the machinery. All mentioned dates are after 1 October 2001.



REQUIRED

Prepare all the relevant notes to the annual financial statements and the revaluation surplus in the statement of change in equity of Universal Ltd for the year ended 31 March 20.12. Your answer must comply with the requirements of *International Financial Reporting Standards*.

No comparative figures are required.

Accounting policy notes are not required.

SOLUTION 22

UNIVERSAL LTD

NOTES FOR THE YEAR ENDED 31 MARCH 20.12

1 Property, plant and equipment

	R
Plant and machinery	
Carrying amount at beginning of year	1 000 000
Cost	1 200 000
Accumulated depreciation	(200 000)
Depreciation	(109 000)
Revaluation	90 000
Carrying amount at end of year	981 000
Gross carrying amount	1 090 000
Accumulated depreciation	(109 000)

The machinery was revalued on 31 March 20.12 by an independent sworn valuer.

If machinery had been shown at cost less accumulated depreciation, the carrying amount on 31 March 20.12 would have been R900 000 (calc 2).

2. Deferred tax

Analysis of temporary differences:	R
Accelerated tax allowance (900 000 – 480 000) x 28% (calc 2)	117 600
Revaluation (calc 2: 81 000 x 28%)	22 680
Deferred tax liability	140 280

OR

	R
Machinery [(981 000 – 480 000) x 28%]	140 280

3. Profit before tax

Included in profit before tax is the following item:

Expenses	R
Depreciation on machinery	109 000

4. Tax expense

	R
Major components of tax expense	
– Current tax (calc 3)	19 320
– Deferred tax (calc 2) (140 280 – 78 400 – 25 200)	36 680
Tax expense	56 000
Income tax relating to the components of other comprehensive income	
Deferred tax relating to revaluation of machinery	25 200

5. Revaluation surplus (in SCE)

	R
Balance at beginning of year	–
Revaluation during the year (OCI) [90 000 – (90 000 x 28%)]	64 800
Transfer to retained earnings [(90 000 – 25 200)/10 years)] or (9 000 x 72%)	(6 480)
Balance end of year	58 320

CALCULATIONS

1. Revaluation of machinery

	R
Cost of machinery	1 200 000
Accumulated depreciation at 31 March 20.11 (1 200 000/12 x 2)	(200 000)
	1 000 000
Remaining useful life	10 years
Net replacement value at 1 April 20.11 (981 000/9 x 10)	1 090 000
Revaluation surplus (1 090 000 – 1 000 000)	90 000
Depreciation – on historical cost	100 000
– on revaluation (90 000/10)	9 000
Total depreciation	109 000

2. Deferred tax

	Total R	Revaluation R	Historical cost R	Tax base R	Temporary difference R	Deferred tax asset/ (liability) @ 28% R
Cost	1 200 000	–	1 200 000	1 200 000		
Accumulated depreciation/tax allowance till 31/03/20.11	(200 000)	–	(200 000)	(480 000)		
Carrying amount 01/04/20.11	1 000 000	–	1 000 000	720 000	280 000	(78 400)
Revaluation	90 000	90 000	–	–		
	1 090 000	90 000	1 000 000	720 000		
Depreciation/tax allowance	(109 000)	(9 000)	(100 000)	(240 000)		
Carrying amount 31/03/20.12	981 000	81 000	900 000	480 000	501 000	(140 280)

3. Tax expense

	R
Profit before tax (given)	200 000
Temporary differences	(131 000)
Depreciation	109 000
Tax allowance	(240 000)
Taxable income	69 000
Current tax (69 000 x 28%)	19 320

Journals

	Dr R	Cr R
Accumulated depreciation (SFP)	200 000	
Machinery (SFP)		1 200 000
Machinery @ revalued amount (SFP)	1 090 000	
Revaluation surplus (OCI)		90 000
Revaluation of machine		
Revaluation surplus (OCI)	25 200	
Deferred tax (SFP)		25 200
Transfer to deferred tax		

	Dr R	Cr R
Depreciation (P/L)	109 000	
Accumulated depreciation (SFP)		109 000
Provide depreciation for the year		
Revaluation surplus (SCE) [(90 000 – 25 200)/10]	6 480	
Retained earnings (SCE)		6 480
Realisation of revaluation surplus by utilisation		
Deferred tax (P/L) (calc 2) (140 280 – 78 400 – 25 200)	36 680	
Deferred tax (SFP) (calc 2)		36 680
Provide deferred tax on temporary difference – depreciation		



ASSESSMENT CRITERIA

After having studied this learning unit you should be able to:

- define property, plant and equipment.
- define the carrying amount of an asset.
- name and apply the criteria for the recognition of an item as property, plant and equipment.
- describe the rules applying to different situations for measuring the cost and residual values of assets and apply those rules in calculations.
- apply and calculate different methods of depreciation.
- properly account for property, plant and equipment and depreciation.
- name and apply the disclosure requirements for property, plant and equipment in accordance with *International Financial Reporting Standards*.
- describe and apply the accounting concepts relating to the revaluation of property, plant and equipment.
- accurately calculate and record revaluations.
- properly disclose revaluations in the financial statements of an entity in accordance with *International Financial Reporting Standards*.
- accurately calculate, account for and disclose the tax implications of property, plant and equipment in accordance with the ruling tax acts and *International Financial Reporting Standards*.

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LEARNING UNIT 2

INVESTMENT PROPERTY [IAS 40]



Distinctive Financial Reporting

LEARNING UNIT 2 – INVESTMENT PROPERTY

LEARNING OUTCOME

Once you have studied this course material, you should be able to:

- account for investment property in the financial statements of an entity in terms of the requirements of *International Financial Reporting Standards*.

OVERVIEW

This learning unit will be discussed under the following sections:

A ACCOUNTING TREATMENT

2.1 Objective – IAS 40.1
2.2 Scope IAS 40.2–4

2.3 Definitions IAS 40.5
- 2.3.1 Terms
- 2.3.2 A property interest held under an operating lease (not part of the module)
- 2.3.3 Difference between investment property and owner-occupied property – IAS 40.7–15

2.4 Recognition IAS 40.16–19
2.5 Measurement at recognition IAS 40.20–29

2.6 Measurement after recognition IAS 40.30–56
- 2.6.1 Accounting policy: fair value model or cost model IAS 40.30–32
- 2.6.2 Determining of fair value of investment property is a requirement

2.7 Fair value model IAS 40.33–55
- 2.7.1 Fair value
- 2.7.2 Fair value reflects market conditions at reporting date
- 2.7.3 Inability to determine fair value reliably

2.8 Cost model IAS 40.56

2.9 Transfers IAS 40.57–65
- 2.9.1 Transfer when the cost model is applied
- 2.9.2 Transfer when the fair value model is applied
- 2.9.3 Summary of transfers

2.10 Disposals IAS 40.66–73
- 2.10.1 Derecognition
- 2.10.2 Gains or losses on disposal
- 2.10.3 Compensation from third parties

B DISCLOSURE

2.11 Fair value model and cost model IAS 40.74–75
2.12 Fair value model IAS 40.76–78

2.13 Cost model IAS 40.79
2.14 Decision diagram

C TAX IMPLICATIONS

2.15 Deferred tax and capital gains tax
2.16 Summary of tax implications

D COMPREHENSIVE EXAMPLES

STUDY

PRESCRIBED:
Descriptive Accounting
Chapter 25

RECOMMENDED:
A Guide through IFRS
IAS 40

A ACCOUNTING TREATMENT

2.1 OBJECTIVE – IAS 40.1

IAS 40 prescribes the accounting treatment (recognition and measurement) for investment property and related disclosure requirements.

2.2 SCOPE – IAS 40.2–4

The standard shall be applied in the recognition, measurement and disclosure of investment property.

This standard deals, inter alia, with the measurement in a lessee's financial statements of investment property interests held under a finance lease and with the measurement in a lessor's financial statements of investment property leased out to a lessee under an operating lease. This standard does not deal with other matters covered in IAS 17 *Leases*.

This standard does not apply to:

(a) biological assets related to agricultural activity (see IAS 41 *Agriculture*); and
(b) mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources.

2.3 DEFINITIONS – IAS 40.5

2.3.1 Terms

The following terms are used in the standard with the meanings specified:

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

Cost
It is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognized in accordance with the specific requirements of other IFRSs, eg IFRS 2 *Share-based payment*.

Fair value
The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Investment property
Is property (land or a building – or part of a building – or both held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

(a) use in the production or supply of goods or services or for administrative purposes; or
(b) sale in the ordinary course of business.

Owner-occupied property
Property held (by the owner or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes.

2.3.2 A property interest held under an operating lease (note: this paragraph is not part of the module)

A property interest that is held by a lessee under an operating lease may be classified and accounted for as investment property if, and only if, the property would otherwise meet the definition of an investment property and the lessee uses the fair value model for the asset recognised (see below under 2.7 for fair value model). This classification alternative is available on a property-by-property basis. However, once this classification alternative is selected for one such property interest held under an operating lease, all property classified as investment property shall be accounted for using the fair value model. When this classification alternative is selected, any interest so classified is included in the required disclosures (refer to part B for disclosure).

2.3.3 Difference between investment property and owner-occupied property – IAS 40.7–15

Investment property is held to earn rentals or for capital appreciation or both. Therefore, an investment property generates cash flows largely independently of the other assets held by an entity. This distinguishes investment property from owner-occupied property. The production or supply of goods or services (or the use of property for administrative purposes) generates cash flows that are attributable not only to property, but also to other assets used in the production or supply process. IAS 16 *Property, plant and equipment* (see learning unit 1) applies to owner-occupied property.

Examples of investment properties:

(a) land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business.
(b) land held for a currently undetermined future use. (If an entity has not determined that it will use the land as owner-occupied property or for short-term sale in the ordinary course of business, the land is regarded as held for capital appreciation.)
(c) a building owned by the entity (or held by the entity under a finance lease) and leased out under one or more operating leases.
(d) a building that is vacant but is held to be leased out under one or more operating leases.
(e) property that is being constructed or developed for future use as investment property.

Examples of items that are not investment property and therefore not in the scope of this standard:

(a) property intended for sale in the ordinary course of business or in the process of construction or development for such sale (see IAS 2 *Inventories*), for example, property acquired exclusively with a view to subsequent disposal in the near future or for development and resale.
(b) property being constructed or developed on behalf of third parties (see IAS 11 *Construction contracts*).
(c) owner-occupied property (IAS 16), including:
    (i) property held for future use as owner-occupied property,
    (ii) property held for future development and subsequent use as owner-occupied property,
    (iii) property occupied by employees (whether or not the employees pay rent at market rates), and
    (iv) owner-occupied property awaiting disposal.
(d) property that is leased to another entity under a finance lease.

Some properties comprise a portion that is held as investment property and another portion that is held as owner-occupied property. If these portions could be sold separately (or leased out separately under a finance lease), an entity accounts for the portions separately. If the portions could not be sold separately, the property is investment property only if an insignificant portion is held for use in production or supply of goods or services or for administrative purposes.

In some cases, an entity provides ancillary services to the occupants of a property it holds, for example security and maintenance services. An entity treats such a property as investment property if the services are insignificant to the arrangement as a whole.

In other cases, the services provided are significant. For example, if an entity owns and manages a hotel, services provided to guests are significant to the arrangement as a whole. Therefore, an owner-managed hotel is owner-occupied property, rather than investment property.

Judgement is needed to determine whether a property qualifies as investment property. An entity develops criteria by which it can consistently judge in accordance with this standard whether a property is investment property. These criteria must be disclosed when classification is difficult.

In some cases, an entity owns property that is leased to, and occupied by, its parent or another subsidiary. The property does not qualify as investment property in the consolidated financial statements, because it is owner-occupied from the perspective of the group, but in its individual financial statements it would be shown as investment property.

EXAMPLE 1

Tinta Ltd is a holding company which is rapidly expanding. The company owns several properties that are occupied in different manners. The details are:

Property 1
Tinta Ltd expanded its business to a small rural town and has bought an old house that was converted to offices. The business operated by Tinta Ltd in this town is still growing and the house is therefore not fully occupied by the company. The house has a small flatlet attached to it that is currently being rented out. This part of the house will eventually also be occupied by the business.

Property 2
Tinta Ltd owns a piece of land in Johannesburg. There is the possibility that this piece of land will be expropriated by the local council for the construction of a new road. Tinta Ltd's original intention with buying this land was to develop its head offices there. Tinta Ltd has decided to wait for the final decision of the local council before erecting the new offices on this land.

Property 3
Tinta Ltd and all of its subsidiaries are occupying a building that Tinta Ltd owns. The subsidiaries pay market-related rental to Tinta Ltd. The building is occupied in the ratio of 30% to 70% by Tinta Ltd and its subsidiaries respectively. The intention is that Tinta Ltd and its subsidiaries will move to the new head offices once they have been erected and that the existing building will then be held until it can be sold for a good price.



REQUIRED

Classify the properties as either investment properties or owner-occupied properties in the accounting records of Tinta Ltd.

SOLUTION 1

Property 1 will be classified as an owner-occupied property used in the supply of services. The supply of these services generates cash flow that is attributable not merely to this property, but also to other assets used in the business of Tinta Ltd. The services supplied from this home office are the most significant component of the whole arrangement. The letting out of the flat to tenants is an ancillary service and does not change the classification of this building as an owner-occupied property.

Property 2 will be classified as an owner-occupied property. Paragraph .09 of the standard states that property held for future development and subsequent use as owner-occupied property is not investment property but must be classified as owner-occupied property.

The fact that there is uncertainty as to the ultimate use of this land because of the outstanding decision of the local council does not change the intention of Tinta Ltd to build its head offices on this piece of land.

It will be difficult to classify **Property 3**. Judgement must be used when determining whether this property qualifies as investment property in the records of Tinta Ltd. Tinta Ltd must develop criteria in order to exercise judgement in accordance with the definition of investment property. The criteria applied must be disclosed when the classification is difficult. The fact that less than 50% of the building is occupied by Tinta Ltd itself and therefore used in the production of goods or the supply of services or for administration purposes means that the majority of the building is occupied by tenants. The building can therefore be classified as investment property (depending on the criteria used by Tinta Ltd). The possible change in use in the future does not influence the classification of the property at this stage.

In the consolidated financial statements of Tinta Ltd and its subsidiaries, however, the property does not qualify as investment property, but is owner-occupied from the perspective of the group.

2.4 RECOGNITION – IAS 40.16–19

Investment property shall be recognised as an asset when, and only when:

(a) it is probable that the future economic benefits that are associated with the investment property will flow to the entity; and
(b) the cost of the investment property can be measured reliably.

An entity evaluates under this recognition principle all its investment property costs at the time they are incurred. These costs include:

- costs incurred initially to acquire an investment property and
- costs incurred subsequently to add to, replace part of, or service a property.

Under this recognition principle, an entity does not recognise in the carrying amount of an investment property the costs of the day-to-day servicing of such a property. Rather, these costs are recognised in profit or loss as incurred. Examples of such costs include cost of labour and consumables, and may include the cost of minor parts. The purpose of these expenditures is often described as for the repairs and maintenance of the property.

Parts of investment properties may have been acquired through replacement. For example, the interior walls may be replacements of original walls. Under the recognition principle, an entity recognises in the carrying amount of an investment property the cost of replacing part of an existing investment property at the time that cost is incurred if the recognition criteria are met.

The carrying amount of those parts that are replaced is derecognised in accordance with the derecognition provisions of this standard.

2.5 MEASUREMENT AT RECOGNITION – IAS 40.20–29

An investment property shall be measured initially at its cost. Transaction costs should be included in the initial measurement.

The cost of a purchased investment property comprises its purchase price and any directly attributable expenditure such as professional fees for legal services, property transfer taxes (duties) and other transaction costs. The transfer duties or Value Added Tax (VAT) implications of the purchase of a property can be one of the following:

- The property is bought from an entity that is registered for VAT. The purchase price will include VAT and if the company is registered for VAT, then the VAT can be claimed back from the SA Revenue Service.
- The property is bought from an entity that is not registered for VAT. It will have to pay transfer duty at prescribed rate on the property value. If it is registered for VAT, then it will be able to claim the transfer duty back as VAT from the SA Revenue Service.

The cost of a self-constructed investment property is its cost at the date when the construction or development is complete.

The cost of investment property is not increased by:

(a) start-up costs (unless they are necessary to bring the property to the condition necessary for it to be capable of operating in the manner intended by management),
(b) operating losses incurred before the investment property achieves the planned level of occupancy, or
(c) abnormal amounts of wasted material, labour or other resources incurred in constructing or developing the property.

Abnormal credit terms

If payment for an investment property is deferred, its cost is the cash price equivalent (ie the present value of future cash flows). The difference between this amount and the total payments is recognised as interest expense over the period of credit.

	R
Total instalments payable	xxx
Less: present value of future cash flows	(xxx)
Interest payable	xx

EXAMPLE 2

Peregrine Ltd has bought a property, from a registered VAT vendor, of which the details are as follows:

	R
Cost price (including VAT)	695 400
Agent's commission	36 600
Legal fees	8 300
Expenditure incurred to upgrade the property before occupying it	73 000

Peregrine Ltd is registered for VAT and the current VAT rate is 14%. The expenditure incurred was necessary because of the neglected state the property was in at the date of acquisition.

The intention of Peregrine Ltd is to rent this property out and earn rental income from it. Peregrine Ltd incurred costs to the amount of R18 000 to secure tenants.



REQUIRED

Calculate the initial price that the investment property must be recorded at.

SOLUTION 2

Initial cost price of the investment property

	R
Cost price	695 400
VAT claimed back (695 400 x 14/114)	(85 400)
Agent's commission	36 600
Legal fees	8 300
Expenditure incurred to upgrade the property	73 000
	727 900

Exchange (swap) of investment properties

One or more investment properties may be acquired in exchange for monetary or non-monetary asset(s) or a combination of both. The cost of the acquired investment property is measured at fair value unless:

(a) the exchange transaction lacks commercial substance, or
(b) the fair value of neither the asset received nor the asset given up is reliably measurable.

If the acquired asset is not measured at fair value, the acquired asset, is measured at the carrying value of the asset given up.

An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows (after tax) are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

(a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred, or
(b) the entity-specific value of the portion of the entity's operations affected by the transaction (after tax cash flows) changes as a result of the exchange, and
(c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

When the fair values of both the acquired asset and the asset given up can be measured reliably, then the fair value of the asset given up is used to measure the cost of the asset received unless the fair value of the asset received is more evident, in which case it can be used.

2.6 MEASUREMENT AFTER RECOGNITION – IAS 40.30–56

2.6.1 Accounting policy – IAS 40.30–32

An entity shall choose either
- the fair value model or
- the cost model

as its accounting policy and shall apply that policy to all of its investment property.

IAS 8 *Accounting policies, changes in accounting estimates and errors* states that a voluntary change in accounting policy shall be made only if the change will result in a more appropriate presentation of transactions, other events or conditions in the entity's financial statements. It is highly unlikely that a change from the fair value model to the cost model will result in a more appropriate presentation.

2.6.2 Determining of fair value of investment property is a requirement

The fair value of investment property must be determined, whether the fair value model or the cost model is used. The standard requires all entities to determine the **fair value** of investment property, for the purpose of either **measurement** (if the entity uses the fair value model) **or disclosure** (if it uses the cost model). An entity is encouraged, but not required, to determine the fair value of investment property on the basis of a valuation by an independent valuer who holds a recognised and relevant professional qualification and has recent experience in the location and category of the investment property being valued.

2.7 FAIR VALUE MODEL – IAS 40.33–55

After initial recognition, an entity that chooses the fair value model **shall measure all of its investment property at fair value**, except when there is clear evidence when an entity first acquires an investment property that the entity will not be able to determine the fair value of the investment property reliably on a continuing basis (see 2.7.3 below for inability to determine fair value reliably).

When a property interest held by a lessee under an operating lease is classified as an investment property, the fair value model shall be applied. **(Note: investment property held under an operating lease does not form part of this module.)**

A **gain or loss** arising from a change in the fair value of investment property shall be recognised in profit or loss for the period in which it arises.

2.7.1 Fair value

The fair value of investment property is the price at which the property could be exchanged between knowledgeable, willing parties in an arm's length transaction. Fair value specifically excludes an estimated price inflated or deflated by special terms or circumstances such as atypical financing, sale and leaseback arrangements, special considerations or concessions granted by anyone associated with the sale.

An entity determines fair value without any deduction for transaction costs it may incur on sale or other disposal.

2.7.2 Fair value reflects market conditions at reporting date

The fair value of investment property shall reflect **market conditions** at the end of the reporting period.

Time-specific

Fair value is time-specific at a given date. Because market conditions may change, the amount reported as fair value may be incorrect or inappropriate if estimated as of another time. The definition of fair value also assumes simultaneous exchange and completion of the contract for sale without any variation in price that might be made in an arm's length transaction between knowledgeable, willing parties if exchange and completion are not simultaneous.

The fair value reflects:

- the rental income from current leases,
- reasonable and supportable assumptions that represent what knowledgeable, willing parties would assume about rental income from future leases in the light of current market conditions, and
- any cash outflows (including rental payments and other outflows) that could be expected in respect of the property.

Knowledgeable, willing parties in an arm's length transaction

The definition of fair value refers to **knowledgeable, willing** parties in an arm's length transaction. The term **knowledgeable** means that both the willing buyer and the willing seller are reasonably informed about the nature and characteristics of the investment property, its actual and potential uses, and market conditions at the end of the reporting period.

A **willing buyer** is motivated, but not compelled, to buy. This buyer is neither over-eager nor determined to buy at any price. The assumed buyer would not pay a higher price than a market comprising knowledgeable, willing buyers and sellers would require.

A **willing seller** is neither an over-eager nor a forced seller, prepared to sell at any price, nor one prepared to hold out for a price not considered reasonable in current market conditions. The willing seller is motivated to sell the investment property at market terms for the best price obtainable.

The term **arm's length transaction** means that the transaction is one between parties that do not have a particular or special relationship that makes prices of transactions uncharacteristic of market conditions. The transaction is presumed to be between unrelated parties, each acting independently.

Current prices in an active market

The best evidence of fair value is given by current prices in an active market for similar property in the same location and condition and subject to similar lease and other contracts. An entity takes care to identify any differences in the nature, location or condition of the property, or in the contractual terms of the leases and other contracts relating to the property.

Other sources to consider in the absence of current prices in an active market

In the absence of current prices in an active market of the kind described in the previous paragraph, an entity considers information from a variety of sources, including:

(a) current prices in an active market for properties of different nature, condition or location (or subject to different lease or other contracts), adjusted to reflect those differences;
(b) recent prices of similar properties on less active markets, with adjustments to reflect any changes in economic conditions since the date of the transactions that occurred at those prices; and
(c) discounted cash flow projections based on reliable estimates of future cash flows, supported by the terms of any existing lease and other contracts and (when possible) by external evidence such as current market rents for similar properties in the same location and condition, and using discount rates that reflect current market assessments of the uncertainty in the amount and timing of the cash flows.

In some cases, the various sources listed above may suggest different conclusions about the fair value of an investment property. An entity considers the reasons for those differences, in order to arrive at the most reliable estimate of fair value within a range of reasonable fair value estimates.

In exceptional cases there is clear evidence that the fair value of the property will not be reliably determinable on a continuing basis (see 2.7.3 below).

Fair value differs from value in use

Fair value differs from value in use, as defined in IAS 36 *Impairment of assets* (refer to learning unit 4). Fair value reflects the knowledge and estimates of knowledgeable, willing buyers and sellers. In contrast, value in use reflects the entity's estimates, including the effects of factors that may be specific to the entity and not applicable to entities in general. For example, fair value does not reflect any of the following factors to the extent that they would not be generally available to knowledgeable, willing buyers and sellers:

(a) additional value derived from the creation of a portfolio of properties in different locations;
(b) synergies between investment properties and other assets;
(c) legal rights or legal restrictions that are specific only to the current owner; and
(d) tax benefits or tax burdens that are specific to the current owner.

Separately recognised assets or liabilities should not be included in the fair value

In determining the fair value of investment property, an entity does not double-count assets or liabilities that are recognised as separate assets or liabilities. For example:

(a) Equipment such as lifts or air-conditioning is often an integral part of a building and is generally included in the fair value of the investment property, rather than recognised separately as property, plant and equipment;
(b) If an office is leased on a furnished basis, the fair value of the office generally includes the fair value of the furniture, because the rental income relates to the furnished office. The furniture would therefore not be recognised as a separate asset;
(c) The fair value of investment property excludes prepaid or accrued operating lease income, because the entity recognises it as a separate liability or asset.
(d) The fair value of investment property held under a lease reflects expected cash flows (including contingent rent that is expected to become payable). Accordingly if a valuation obtained for a property is net of all payments expected to be made, it will be necessary to add back any recognized lease liability, to arrive at the carrying amount of the investment property using the fair value model.

The fair value of investment property does not reflect future capital expenditure that will improve or enhance the property and does not reflect the related future benefits from this future expenditure.

In some cases, an entity expects that the present value of its payments relating to an investment property (other than payments relating to recognised liabilities) will exceed the present value of the related cash receipts. An entity applies IAS 37 *Provisions, contingent liabilities and contingent assets* to determine whether to recognise a liability and, if so, how to measure it.

2.7.3 Inability to determine fair value reliably

There is a rebuttable presumption that an entity can reliably determine the fair value of an investment property on a continuing basis. However, in exceptional cases, there is clear evidence when an entity first acquires an investment property (or when an existing property first becomes investment property after a change in use) that the fair value of the investment property is not reliably determinable on a continuing basis. This arises when, and only when, comparable market transactions are infrequent and alternative reliable estimates of fair value (for example, based on discounted cash flow projections) are not available. In such cases, an entity shall measure that investment property using the **cost model** in IAS 16 *Property, plant and equipment*. The residual value of the investment property shall be assumed to be zero. The entity shall apply IAS 16 until disposal of the investment property.

If an entity determines that the fair value of an investment property under construction is not reliably determinable but expects the fair value of the property to be reliably determinable when construction is complete, it shall measure that investment property under construction at cost until its fair value becomes reliably determinable or construction is completed (whichever is earlier).

In the exceptional cases when an entity is compelled (for the reason given in the previous paragraph) to measure an investment property using the cost model, it measures all its other investment property at fair value (since this was the model chosen to measure its investment property).

If an entity has previously measured an investment property at fair value, it shall continue to measure the property at fair value until disposal (or until the property becomes owner-occupied property or the entity begins to develop the property for subsequent sale in the ordinary course of business) even if comparable market transactions become less frequent or market prices become less readily available.



LECTURER'S COMMENT

Refer to:

Descriptive Accounting, example 25.2 for an illustrative example on measuring investment property according to the fair value model.

2.8 COST MODEL – IAS 40.56

After initial recognition, an entity that chooses the cost model shall measure **all** of its investment property at cost less accumulated depreciation and accumulated impairment losses, according to IAS 16 *Property, plant and equipment*. This does not apply to those investment property that meet the criteria to be classified as held for sale (or are included in a disposal group that is classified as held for sale) in accordance with IFRS 5 *Non-current assets held for sale and discontinued operations* (refer to learning unit 5). Investment properties that meet the criteria to be classified as held for sale (or are included in a disposal group that is classified as held for sale) shall be measured in accordance with IFRS 5.

2.9 TRANSFERS – IAS 40.57–65

Transfers to, or from, investment property shall be made when, and only when, there is a change in use, evidenced by:

(a) commencement of owner-occupation – transfer from investment property to owner-occupied property;
(b) commencement of development with a view to sale – transfer from investment property to inventories;
(c) end of owner-occupation – transfer from owner-occupied property to investment property;
(d) commencement of an operating lease to another party – transfer from inventories to investment property.

Number (b) above requires an entity to transfer a property from investment property to inventories when, and only when, there is a change in use, evidenced by commencement of development with a view to sale. When an entity decides to dispose of an investment property without development, it continues to treat the property as an investment property until it is derecognised (eliminated from the statement of financial position) and does not treat it as inventory.

2.9.1 Transfer when the cost model is applied

When an entity uses the cost model, transfers between investment property, owner-occupied property and inventories do not change the carrying amount of the property transferred or the cost of that property for measurement or disclosure purposes.

2.9.2 Transfer when the fair value model is applied

(a) Background

IAS 16 *Property, plant and equipment* is part of the study material for this module and covers the recording and disclosure of property, plant and equipment. A general understanding of the principle of revaluation of property, plant and equipment is needed to fully understand IAS 40 *Investment property*.

According to IAS 16 the initial recording of property, plant and equipment is at **cost**. Subsequent to the initial recognition of an asset at cost, an item of property, plant and equipment should be carried at its **cost less accumulated depreciation and accumulated impairment losses.**

The revaluation of property, plant and equipment is the allowed alternative in terms of IAS 16. The standard allows that subsequent to the initial recognition of an asset at cost, an item of property, plant and equipment can be carried at a **revalued amount less subsequent accumulated depreciation and subsequent accumulated impairment losses.**

EXAMPLE 3

Company A follows the alternative method of recording property, plant and equipment. The plant was revalued to R75 000 on the net replacement value basis in the current year. At the date of the revaluation, the details of its plant were as follows:

	R
Plant – original cost	100 000
Accumulated depreciation	40 000
Net replacement value	75 000



REQUIRED

Journalise the revaluation. Ignore tax and depreciation.

SOLUTION 3

The recording of the revaluation will be as follows:

	Dr	Cr
	R	R
Plant revalued (SFP)	75 000	
Accumulated depreciation revalued (SFP)	40 000	
Plant at cost revalued (SFP)		100 000
Revaluation surplus (credit to OCI, not to P/L).		15 000
Recording of revaluation		

The plant will now be disclosed at its revalued amount of R75 000.

(b) Transfers

For a transfer from **investment property** carried at fair value **to owner-occupied property or inventories**, the property's deemed cost for subsequent accounting in accordance with IAS 16 *Property, plant and equipment* or IAS 2 *Inventories*, shall be its **fair value at the date of change in use**.

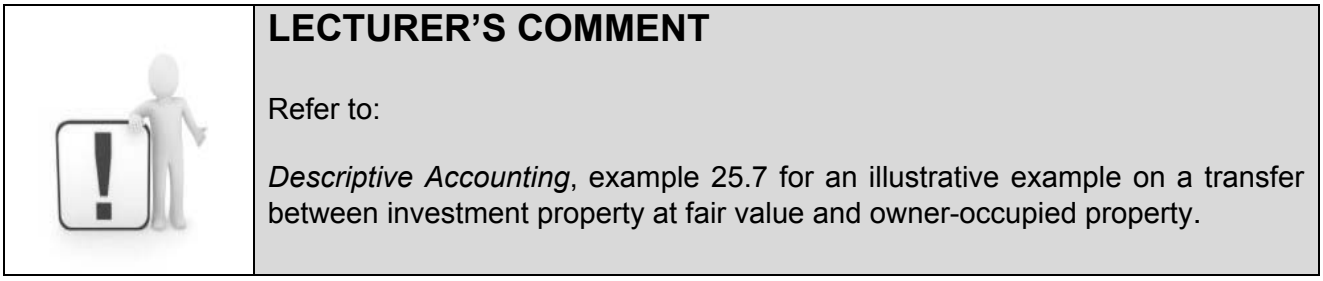
If an **owner-occupied property becomes an investment property** that will be carried at fair value, an entity shall apply IAS 16 up to the date of change in use (transfer date). The entity shall treat **any difference** at that date between the carrying amount of the property in accordance with IAS 16 and its fair value in the same way **as a revaluation** in accordance with IAS 16.
Up to the date when an owner-occupied property becomes an investment property carried at fair value, an entity depreciates the property and recognises any impairment losses that have occurred. The entity treats any difference at that date between the carrying amount of the property in accordance with IAS 16 and its fair value in the same way **as a revaluation** in accordance with IAS 16. In other words:

(a) any resulting decrease in the carrying amount of the property is recognised in profit or loss. However, to the extent that an amount is included in revaluation surplus for that property, the decrease is recognised in other comprehensive income and reduces the revaluation surplus within equity.
(b) any resulting increase in the carrying amount is treated as follows:

    (i) To the extent that the increase reverses a previous impairment loss for that property, the increase is recognised in profit or loss. The amount recognised in profit or loss does not exceed the amount needed to restore the carrying amount to the carrying amount that would have been determined (net of depreciation) had no impairment loss been recognised.
    (ii) Any remaining part of the increase is recognised in other comprehensive income and increases the revaluation surplus within equity. On subsequent disposal of the investment property, the revaluation surplus included in equity may be transferred to retained earnings. The transfer from revaluation surplus to retained earnings is not made through profit or loss.

For a transfer **from inventories to investment property** that will be carried at fair value, **any difference** between the fair value of the property at that date and its previous carrying amount shall be recognised **in profit or loss**. (This treatment of transfers from inventories to investment property that will be carried at fair value is consistent with the treatment of sales of inventories).

When an entity **completes the construction or development of a self-constructed investment property** that will be carried at fair value, **any difference** between the fair value of the property at that date and its previous carrying amount shall be recognised in **profit or loss** (not as a revaluation.)



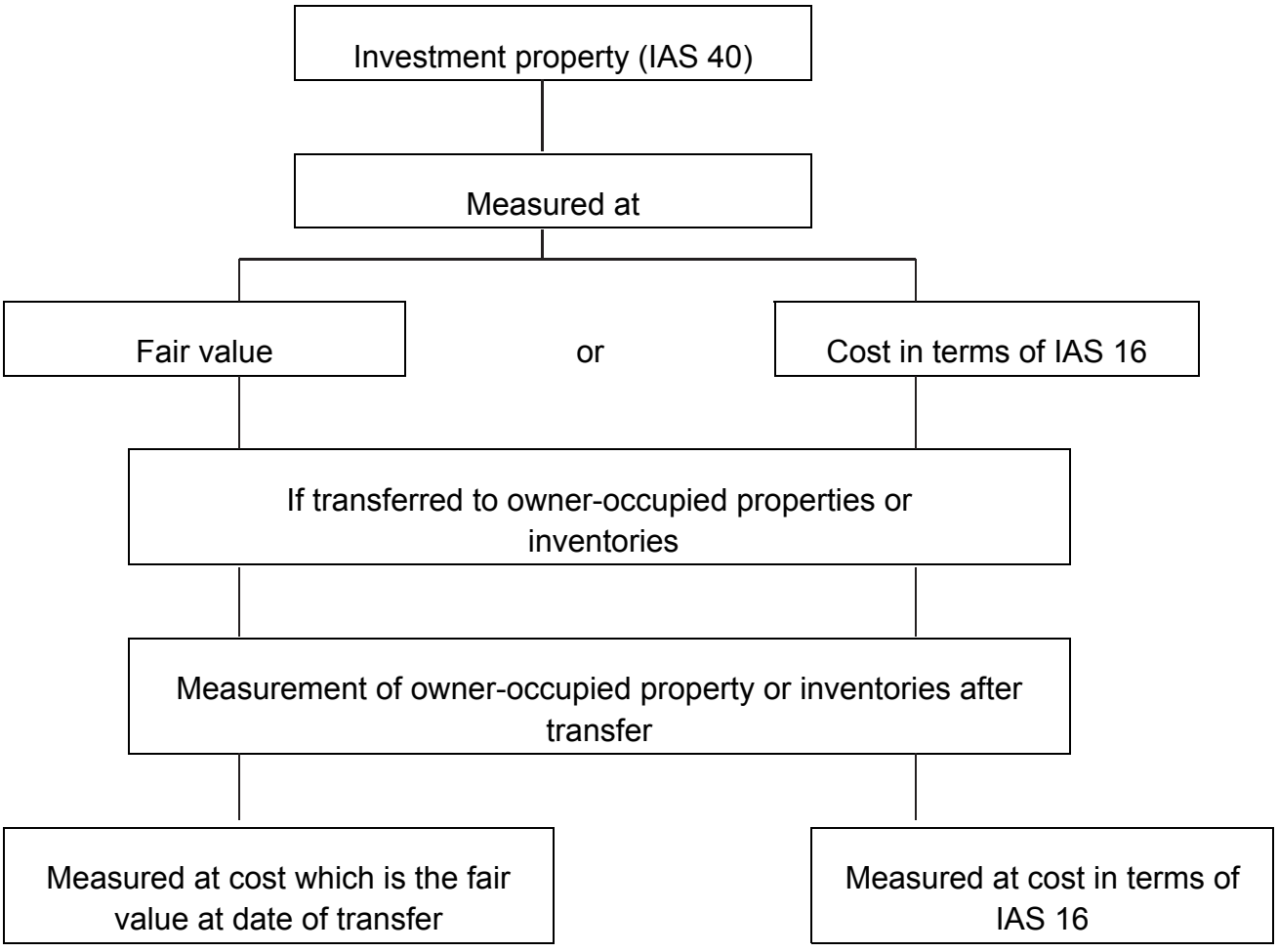
LECTURER'S COMMENT

Refer to:

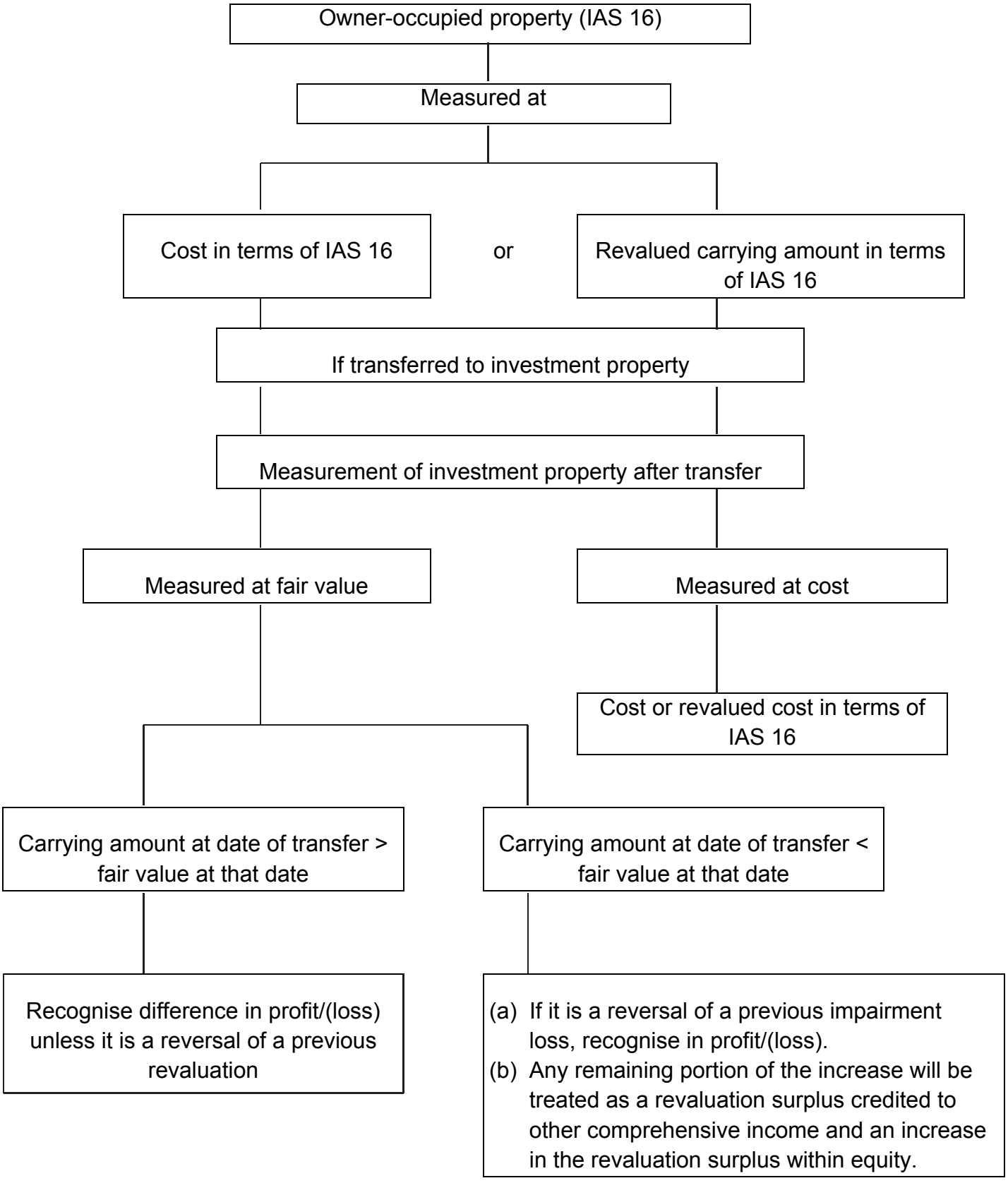
Descriptive Accounting, example 25.7 for an illustrative example on a transfer between investment property at fair value and owner-occupied property.

2.9.3 Summary of transfers

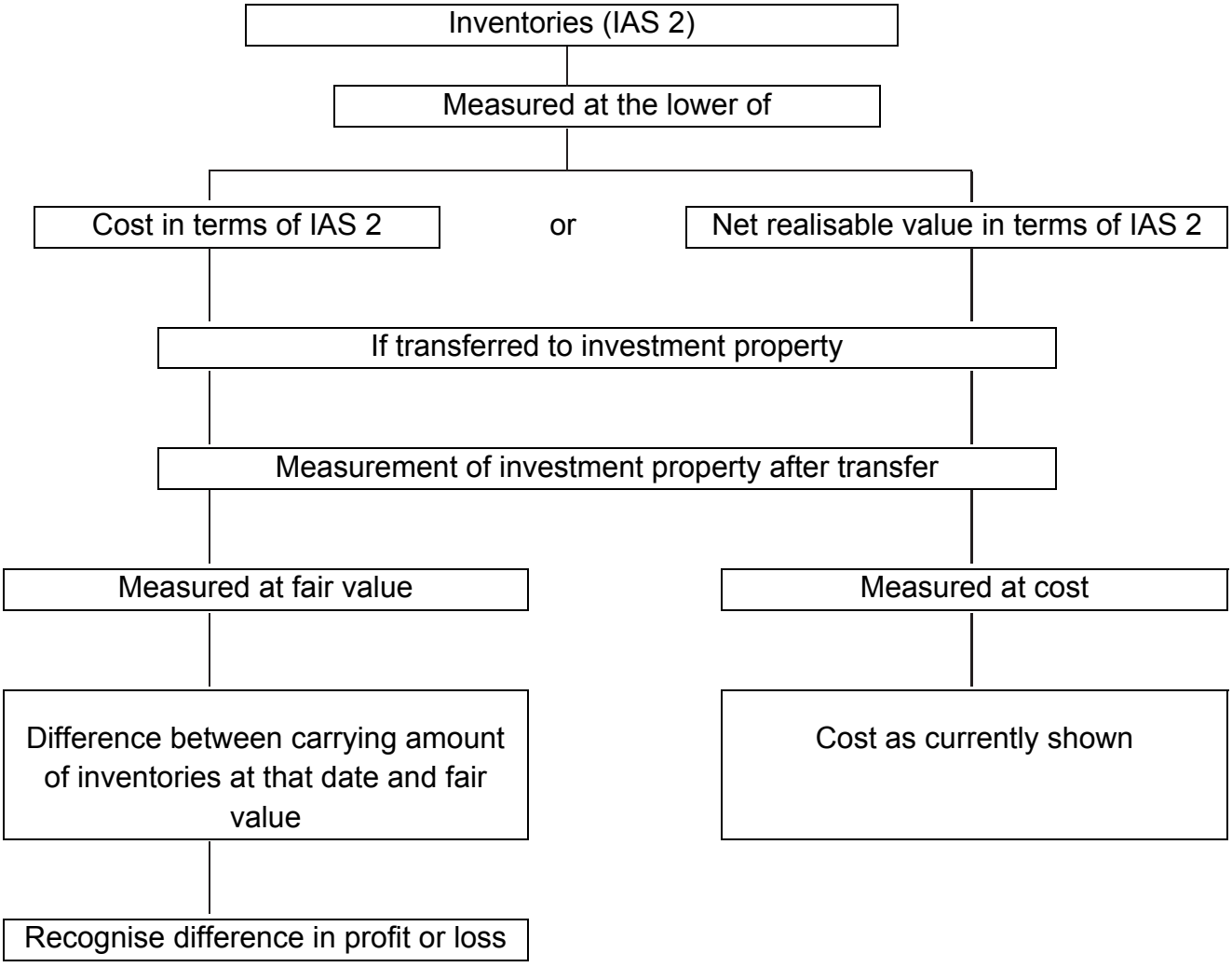
(a) Transfer of investment property to owner-occupied property or inventory



(b) Transfer of owner-occupied property to investment property



(c) Transfer from inventory to investment property



2.10 DISPOSALS – IAS 40.66–73

2.10.1 Derecognition

An investment property shall be derecognised (eliminated from the statement of financial position) on disposal or when the investment property is permanently withdrawn from use and no future economic benefits are expected from its disposal.

The disposal of an investment property may be achieved by sale or by entering into a finance lease. In determining the date of disposal for an investment property, an entity applies the criteria in IFRS 15 *Revenue from contracts with customers* for recognising revenue from the sale of goods and considers the related guidance in the appendix to that standard. (IAS 17 *Leases* applies to a disposal effected by entering into a finance lease and to a sale and leaseback. Leases do not form part of this module.)

If, in accordance with the recognition principle (refer to 2.4 above), an entity recognises in the carrying amount of an asset the cost of a replacement for part of an investment property, it derecognises the carrying amount of the replaced part.

- For investment property accounted for using the **cost model**, a replaced part may not be a part that was depreciated separately. If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or constructed.
- Under the **fair value model**, the fair value of the investment property may already reflect that the part to be replaced has lost its value. In other cases it may be difficult to discern how much fair value should be reduced for the part being replaced. An alternative to reducing fair value for the replaced part, when it is not practical to do so, is to include the cost of the replacement in the carrying amount of the asset and then to reassess the fair value, as would be required for additions not involving replacement.

2.10.2 Gains or losses on disposal

Gains or losses arising from the retirement or disposal of investment property shall be determined as the difference between the net disposal proceeds and the carrying amount of the asset and shall be recognised in profit or loss in the period of the retirement or disposal.

The consideration receivable on disposal of an investment property is recognised initially at fair value. In particular, if payment for an investment property is deferred, the consideration received is recognised initially at the cash price equivalent (ie the present value of future cash flows). The difference between the nominal amount of the consideration and the cash price equivalent is recognised as interest revenue in accordance with IFRS 15 *Revenue from contracts with customers* using the effective interest method.

An entity applies IAS 37 *Provisions, contingent liabilities and contingent assets* or other standards, as appropriate, to any liabilities that it retains after disposal of an investment property.

2.10.3 Compensation from third parties

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

Impairments or losses of investment property, related claims for or payments of compensation from third parties and any subsequent purchase or construction of replacement assets are separate economic events and are accounted for separately as follows:

(a) impairments of investment property are recognised in accordance with IAS 36;
(b) retirements or disposals of investment property are recognised in accordance with this standard (see 2.10.1–2 above);
(c) compensation from third parties for investment property that was impaired, lost or given up is recognised in profit or loss when it becomes receivable; and
(d) The cost of assets restored, purchased or constructed as replacements is determined in accordance with this standard (see 2.5 above).

B DISCLOSURE

2.11 FAIR VALUE MODEL AND COST MODEL – IAS 40.74–75

An entity shall disclose:

(a) whether it applies the fair value model or the cost model.
(b) if it applies the fair value model, whether, and in what circumstances, property interests held under operating leases are classified and accounted for as investment property (not part of this module).
(c) when classification is difficult (see 2.3.3 above), the criteria it uses to distinguish investment property from owner-occupied property and from property held for sale in the ordinary course of business.
(d) the extent to which the fair value of investment property (as measured or disclosed in the financial statements) is based on a valuation by an independent qualified valuer who holds a recognised and relevant professional qualification and has recent experience in the location and category of the investment property being valued. If there has been no such valuation, that fact shall be disclosed.
(e) the amounts recognised in profit or loss for:
    (i) rental income from investment property;
    (ii) direct operating expenses (including repairs and maintenance) arising from investment property that generated rental income during the period; and
    (iii) direct operating expenses (including repairs and maintenance) arising from investment property that did not generate rental income during the period.
    (iv) the cumulative change in fair value recognized in profit/loss on a sale of investment property from a pool of assets in which the cost model is used into a pool in which the fair value model is used.
(f) the existence and amount of restrictions on the realisability of investment property or the remittance of income and proceeds of disposal.
(g) contractual obligations to purchase, construct or develop investment property or for repairs, maintenance or enhancements.

2.12 FAIR VALUE MODEL – IAS 40.76–78

In addition to the disclosures required above, an entity that applies the fair value model shall disclose a **reconciliation** between the carrying amounts of investment property at the beginning and end of the period, showing the following:

(a) additions, disclosing separately those additions resulting from acquisitions and those resulting from subsequent expenditure recognised in the carrying amount of an asset;
(b) additions resulting from acquisitions through business combinations (not applicable to this module);
(c) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with IFRS 5 and other disposals;
(d) net gains or losses from fair value adjustments;
(e) the net exchange differences arising on the translation of the financial statements into a different presentation currency, and on translation of a foreign operation into the presentation currency of the reporting entity (not applicable to this module);
(f) transfers to and from inventories and owner-occupied property; and
(g) other changes.

When a valuation obtained for investment property is adjusted significantly for the purpose of the financial statements, for example to avoid double-counting of assets or liabilities that are recognised as separate assets and liabilities (as described in 2.7.2 above), the entity shall disclose a reconciliation between the valuation obtained and the adjusted valuation included in the financial statements. It shall show separately the aggregate amount of any recognised lease obligations that have been added back, and any other significant adjustments.

In the exceptional cases (referred to in 2.7.3 above) when an entity measures investment property using the cost model in IAS 16 *Property, plant and equipment* (because of the lack of a reliable fair value), the reconciliation required above shall disclose amounts relating to that investment property separately from amounts relating to other investment property. In addition, an entity shall disclose:

(a) a description of the investment property;
(b) an explanation of why fair value cannot be determined reliably;
(c) if possible, the range of estimates within which fair value is highly likely to lie; and
(d) on disposal of investment property not carried at fair value:
    (i) the fact that the entity has disposed of investment property not carried at fair value;
    (ii) the carrying amount of that investment property at the time of sale; and
    (iii) the amount of gain or loss recognised.

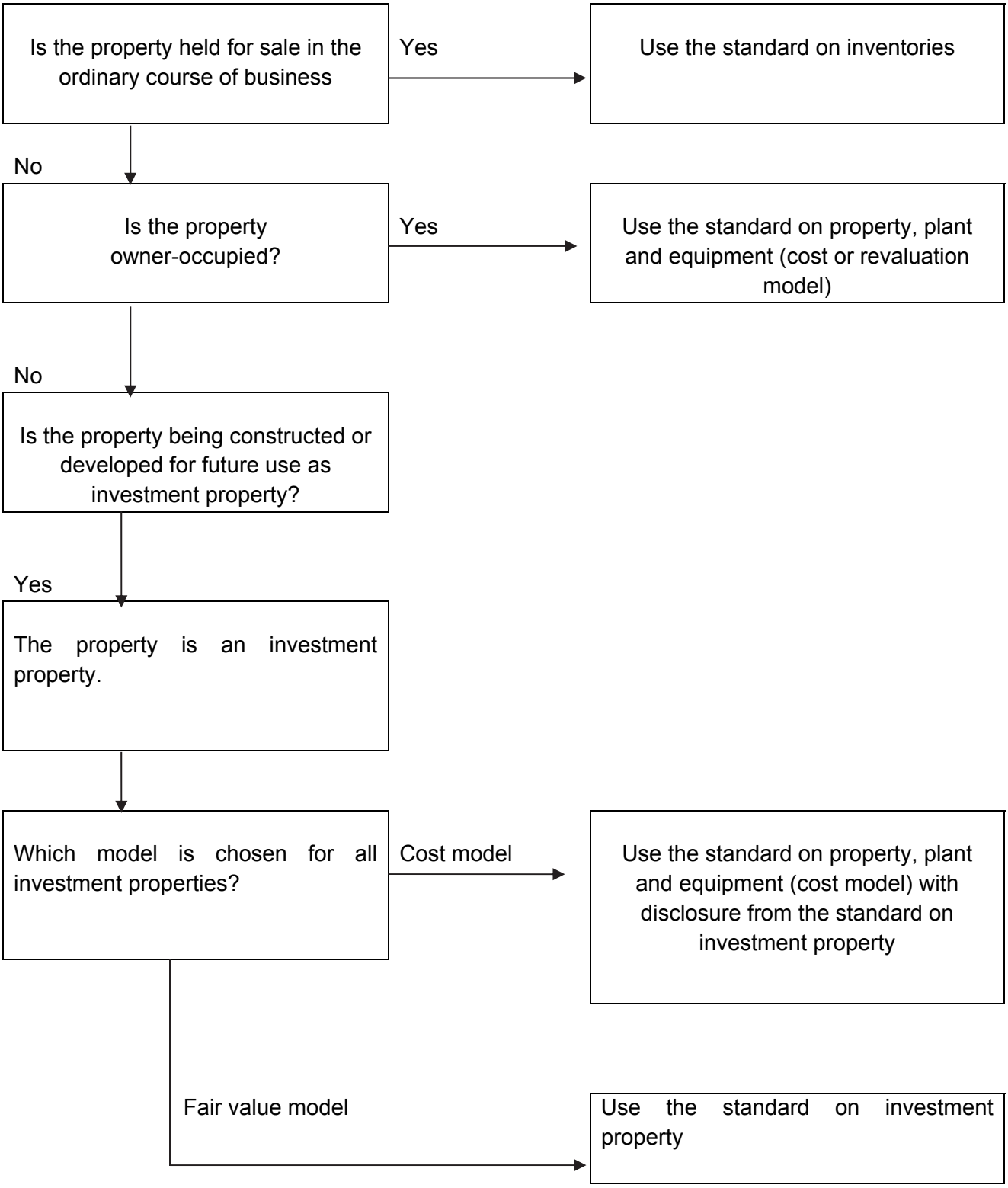
2.13 COST MODEL – IAS 40.79

In addition to the disclosures required for the fair value model and the cost model (as described above in 2.11), an entity that applies the cost model shall disclose:

(a) the depreciation methods used;
(b) the useful lives or the depreciation rates used;
(c) the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period;
(d) a reconciliation of the carrying amount of investment property at the beginning and end of the period, showing the following:
    (i) additions, disclosing separately those additions resulting from acquisitions and those resulting from subsequent expenditure recognised as an asset;
    (ii) additions resulting from acquisitions through business combinations (not applicable to this module);
    (iii) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with IFRS 5 and other disposals;
    (iv) depreciation;
    (v) the amount of impairment losses recognised, and the amount of impairment losses reversed, during the period in accordance with IAS 36 *Impairment of assets*;
    (vi) the net exchange differences arising on the translation of the financial statements into a different presentation currency, and on translation of a foreign operation into the presentation currency of the reporting entity (not applicable to this module);
    (vii) transfers to and from inventories and owner-occupied property; and
    (viii) other changes; and
(e) the fair value of investment property. In the exceptional cases when an entity cannot determine the fair value of investment property reliably, the entity shall disclose:
    (i) a description of the investment property;
    (ii) an explanation of why fair value cannot be determined reliably; and
    (iii) if possible, the range of estimates within which fair value is highly likely to lie.

2.14 DECISION DIAGRAM

The purpose of the following decision diagram is to summarise which *International Financial Reporting Standards* apply to the different types of property.



C TAX IMPLICATIONS

2.15 DEFERRED TAX AND CAPITAL GAINS TAX

Please note that this discussion follows from the assumption that students have already studied deferred tax in the applicable learning unit of the FAC3701 module.

Refer to learning unit 1, Part D: TAX IMPLICATIONS for a discussion on the implications of capital gains tax and deferred tax on revaluations.

- If the cost model is applied on investment property, the tax implications are exactly the same as for property, plant and equipment under the cost model in accordance with IAS 16.
- If the fair value model is applied on investment property, the deferred tax implications of fair value adjustments are calculated on the presumption that recovery of the carrying amount will, normally be, through sale. (However, remember that according to the fair value model there will be no depreciation on investment property, which is different from the revaluation model where a PPE item shall be depreciated.)

The South African Revenue Service (SARS) does not distinguish between owner-occupied properties or investment property. SARS only gives capital allowances on properties if they are utilised in a manufacturing process or if the building is a hotel building, a residential building where the tenants are also employees of the owner entity, or other commercial building. There are no capital allowances on land or any other residential buildings.

According to IAS 12 *Income taxes*, par 51 (c), a presumption has been introduced that the recovery of the carrying amount of investment properties carried at fair value will, normally be, through sale. Deferred tax will thus be provided for at 80% x 28% on the fair value adjustments of both land and buildings.

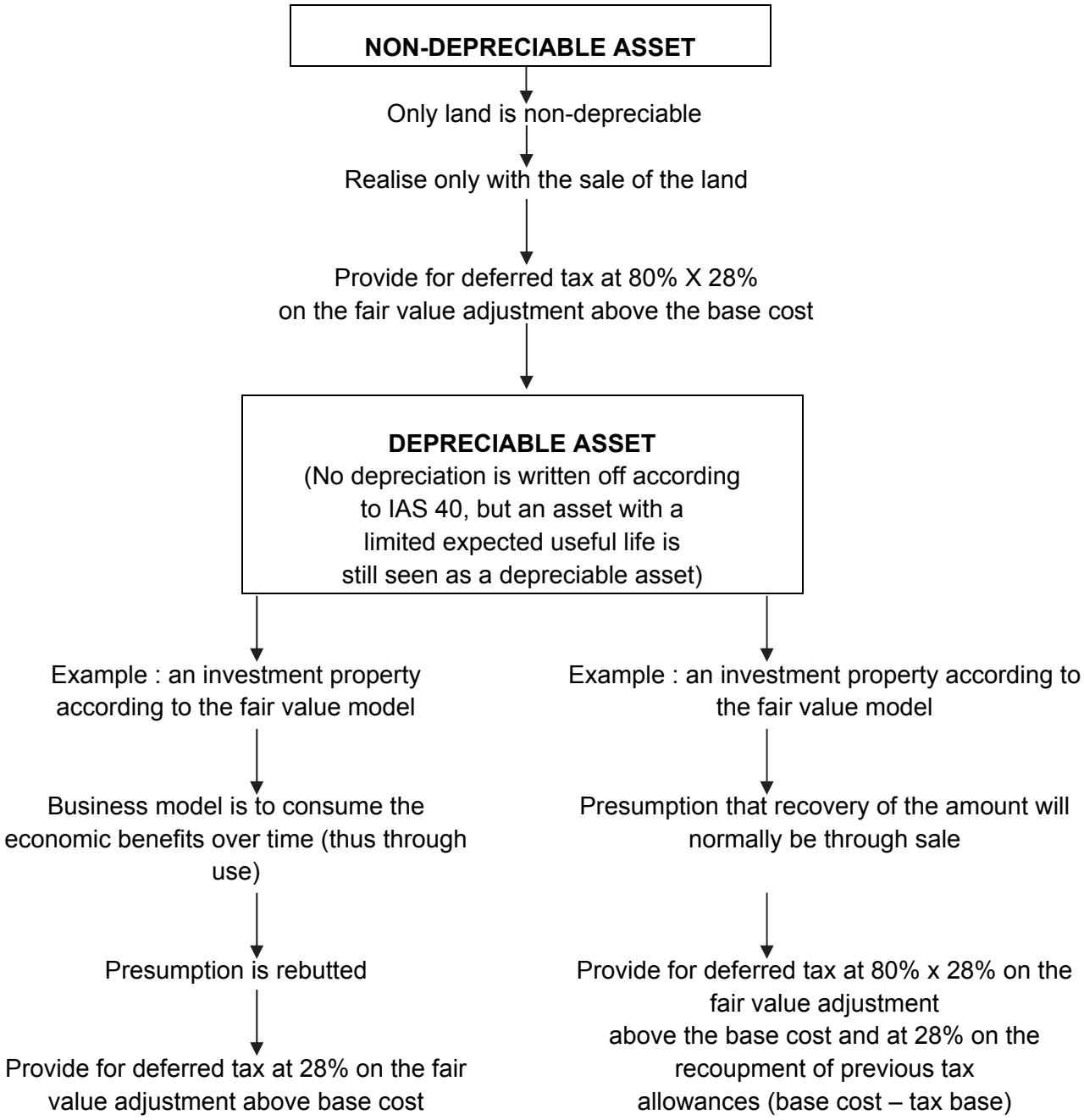
However take note that the presumption is rebutted if the investment property is depreciable and is held within a business model where the objective is to consume substantially all the economic benefits of the investment properties over time rather than through sale. If the presumption is rebutted the deferred tax on the fair value adjustment of the building will be provided for at 28%.

The deferred tax implications of investment property are as follows:

	COST MODEL	**FAIR VALUE MODEL**
Land	No deferred tax – IAS 12.15 (b) (ii)	80% x 28% on the fair value adjustment – IAS 12
Administration building (acquired before 1 April 2007)	No deferred tax – IAS 12.15 (c) (ii)	80% x 28% on the fair value adjustment – IAS 12 [if the presumption is applied]
Manufacturing building or commercial building (acquired on/after 1 April 2007)	Deferred tax provided for on the temporary difference between the tax base and the carrying amount of asset @ 28%.	80% x 28% on the fair value adjustment – IAS 12 [if the presumption is applied] 28% on the difference between the base cost and the tax base (recoupment of tax allowances)

2.16 SUMMARY OF TAX IMPLICATIONS

The following schematic diagram explains the tax implications in respect of investment properties which are disclosed on the fair value model:



D COMPREHENSIVE EXAMPLES

EXAMPLE 4

Barocca Ltd is a manufacturing company and its year-end is 30 June. The following details are available relating to its fixed property:

1. Land situated at stand 88, Mayfair, with an original cost of R100 000, was originally bought on 1 April 20.12 without any specific future use. The area in which the land is situated has become very popular and on 1 May 20.13 a property developer approached Barocca Ltd to buy the land from it. The developer offered Barocca Ltd R280 000 for the piece of land. The fair value of this land on 30 June 20.12 was R145 000. Barocca Ltd has decided to accept the property developer's offer.
2. Barocca Ltd owns property in Sandton, situated at stand 33, which was originally purchased on 1 July 20.12 for R1 800 000. The value of the land at that date was R500 000 and the office building R1 300 000. This property is rented out in full under a four year operating lease agreement since the date of acquisition. There are two tenants occupying the building and the monthly rental receivable from them is R10 000 and R18 000 respectively. Barocca Ltd repainted the building during the current year as part of its general maintenance programme for the building. The cost of repainting the building amounted to R42 000. At year-end the fair value of this property was to be R2 010 000 (land R600 000 and building R1 410 000).
3. Barocca Ltd owns property in Alberton, situated at stand 55, that is being constructed for future use as an investment property. The cost of the land on 1 January 20.12 was R400 000. At 30 June 20.12, the construction costs to date amounted to R1 420 000. The construction of the office building was completed on 30 November 20.12 and the total cost of constructing this building amounted to R1 790 000 (this is also the fair value of the building).
   There was no abnormal wastage of materials. No depreciation is written off on the asset. Barocca Ltd was able to secure only one tenant for the new building by 30 June 20.13. Additional capital expenditure of R38 000 was incurred during May 20.13 in order to secure this tenant. The office building is leased out in terms of an operating lease agreement since 1 June 20.13 for the next five years. On 30 June 20.13 the fair value of the building was determined at R1 840 000 and that of the land at R480 000.
4. Barocca Ltd owns an office building in Randburg, situated at stand 11, that it occupies for its own business purposes. The original cost (date of acquisition 1 July 20.10) of the property was R1 200 000, of which R180 000 of the cost can be allocated to the land. The building is depreciated over 20 years. There is no impairment of value applicable to this land and building. The residual value of the building will remain at Rnil.
5. Barocca Ltd applies the fair value model to its investment property and the cost model to its property, plant and equipment.
6. All valuations were performed by P Taks of Val a Prop, a firm of independent sworn appraisers. Mr Taks holds a recognised and relevant professional qualification and has recent experience in the location and category of the investment property being valued. The fair values were determined by reference to current market evidence. The most recent valuations were performed at year-end.
7. Profit before tax for the year ended 30 June 20.13, after taking into account the effect of all of the above information, amounted to R500 000 (20.12 – R400 000).
8. The applicable tax rate is 28% (20.12 – 28%). 80% of all capital gains are taxable.
9. The South African Revenue Service does not allow a building allowance on the abovementioned office buildings.

10. Deferred tax is provided on all temporary differences by using the statement of financial position approach. Only the above information will have deferred tax implications for both years. All assets were acquired after 1 October 2001.



REQUIRED

Disclose the above-mentioned information in the statement of financial position of Barocca Ltd on 30 June 20.13 and in the notes for the year that ended on that date. Your answer must comply with the requirements of *International Financial Reporting Standards*.

Comparative figures are required.

SOLUTION 4

BAROCCA LTD

STATEMENT OF FINANCIAL POSITION AT 30 JUNE 20.13.

	Notes	20.13 R	20.12 R
ASSETS			
Non-current assets			
Property, plant and equipment (867 000 + 180 000);(180 000 + 918 000)	5	1 047 000	1 098 000
Investment property	6	4 330 000	1 965 000

BAROCCA LTD

NOTES FOR THE YEAR ENDED 30 JUNE 20.13

1. Accounting policies

The financial statements have been prepared on the historical cost basis, except for investment property which are accounted at fair value. This complies with the requirements of *International Financial Reporting Standards*. The principal accounting policies which are followed by the company and which are consistent with those of the previous year are set out below.

1.1 Property, plant and equipment

Initially property, plant and equipment are recognised at cost price.

Subsequently property, plant and equipment are measured at historical cost less accumulated depreciation and accumulated impairment losses.

Land is not depreciated, but buildings are depreciated on the straight-line basis over the estimated useful life of 20 years

The residual value and useful life of all items of property, plant and equipment are reviewed, and adjusted if necessary at each reporting date.

Depreciation is charged to profit or loss. Gains or losses on disposal are determined by comparing the proceeds with the carrying amount of the asset. The net amount is included in profit or loss for the period.

1.2 Investment property

Investment property is represented by land and buildings held to earn rental income or for capital appreciation or both. 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 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 Deferred tax

Deferred tax is recognised for all temporary differences by using the statement of financial position (SFP) approach and based on tax rates that have been 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 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 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)

The carrying amount of deferred tax assets is reviewed at each reporting date and is reduced to the extent that it is no longer probable that sufficient taxable profit will be available to utilise the benefit.

Deferred tax assets and liabilities are offset when the entity has a legally enforceable right to offset current tax assets and liabilities and when they relate to income taxes levied by the same taxation authority on either the same taxable entity or different taxable entities (when the taxable entities intends to settle current tax assets and liabilities on a net basis)

2. Profit before tax

	20.13 **R**	**20.12** **R**
Profit before tax includes the following disclosable items:		
Income		
Profit on disposal of land (280 000 – 145 000)	135 000	–
Rent received from investment property [(10 000 + 18 000) x 12]	336 000	–
Fair value adjustment	302 000	45 000
Expenses		
Direct operating expenses of investment property that generate rental income – repairs and maintenance	(42 000)	–
Depreciation – buildings [(1 200 000 – 180 000)/20]	(51 000)	(51 000)

3. Tax expense

Major components of tax expense		
– Current tax (calc 9)	72 240	113 680
– Deferred tax [1](calc 10)	57 568	10 080
Tax expense	129 808	123 760

	20.13 R	20.12 R
Tax reconciliation		
Accounting profit (given)	500 000	400 000
Tax at applicable rate at 28%	140 000	112 000
Non-taxable profits:		
Capital gain on disposal of land [(36 000 - 9 000) x 28%]	(7 560)	–
Fair value adjustment of investment property [(36 000 + 24 400) x 28%] [9 000 x 28%]	(16 912)	(2 520)
Non-deductible expense:		
Depreciation – administration building (calc 7)	14 280	14 280
Tax expense	129 808	123 760

[1]22 400 + 24 640 + 17 920 + 2 688 – 10 080

4. Deferred tax

Analysis of temporary differences:	20.13 R	20.12 R
Fair value adjustment (calc 2, 3, 4, 5); (calc 1)	(67 648)	(10 080)
Deferred tax asset/(liability)	(67 648)	(10 080)
OR		
Land (22 400 + 17 920)	(40 320)	(10 080)
Building (24 640 + 2 688)	(27 328)	-
Deferred tax asset/(liability)	(67 648)	(10 080)

5. Property, plant and equipment

	20.13 R	20.12 R
Land		
Carrying amount at beginning of year	180 000	180 000
Carrying amount at end of year	180 000	180 000

	20.13 R	20.12 R
Buildings		
Carrying amount at beginning of year	918 000	969 000
Cost (property 4)	1 020 000	1 020 000
Accumulated depreciation (property 4)	(102 000)	(51 000)
Depreciation for the year	(51 000)	(51 000)
Carrying amount at end of year	867 000	918 000
Cost	1 020 000	1 020 000
Accumulated depreciation	(153 000)	(102 000)

6. Investment property

	20.13 R	20.12 R
Land and buildings		
Carrying amount at beginning of year (property 1)	1 965 000	–
Additions resulting from acquisitions (property 2); (property 1 and 3)	1 800 000	500 000
Additions resulting from property under construction at cost (property 3)	370 000	1 420 000
Additions from recognised subsequent expenditure (property 3)	38 000	–
Fair value adjustments (calc 2, 3, 4, 5); (calc 1)	302 000	45 000
Disposal (property 1) (calc 1)	(145 000)	–
Carrying amount at end of year	4 330 000	1 965 000

The investment properties were valued on 30 June 20.13. The valuation was performed by an independent sworn appraiser with a recognized and relevant professional qualification who has recent experience in the location and category of the property being valued.

CALCULATIONS

1. Property 1 – Land

	Total R	Cost R	Fair value adjust-ment R	Tax base R	Tempora-ry diffe-rence R	Deferred tax asset/ (liability) (80% x 28%) R
Cost 1 April 20.12	100 000	100 000	–	100 000	–	–
Fair value adjustment	45 000	–	45 000	–		
Carrying amount 30 June 20.12	145 000	100 000	45 000	100 000	45 000	(10 080)
Disposal	(145 000)	(100 000)	(45 000)	(100 000)		
Carrying amount 30 June 20.13	–	–	–	–	–	–

2. Property 2 – Land

	Total R	Cost R	Fair value adjust-ment R	Tax base R	Tempora-ry diffe-rence R	Deferred tax asset/ (liability) (80% x 28%) R
Cost 1 July 20.12	500 000	500 000	–	500 000		
Fair value adjustment	100 000	–	100 000	–		
Carrying amount 30 June 20.13	600 000	500 000	100 000	500 000	100 000	(22 400)

3. Property 2 – Office building

	Total R	Cost R	Fair value adjust-ment R	Tax base R	Tempora-ry diffe-rence R	Deferred tax asset/ (liability) (80% x 28%) R
Cost 1 July 20.12	1 300 000	1 300 000	–	1 300 000		
Fair value adjustment	110 000	–	110 000	–		
Carrying amount 30 June 20.13	1 410 000	1 300 000	110 000	1 300 000	110 000	(24 640)

4. Property 3 – Land

	Total R	Cost R	Fair value adjust-ment R	Tax base R	Tempora-ry diffe-rence R	Deferred tax asset/ (liability) (80% x 28%) R
Cost 30 June 20.12	400 000	400 000	–	400 000		
Fair value adjustment	80 000	–	80 000	–		
Carrying amount 30 June 20.13	480 000	400 000	80 000	400 000	80 000	(17 920)

5. Property 3 – Building

	Total R	Cost R	Fair value adjust-ment R	Tax base R	Tempora-ry diffe-rence R	Deferred tax asset/ (liability) (80% x 28%) R
Cost 30 June 20.12	1 420 000	1 420 000	–	1 420 000		
Additions due to construction	370 000	370 000	–	370 000		
Additions	38 000	38 000	–	38 000		
Fair value adjustment	12 000	–	12 000	–		
Carrying amount 30 June 20.13	1 840 000	1 828 000	12 000	1 828 000	12 000	(2 688)

6. Property 4 – Land

	Total R	Cost R	Fair value adjust-ment R	Tax base R	Tempora-ry diffe-rence R	Deferred tax asset/ (liability) R
Carrying amount 30 June 20.12	180 000	180 000	–	180 000	–	–
Carrying amount 30 June 20.13	180 000	180 000	–	180 000	–	–

7. Property 4 – Building

	Total R	Cost R	Fair value adjust-ment R	Tax base R	Exempt differen-ce R	Deferred tax asset/ (liability) R
Carrying amount 30 June 20.12	918 000	918 000	–	–	918 000	–
Depreciation	(51 000)	(51 000)	–	–	(51 000)	–
Carrying amount 30 June 20.13	867 000	867 000	–	–	867 000	–

8. Deferred tax balance

	20.13 R dr/(cr)	20.12 R dr/(cr)
Property 1 – Land	–	(10 080)
Property 2 – Land	(22 400)	–
Property 2 – Building	(24 640)	–
Property 3 – Land	(17 920)	–
Property 3 – Building	(2 688)	–
Property 4 – Land	–	–
Property 4 – Building	–	–
Deferred tax liability	(67 648)	(10 080)

9. Tax expense

	20.13 R	20.12 R
Profit before tax (given)	500 000	400 000
Non-deductible expense: depreciation – Property 4 (administration building)	51 000	51 000
Non-taxable profits:		
Fair value adjustments: land		
– Property 1 (45 000 x 20%)	–	(9 000)
– Property 2 and 3 [(100 000 + 80 000) x 20%]	(36 000)	–
Fair value adjustments: building	(24 400)	
– Property 2 and 3 [(110 000 + 12 000) x 20%)		
Profit on disposal – Property 1		
[(280 000 – 145 000 (carrying amount)) x 20%] [2]	(27 000)	–
	463 600	442 000
Temporary differences	(205 600)	(36 000)
Fair value adjustment	(205 600)	(36 000)
Property 1 reversal (with sale) and origination (45 000 x 80%) [3]	36 000	(36 000)
Property 2 and 3 – land [(100 000 + 80 000) x 80%]	(144 000)	–
Property 2 and 3 buildings [(110 000 + 12 000) x 80%]	(97 600)	–
Taxable income	258 000	406 000
Current tax at 28% (258 000 x 28%)	72 240	113 680

10. Calculation of deferred tax movement

	20.13 R	20.12 R
Deferred tax balance beginning of year (liability)	10 080	–
Deferred tax balance end of year (liability)	67 648	10 080
Deferred tax movement (dr to P/L)	57 568	10 080



LECTURER'S COMMENT

[2] Property 1 was sold during the year. The profit on disposal of R135 000 (280 000 – 145 000 (carrying amount)) is included in the given accounting profit. Since only 80% of capital gains are taxed, it follows that 20% (100% – 80%) should be deducted from the accounting profit (ie 80% of the capital gain is included in taxable income). The total capital gain is R280 000 (selling price) less R100 000 (base cost) = R180 000. R144 000 (180 000 x 80%) is included in taxable income on which tax of R40 320 (144 000 x 28%) is payable. R9 000 (fair value adjustment of 45 000 x 20%) of the R36 000 (180 000 x 20%) was deducted in 20.12 as an exempt difference (ie the 20% portion of the capital gain that is not taxed). To prevent a double deduction of the R9 000, only R27 000 (36 000 – 9 000) can be deducted in 20.13 as an exempt difference.

[3] In 20.12 only 80% of the capital gain was included as an originating temporary difference in the calculation of deferred tax. Since the asset was sold during 20.13 there could no longer be a deferred tax balance in respect of this asset in the records of the entity at the end of 20.13. The R36 000 created in 20.12 should therefore be reversed in 20.13.

EXAMPLE 5

The following information refers to the fixed assets of Investors Ltd for the year ended 31 December 20.13:

	R
Land, stand 181 Walkerville (purchased on 1 January 20.13)	800 000
Office building thereon (purchased on 1 January 20.13)	2 100 000
Improvements to the building (up to 28 February 20.13)	400 000
Rental income received	200 000
Repairs and maintenance	50 000

The building is used as Investors Ltd's administration building. The company occupies only 5% of the floor space. The remainder of the building is leased out under an operating lease for R20 000 per month from 1 March 20.13.

On 31 December 20.13, the financial year-end of Investors Ltd, Mr Worthy, an independent sworn appraiser who holds a recognised and relevant professional qualification and has recent experience in the location and category of the property being valued, valued the property at the following fair values:

	R
Land	1 000 000
Building	2 600 000

The valuation is based on current market prices for similar property in the Walkerville area in the same condition and subject to similar lease and other contracts.

Investors Ltd applies IAS 40 *Investment property* on its investment property according to the fair value model.

According to section 13*quin* of the Income Tax Act, the South African Revenue Service allows a 5% annual tax allowance, on the straight-line method, on the office building. This allowance is not apportioned for part of a year.

The company shows a profit before tax of R450 000, including all the above information, for the year ended 31 December 20.13. Deferred tax is provided for on all temporary differences according to the statement financial position approach. There are no other items to be considered for deferred tax. The current income tax rate is 28%. 80% of all capital gains are taxable. Accept that the cost price of the property is equal to the base cost.



REQUIRED

Disclose the following notes to the financial statements of Investors Ltd for the year ended 31 December 20.13. Your answer must comply with the requirements of *International Financial Reporting Standards*:

1. Profit before tax
2. Income tax expense, including the tax reconciliation
3. Deferred tax
4. Investment property

Accounting policy notes are not required

SOLUTION 5

INVESTORS LTD

NOTES FOR THE YEAR ENDED 31 DECEMBER 20.13

1. Profit before tax

Profit before tax includes the following items:

	20.13 R
Income	
Rent received from investment property (R20 000 x 10 months)	200 000
Fair value adjustment	300 000
Expenses	
Direct operating expenses of investment property that generates rental income (repairs and maintenance)	50 000

2. Tax expense

	20.13 R
Major components of tax expense	
– Current tax expense (calc 1)	7 000
– Deferred tax expense (calc 3) (44 800 + 57 400))	102 200
Tax expense	109 200
Tax reconciliation:	
Accounting profit	450 000
Tax at standard rate of 28% (450 000 x 28%)	126 000
Tax effect of non-taxable profit:	
Capital gain on fair value adjustment of land (40 000 x 28%)	(11 200)
Capital gain on fair value adjustment of building (20 000 x 28%)	(5 600)
Tax expense	109 200

3. Deferred tax

	20.13 R
Analysis of temporary differences:	
Fair value adjustments (300 000 x 28% x 80%)	67 200
Accelerated tax allowance [(2 500 000 – 2 375 000) x 28%]	35 000
Deferred tax liability	102 200

OR

	20.13 R
Land (calc 2)	44 800
Building (calc 2)	57 400
Deferred tax liability	102 200

4. Investment property

	20.13 R
Carrying amount at beginning of year	–
Additions from acquisitions (800 000 + 2 100 000)	2 900 000
Additions from subsequent expenditure recognised (given)	400 000
Fair value adjustment (1 000 000 + 2 600 000 – 2 900 000 – 400 000)	300 000
Carrying amount at end of year	3 600 000

The fair value of the investment property as disclosed in the financial statements was based on a valuation performed on 31 December 20.13 by an independent valuer with a recognized and relevant professional qualification who has recent experience in the location and category of the property being valued.

CALCULATIONS

1. Tax expense

	20.13 R
Profit before tax	450 000
Exempt differences	(60 000)
– Fair value adjustment (land) [20%[1] x (1 000 000 – 800 000)]	(40 000)[1]
– Fair value adjustment (building) [20%[2] x (2 600 000 – 2 500 000)]	(20 000)[2]
Temporary differences	(365 000)
– Fair value adjustments (building) [80% x (2 600 000 – 2 500 000)]	(80 000)
– Fair value adjustment (land) [80% x (1 000 000 – 800 000)]	(160 000)[1]
– Tax allowance (building) (2 500 000 x 5%)	(125 000)
Taxable income	25 000
Current tax @ 28%	7 000



LECTURER'S COMMENT

1 20% (100% – 80%) of the fair value adjustment of land above base cost is not taxable.
It is therefore an exempt difference.

2 20% (100% – 80%) of the fair value adjustment of buildings above base cost is not taxable.
It is therefore an exempt difference.

2. Deferred tax balance

Land

	Carrying amount R	Fair value adjustment R	Exempt difference R	Tempo-rary dif-ferences R	Deferred tax asset/ (liability) R
Cost 1 January 2013	800 000	-	800 000		
Fair value adjustment	200 000	200 000			
Carrying amount 31 December 2013	1 000 000	200 000	800 000	200 000	(44 800)[1]

Building

	Carrying amount R	Fair value adjustment R	Tax base R	Tempo-rary dif-ferences R	Deferred tax asset/ (liability) R
Cost 1 January 2013	2 100 000	-	2 100 000		
Improvements	400 000		400 000		
Fair value adjustment	100 000[2]	100 000	-		
Tax allowance	-	-	(125 000)[3]		
Carrying amount 31 December 2013	2 600 000	100 000	2 375 000	225 000	(57 400)[4]



LECTURER'S COMMENT

1 (1 000 000 – 800 000) x 80% x 28%
2 2 600 000 – (2 100 000 + 400 000)
3 2 500 000 x 5%
4 [(2 600 000 – 2 500 000) x 80% x 28%] + [(2 500 000 – 2 375 000) x 28%]
5 If there is an upward fair value adjustment of land, deferred tax is provided for at 80% x 28% on the surplus above base cost. This happens irrespective of whether or not there is any intension to dispose of the land or not, as the carrying amount of the land (a non-depreciable asset) can only be recovered by means of a sale.
6. If there is an upward fair value adjustment of buildings deferred tax is provided for at 80% x 28% on the surplus above base cost. This happens irrespective of whether or not there is any intension to dispose of the building or not, as the carrying amount of the building (if the fair value model is applied) is presumed to be recovered by means of a sale.

3. Calculation of deferred tax movement

	20.13 R
Deferred tax balance beginning of year	–
Deferred tax balance end of year (liability)	102 200
Deferred tax movement (dr to P/L)	102 200

EXAMPLE 6

Cemstone Ltd is a company, situated in Rustenburg, which specialises in the production and installation of concrete products. The company has a 28 February year-end.

The following details relate to the assets of Cemstone Ltd:

Office building

Cemstone Ltd acquired an office building on 1 July 20.5 for an amount of R4 500 000 (Land: R750 000, Buildings: R3 750 000). The building was available for use as intended by management on 1 August 20.5. On 1 August 20.5, it was determined that the building had an estimated useful life of 35 years. A residual value of R500 000 was allocated to the building. The estimated useful life and residual value remained unchanged throughout.

During the current financial year Cemstone Ltd decided to rent out 95% of the office space to a suitable tenant. A three year operating lease contract effective from 1 December 20.10 was concluded at a monthly rental of R25 000. The tenant occupied the building from 1 December 20.10.

The respective net replacement values and fair values of the office building were as follows:

Date of valuation	**Land**	**Building**	**Total value**
	R	**R**	**R**
28 February 20.10	790 000	3 410 000	4 200 000
1 December 20.10	850 000	3 500 000	4 350 000
28 February 20.11	900 000	3 560 000	4 460 000

Machinery

During the current financial year the company purchased a new machine which would be used in the manufacturing process. The machine was purchased on 31 May 20.10 at a cost of R670 000. It is estimated that the machine will produce 380 000 units during its economic life. The machine produced 45 000 units in the 20.11 financial year. No residual value was allocated to the machinery.

Additional information:

1. During the 20.10 financial year, the board of directors decided to disclose property, plant and equipment in future at their respective net replacement values. Machinery will only be revalued in the 20.12 financial year.
2. It is the accounting policy of Cemstone Ltd to apply the fair value model to its investment property.
3. It is the accounting policy of Cemstone Ltd to provide for depreciation on property according to the straight-line method on to provide for depreciation on machinery according to the units of production method.
4. All of the net replacement values and fair values were determined by Mr Xhosa, and independent sworn appraiser. Mr Xhosa has recent experience in the location and category of the property being valued. These values were determined with reference to current market prices on an arm's length basis, of similar properties in the same area.

5. It is the accounting policy of the company to realise any revaluation surplus on sale of the underlying assets.
6. Assume all amounts are material.



REQUIRED

Disclose the following notes to the annual financial statements of Cemstone Ltd for the year ended 28 February 20.11:

1. Property, plant and equipment
2. Investment property

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

Note:

- Accounting policy notes are **not required**.
- Show all calculations.
- Round off all amounts to the nearest rand.
- Ignore comparative information.
- Ignore all tax and VAT implications.

SOLUTION 6

CEMSTONE LTD

NOTES TO THE ANNUAL FINANCIAL STATEMENTS FOR THE YEAR ENDED 28 FEBRUARY 20.11

1. Property, plant and equipment

	Land	Building	Machinery	Total
	R	R	R	R
Carrying amount beginning of the year	790 000	3 410 000	–	4 200 000
Gross carrying amount	790 000	3 505 671	–	4 295 671
Accumulated depreciation (calc 1)	–	(95 671)	–	(95 671)
Additions	–	–	670 000	670 000
Depreciation (calc 2) (calc 3)	–	(71 753)	(79 342)	(151 095)
Revaluation (calc 4) (calc 5)	60 000	161 753	–	221 753
Transfer to Investment property	(850 000)	(3 500 000)	–	(4 350 000)
Carrying amount at the end of the year	–	–	590 658	590 658
Gross carrying amount	–	–	670 000	670 000
Accumulated depreciation	–	–	(79 342)	(79 342)

The valuation was performed on 1 December 20.10 by a sworn appraiser.

2. Investment property

	Land R	Buildings R	Total R
Carrying amount at the beginning of the year			
Transfer from property, plant and equipment	850 000	3 500 000	4 350 000
Fair value adjustment (calc 6) (calc 7)	50 000	60 000	110 000
Carrying amount at the end of the year	900 000	3 560 000	4 460 000

The valuation was performed on 28 February 20.11 by a sworn appraiser with a recognized and relevant professional qualification who has recent experience in the location and category of the property being valued.

Calculations:

1 August 20.5 – 28 February 20.6 = 7 months
1 March 20.6 – 28 February 20.9 = 36 months
1 March 20.6 – 28 February 20.10 = 48 months
1 March 20.10 – 30 November 20.10 = 9 months

1. (3 410 000 – 500 000)/365 x 377 = 3 005 671 + 500 000 = 3 505 671
   3 505 671 – 3 410 000 = 95 671
   377 = 420 – 43 (36+7)
   365 = 420 – 55 (48+7)
2. (3 410 000 – 500 000)/365 x 9 = 71 753
3. 670 000 x 45 000/380 000 = 79 342
4. 850 000 – 790 000 = 60 000
5. 3 500 000 – (3 410 000 – 71 753) = 161 753
6. 900 000 – 850 000 = 50 000
7. 3 560 000 – 3 500 000 = 60 000



ASSESSMENT CRITERIA

After having studied this learning unit you should be able to:

- define an investment property and differentiate it from owner-occupied property or property held as inventory;
- describe and apply the accounting treatment specific to an investment property;
- accurately account for the transfer of property between the different categories;
- accurately calculate and apply the tax and deferred tax implications of investment property;
- properly disclose investment property and its tax implications in the financial statements of a company in accordance with *International Financial Reporting Standards.*

FAC3702

LEARNING UNIT 3

IMPAIRMENT OF ASSETS (EXCLUDING CASH-GENERATING ASSETS) [IAS 36]



Distinctive Financial Reporting

LEARNING UNIT 3 – IMPAIRMENT OF ASSETS

LEARNING OUTCOMES

Once you have studied and completed this learning unit, you should be able to:

- identify and calculate the impairment of assets and business units
- properly disclose such impairment in the financial statements of the company in terms of the requirements of *International Financial Reporting Standards*.

OVERVIEW

This learning unit will be discussed under the following sections:

3.1 What is impairment?

3.2 When does impairment take place?
- 3.2.1 External sources of information – IAS 36.12
- 3.2.2 Internal sources of information – IAS 36.12
- 3.2.3 Evidence from internal reporting indicating that an asset may be impaired – IAS 36.14

3.3 When should impairment be applied?
3.4 How to calculate an impairment loss
3.5 What about goodwill?

3.6 What happens if the asset was impaired in prior years, but it is now worth much more?
- 3.6.1 External sources of information
- 3.6.2 Internal sources of information

3.7 Reversal of an impairment loss – individual assets
3.8 Reversal of an impairment loss for goodwill
3.9 What are the tax implications?

3.10 Disclosure
- 3.10.1 Disclosure requirements
- 3.10.2 Model for disclosure

3.11 Comprehensive examples

STUDY

PRESCRIBED:
Descriptive Accounting
Chapter 22

RECOMMENDED:
A Guide through IFRS
IAS 36

3.1 WHAT IS IMPAIRMENT?

Impairment will occur when the carrying amount of the asset in the books of the entity exceeds the asset's recoverable amount. This will lead to an impairment loss.

The impairment loss may be reversed if there is any indication that an impairment loss recognised for an asset in prior years may no longer exist or may have decreased. (Refer to 3.6.)

3.2 WHEN DOES IMPAIRMENT TAKE PLACE?

An asset is impaired when the carrying amount of the asset exceeds its recoverable amount. An entity should assess at the end of each reporting period whether or not there is any indication that an asset may be impaired. If any such indication exists, the entity should estimate the recoverable amount of the asset. (IAS 36.08–09)

If there is no indication of a potential impairment loss then the statement does not require an entity to make a formal estimate of the recoverable amount.

Irrespective of whether there is any indication of impairment, an entity shall also:

- test an intangible asset with an indefinite useful life or intangible asset not yet available for use for impairment annually by comparing its carrying amount with its recoverable amount;
- test goodwill acquired in a business combination for impairment **annually.**

In assessing whether or not there is any indication that an asset may be impaired, an entity should consider, as a minimum, the following indications:

3.2.1 External sources of information – (IAS 36.12)

- During the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use.
- Significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated.
- Market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially.
- The carrying amount of the net assets of the reporting entity is more than its market capitalisation.

3.2.2 Internal sources of information – (IAS 36.12)

- Evidence is available of obsolescence or physical damage of an asset.
- Significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite.

- Evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.

3.2.3 Evidence from internal reporting indicating that an asset may be impaired – (IAS 36.14)

Evidence from internal reporting indicating that an asset may be impaired includes the existence of:

- cash flows for acquiring the asset or subsequent cash needs for operating or maintaining it, that are significantly higher than those originally budgeted;
- actual cash flows or operating profit or loss flowing from the asset that are significantly worse than those budgeted;
- a significant decline in budgeted net cash flows or operating profit or a significant increase in budgeted loss, flowing from the assets; or
- operating losses or net cash outflows for the asset, when current period figures are aggregated with budgeted figures for the future.

The list is not comprehensive.

The concept of materiality applies in identifying whether or not the recoverable amount of an asset needs to be estimated. For example, if previous calculations show that an asset's recoverable amount is significantly greater than its carrying amount, the entity need not re-estimate the asset's recoverable amount if no events have occurred that would eliminate that difference. Similarly, previous analysis may show that an asset's recoverable amount is not sensitive to one or more of the indicators of possible impairments. (IAS 36.15)

As an illustration of the above, if market interest rates or other market rates of return on investment have increased during the period, an entity is not required to make a formal estimate of an asset's recoverable amount in the following cases:

- if the discount rate used in calculating the asset's value in use is unlikely to be affected by the increase in these market rates. For example, increase in short-term interest rates may not have a material effect on the discount rate used for an asset that has a long remaining useful life.
- if the discount rate used in calculating the asset's value in use is likely to be affected by the increase in these market rates but previous sensitivity analysis of recoverable amount shows that:
  - it is unlikely that there will be a material decrease in recoverable amount because future cash flows are also likely to increase (eg in some cases, an entity may be able to demonstrate that it adjusts its revenues to compensate for any increase in market rates; or
  - the decrease in recoverable amount is unlikely to result in a material impairment loss. (IAS36.16)

If there is an indication that an asset may be impaired, this may indicate that the remaining useful life, the depreciation (amortisation) method or the residual value for the asset needs to be reviewed and adjusted in accordance with the standard applicable to the asset, even if no impairment loss is recognised for the asset. (IAS 36.17)

3.3 WHEN SHOULD IMPAIRMENT BE APPLIED?

This standard shall be applied in accounting for the impairment of all assets other than:

- inventories,
- construction contracts,
- deferred tax assets,
- assets arising from employee benefits,
- financial assets that are included in the scope of the statement on financial instruments: disclosure and presentation,
- investment property that is measured at fair value,
- biological assets related to agricultural activity that are measured at fair value less estimated point-of-sale costs,
- deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance contracts, and
- non-current assets (or disposal groups) classified as held for sale. (IAS 36.02)

The recognition and measurement of these assets are dealt with by specific applicable standards.

This standard applies to financial assets classified as:

- investments in subsidiaries, associates and joint ventures as they are excluded from the scope of the standard on financial instruments: disclosure and presentation; (IAS 36.04)
- assets that are carried at revalued amounts in accordance with other standards such as the revaluation model in IAS 16 *Property, plant and equipment*. (IAS 36.05)

A cash-generating unit (not part of this module)

The smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets. (IAS 36.06)

Corporate assets (not part of this module)

Assets other than goodwill that contribute to future cash flows of both the cash-generating unit under review and other cash generating units. It includes group or divisional assets such as a building of a headquarter or a division of the entity, EDP equipment or a research centre. Corporate assets do not generate cash inflows independently from other assets or group of assets. (IAS 36.06)

3.4 HOW TO CALCULATE AN IMPAIRMENT LOSS

Step 1: Understand the basic principle

After identifying an asset that may be impaired at the end of the reporting period (refer to 3.2), the impairment loss must be calculated.

Definitions:

Impairment loss

Carrying amount The amount at which an asset is recognised in the statement of financial position after deducting any accumulated depreciation (amortisation)[1] and accumulated impairment losses thereon. (IAS 36.06)	**Less**	**Recoverable amount** The higher of an asset's fair value less costs to sell[4] and its value in use.[5]
[1]**Depreciation (amortisation)** The systematic allocation of the depreciable amount[2] of an asset over its useful life[3]. Note: in the case of an intangible asset, the term "amortisation" is generally used instead of "depreciation". Both terms have the same meaning.		[4] **Fair value less costs to sell** The amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.[6]
[2] **Depreciable amount** The cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.		[5] **Value in use** The present value of future cash flows expected to be derived from an asset.
[3] **Useful life is either:** • the period of time over which an asset is expected to be used by the entity; or • the number of production or similar units expected to be obtained for the asset by the entity.		[6] **Costs of disposal** Incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense. Examples of costs are legal costs, stamp duty, transaction taxes, costs of removing the asset and direct incremental costs to bring an asset into condition for sale.

Step 2: Calculate the asset's carrying amount

Refer to learning unit 1 of your study material where the calculation of carrying amounts is discussed in detail.

Step 3: Calculate the asset's recoverable amount

The recoverable amount is the higher of an asset's fair value less costs to sell and its value in use. (IAS 36.18)

It is not always necessary to determine both an asset's fair value less costs to sell and its value in use. For example, if either of these amounts exceeds the asset's carrying amount, the asset is not impaired. (IAS 36.19)

If there is no reason to believe that an asset's value in use materially exceeds its fair value less costs to sell, the asset's recoverable amount may be taken to be its fair value less costs to sell. This will often be the case for an asset that is held for disposal. This is because the value in use of an asset held for disposal will consists mainly of the net disposal proceeds as the future cash flows from continuing use of the asset until its disposal are likely to be negligible. (IAS 36.21)

A. Fair value less costs to sell is determined by:

- a binding sale agreement in an arm's length transaction adjusted for incremental costs of disposal. (IAS 36.25); or
- if the asset is traded in an active market, the current market price less the costs of disposal (IAS 36.26); or
- based on the best available information of the most recent transaction(s) for similar assets within the same industry. Please note that fair value less costs to sell does not reflect a forced sale unless management is compelled to sell immediately. (IAS 36.27)

B. Value in use

The following elements shall be reflected in the calculation of an asset's value in use:

- an estimate of the future cash flows the entity expects to derive from the asset;
- expectations about possible variations in the amount or timing of those future cash flows;
- the time value of money, represented by the current market risk-free rate of interest;
- the price for bearing the uncertainty inherent in the asset; and
- other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset. (IAS 36.30)

Estimating the value in use of an asset involves the following steps:

- estimating the future cash inflows and outflows to be derived from the continuing use of the asset and from its ultimate disposal; and
- applying the appropriate discount rate to these future cash flows. (IAS 36.31)

The elements identified above can be reflected either as adjustments to the future cash flows or as adjustments to the discount rate. (IAS 36.32)

The basis for estimates of future cash flows in measuring value in use:

- cash flow projections shall be based on reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset. Greater weight should be given to external evidence.
- cash flow projections shall be based on the most recent financial budgets/forecasts that have been approved by management, but shall exclude any estimated future cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset's performance. Projections based on these budgets/forecasts shall cover a maximum period of five years, unless a longer period can be justified.
- cash flow projections beyond the period covered by the most recent budgets/forecasts shall be estimated by extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years unless an increasing rate can be justified. (IAS36.33)

Management must assess the reasonableness of the assumptions on which its current cash flow projections are based by examining the causes of differences between past cash flow projections and actual cash flows.

In using information from financial budgets/forecasts, an entity considers whether or not the information reflects reasonable and supportable assumptions, and represents management's best estimates of the set of economic conditions that will exist over the remaining useful life of the asset. (IAS 36.38)

Estimates of future cash flows shall include:

- projections of cash inflows from the continuing use of the asset;
- projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset and that can be directly attributed, or allocated on a reasonable and consistent basis to the asset; and
- net cash flows, if any, to be received (or paid) for the disposal of the asset at the end of its useful life. (IAS 36.39)

To avoid double counting, estimates of future cash flows do not include:

- cash inflows from assets that generate cash inflows from continuing use that are largely independent of cash inflows from the asset under review (for example receivables); and
- cash outflows that relate to obligations that have already been recognised as liabilities (for example payables, pensions and provisions). (IAS 36.43)

Future cash flows shall be estimated for the asset in its current condition. Estimates of future cash flows shall not include estimated cash inflows or outflows that are expected to arise from:

- a future restructuring to which an entity is not yet committed; or
- improving or enhancing the asset's performance. (IAS 36.44)

Estimates of future cash flows shall not include:

- cash inflows or outflows from financing activities; or
- income tax receipts or payments. (IAS 36.50)

The estimate of net cash flows to be received (or paid) for the disposal of an asset at the end of its useful life shall be the amount that the entity expects to obtain from the disposal of the asset in an arm's length transaction between knowledgeable willing parties after deducting the estimated costs of disposal. (IAS 36.52)

C. Discount rate

The discount rate (or rates) shall be a **pre-tax rate** (or rates) that reflect(s) current market assessments of:

- the time value of money and
- the risk specific to the asset for which future cash flow estimates have not been adjusted. (IAS36.55)

A rate that reflects current market assessments of the time value of money and the risks specific to the asset is the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the entity expects to derive from the asset. This rate is estimated from the rate implicit in current market transactions for similar assets or from the weighted average cost of capital of a listed entity that has a single asset (or a portfolio of assets) similar in terms of service potential and risks to the asset under review. However, the discount rate(s) used to measure an asset's value in use shall not reflect risks for which the future cash flows estimates have been adjusted. (IAS 36.56)

When an asset-specific rate is not directly available from the market, an entity uses surrogates to estimate the discount rate. (IAS 36.57)

As a starting point in making such an estimate, the entity might take the following into account:

- the entity's weighted average cost of capital determined using techniques such as the capital asset pricing model;
- the entity's incremental borrowing rate; and
- other market borrowing rates. (IAS 36 Appendix A.A17)

These rates are adjusted:

- to reflect the way that the market would assess the specific risks associated with the projected cash flows; and
- to exclude risks that are not relevant to the projected cash flow.

Consideration is given to risks such as country risk, currency risk, price risk and cash flow risk. (IAS 36 Appendix A.A18)

The discount rate is independent of the entity's capital structure and the way the entity financed the purchase of the asset. (IAS 36 Appendix A.A19)

An entity normally uses a single discount rate for the estimate of an asset's value in use. However, an entity uses separate discount rates for different future periods where value in use is sensitive to a difference in risk for different periods or to the term structure of interest rates. (IAS 36 Appendix A.A21)

Step 4: Recognise the impairment loss in the financial statements

If, and only if, the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable amount. That reduction is referred to as an impairment loss. (IAS 36.59)

An impairment loss shall be recognised immediately in profit or loss, unless the asset is carried at revalued amount under another standard (for example, in accordance with the revaluation model in IAS 16 *Property, plant and equipment*). Any impairment loss of a revalued asset shall be treated as a revaluation decrease under that other standard. (IAS 36.60)

An impairment loss on a non-revalued asset is recognised in profit or loss. However, an impairment loss on a revalued asset is recognised in other comprehensive income to the extent that the impairment loss does not exceed the amount in the revaluation surplus for that same asset. Such an impairment loss on a revalued asset reduces the revaluation surplus for that asset. (IAS 36.61)

When the amount estimated for an impairment loss is greater than the carrying amount of the asset to which it relates, an entity shall recognise a liability if and only if, it is required by another standard. (IAS 36.62). This, however, falls outside the scope of this module.

After the recognition of an impairment loss, the depreciation (amortisation) charge for the asset shall be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life. (IAS 36.63)

If an impairment loss is recognised, any related deferred tax assets or liabilities are determined in accordance with IAS 12 *Income Taxes*, by comparing the revised carrying amount of the asset with its tax base. (IAS 36.64).

Journal entry for asset that is carried at cost less accumulated depreciation:

Date	**Description**	**Dr R**	**Cr R**
	Impairment loss (P/L)	XXXXX	
	Accumulated impairment loss (SFP)		XXXXX
	Recording of impairment loss of asset where no revaluation was done on asset		

Journal entry for asset that is carried at revalued amount:

Date	Description	Dr R	Cr R
	Revaluation surplus (OCI)	XXXXX	
	Impairment loss (P/L)	XXXXX	
	Accumulated impairment loss (SFP)		XXXXX
	Impairment following a revaluation from previous year. The impairment will first reduce the revaluation surplus to the extent that the impairment loss does not exceed the amount held in the revaluation surplus. The rest is an impairment loss recognised in profit or loss.		

3.5 WHAT ABOUT GOODWILL?

For the purpose of impairment testing, goodwill acquired in a business combination shall from the acquisition date, be allocated to each of the acquirer's cash-generating units, or groups of cash-generating units that are expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units. Each unit or group of units to which the goodwill is so allocated shall:

- represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and
- not be larger than a segment based on either the entity's primary or the entity's secondary reporting format determined in accordance with IFRS 8 *Operating segments.* (IAS 36.80).

Goodwill acquired in a business combination represents a payment made by an acquirer in anticipation of future economic benefits from assets that are not capable of being individually identified and separately recognised. Goodwill does not generate cash flows independently of other assets or groups of assets, and often contributes to the cash flows of multiple cash-generating units. Goodwill sometimes cannot be allocated on a non-arbitrary basis to individual cash-generating units, but only to groups of cash-generating units. As a result, the lowest level within the entity at which the goodwill is monitored for internal management purposes sometimes comprises a number of cash-generating units to which the goodwill relates, but to which it cannot be allocated. (IAS 36.81)

Although cash-generating units fall outside the scope of this module it is important that you take note of the following basic concepts:

- Goodwill shall be allocated to each of the acquirer’s cash-generating units or group of cash-generating units that are expected to benefit from the synergies of the business combination (IAS 36.80).
- Goodwill shall be tested for impairment **annually** and an impairment loss recognised accordingly. (IAS 36.10(b))

3.6 WHAT HAPPENS IF THE ASSET WAS IMPAIRED IN PRIOR YEARS, BUT IS NOW WORTH MUCH MORE?

This may lead to a reversal of an impairment loss

An entity shall assess at each reporting date whether or not there is any indication that an impairment loss recognised for an asset in prior years may no longer exist or may have decreased. If any such indication exists, the entity shall estimate the recoverable amount of that asset. (IAS36.110)

In assessing whether or not there is any indication that an impairment loss recognised for an asset in prior years may no longer exist or may have decreased, an entity shall consider, at a minimum, the following indications:

3.6.1 External sources of information

- The asset's market value has increased significantly during the period.
- Significant changes with a favourable effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which the asset is dedicated.
- Market interest rates or other market rates of return on investments have decreased during the period, and those decreases are likely to affect the discount rate used in calculating the asset's value in use and increase the asset's recoverable amount materially.

3.6.2 Internal sources of information

- Significant changes with a favourable effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, the asset is used or is expected to be used. These changes include capital expenditure that has been incurred during the period to improve or enhance an asset in excess of its originally assessed standard of performance or a commitment to discontinue or restructure the operation to which the asset belongs.
- Evidence is available from internal reporting that indicates that the economic performance of the asset is, or will be, better than expected. (IAS 36.111)

If there is an indication that an impairment loss recognised for an asset other than goodwill may no longer exist or may have decreased, this may indicate that the remaining useful life, the depreciation (amortisation) method or the residual value may need to be reviewed and adjusted in accordance with the Standard applicable to the asset, even if no impairment loss is reversed for the asset. (IAS 36.113)

3.7 REVERSAL OF AN IMPAIRMENT LOSS – INDIVIDUAL ASSETS

An impairment loss recognised for an asset in prior years shall be reversed if, and only if, there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. If this is the case, the carrying amount of the asset shall be increased to its recoverable amount. That increase is a reversal of an impairment loss. (IAS36.114)

A reversal of an impairment loss reflects an increase in the estimated service potential of an asset, either from use or from sale, since the date when an entity last recognised an impairment loss for the asset.

Please remember to distinguish a change in estimate from other reasons for the increase in the asset's value. Examples of changes in estimates are:

- a change in the basis of the recoverable amount (ie whether the recoverable amount is based on fair value less costs to sell or value in use);
- a change in the amount or timing of estimated future cash flows or in discount rate if the recoverable amount was based on value in use;
- a change in estimate of the components of fair value less costs to sell, if the recoverable amount was based on the fair value less costs to sell. (IAS 36.115)

An asset's value in use may become greater than the carrying amount simply because the present value of future cash inflows increases as they become closer. However, the service potential of the asset has not increased. The impairment loss should not be reversed just because of the passage of time. (IAS 36.116)

The increased carrying amount of an asset other than goodwill due to a reversal of an impairment loss shall not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior years. The amount in excess of what the original carrying amount would have been, is a revaluation. In accounting for such a revaluation, an entity applies the standard applicable to the asset. (IAS 36.117-.118)

A reversal of an impairment loss for an asset shall be recognised immediately in profit or loss, unless the asset is carried at a revalued amount. Any reversal of an impairment loss on a revalued asset shall be treated as a revaluation increase in accordance with the other standard (IAS 36.119)

A reversal of an impairment loss on a revalued asset is recognised in other comprehensive income and increases the revaluation surplus for that asset. However, to the extent that an impairment loss on the same revalued asset was previously recognised in profit or loss, a reversal of that impairment loss is also recognised in profit or loss. (IAS 36.120)

After a reversal of an impairment loss is recognised, the depreciation (amortisation) charge for the asset shall be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life. (IAS 36.121)

Journal entry for asset that is carried at cost less accumulated depreciation:

Date	Description	Dr R	Cr R
	Accumulated impairment loss (SFP)	XXXXX	
	Reversal of impairment loss (P/L)		XXXXX
	Reversal of impairment loss of asset. The reversal of impairment loss is **limited** to what the **carrying amount of the asset would have been** had there been no impairment previously.		

Journal entry for asset carried at revalued amount:

Date	Description	Dr R	Cr R
	Accumulated impairment loss (SFP)	XXXXX	
	Reversal of impairment loss (P/L)		XXXXX
	Revaluation surplus (OCI)		XXXXX
	Reversal of impairment loss of revalued asset. To the extent that an impairment loss was previously recognised in profit or loss the reversal of an impairment loss is also recognised in profit or loss. If the reversal is more than that, the remainder will be credited to the revaluation surplus in other comprehensive income.		

3.8 REVERSAL OF AN IMPAIRMENT LOSS FOR GOODWILL

An impairment loss recognised for goodwill shall not be reversed in a subsequent period. (IAS36.124)

IAS 38 *Intangible assets* prohibits the recognition of internally generated goodwill. Any increase in the recoverable amount of goodwill in the periods following the recognition of an impairment loss for that goodwill, is likely to be an increase in internally generated goodwill, rather than a reversal of the impairment loss recognised for the acquired goodwill.

3.9 WHAT ARE THE TAX IMPLICATIONS?

Impairment losses and the reversal thereof are not recognised as tax deductions in terms of the Income Tax Act. Consequently temporary differences and therefore deferred tax arises. Refer to IAS 12 regarding the disclosure requirements.

Model for tax calculation

	R
Profit before tax	XXXX
Exempt differences	XXXX
Temporary differences	XXX
Reversal of impairment loss (P/L)	(XXX)
Impairment loss (P/L)	XXX
Depreciation/Amortisation	XXX
Tax allowance	(XXX)
Taxable income	XXX

3.10 DISCLOSURE

3.10.1 Disclosure requirements

(a) An entity shall disclose the following for each class of assets:

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

A class of assets is a grouping of assets of similar nature and use in an entity's operations.

The information required above may be presented with the other information disclosed for the class of assets. For example, this information may be included in a reconciliation of the carrying amount of property, plant and equipment, at the beginning and end of the period, as required by IAS 16 *Property, plant and equipment*.

(b) An entity that reports segment information in accordance with IFRS 8 *Operating segments*, shall disclose the following for each reportable segment based on an entity's primary reporting format:

- the amount of impairment losses recognised in profit or loss and in other comprehensive income during the period.
- the amount of reversals of impairment losses recognised in profit or loss and in other comprehensive income during the period.

(Note: Segment reporting does not form part of this module.)

(c) If the impairment loss for an **individual asset** recognised or reversed during the period is **material** an entity shall disclose the following information in the note:

- the events and circumstances that led to the recognition or reversal of the impairment loss;
- the amount of the impairment loss recognised or reversed;
- for an individual asset:
  - the nature of the asset; and
  - if the entity report segment information in accordance with IFRS 8 *Operating segments,* it shall disclose the reportable segment to which the asset belongs, based on the entity's primary format. (IAS 36.130 (a)–(c));
- whether the recoverable amount of the asset is its fair value less costs to sell or its value in use; (IAS 36.130(e))

- if the recoverable amount of the asset is its fair value less costs to sell, the basis used to determine fair value less costs to sell (such as whether selling price was determined by reference to an active market or in some other way); (IAS 36.130(f))
- if the recoverable amount of the asset is its value in use, the discount rate(s) used in the current estimate and previous estimate (if any) of value in use. (IAS 36.130(g))

(d) If impairment losses recognised/reversed during the period are **material** in aggregate to the financial statements of the reporting entity **as a whole**, an entity shall disclose a brief description of the following:

- the main classes of assets affected by impairment losses (reversals of impairment losses) for which no information is disclosed under the above-mentioned paragraphs.
- the main events and circumstances that led to the recognition/reversal of these impairment losses for which no information is disclosed under the above-mentioned paragraphs. (IAS 36.131)

3.10.2 Model for disclosure

If an asset is impaired, the financial statements should disclose the following:

X LTD

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 MARCH 20.X

	R
Revenue	
Cost of sales	
Gross profit	XXX
Other income (xx + impairment loss reversal)[1]	XXX
Other expenses (xx + impairment loss)[2]	(XXX)
Investment income received	
Finance charges	
Profit before tax	
Income tax expense	
Profit for the period	XXX
Other comprehensive income:	
Impairment loss[3]	(XXX)
Reversal of impairment loss[4]	XXX
Other comprehensive income, net of tax	XXX
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	XXX

1 Refer IAS 36.126(b)
2 Refer IAS 36.126(a)
3 Refer IAS 36.126(c) – impairment loss on revalued assets
4 Refer IAS 36.126(d) – reversal of impairment loss on revalued assets

X LTD

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 MARCH 20.X

	Share capital R	Non-distributable reserve R	Accumulated profits R	Total R
Balance at beginning of year	XXX	XXX	XXX	XXX
Changes in equity				
Profit for the year/Total comprehensive income for the year			XXX	
Balance at end of year	XXX	XXX	XXX	XXX

X LTD

NOTES FOR THE YEAR ENDED 31 MARCH 20.X

2. Property, plant and equipment

Carrying amount beginning of year	**R**
Gross carrying amount	
Accumulated depreciation	
Depreciation	
Reversal of impairment loss through profit or loss (included in other income)[1]	XXX
Impairment loss[1]	(XXX)
Included in other expenses	(XXX)
Recognised in other comprehensive income during the year	(XXX)
Carrying amount at end of year	
Gross carrying amount	
Accumulated depreciation and impairment losses	

3. Profit before tax

Profit before tax is arrived at after taking into account the following:

	R
Reversal of impairment loss – Machine A[2]	XXX
Impairment loss recognised – Machine B[3]	(XXX)

Machine A is a manufacturing machine that is used in the manufacturing segment.[4] The recoverable amount is its fair value less costs to sell and is based on an arms' length transaction.[5] The reversal of the impairment loss of the machine of Rxxx was caused by a significant increase in the market value of the asset during the period.[6]

Machine B is a manufacturing machine that is used in the manufacturing segment.[4] The recoverable amount is its fair value less cost to sell and is based on an arm's length transaction.[5] The impairment of the machine of Rxxx was caused by the occurrence of technological advances that affected this specific machine.[6]

[1] Refer IAS 36.126(a) and (b) IAS 36.128
[2] Refer IAS 36.126(b)
[3] Refer IAS 36.126(a)
[4] Refer IAS 36.130(c) (for each material impairment loss recognised or reversed during the period)
[5] Refer IAS 36.130(e) and (f) (for each material impairment loss recognised or reversed during the period)
[6] Refer IAS 36.130(a) (for each material impairment loss recognised or reversed during the period)

3.11 COMPREHENSIVE EXAMPLES

EXAMPLE 1

Blanch Ltd is a company which produces and sells wine. The company has a 31 March year-end.

On 1 April 2009, they purchased *"Blanch Veritas"*, a brand name, for R4 250 000. The asset had a definite useful life of 8 years and a residual value of Rnil. The brand name was ready to be used, as intended by management, on acquisition date.

Due to employee strike action during the current financial year, the Gauteng bottling plant had to use temporary workers to enable the plant to meet its current volume demands.

The temporary workers were not sufficiently trained in the operation of the machinery. This resulted in 20 000 bottles, filled during the months of July and August 2010, becoming spoilt as they had not been properly sealed. Management only became aware of this problem after the brand received negative publicity and subsequently decided to recall all those bottles of wine. On 31 March 20.11, the impact of the negative publicity on the brand name was assessed and the fair value less cost to sell on that date was estimated to be R2 200 000. Due to the negative publicity, possible impairment had to be assessed.

Management expects the brand to generate the following cash flows over its remaining useful life:

Year	**Net cash inflow**
	R
1 April 20.11 – 31 March 20.12	1 200 000
1 April 20.12 – 31 March 20.13	1 000 000
1 April 20.13 – 31 March 20.14	800 000
1 April 20.14 – 31 March 20.15	500 000
1 April 20.15 – 31 March 20.16	500 000

A pre-tax discount rate of 15% is considered to be appropriate.



REQUIRED

Calculate the impairment loss on 31 March 20.11.

SOLUTION 1

Calculate the asset's carrying amount

Cost price	R 4 250 000
Useful life	8 years
Accumulated amortisation (R 4 250 000 x 2/8)	R 1 062 500
Carrying amount	R3 187 500

Calculate the asset's recoverable amount

The recoverable amount is the higher of an asset's fair value less costs to sell and its value in use.

Fair value less costs to sell

Amount given	R 2 200 000

Value in use

Using HP10bii financial calculator:		**Using Sharp financial calculator:**	
CF0	0	N 0	0
CF1	1 200 000	N 1	1 200 000
CF2	1 000 000	N 2	1 000 000
CF3	800 000	N 3	800 000
CF4	500 000	N 4	500 000
CF5	500 000	N 5	500 000
‘i =	15%	‘i =	15%
Comp NPV =	R2 860 100	Comp NPV =	R2 860 100

OR:

Alternative:

FV = 1 200 000	FV = 1 000 000	FV = 800 000	FV = 500 000	FV = 500 000
N = 1	N = 2	N = 3	N = 4	N = 5
‘i = 15%	‘i = 15%	‘i = 15%	‘i = 15%	‘i = 15%
PV = ?	PV = ?	PV = ?	PV = ?	PV = ?
R1 043 478	R756 144	R526 013	R285 877	R248 588

Total PV	R2 860 100

Therefore, recoverable amount is **R2 860 100** as it is the higher of value in use or fair value less cost to sell.

Impairment loss

	R
Carrying amount	3 187 500
Recoverable amount	2 860 100
Impairment loss	327 400

EXAMPLE 2

Toys For You Ltd is a company listed on the JSE Security Exchange. The company has a 31 March year-end. The primary segments of the business operations are the manufacturing and selling of toys and infant clothing.

On 1 April 20.10 Toys For You Ltd obtained a licence to sell Bogus Toys for 25 years. The total cost of the licence amounted to R2 500 000. The licence is amortised on the straight-line basis over a period of 25 years, as it is expected that economic benefits relating to the licence will flow to the entity over this period.

On 31 March 20.12 it is estimated that the licence will generate cash inflows amounting to R750 000 per annum. The annual cash outflow required to generate the inflow amounts to R325 000. Assume that all cash flows occur annually at 31 March. A pre-tax discount rate of 20% is regarded as appropriate.

However, the expected future cash flow is now less than the original estimate because a second licence to sell Bogus Toys was awarded to a major competitor on 30 September 20.11. The original estimated useful life, however, remains unchanged. The licence can be sold for R2 000 000 on 31 March 20.12. For the year ended 31 March 20.11 the recoverable amount exceeded the carrying amount of the licence.

Deferred tax is provided for on all temporary differences by using the statement of financial position approach. There are no other temporary differences other than those identified in the question.

The company regards all impairment losses or the reversal thereof above R100 000 as material.

The tax rate has remained unchanged at 28%. 80% of all capital gains are taxable.

According to section 11(gC) of the Income Tax Act, the South African Revenue Service allows a tax allowance on the licence on the straight-line method over 20 years. This allowance is not apportioned for a part of the year. Toys For You Ltd had a profit before tax of R269 080, before the impairment was taken into account, for the year ended 31 March 20.12.



REQUIRED

Prepare the notes of Toys for You Ltd for the year ended 31 March 20.12. Your answer must comply with *International Financial Reporting Standards*.

Comparative figures are not required.

Round off all calculations to the nearest rand.

SOLUTION 2

TOYS FOR YOU LTD

NOTES FOR THE YEAR ENDED 31 MARCH 20.12

1. Accounting policy

1.1 Intangible assets

Licences have a finite useful life, are disclosed at cost less accumulated amortisation and impairment losses and are amortised on the straight-line basis over the expected useful life of 25 years.

1.2 Deferred tax

Deferred tax is recognised for all temporary differences by using the statement of financial position approach and based tax rates that have been 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 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).

The carrying amount of deferred tax assets is reviewed at each reporting date and is reduced to the extent that it is no longer probable that sufficient taxable profit will be available to utilise the benefit.

Deferred tax assets and liabilities are offset when there is a legally enforceable right to offset current tax assets and liabilities and when they relate to income taxes levied by the same taxation authority on either the same taxable entity or different taxable entities (when the taxable entities intends to settle current tax assets and liabilities on a net basis).

1.3 Impairment of non-financial assets

Non-financial assets are assessed at each reporting date to determine whether there is an indication that the carrying amount may be impaired. If such an indication exists, the recoverable amount of the asset is determined. The recoverable amount of goodwill, indefinite-life intangible assets and intangible assets which are not available for use are determined annually irrespective of whether an indication of impairment exists or not.

The recoverable amount of an asset is the higher of its fair value less costs to sell and its value in use. In determining the value in use the estimated future cash flows of the asset is discounted to their present value based on pre-tax discount rates. The pre-tax discount rate reflects the current market assessments of the time value of money and the risks that are specific to the asset.

An impairment loss is recognised in profit or loss when the carrying amount of an asset exceeds its recoverable amount. If the loss relates to the reversal of a previous revaluation surplus, it is recognised in other comprehensive income.

Impairment losses are reversed if there has been a change in the estimates used to determine the recoverable amount of the asset. Impairment losses are reversed only to the extent that the carrying amount of the asset does not exceed the carrying amount that would have been determined if no impairment loss had been recognised in the past. Reversals of impairment losses are recognised directly in profit or loss.

2. Intangible assets

	Licences (purchased) **R**
Carrying amount at beginning of year	2 400 000
Cost	2 500 000
Accumulated amortisation	(100 000)
Amortisation (2 500 000/25)	(100 000)
Impairment loss through profit or loss (included in other expenses)[1] (calc.3)	(207 077)
Carrying amount at end of year (calc.1)	2 092 923
Cost	2 500 000
Accumulated amortisation and impairment loss	(407 077)

3. Impairment of assets[2]

The intangible asset, a licence for the selling of Bogus Toys, was impaired during the year due to a licence also being awarded to a major competitor of Toys For You Ltd. The impairment amounted to R207 077 and is part of the toys segment of the primary business operations of the company.

The recoverable amount of the asset is based on the value in use and a pre-tax discount rate of 20%. There was no impairment of the asset in the previous year.

1 The information may also be disclosed as part of the profit before tax note. (IAS 36.128)

2 This note is only required if the impairment loss recognised or reversed was material.

4. Profit before tax

Included in profit before tax are the following items:

Expenses	R
Amortisation of intangible asset (licence) – included in line item "other expenses" (calc. 1)	100 000
Impairment of licence (calc. 3) – included in “other expenses”	207 077

5. Income tax expense

	R
Major components of tax expense	
Current tax expense (calc. 4)	68 342
Deferred tax expense (calc. 5)	(50 982)
Tax expense	17 360

6. Deferred tax

	R
Analysis of temporary differences:	
Accelerated tax allowance	43 982
Deferred tax asset (calc. 5)	43 982

OR

	R
Intangible assets [(2 092923 – 2 250 000) x 28%]	43 982
Deferred tax asset	43 982

CALCULATIONS

1. Carrying amount and tax base

	Historical R	Adjusted for impairment R	Tax base R
Cost price 1 April 20.10	2 500 000	2 500 000	2 500 000
Amortisation/tax allowance (2 500 000/25);(2 500 000/20)	(100 000)	(100 000)	(125 000)
Carrying amount 31 March 20.11	2 400 000	2 400 000	2 375 000
Amortisation/tax allowance (2 500 000/25);(2 500 000/20)	(100 000)	(100 000)	(125 000)
Impairment of asset (calc. 3)	–	(207 077)	–
Carrying amount 31 March 20.12	2 300 000	2 092 923	2 250 000

2. Recoverable amount

	R
Fair value less costs to sell (given)	2 000 000

Value in use
i = 20%
n = 23 years remaining
PMT = 425 000 (R750 000 – R325 000)
PV = 2 092 923

Recoverable amount is therefore	2 092 923

3. Impairment loss

	R
Carrying amount on 31 March 20.12 [2 500 000 – (2 500 000/25 x 2)] (calc. 1)	2 300 000
Recoverable amount (calc. 2)	(2 092 923)
Impairment loss	207 077

4. Current tax expense

	R
Profit before tax (given)	269 080
Impairment loss (not taken into account)	(207 077)
Profit before tax	62 003
Temporary differences	182 077
Amortisation	100 000
Impairment loss	207 077
Tax allowance	(125 000)
Taxable profit	244 080
Current tax expense (244 080 x 28%)	68 342

5. Deferred tax expense

	Carrying amount R	Tax base R	Temporary difference R	Deferred Tax asset/ (liability) R
Beginning of the year 1 April 20.11	2 400 000	2 375 000	(25 000)	(7 000)
End of the year 31 March 20.12	2 092 923	2 250 000	157 077	43 982

Movement for the year:

Deferred tax liability at beginning of the year	(7 000)
Deferred tax asset at the end of the year	43 982
Movement for the year (7 000 + 43 982) (or to P/L)	50 982

EXAMPLE 3

The same information as for example 1 applies.

The following details relate to the licence:

Date	Carrying amount (based on carrying amount on 31/03/20.12) R	Value in use R	Selling price R
31/03/20.13 (calc. 1)	2 001 926	2 001 926	1 900 000
31/03/20.14 (calc. 1)	1 910 929	2 200 000	1 850 000

During 20.13 the competitor to whom the licence was also awarded ran into financial difficulties and had to be liquidated. This had a positive effect on the cash inflows of Toys For You Ltd which resulted in the value in use to be R2 200 000 on 31 March 20.14.

Profit before tax before any impairment losses or the reversal thereof was R40 929 for the year ended 31 March 20.14.

It is not the policy of the company to revalue its assets.



REQUIRED

Prepare the notes to the annual financial statements of Toys For You Ltd for the year ended 31 March 20.14. Your answer must comply with the requirements of *International Financial Reporting Standards*.

- Comparative figures are not required.
- Round off all calculations to the nearest rand.
- Accounting policy notes are not required

SOLUTION 3

TOYS FOR YOU LTD

NOTES FOR THE YEAR ENDED 31 MARCH 20.14

1. Intangible assets

	Licences (purchased)
	R
Carrying amount at beginning of year	2 001 926
Cost	2 500 000
Accumulated amortisation and impairment loss (calc. 3)	(498 074)
Amortisation (calc. 2)	(90 997)
Reversal of previous impairment loss through profit or loss (included in other income) (calc. 4)	189 071
Carrying amount at end of year	2 100 000
Cost	2 500 000
Accumulated amortisation	(400 000)

2. Reversal of previous impairment loss of intangibles

The previous impairment of the licence has been reversed due to the liquidation of the major competitor to whom the licence to sell Bogus Toys had also been awarded. The reversal of the impairment loss amounted to R189 071. The reversal was limited to the carrying amount that would have been determined had no impairment loss been recognised for the asset in prior years. It forms part of the toys segment of the primary business operations.

3. Profit before tax

Included in profit before tax are the following items:

Income	R
Reversal of previous impairment loss of licence (calc. 4) (included in “other income”)	189 071
Expenses	
Amortisation of intangible asset (licence) – included in line item "other expenses" (calc. 2)	90 997

4. Income tax expense

	R
Major components of tax expense	
Current tax expense (calc. 5)	1 939
Deferred tax expense (calc. 6)	62 461
Tax expense	64 400

5. Deferred tax

Analysis of temporary differences:	R
Intangible asset (accelerated tax allowance)	28 000
Deferred tax liability (calc. 6)	28 000

OR

	R
Intangible asset [(2 100 000 – 2 000 000) x 28%]	28 000
Deferred tax liability	28 000

CALCULATIONS

1. Carrying amount and tax base

	Historical R	Adjusted for impairment R	Tax base R
Carrying amount 31 March 20.12	2 300 000	2 092 023	2 250 000
Amortisation/Tax allowance (calc. 2)	(100 000)	(90 997)	(125 000)
Carrying amount 31 March 20.13	2 200 000	2 001 926	2 125 000
Amortisation/Tax allowance	(100 000)	(90 997)	(125 000)
Carrying amount 31 March 20.14 before impairment	2 100 000	1 910 929	2 000 000
Impairment reversed (calc. 4)	–	189 071	–
Carrying amount 31 March 20.14	2 100 000	2 100 000	2 000 000

2. Amortisation for the year

	R
Carrying amount at 31 March 20.12 (given)	2 092 923
Amortisation is therefore [2 092 923/23 (given)]	90 997

3. Accumulated amortisation on 31 March 20.13

	R
Accumulated amortisation on 31 March 20.12 (from example 1)	407 077
Amortisation for 20.13 (calc. 2)	90 997
	498 074

4. The amount of impairment loss to be reversed

	R
20.13	
Carrying amount	2 001 926
Recoverable amount	2 001 926

Therefore no impairment loss or reversal thereof.

20.14	**R**
Carrying amount	1 910 929
Recoverable amount	2 200 000
Reversal of previously accounted for impairment loss	289 071
Limited to the historical carrying amount	2 100 000
Therefore the impairment loss to be reversed (2 100 000 – 1 910 929)	189 071

5. Current tax expense

	R
Profit before tax (given)	40 929
Reversal of impairment loss	189 071
Profit before tax	230 000
Temporary differences	(223 074)
Amortisation	90 997
Tax allowance	(125 000)
Reversal of impairment loss	(189 071)
Taxable profit	6 926
Current tax expense (6 926 x 28%)	1 939

6. Calculation of deferred tax

	Carrying amount R	**Tax base R**	**Temporary diffe-rence R**	**Deferred Tax asset/ (liability) R**
Beginning of the year 1 April 20.13 (calc. 1)	2 001 926	2 125 000	123 074	34 461
End of the year 31 March 20.14 (calc. 1)	2 100 000	2 000 000	100 000	(28 000)

Movement for the year:

Deferred tax asset at beginning of the year	34 461
Deferred tax liability at the end of the year	28 000
Movement for the year (34 461 + 28 000) (debit to the SCI)	62 461



ASSESSMENT CRITERIA

After having studied this learning unit you should be able to:

- apply the definitions contained in the statement on impairment of assets;
- state the procedures that an entity applies to ensure that its assets are not overstated, that is, the comparison of the asset's carrying amount to the recoverable amount of the asset;
- calculate and account for an identified impairment loss as well as a reversal of an impairment loss;
- properly disclose impairment of assets in the financial statements of an entity in accordance with *International Financial Reporting Standards*.

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LEARNING UNIT 4

INTANGIBLE ASSETS [IAS 38]



Distinctive Financial Reporting

LEARNING UNIT 4 – INTANGIBLE ASSETS

LEARNING OUTCOMES

Once you have studied and completed this learning unit, you should be able to:

- correctly account for intangible assets;
- identify intangible assets on the basis of certain required criteria;
- measure the carrying amount of intangible assets; and
- disclose intangible assets in terms of *International Financial Reporting Standards*.

OVERVIEW

This learning unit will be discussed under the following sections:

4.1 Objective of the statement
4.2 Scope
4.3 Terminology

- 4.3.1 Definitions
- 4.3.2 Intangible assets

4.4 Recognition and initial measurement of an intangible asset

- 4.4.1 Separate acquisition
- 4.4.2 Acquisition as part of a business combination
- 4.4.3 Acquisition by way of a government grant
- 4.4.4 Exchange of assets
- 4.4.5 Internally generated goodwill
- 4.4.6 Internally generated intangible assets
- 4.4.7 Summary of intangible assets

4.5 Cost of an internally generated intangible asset
4.6 Recognition of an expense
4.7 Measurement after recognition

- 4.7.1 Cost model
- 4.7.2 Revaluation model

4.8 Useful life
4.9 Intangible assets with finite useful lives

- 4.9.1 Amortisation period and amortisation method
- 4.9.2 Residual value
- 4.9.3 Review of amortisation period and amortisation method

4.10 Intangible assets with indefinite useful lives

- 4.10.1 Review of useful life assessment

4.11 Recoverability of the carrying amount – impairment losses
4.12 Retirements and disposals
4.13 Disclosure

- 4.13.1 General
- 4.13.2 Intangible assets measured after recognition using the revaluation model
- 4.13.3 Research and development expenditure

4.14 Tax implications

4.14.1 Patents, designs, copyrights and knowledge connected with the use of such assets (section 11(gC))
4.14.2 Deductions in respect of research and development (section 11(B))
4.14.3 Deductions in respect of scientific or technological research and development (section 11(D))
4.14.4 Deduction of expenditure of obtaining, restoration, extension, registration, or renewal of registration of intellectual property (section 11(gB))
4.14.5 Model for tax calculation

4.15 Comprehensive example

STUDY

PRESCRIBED:
Descriptive Accounting
Chapter 24

RECOMMENDED:
A Guide through IFRS
IAS 38

4.1 OBJECTIVE OF THE STATEMENT

The objective of this statement is to:

- prescribe the accounting treatment for intangible assets that is not dealt with specifically in another standard;
- specify that an entity can only recognise an intangible asset if certain criteria are met;
- specify how to measure the carrying amount of intangible assets; and
- specify the disclosure requirements of intangible assets. (IAS 38.01)

4.2 SCOPE

The standard shall be applied by all entities in accounting for intangible assets. The standard is not applicable to:

- intangible assets that are within the scope of another standard of *International Financial Reporting Standards*;
- financial assets as defined in IAS 32 *Financial instruments: presentation*;

- the recognition and measurement of exploration and evaluation assets (IFRS 6 *Exploration for and evaluation of mineral resources*); and
- expenditure on the development and extraction of minerals, oil, natural gas and similar non-regenerative resources. (IAS 38.02)

If another standard prescribes the accounting for a specific type of intangible asset, an entity applies that standard instead of this standard. This standard does not apply to:

- intangible assets held by an entity for sale in the ordinary course of business;
- deferred tax assets;
- leases;
- assets arising from employee benefits;
- financial assets;
- goodwill acquired in a business combination;
- deferred acquisition costs and intangible assets, arising from an insurer's contractual rights under insurance contracts;
- non-current intangible assets classified as held for sale (or included in a disposal group classified as held for sale.

In determining whether an asset that incorporates both intangible and tangible elements should be treated under the standard on property, plant and equipment or as an intangible asset under this standard, judgement is required to assess which element is more significant. In general, computer software which is not an integrated part of the related hardware, is treated as an intangible asset. A computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as property, plant and equipment. (IAS 38.04)

This standard applies to expenditure on advertising, training, start-up, research and development activities. Research and development activities are directed to the development of knowledge. (IAS38.05)

In the case of a finance lease, the underlying asset may be either tangible or intangible. If it is an intangible asset, it is treated in terms of IAS 38. Rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights are excluded from the scope of the standard on leases IAS 17 and fall within the scope of this standard. (IAS38.06)

4.3 TERMINOLOGY

4.3.1 Definitions

The following terms are used in IAS 38.08 with the meanings specified:

- An **intangible asset**
  - is an identifiable non-monetary asset
  - without physical substance.

- An **asset** is a resource
  - controlled by an entity as a result of past events, and
  - from which future economic benefits are expected to flow to the entity.
- **Monetary assets** are money held and assets to be received in fixed or determinable amounts of money.
- **Research** is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.
- **Development** is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.
- **Amortisation** is the systematic allocation of the depreciable amount of an intangible asset over its useful life.
- **Depreciable amount** is the cost of an asset, or other amount substituted for cost, less its residual value.
- **Useful life** is:
  - the period over which an asset is expected to be available for use by an entity, or
  - the number of production or similar units expected to be obtained from the asset by the entity.
- **Cost** is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction, or, when applicable the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs.
- **Residual value** of an intangible asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset was already at the age and the condition expected at the end of its useful life.
- **Fair value** of an asset 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.
- An **active market** is a market where all the following conditions exist:
  - the items traded within the market are homogenous;
  - willing buyers and sellers can normally be found at any time; and
  - prices are available to the public.
- An **impairment loss** is the amount by which the carrying amount of an asset exceeds its recoverable amount.
- **Carrying amount** is the amount at which an asset is recognised in the statement of financial position after deducting any accumulated amortisation and accumulated impairment losses thereon.

4.3.2 Intangible assets

The components of the definition of an intangible asset are:

- identifiable,
- non-monetary asset,
- without physical substance,
- controlled as a result of past events, and
- expected inflow of future economic benefits. (IAS 38.08)

If an item covered by this standard does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense in the statement of comprehensive income when it is incurred. However, if the item is acquired in a business combination, it forms part of the goodwill recognised at the date of acquisition. (IAS 38.10)

(a) Identifiability

An intangible asset shall be identifiable in order to distinguish it clearly from goodwill. (IAS 38.11)

Goodwill acquired in a business combination represents a payment made by the acquirer in anticipation of future economic benefits from assets that are not capable of being individually identified and separately recognised.

The future economic benefits may result from synergy between the identifiable assets acquired or from assets that, individually, do not qualify for recognition in the financial statements, but for which the acquirer is prepared to make a payment in a business combination. (IAS 38.11)

An asset meets the criterion in the definition of an intangible asset when it:

- is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability, regardless of whether the entity intends to do so; or
- arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations. (IAS 38.12)

(b) Control

An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from it and to restrict the access of others to those benefits. Control exists because of enforceable legal rights. However, legal enforceability is not a necessary condition for control since the future economic benefits may be controlled in some other way. (IAS 38.13)

(c) Future economic benefits

The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the entity. (IAS 38.17)

4.4 RECOGNITION AND INITIAL MEASUREMENT OF AN INTANGIBLE ASSET

The recognition of an item as an intangible asset requires an entity to demonstrate that the item meets:

- the definition of an intangible asset as per paragraph 4.3.2; and
- the recognition criteria.

This requirement applies to costs incurred initially to acquire or internally generate an intangible asset and those incurred subsequently to add, replace part of, or service it.

An intangible asset shall be recognised if, and only if:

- it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and
- the cost of the asset can be measured reliably. (IAS 38.21)

An entity shall assess the probability of expected future economic benefits using reasonable and supportable assumptions that represent management's best estimate of the economic conditions that will exist over the useful life of the asset. (IAS 38.22)

An intangible asset shall be measured initially at cost. (IAS 38.24)

4.4.1 Separate acquisition

If an intangible asset is acquired separately, the cost of the asset can usually be measured reliably, particularly so when the purchase consideration is in the form of cash or other monetary assets. (IAS 38.26)

The cost of an intangible asset comprises:

- its purchase price, including import duties and other non-refundable purchase taxes, after deducting trade discounts and rebates; and
- any directly attributable costs of preparing the asset for its intended use. (IAS 38.27)

Examples of directly attributable costs are:

- costs of employee benefits (defined in IAS 19) arising directly from bringing the asset to its working condition;
- professional fees arising directly from bringing the asset to its working condition; and
- costs of testing whether the asset is functioning properly. (IAS 38.28)

Examples of expenditures that are not part of the cost of an intangible asset are:

- costs of introducing a new product or service (including advertising and promotional costs);
- costs of conducting business in a new location or with a new class of customer (including staff training costs); and
- administration and other general overhead costs. (IAS 38.29)

Some operations occur in connection with the development of an intangible asset, but are not necessary to bring the asset to the condition necessary for it to be capable of operating in the manner intended by management. Because incidental operations are not necessary to bring an asset to the condition necessary for it to be capable in operating in the manner intended by management, the income and related expenses of incidental operations are recognised in profit or loss. (IAS 38.31)

If payment for an intangible asset is deferred beyond normal credit terms, its cost is the cash price equivalent. (IAS 38.32)

4.4.2 Acquisition as part of a business combination

The cost of an intangible asset acquired in a business combination in accordance with IFRS 3, is its fair value at the date of acquisition. (IAS 38.33)

The acquirer in a business combination recognises as an asset separately from goodwill, an in-process research and development project of the acquiree if the project meets the definition of an intangible asset and its fair value can be measured reliably. (IAS 38.34)

An acquiree's in-process research and development project meets the definition of an intangible asset when it:

- meets the definition of an asset; and
- is identifiable, that is, is separable or arises from contractual or other legal rights. (IAS 38.34)

If an intangible asset acquired in a business combination is separable or arises from contractual or other legal rights, sufficient information exists to measure reliably the fair value of the asset (IAS38.35)

4.4.3 Acquisition by way of a government grant

Under the standard on accounting for government grants and disclosure of government assistance (not part of this module), an entity may choose to recognise both the intangible asset and the grant initially at fair value. The alternative treatment for the entity is to recognise the asset initially at a nominal amount plus any expenditure that is directly attributable to preparing the asset for its intended use. (IAS 38.44)

4.4.4 Exchange of assets

One or more intangible assets may be acquired in exchange for a non-monetary asset or assets.

The cost of an intangible asset in this case is measured at **fair value**, unless the exchange transaction lacks commercial substance or the fair value of neither the asset received nor the asset given up is reliably measurable. If the **acquired asset is not measured at fair value**, the **cost** is measured at the **carrying amount of the asset given up**. (IAS 38.45)

When the fair values of both the acquired asset and the asset given up can be measured reliably, then the fair value of the asset given up is used to measure the cost of the asset received unless the fair value of the asset received is more evident, in which case it can be used.

An exchange transaction has commercial substance if:

(a) the risk, timing and amount of the cash flows of the asset received differs from the risk, timing and amount of the cash flows of the asset transferred; or
(b) the entity-specific value (calculated by using post tax cash flows) of the portion of the entity's operations affected by the transaction, changes as a result of the exchange; and
(c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged. (IAS 38.46)

EXAMPLE 1

A company acquires the right to a certain patent.

	R
Fees of professional consultant (including VAT)	17 100
Legal fees (including VAT)	22 800
Apportionment of management fees (capital in nature) (directly attributable to acquisition)	35 000

The cost price will be settled by the issue of 150 000 shares at R2,00 each. The shares are trading at R2,50 on settlement date



REQUIRED

Determine the total cost price of the patent.

SOLUTION 1

	R
Fair value of shares on settlement date (150 000 x 2,50)	375 000
Professional fees (17 100 x 100/114)	15 000
Legal fees (22 800 x 100/114)	20 000
Management fees	35 000
	445 000

EXAMPLE 2

A company exchanges computer program A with a carrying amount of R850 000, for computer program B with a fair value of R950 000.

Computer program B will be accounted for at R950 000 in the company's records and R100 000 will be recognised as a profit.

If the fair value for computer program B was R800 000, it indicates an impairment loss of computer program A of R50 000 that will first be recognised before computer program B is accounted for at R800 000.

4.4.5 Internally generated goodwill

Internally generated goodwill shall not be recognised as an asset. (IAS 38.48)

Internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the entity that can be measured reliably at cost. (IAS 38.49)

4.4.6 Internally generated intangible assets

It is sometimes difficult to assess whether or not an internally generated intangible asset qualifies for recognition. It is often difficult to determine:

- if there is an identifiable asset that will generate probable future economic benefits, and
- the cost of the asset reliably. (IAS 38.51)

To assess whether an internally generated intangible asset meets the recognition criteria, the generation of an asset is classified in:

- a research phase, and
- a development phase. (IAS 38.52)

If an entity cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the entity treats the expenditure as if it were incurred in the research phase only. (IAS 38.53)

(a) The research phase

No intangible asset arising from **research** shall be recognised. Expenditure on research shall be recognised as an expense when it is incurred. (IAS 38.54)

The reason for this is that, in the research phase of a project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. (IAS 38.55)

Examples of research activities are:

- activities aimed at obtaining new knowledge;
- the search for, evaluation and final selection of, applications of research findings or other knowledge;
- the search for alternatives for materials, devices, products, processes, systems or services; and
- the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services. (IAS 38.56)

(b) The development phase

An intangible asset arising from **development** shall be recognised if, and only if, an entity can demonstrate **all** of the following:

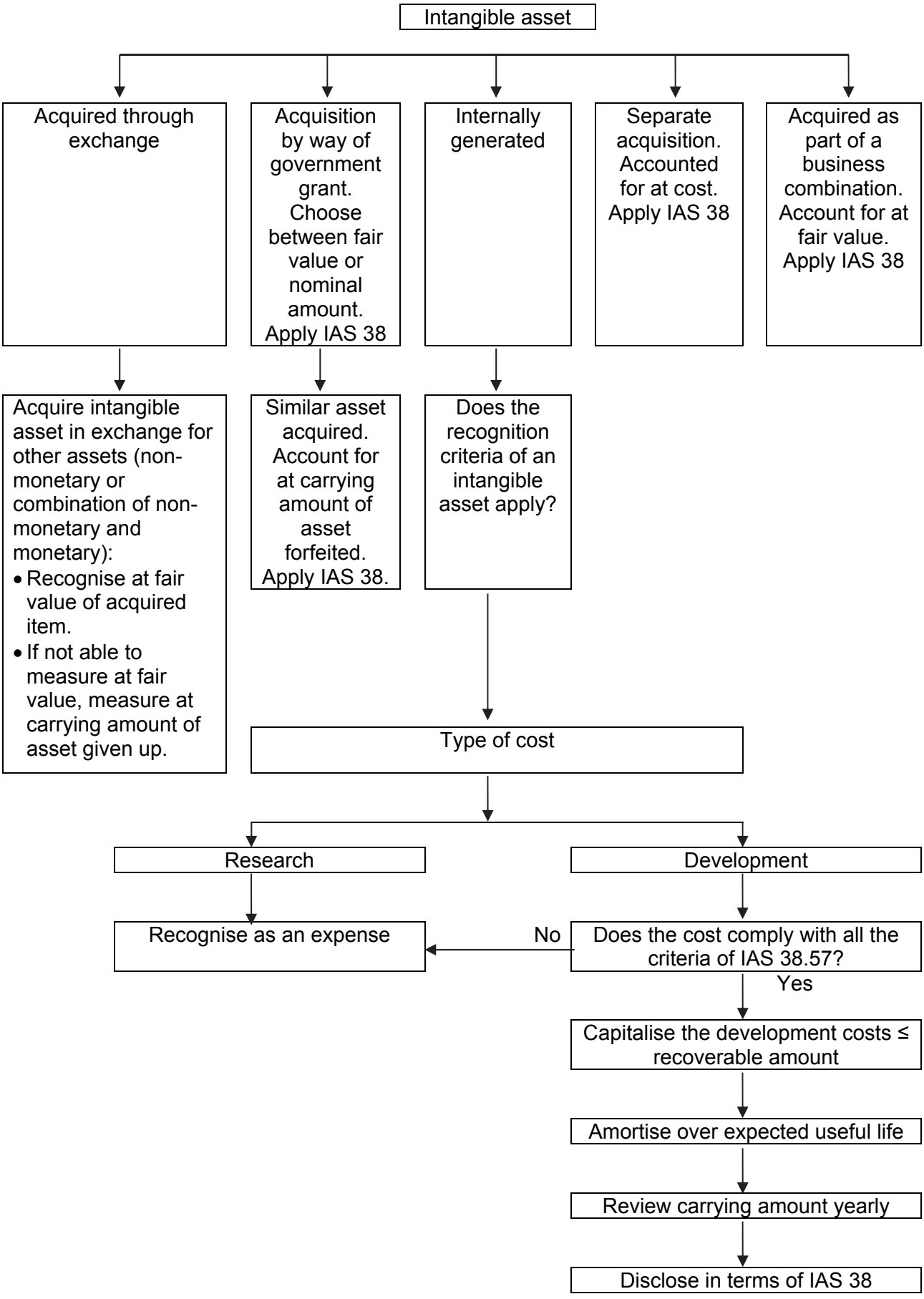
- The technical feasibility of completing the intangible asset so that it will be available for use or sale.
- Its intention to complete the intangible asset and use or sell it.
- Its ability to use or sell the intangible asset.
- How the intangible asset will generate probable future economic benefits. Among other things, the entity shall demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
- The availability of adequate technical, financial and other resources to complete the development, and to use or sell the intangible asset.
- Its ability to measure the expenditure attributable to the intangible asset during its development reliably. (IAS 38.57)

Examples of development activities are:

- the design, construction and testing of pre-production or pre-use prototypes and models,
- the design of tools, jigs, moulds and dies involving new technology,
- the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production, and
- the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services. (IAS 38.59)

Internally generated brands, newspaper mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets, because it cannot be distinguished from the cost of developing the business as a whole. (IAS 38.63–64)

4.4.7 Summary of intangible assets



4.5 COST OF AN INTERNALLY GENERATED INTANGIBLE ASSET

The cost of an internally generated intangible asset is the sum of expenditure incurred from the date when the intangible asset first meets the recognition criteria. The reinstatement of expenditure recognised as an expense in previous annual financial statements or interim financial reports is prohibited. (IAS 38.65)

The cost of an internally generated intangible asset comprises all directly attributable costs necessary to create, produce and prepare the asset to be capable of operating in the manner intended by management.

The examples of directly attributable costs are:

- costs of materials and services used in generating the intangible asset;
- costs of employee benefits (salaries and wages) arising from the generation of the intangible asset;
- fees to register a legal right; and
- amortisation of patents and licences that are used to generate the intangible asset. (IAS 38.66)

Specifically excluded from the cost is:

- selling, administration and other general overhead expenditure unless this expenditure can be directly attributed to preparing the asset for use;
- clearly identified inefficiencies and initial operating losses incurred before an asset achieves planned performance;
- expenditure on training staff to operate the asset. (IAS 38.67)

EXAMPLE 3

An entity, Lancelot Ltd, developed a new computer software package for internal use. The following expenditure was incurred relating to this package:

	R
1 January 20.10 to 30 November 20.10	90 000
1 December 20.10 to 31 December 20.10	10 000
1 January 20.11 to 31 December 20.11	200 000

You established the following:

1. On 1 December 20.10 proof was provided that the software package met the criteria for recognition as an intangible asset.
2. The recoverable amount of the package, including future cash outflows to complete the package before it is available for use, is estimated to be R50 000 on 31 December 20.10 and R190 000 on 31 December 20.11.



REQUIRED

Explain the accounting treatment of the cost of the software package in the records of Lancelot Ltd at 31 December 20.10 and 20.11 applying the requirements of IAS 38.

Ignore the amortisation of the software package.

SOLUTION 3

On 31 December 20.10:

The computer software package is recognised as an intangible asset at a cost of R10 000 in the records of the entity on 31 December 20.10. (That is the expenditure incurred since the date when the recognition criteria for an intangible asset were met.)

Expenditure of R90 000 incurred before 1 December 20.10 is recognised as research expenses in the statement of comprehensive income and will never form part of the cost of the software package recognised in the statement of financial position.

On 31 December 20.11:

The computer software package is recognised as an intangible asset at a cost of R190 000 (R200 000 + R10 000 (20.10) – R20 000 (impairment loss)). This impairment loss can be reversed in a subsequent period if the requirements for the reversal of an impairment loss are met. (See IAS36)

4.6 RECOGNITION OF AN EXPENSE

Expenditure on an intangible item shall be recognised as an expense when it is incurred, unless:

- it forms part of the cost of an intangible asset that meets the recognition criteria; or
- the item is acquired in a business combination and cannot be recognised as an intangible asset, and thus forms part of goodwill. (IAS 38.68)

The following items are recognised as expenses:

- research costs
- expenditure on start-up activities unless the expenditure is included in the cost of an item of property, plant and equipment (IAS 16). Start-up costs may consist of:
  - establishment costs (legal and secretarial costs in establishing a legal entity);
  - pre-opening costs (expenditure to open a new facility or business); and
  - pre-operating costs (expenditure for starting new operations or launching new products or processes).
- training costs
- advertising and promotional costs
- relocating or re-organising costs. (IAS 38.69)

Expenditure on an intangible item that was initially recognised as an expense shall not be recognised as part of the cost of an intangible asset at a later date. (IAS 38.71)

4.7 MEASUREMENT AFTER RECOGNITION

An entity shall choose either the cost model or the revaluation model as its accounting policy. If an intangible is accounted for using the revaluation model, all the other assets in its class shall also be accounted for using the same model, unless there is no active market for those assets. (IAS 38.72)

4.7.1 Cost model

After initial recognition, an intangible asset shall be carried at its cost less any accumulated amortisation and any accumulated impairment losses. (IAS 38.74)

4.7.2 Revaluation model

After initial recognition, an intangible asset shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated amortisation and impairment losses. Fair value shall be determined by reference to an active market. Revaluations shall be made with such regularity that at the end of the reporting period the carrying amount of the asset does not materially differ from its fair value. (IAS 38.75)

The revaluation model does not allow:

- the revaluation of intangible assets that have not previously been recognised as assets, or
- the initial recognition of intangible assets at amounts other than their cost. (IAS 38.76)

The revaluation model is applied after an asset has been initially recognised at cost. However, if only part of the cost of an intangible asset is recognised as an asset because the asset did not meet the criteria for recognition until part of the way through the process, the revaluation model may be applied to the whole of that asset. Also, the revaluation model may be applied to an intangible asset that was received by way of a government grant and recognised at a nominal amount. (IAS 38.77)

The frequency of revaluations depends on the volatility of the fair values of the intangible assets being revalued. (IAS 38.79)

If an intangible asset is revalued, any accumulated amortisation at the date of the revaluation is either:

- restated proportionately with the change in the gross carrying amount of the asset so that the carrying amount of the asset after revaluation equals its revalued amount, or
- eliminated against the gross carrying amount of the asset, and the net amount restated to the revalued amount of the asset. (IAS 38.80)

EXAMPLE 4

Cost price of asset	R300 000
Accumulated amortisation at 31/12/20.10	R50 000
Total useful life	12 years
Net replacement value at 31/12/20.11	R350 000



REQUIRED

Apply the revaluation model for the determination of fair value to the above scenario.

SOLUTION 4

Alternative 1: Proportional increase in accumulated amortisation

	R
Carrying amount 31/12/20.10 (300 000 – 50 000)	250 000
Net replacement value 01/01/20.11 [350 000 + (350 000/9)]	388 889
Revaluation surplus (388 889 – 250 000)	138 889
Gross replacement value (388 889 x 12/10)	466 667

	Revalued amount R	Carrying amount R	Revaluation R
Cost	466 667	300 000	166 667
Accumulated amortisation	(77 778)	(50 000)	(27 778)
Carrying amount	388 889	250 000	138 889

Journal entry	**Dr R**	**Cr R**
Asset @ cost price (SFP)	166 667	
Accumulated amortisation (SFP)		27 778
Revaluation surplus (OCI)		138 889

Alternative 2: Elimination of amortisation

		R
Carrying value 31/12/20.10		250 000
Net replacement value 01/01/20.11		388 889

Journal entry	**Dr**	**Cr**
	R	**R**
Accumulated amortisation (SFP)	50 000	
Asset @ cost price (SFP)		300 000
Asset at revalued amount (SFP)	388 889	
Revaluation surplus (OCI)		138 889

If an intangible asset is revalued, all the other assets in its class shall also be revalued, unless there is no active market for those assets. In that case, the asset is carried at cost less accumulated amortisation and impairment losses. (IAS 38.81) If the fair value of a revalued intangible asset can no longer be determined by reference to an active market, the carrying amount of the asset shall be its revalued amount at the date of the last revaluation by reference to the active market less any subsequent accumulated amortisation and any subsequent accumulated impairment losses. (IAS 38.82)

The fact that an active market no longer exists may indicate that the asset may be impaired. If the fair value of the asset can again be determined by reference to an active market at a subsequent measurement date, the revaluation model is applied from that date. (IAS 38.83–84)

If an intangible asset's carrying amount is increased as a result of a revaluation, the increase shall be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus. However, a revaluation increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease (impairment loss) of the same asset previously recognised in profit or loss. (IAS 38.85)

If an asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognised in profit or loss. However, a revaluation decrease shall be recognised in other comprehensive income (debit) to the extent of any credit balance in the revaluation surplus in respect of that asset. The decrease recognised in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus. (IAS 38.86)

The cumulative revaluation surplus included in equity, may be transferred directly to retained earnings when the surplus is realised. The whole surplus may be realised on the retirement or disposal of the asset. Some of the surplus may be realised as the asset is used by the entity. The amount realised is the difference between amortisation based on the revalued carrying amount of the asset and amortisation that would have been recognised based on the asset's historical cost. The transfer from revaluation surplus to retained earnings is not made through profit/loss. (IAS38.87)

4.8 USEFUL LIFE

An entity shall assess whether the useful life of an intangible asset is finite or indefinite and, if finite, the length of, or number of production or similar units constituting, that useful life. An intangible asset shall be regarded by the entity as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity. (IAS 38.88)

The accounting for an intangible asset is based on its useful life. An intangible asset with a finite useful life is amortised, and an intangible asset with an indefinite useful life is not. (IAS 38.89)

Many factors are considered in determining the useful life of an intangible asset, including:

- the expected usage of the asset;
- typical product life cycles for the asset and public information on estimates of useful lives of similar assets that are used in a similar way;
- technical, technological, commercial or other types of obsolescence;
- the stability of the industry in which the asset operates and changes in the market demand for the products or services output from the asset;
- expected actions by competitors or potential competitors;
- maintenance expenditure required to obtain the expected future economic benefits from the asset;
- the period of control over the asset and legal or similar limits on the use of the asset; and
- whether the useful life of the asset is dependent on the useful life of other assets of the entity. (IAS 38.90)

The term "indefinite" does not mean "infinite". The useful life of an intangible asset reflects only that level of future maintenance expenditure required to maintain the asset at its standard of performance assessed at the time of estimating the asset's useful life, and an entity's ability and intention to reach such a level. (IAS 38.91)

Given the history of rapid changes in technology, computer software and many other intangible assets are susceptible to technological obsolescence. Therefore, it is likely that their useful life is short. (IAS 38.92)

The useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period of the contractual or other legal rights, but may be shorter depending on the period over which the entity expects to use the asset. If the contractual or other legal rights are conveyed for a limited term that can be renewed, the useful life of the intangible asset shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost. (IAS 38.94)

Existence of the following factors, among others, indicates that an entity would be able to renew the contractual or other legal rights without significant cost:

- there is evidence, possibly based on experience, that the contractual or other legal rights will be renewed;
- there is evidence that any conditions necessary to obtain renewal will be satisfied; and
- the cost to the entity of renewal is not significant when compared with the future economic benefits expected to flow to the entity from renewal. (IAS 38.96)

4.9 INTANGIBLE ASSETS WITH FINITE USEFUL LIVES

4.9.1 Amortisation period and amortisation method

The depreciable amount of an intangible asset with a finite useful life shall be **allocated on a systematic basis over its useful life**.

Amortisation shall begin when the asset **is available for use**, ie when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

Amortisation shall cease at the earlier of the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 *Non-current assets held for sale and discontinued operations* (refer learning unit 5) and the date that the asset is derecognised.

The amortisation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. If that pattern cannot be determined reliably, the straight-line method shall be used. The amortisation charge for each period shall be recognised in profit or loss unless this or another standard permits or requires it to be included in the carrying amount of another asset. (IAS 38.97)

A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the unit of production method as discussed in learning unit 1. (IAS38.98)

EXAMPLE 5

1. An entity has purchased an exclusive right to generate hydroelectric power for sixty years. The costs of generating hydroelectric power are much lower than the costs of obtaining power from alternative sources. It is expected that the geographical area surrounding the power station will demand a significant amount of power from the power station for at least sixty years.

   The entity amortises the right to generate power over sixty years, unless there is evidence that its useful life is shorter.

2. An entity has purchased an exclusive right to operate a toll motorway for thirty years. There is no plan to construct alternative routes in the area served by the motorway. It is expected that this motorway will be in use for at least thirty years.

   The entity amortises the right to operate the motorway over thirty years, unless there is evidence that its useful life is shorter.

4.9.2 Residual value

The residual value of an intangible asset with a finite useful life shall be assumed to be zero unless:

- there is a commitment by a third party to purchase the asset at the end of its useful life; or
- there is an active market for the asset and:
  - the residual value can be determined by reference to that market; and
  - it is probable that such a market will exist at the end of the asset's useful life. (IAS 38.100)

The depreciable amount of an asset with a finite useful life is determined after deducting its residual value. A residual value other than zero implies that an entity expects to dispose of the intangible asset before the end of its economic life. (IAS 38.101)

The residual value is reviewed at least at each financial year-end. A change in the asset's residual value is accounted for as a change in an accounting estimate in accordance with IAS 8.

The residual value of an intangible asset may increase to an amount equal to or greater than the asset's carrying amount. If it does, the asset's amortisation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount. (IAS38.103)

4.9.3 Review of amortisation period and amortisation method

The amortisation period and amortisation method of an intangible asset with a finite useful life shall be reviewed at least at each financial year-end. If the expected useful life of the asset is different from previous estimates, the amortisation period shall be changed accordingly. If there has been a change in the expected pattern of consumption of the future economic benefits embodied in the asset, the amortisation method shall be changed to reflect the changed pattern.

Such changes shall be accounted for as changes in accounting estimates in accordance with IAS 8. (IAS 38.104)

4.10 INTANGIBLE ASSETS WITH INDEFINITE USEFUL LIVES

An intangible asset with an indefinite useful life shall not be amortised. (IAS 38.107)

In accordance with IAS 36 *Impairment of assets*, an entity is required to test an intangible asset with an indefinite useful life for impairment by comparing its recoverable amount with its carrying amount

(a) annually, and
(b) whenever there is an indication that the intangible asset may be impaired. (IAS 38.108)

4.10.1 Review of useful life assessment

The useful life of an intangible asset that is not being amortised shall be reviewed each period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from indefinite to finite shall be accounted for as a change in accounting estimate in accordance with IAS 8 *Accounting policies, changes in accounting estimates and errors*. (IAS 38.109)

In accordance with IAS 36, reassessing the useful life of an intangible asset as finite rather than indefinite is an indicator that the asset may be impaired. As a result, the entity tests the asset for impairment. (IAS 38.110)

4.11 RECOVERABILITY OF THE CARRYING AMOUNT – IMPAIRMENT LOSSES

The standard on impairment of assets shall be applied in establishing whether or not an intangible asset is impaired. The recoverable amount must be determined and the resulting impairment losses recognised. (IAS 38.111) Refer to learning unit 3.

4.12 RETIREMENTS AND DISPOSALS

An intangible asset shall be derecognised (eliminated from the statement of financial position):

- on disposal; or
- when no future economic benefits are expected from its use or disposal. (IAS 38.112)

The gain or loss arising from the derecognition of an intangible asset shall be determined as the difference between the net disposal proceeds and the carrying amount of the asset, and shall be recognised in profit or loss. Gains shall not be classified as revenue. (IAS 38.113)

EXAMPLE 6

Cost price	R3 000 000
Accumulated amortisation 31/12/20.11	R1 200 000
Total useful life	10 years
Retired from use on 30/06/20.12	
Proceeds on disposal 31/12/20.12	R1 400 000
Disposal costs 31/12/20.12	R200 000



REQUIRED

Calculate the profit/loss on disposal at 31/12/20.12.

SOLUTION 6

	R
Carrying value 31/12/20.12	
Cost price	3 000 000
Accumulated amortisation 31/12/20.11	(1 200 000)
Amortisation up to 30/06/20.12 (3 000 000/10 x 6/12)	(150 000)
Carrying amount	1 650 000
Proceeds on disposal 31/12/20.12 (1 400 000 – 200 000)	(1 200 000)
Loss on disposal on 31/12/20.12	450 000

4.13 DISCLOSURE

4.13.1 General

An entity shall disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

- whether the useful lives are indefinite or finite and, if finite, the useful lives or the amortisation rates used;
- the amortisation methods used for intangible assets with finite useful lives;
- the gross carrying amount and any accumulated amortisation (and accumulated impairment losses) at the beginning and end of the period;
- the line item(s) of the statement of comprehensive income in which any amortisation of intangible assets is included;
- a reconciliation of the carrying amount at the beginning and end of the period showing:
  - additions, indicating separately those from internal development, those acquired separately, and those acquired through business combinations;
  - assets classified as held for sale or included in a disposal group in accordance with IFRS 5 and other disposals;
  - increases or decreases during the period resulting from revaluations and from impairment *losses recognised or reversed in other comprehensive income in accordance with IAS 36 Impairment of assets* (if any);
  - impairment losses recognised in profit or loss during the period in accordance with IAS 36 (if any);
  - impairment losses reversed in profit or loss during the period in accordance with IAS 36 (if any);
  - any amortisation recognised during the period;
  - net exchange differences arising on the translation of the financial statements into the presentation currency, and on the translation of a foreign operation into the presentation currency of the entity; and
  - other changes in the carrying amount during the period. (IAS 38.118)

A class of intangible assets is a grouping of assets of a similar nature and use in an entity's operations. Examples of separate classes may include:

- brand names;
- mastheads and publishing titles;
- computer software;
- licences and franchises;
- copyrights, patents and other industrial property rights, service and operating rights;
- recipes, formulae, models, designs and prototypes; and
- intangible assets under development.

The classes mentioned above are disaggregated (aggregated) into smaller (larger) classes if this results in more relevant information for the users of the financial statements. (IAS 38.119)

An entity discloses information on impaired intangible assets in accordance with IAS 36 *Impairment of assets* (IAS 38.120), in addition to the general disclosure requirements.

IAS 8 requires an entity to disclose the nature and amount of a change in an accounting estimate that has a material effect in the current period or is expected to have a material effect in subsequent periods. Such disclosure may arise from changes in:

- the assessment of an intangible asset's useful life;
- the amortisation method; or
- residual values. (IAS 38.121)

An entity shall also disclose:

- for an intangible asset assessed as having an indefinite useful life, the carrying amount of that asset and the reasons supporting the assessment of an indefinite useful life. In giving these reasons, the entity shall describe the factor(s) that played a significant role in determining that the asset has an indefinite useful life.
- a description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the entity's financial statements.
- for intangible assets required by way of a government grant and initially recognised at fair value:
  - the fair value initially recognised for these assets;
  - their carrying amount; and
  - whether they are measured after recognition under the cost model or the revaluation model.
- the existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities.
- the amount of contractual commitments for the acquisition of intangible assets (IAS 38.122)

4.13.2 Intangible assets measured after recognition using the revaluation model

If intangible assets are accounted for at revalued amounts, an entity shall disclose the following:

- by class of intangible assets:
  - the effective date of the revaluation;
  - the carrying amount of revalued intangible assets; and
  - the carrying amount that would have been recognised had the revalued class of intangible assets been measured after recognition using the cost model;
- the amount of the revaluation surplus that relates to intangible assets at the beginning and end of the period, indicating the changes during the period and any restrictions on the distribution of the balance to shareholders.

4.13.3 Research and development expenditure

An entity shall disclose the aggregate amount of research and development expenditure recognised as an expense during the period. (IAS 38.126)

4.14 TAX IMPLICATIONS

4.14.1 Patents, designs, copyrights, and knowledge connected with the use of such assets (section 11(gC))

Under section 11(gC) the taxpayer is allowed a deduction of:

Expenditure actually incurred by the taxpayer on or after 1 January 2004:

- in acquiring an invention or patent as defined in the Patents Act, 1978; or
- in acquiring a design as defined in the Designs Act, 1993; or
- in acquiring a copyright as defined in the Copyright Act, 1978; or
- in acquiring other property which is of a similar nature (other than trade marks); or
- in acquiring any knowledge in respect of any of the above property.

The expenditure actually incurred is deductable as follows:

- expenses under R5 000 are deducted immediately.
- if the expenditure exceeds R5 000, the following deduction will be allowed each year:
  - 5% of the amount of the cost in respect of any invention, patent, copyright or other property of a similar nature or any knowledge connected with the use of such asset or the right to impart such knowledge.
  - 10% of the amount of the cost of any design or other property of a similar nature or any knowledge connected with the use of the relevant asset or the right to impart such knowledge.

These allowances are not apportioned for part of the year.

Where any such invention, patent, design, copyright or other property or knowledge was acquired from any person who is a connected person in relation to the taxpayer, the allowance under this paragraph (section 11(gC)) shall be calculated on an amount not exceeding the lesser of the cost to that connected person or the market value of that acquired asset on the date upon which it was acquired by the taxpayer.

4.14.2 Deductions in respect of research and development (section 11B)

For the purposes of the section, "research and development" means research and development conducted in the Republic that will result or potentially may result in an identifiable intangible asset as contemplated under generally accepted accounting practice, but **does not include** research and development relating to:

- the social sciences, arts, humanities or management; or
- market research, sales or marketing promotion.

The deduction allowed during any year of assessment commencing on or after 1 January 2004, is as follows:

(a) any expenditure actually incurred by a taxpayer in that year of assessment

- in respect of research and development undertaken directly by that taxpayer; or
- by way of payment to any other person for research and development undertaken by that other person on behalf of that taxpayer, for the purpose of devising, developing or creating any invention, patent, design, copyright or other property which is of a similar nature;

(b) any expenditure actually incurred by a taxpayer in that year of assessment for the purposes of:

- registration of any invention, patent, design, copyright or other property; and
- obtaining the extension of the period of a legal protection, the extension of the registration period, or the renewal of the registration of any such invention, patent, design, copyright or other property.

The deduction allowed in respect of any building, machinery, plant, implement, utensil and article of a capital nature used by that taxpayer for purposes of research and development, is as follows:

- an allowance of 40% of the cost of that asset in the year of assessment that it is brought into use for the first time by the taxpayer; and
- an allowance of 20% in each of the three immediately succeeding years of assessment.

No allowance shall be allowed in terms of this section in respect of any machinery, plant, implement, utensil and article which was used during the year of assessment for purposes other than research and development.

4.14.3 Deductions in respect of scientific or technological research and development (section 11(D))

Section 11(D) is applicable to the expenditure on scientific or technological research and development actually incurred by a taxpayer on or after 2 November 2006 from carrying on any trade. The following amounts are deductible:

- 150% of the expenditure actually incurred on activities in the Republic directly for purposes of:
  - the discovery of novel, practical and non-obvious information; or
  - the devising, developing or creation of any invention (patent), design, computer program or knowledge essential to the use thereof

if that information, invention, design, computer program or knowledge is of a scientific or technological nature and is intended to be used in the production of income.

- A 50/30/20% deduction over three years of the cost of certain assets from the first year that the asset is brought into use for the first time. The assets are any building or part thereof, machinery, plant, implement, utensils or article which
  - is owned by the taxpayer;

- is first brought into use by that taxpayer solely for the purposes as discussed above;
- was previously not used by any person for any purpose; and
- is brought into use by the taxpayer for the above-mentioned purposes and the information, invention, design, computer program or knowledge is intended to be used in the production of his income

None of the above-mentioned deductions are allowed if the expenditure relates to:

- exploration or prospecting;
- management or enhancement of internal business processes;
- trade marks;
- the social sciences or humanities; or
- market research, sales or marketing promotion.

4.14.4 Deduction of expenditure of obtaining, restoration, extension, registration, or renewal of registration of intellectual property (section 11(gB))

Such expenditure on intellectual property is deductible in the year in which it was actually incurred by the taxpayer if the patent, design, or trade mark is used in the production of income. The expenditure is also deductible if the intellectual property is regulated under similar laws of any other country.

Note that the expenditure on the registration or renewal of the registration of a trade mark is deductible, but not the acquisition cost of the trade mark itself.

4.14.5 Model for tax calculation

	R
Profit before tax	XXXX
Exempt differences	XXX
Temporary differences	XXX
Amortisation	XXX
Impairment loss	XXX
Tax allowance on intangible asset	(XXX)
Taxable income	XXX

4.15 COMPREHENSIVE EXAMPLES

EXAMPLE 7

Hegco Ltd is a researcher and manufacturer of electronic components. On 1 January 20.11 Hegco Ltd commenced with research on a new electronic component which will improve the working performance of motor engines.

On 1 March 20.11 the head of research submitted a report to the board of directors for the research of the new motor engine electronic component. The board of directors were very positive about the potential of the component and approved further development which commenced on 1 March 20.11.

The accountant of Hegco Ltd found that the development costs of the motor engine electronic component satisfied all the criteria for intangible asset recognition.

On 1 June 20.11 Hegco Ltd commenced with research on a component which will improve the working performance of swimming pool pumps. The research on the swimming pool component progressed very well and at the end of December 20.11 the directors were very optimistic that this project would be a material asset to Hegco Ltd.

Of the four engineers employed by Hegco Ltd, two worked full-time on the research and development of the motor engine electronic component, until commercial production commenced on 1 September 20.11. Originally only one engineer worked on the swimming pool component. After production on the motor engine electronic component commenced on 1 September 20.11, another engineer started to work on the swimming pool component.

Two laboratory technicians worked on the motor engine electronic component until 31 August 20.11 and three technicians worked on the swimming pool component.

The cost of consumables is allocated to the projects based on actual usage and amounted to R42 000 and R25 000 for the motor engine electronic component and swimming pool component respectively. The cost of consumables were evenly incurred throughout the time period worked on the projects.

Depreciation is allocated on the basis of the time that assets were utilised on a project.

All other applicable costs are allocated based on the time engineers spent on a project. (Ignore leave and bonuses.)

Costs incurred during 20.11 were as follows:

	R
Salaries engineers (4 persons)	780 000
Salaries laboratory technicians (6 persons)	630 000
Salaries administrative personnel (5 persons)	500 000
Laboratory maintenance	90 000
Consumables	74 000
Water, electricity and services	30 000

Research and development equipment with a cost of R3 000 000 (purchased on1 January 20.11) is written off on a straight-line basis over 5 years.

The research and development equipment is utilised as follows:

	01/01/20.11 to 01/03/20.11	**01/03/20.11 to 31/08/20.11**	**01/06/20.11 to 31/12/20.11**
Research activities (motor engine electronic component)	50%	–	–
Development activities (motor engine electronic component)	–	50%	–
Research activities (swimming pool component)	–	–	50%

For the commercial production of the motor engine electronic component, Hegco Ltd bought specialised plant and machinery at a cost of R1 050 000 on 1 September 20.11. The specialised plant and machinery is expected to be sold for R150 000 after three years, and are therefore amortised on the straight line method over three years. Upon review of the residual value and useful life of the specialised plant and machinery at 31 December 20.11, expectations in respect thereof did not differ from previous estimates.

Projections (20.11 actual) for the sale of the motor engine electronic component are as follows:

	20.11	**20.12**	**20.13**
Unit sales	100 000	350 000	150 000

At 31 December 20.11 the company had no inventories of the motor engine electronic component on hand.

With the preparation of the financial statements on 31 December 20.11 there were indications that the recoverable amount of the development costs of the motor engine was materially impaired. A competitor introduced a similar product to the market at a drastically reduced price. On 31 December 20.11 new calculations and estimates showed that the value in use based on the discounted net profits, amounted to R400 000. The cost of capital (16%) of Hegco Ltd was used as the discount rate to calculate the value in use.

It is the policy of the company to amortise development costs on the basis of units sold to total marketable units. Past experience provided persuasive evidence that this method best reflects the pattern in which the assets economic benefits are consumed.

Assume all amounts to be material and ignore taxation.



REQUIRED

Disclose the above mentioned information in the notes to the financial statements of Hegco Ltd for the year ended 31 December 20.11. Notes as required by the standards on revenue and inventory are not required.

Your answer should comply with *International Financial Reporting Standards*. Ignore comparative amounts.

SOLUTION 7

HEGCO LTD

NOTES FOR THE YEAR ENDED 31 DECEMBER 20.11

1. Accounting policy

1.1 Internal generated intangible assets – Development costs

Development costs are written off in the year in which they are incurred, unless they comply with the asset recognition criteria in which case it is capitalised and amortised on a systematic basis which reflects the pattern whereby expected economic benefits are recognised, being the units sold during the year as a percentage of the total marketable units.

Capitalised development costs are carried at cost less accumulated amortisation and accumulated impairment losses.

Amortisation rate of motor engine component – 600 000 estimated saleable units.

1.2 Research costs

Research costs are recognised as an expense in the year in which it is incurred.

1.3 Property, plant and equipment

Initially property, plant and equipment are recognised at cost price.

Subsequently property, plant and equipment are measured at historical cost less accumulated depreciation and accumulated impairment losses.

Property, plant and equipment are depreciated on the straight-line basis over the assets estimated useful lives which are as follows:

Research and development equipment – 5 years
Specialised plant and machinery – 3 years

The residual value and useful life of all items of property, plant and equipment are reviewed, and adjusted if necessary at each reporting date.

1.4 Impairment of non-financial assets

Non-financial assets are assessed at each reporting date to determine whether there is an indication that the carrying amount may be impaired. If such an indication exists, the recoverable amount of the asset is determined. The recoverable amount of goodwill, indefinite-life intangible assets and intangible assets which are not available for use are determined annually irrespective of whether an indication of impairment exists or not.

The recoverable amount of an asset is the higher of its fair value less costs to sell and its value in use. In determining the value in use the estimated future cash flows of the asset is discounted to their present value based on pre-tax discount rates. The pre-tax discount rates reflect the current market assessments of the time value of money and the risks that are specific to the asset.

An impairment loss is recognised in profit or loss when the carrying amount of an asset exceeds its recoverable amount. If the loss relates to the reversal of a previous revaluation surplus, it is recognised in other comprehensive income.

Impairment losses are reversed if there has been a change in the estimates used to determine the recoverable amount of the asset. Impairment losses are reversed only to the extent that the carrying amount of the asset does not exceed the carrying amount that would have been determined if no impairment loss had been recognised in the past. Reversals of impairment losses are recognised directly in profit or loss.

2. Profit before tax

Profit before tax includes the following items:

Expenses	**R**
Employee costs (calc 9)	1 147 500
Research costs (170 500 + 590 000) (calc 2)	760 500
Impairment loss – development costs included in "Cost of Sales" (calc 3)	26 250
Amortisation of development costs[1] (calc 4) included in the line item for "Cost of Sales"[2]	85 250
Depreciation (calc 10) (100 000 (calc 5) + 225 000 (calc 6))	325 000



LECTURER'S COMMENT

1. It is not necessary to disclose amortisation per class of intangible asset and consequently it would normally be sufficient to only disclose total amortisation, without reference to the type of asset it relates to. However, IAS 38.126 requires disclosure of the total research and development expenses recognised during the period, and consequently it would be necessary to disclose here that amortisation relates to development costs.
2. IAS 38.118(d) requires disclosure of the line-item in which the amortisation is included – in this case it is "cost of sales".

3. Property, plant and equipment

	Specialised plant and machinery R	Research and development equipment R
Carrying amount at the beginning of the year	–	–
Cost	–	–
Accumulated depreciation	–	–
Acquisition	1 050 000	3 000 000
Depreciation (calc 5; calc 6)	(100 000)	(225 000)
Carrying amount at the end of the year	950 000	2 775 000
Cost	1 050 000	3 000 000
Accumulated depreciation	(100 000)	(225 000)

4. Internal generated intangible assets

	Development costs R
Capitalised during the year (calc 2)	511 500
Impairment loss recognised through profit or loss (included in cost of sales)	(26 250)
Amortisation (included in cost of sales) (calc 4)	(85 250)
Carrying amount at the end of the year	400 000
Cost	511 500
Accumulated amortisation and impairment losses	(111 500)

The remaining useful life of development costs related to the motor engine electronic component with a carrying amount of R400 000, is estimated on 500 000 marketable units of the product.[1]



LECTURER'S COMMENT

[1] The description, carrying amount and remaining useful life of development costs should be disclosed if the item involved is material to the financial statements – see IAS 38.122(b).

5. Impairment of intangible asset

The carrying amount of development costs related to the motor engine electronic component has decreased in value due to a drastic reduction in the selling price of similar products introduced to the market by a competitor. The impairment loss amounted to R26 250.

The recoverable amount of the development costs is determined by calculating the value in use using a discount rate of 16%.

CALCULATIONS

1. Costs that can be allocated

	R
Laboratory maintenance	90 000
Water, electricity and services	30 000
	120 000

2. Allocation of costs to research and development

	Motor engine electronic component		Swimming pool component
	1/01/20.11 - 28/02/20.11 Research	1/03/20.11 - 1/09/20.11 Development	1/06/20.11 - 31/12/20.11 Research
	R	R	R
Engineers:			
780 000/4 x 2/12 x 2	65 000	–	–
780 000/4 x 6/12 x 2	–	195 000	–
780 000/4 x 7/12 x 1	–	–	113 750
780 000/4 x 4/12 x 1	–	–	65 000

Four (4) engineers were employed. Two (2) worked full-time on the research and development component until commercial production commenced on 1 September 20.11. Originally only one (1) engineer worked on the swimming pool component. After production on the motor engine component commenced on 1 September 20.11, another engineer started to work on the swimming pool component.

Laboratory technicians:

	R	R	R
630 000/6 x 2/12 x 2	35 000	–	–
630 000/6 x 6/12 x 2	–	105 000	–
630 000/6 x 7/12 x 3	–	–	183 750

Consumables: (calc 7)

	R	R	R
42 000 x 2/8	10 500	–	–
42 000 x 6/8	–	31 500	–
25 000	–	–	25 000

Costs that can be allocated:
(calc 1)

	R	R	R
120 000/4 x 2/12 x 2	10 000	–	–
120 000/4 x 6/12 x 2	–	30 000	–
120 000/4 x 7/12 x 1	–	–	17 500
120 000/4 x 4/12 x 1	–	–	10 000

All other applicable costs are allocated based on the time engineers spent on a project.

Depreciation: (calc 1)	**R**	**R**	**R**
3 000 000 x 20% x 2/12 x 50%	50 000	–	–
3 000 000 x 20% x 6/12 x 50%	–	150 000	–
3 000 000 x 20% x 7/12 x 50%	–	–	175 000
	170 500	511 500	590 000

3. Impairment loss of development costs

	R
Recoverable amount (value in use – given)	400 000
Carrying amount of development costs on 31 December 20.11 (511 500 – 85 250 (calc 4))	426 250
Impairment loss	26 250

4. Amortisation of development costs

511 500 (calc 2) /600 000 units x 100 000 units = 85 250

5. Depreciation: plant and machinery

(1 050 000 – 150 000)/3 x 4/12 = 100 000

6. Depreciation of research and development equipment

Total provision (3 000 000 x 20%)	600 000
Less: Allocated (50 000 + 150 000 + 175 000) (calc 2)	(375 000)
Unallocated	225 000

7. Months spend on research and development respectively

Research on motor engine component: 1 January to 1 March	2 months
Development on motor engine component: 1 March to 31 August	6 months
Total months:	8 months

8. Employee benefit costs

780 000 + 630 000 + 500 000 = 1 910 000.

9. Allocation of employee benefit cost

Provided for the year (calc 8)	1 910 000
Less: Allocated to research costs[1] (65 000 + 35 000 + 113 750 + 65 000 + 183 750) (calc 2)	(462 500)
Allocated to development costs[2] (195 000 + 105 000) (calc 2)	(300 000)
	1 147 500

10. Allocation of depreciation

Provided for the year (100 000 (calc 5) + 600 000 (calc 6))	700 000
Less: Allocated to research costs[1] (50 000 + 175 000) (calc 2)	(225 000)
Less: Capitalised as development costs[2] (calc 2)	(150 000)
	325 000



LECTURER'S COMMENT

1. These costs are removed from the actual expense included in the profit before tax note, as they form part of the research costs. To avoid double counting, we deduct them from this calculation. There costs are included as research cost in the profit before tax note.

2. These costs are removed from the actual expense included in the profit before tax note, as they form part of the development costs. To avoid double counting, we deduct them from this calculation.

EXAMPLE 8

Electronics Galore Ltd manufactures electronic equipment. The company has a 31 March year-end.

Electronics Galore Limited has their own research and development department and makes use of local research institutes. The following information is relevant to development costs in respect of a new electronic product:

- Development costs capitalised to 31 March 20.10 amounted to R40 000, after it met all the criteria for it to be classified as an intangible asset.
- A further amount of R50 000 was spent during the current financial year on development costs.
- Production commenced on 1 October 20.10.
- It is expected that the economic benefits that will be enjoyed by the company will far exceed the development costs.

The marketing division estimates that the product will only be sold for a limited period of time and estimates the annual sale, in units, as follows:

	Units
1 October 20.10 – 31 March 20.11	400 000
1 April 20.11 – 31 March 20.12	900 000
1 April 20.12 – 31 March 20.13	600 000
1 April 20.13 – 31 March 20.14	500 000

The tax base of the development costs at 31 March 20.10 and 31 March 20.11 amounted to R30 000 and R51 000. The tax rate is 28% for all five years. 66,6% of all capital gains are taxable. The company provides for deferred tax on all temporary differences using the statement of financial position approach.

The full production is sold during the relevant financial period and there is no inventory on hand at year-end.



REQUIRED

(a) Prepare the notes to the statement of financial position of Electronics Galore Ltd as at 31 March 20.11. Your answer must comply with the requirements of *International Financial Reporting Standards*.
(b) Calculate the deferred tax transfer to/from the statement of profit or loss and other comprehensive income for the year ended 31 March 20.11.(UP adapted)

Accounting policy notes are not required.

SOLUTION 8

(a) ELECTRONICS GALORE LTD

NOTES FOR THE YEAR ENDED 31 MARCH 20.11

1. Intangibles

Internal generated intangible asset	**R**
Carrying amount at beginning of year	40 000
Cost	40 000
Accumulated amortisation	–
Development costs capitalised during the year	50 000
Amortisation (1)	(15 000)
Carrying amount at end of year	75 000
Cost	90 000
Accumulated amortisation	(15 000)

The remaining useful life of development costs related to the development of a new electronic product with a carrying amount of R75 000, is estimated on 2 000 000 saleable units of the product.

CALCULATIONS

(a) Amortisation of intangible assets

	R
Total costs capitalised (40 000 + 50 000)	90 000
Amortisation[1]	15 000

[1] $90\,000 \times \left(\frac{400\,000}{400\,000 + 900\,000 + 600\,000 + 500\,000} \right)$

(b) Deferred tax transfer

	Carrying amount R	Tax base R	Tempora-ry differ-rence R	Deferred tax (liability) R
31 March 20.10 Development Cost	40 000	30 000	(10 000)	(2 800)
31 March 20.11 Development Cost	75 000	51 000	(24 000)	(6 720)
Deferred tax movement (dr to P/L)				(3 920)



ASSESSMENT CRITERIA

After having studied this learning unit you should be able to:

- identify and discuss the components of the definition of intangible assets;
- identify and discuss the components of research and development costs;
- calculate research and development costs treated as an expense;
- distinguish whether development costs should be treated as an expense or as an asset and to treat it correctly in accordance with *International Financial Reporting Standards*;
- explain the basis, principles and methods for the amortisation of an intangible asset;
- explain and apply the principles surrounding recoverability and handling of impairment of intangible assets;
- name and apply the criteria and requirements for the recognition and initial measurement of intangible assets, including internally generated intangible assets;
- explain the criteria for the assessment of the useful life of an intangible asset;
- describe and apply the cost model and the revaluation model for the measurement of intangible assets subsequent to initial recognition; and
- disclose intangible assets in accordance with the requirements of *International Financial Reporting Standards*.

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LEARNING UNIT 5

NON-CURRENT ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS [IFRS 5]



Distinctive Financial Reporting

LEARNING UNIT 5 – NON-CURRENT ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS

LEARNING OUTCOMES

Once you have studied and completed this learning unit, you should be able to:

- account for non-current assets held for sale or disposal groups in the financial statements of an entity in accordance with the requirements of the *International Financial Reporting Standards*;
- account for discontinued operations in the financial statements of an entity in accordance with the requirements of *International Financial Reporting Standards*.

OVERVIEW

Objective

PART I: NON-CURRENT ASSETS HELD FOR SALE

5.1 Introduction
5.2 Definitions (IFRS 5 Appendix A)

5.3 Classification of a non-current asset (or disposal group) as held for sale
- 5.3.1 Criteria to qualify as held for sale
- 5.3.2 Extension of period required to complete a sale
- 5.3.3 Other matters to consider with regard to classification as held for sale

5.4 The criteria in 5.3.1 are met after the reporting period (IFRS 5.12)

5.5 Scope of IFRS 5
- 5.5.1 Included in the scope
- 5.5.2 Items excluded from the scope of IFRS 5 regarding measurement requirements
- 5.5.3 Disposal group containing both items included and excluded from the measurement requirements of IFRS 5

5.6 Measurement of a non-current asset held for sale (or disposal group)
- 5.6.1 Measurement immediately before initial classification as held for sale
- 5.6.2 Application of IFRS 5 to an existing individual asset
- 5.6.3 Application of IFRS 5 to a disposal group at initial classification as held for sale
- 5.6.4 Other matters in respect of measurement
- 5.6.5 Subsequent remeasurement of an individual asset or disposal group

5.7 Recognition of impairment losses and reversals
- 5.7.1 Impairment loss for an individual non-current asset
- 5.7.2 Impairment loss for a disposal group
- 5.7.3 Reversal of an impairment loss/gain on remeasurement of an individual asset
- 5.7.4 Recognition of gains and losses at date of sale of a non-current asset

5.8 Non-current assets to be abandoned

5.9 Changes to a plan of sale
- 5.9.1 General
- 5.9.2 Individual assets no longer classified as held for sale

5.9.3 Individual item part of disposal group, no longer classified as held for sale

5.10 Presentation of a non-current asset or disposal group classified as held for sale
5.10.1 Presentation
5.10.2 Additional disclosures - IFRS 5.41

PART II: DISCONTINUED OPERATIONS

5.11 Introduction
5.11.1 Objective
5.11.2 Definition
5.11.3 Classification as discontinued operation

5.12 Presentation and disclosure
5.12.1 Disclosure

5.13 Gains or losses relating to continuing operations
5.14 Model for disclosure

STUDY

PRESCRIBED:
Descriptive Accounting
Chapter 28

RECOMMENDED:
A Guide through IFRS
IFRS 5

Objective

The objective of this IFRS is to specify the accounting for assets held for sale, and the presentation and disclosure of discontinued operations. In particular, the IFRS requires:

- assets that meet the criteria to be classified as held for sale to be measured at the lower of carrying amount and fair values less cost to sell, and depreciation on such assets to cease;
- assets that meet the criteria to be classified as held for sale to be presented separately on the face of the statement of financial position and the results of discontinued operations to be presented separately in the statement of comprehensive income.

Since discontinuing an operation would by implication comprise, among other things, disposing of current and non-current assets and associated liabilities, it appears logical to combine this issue with discontinued operations in IFRS 5. However, for purposes of studying the two issues, they have been split.

Non-current assets held for sale are dealt with in Part I and Discontinued operations (including associated non-current assets now held for sale) are dealt with in Part II of this chapter.

PART I: NON-CURRENT ASSETS HELD FOR SALE

5.1 INTRODUCTION

In terms of IAS 1 assets and liabilities should be classified between current and non-current on the face of the statement of financial position. IFRS 5 prescribes how non-current non-financial assets that are to be disposed of in the near future should be treated by stating that such assets and associated liabilities to be recovered and settled through sale, shall be remeasured to the lower of carrying amount and fair value less costs to sell and carried as current items on the face of the statement of financial position.

EXAMPLE 1

Bang Ltd holds an item of property, plant and equipment with a historical cost carrying amount of R120 000 at 31 December 20.10. On that date management decides to sell the asset for R130 000 (fair value) by 31 March 20.11 and concludes a valid uncancellable sales contract (using fair prices) to this effect with a buyer. Costs to sell the asset will amount to R12 000. Assume all amounts involved are material and that the criteria for classification as held for sale have been met.

In short, applying IFRS 5 will have the following effect:

The carrying amount of the PPE item at 31 December 20.10 should be determined:

Since the decision to sell was taken at year-end, the carrying amount is R120 000.

Next the fair value less costs to sell of the PPE item should be determined:

Fair value is R130 000 and costs to sell amounts to R12 000. Consequently the fair value less costs to sell is R118 000.

The PPE item initially classified to hold for sale should now be transferred from non-current assets to current assets and should then be measured at the lower of its carrying amount and fair value less costs to sell.

The PPE item with a carrying amount of R120 000 shall thus be transferred from non-current to current assets on the face of the statement of financial position and be described as "held for sale". This "held for sale" asset shall then be written down from R120 000 to R118 000 and an impairment loss of R2 000 shall be recognised in the statement of comprehensive income of 20.10.

5.2 DEFINITIONS (IFRS 5 Appendix A)

The definitions set out below should be studied carefully before the content of the rest of the material and standard is attempted to ensure that you understand clearly what you are dealing with. Note that some of the definitions will be familiar to you, as you have encountered them in other learning units. However, since these definitions are also important in this standard, they have been repeated here.

Cash-generating unit is the smallest identifiable group of assets generating cash inflows that are largely independent of the cash inflows from other assets or groups of assets. This definition is also used in IAS 36 and is dealt with in learning unit 3.

Component of an entity is operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

Costs to sell is the incremental costs directly attributable to the disposal of an asset (or disposal group), excluding finance costs and the income tax expense.

A current asset is an asset that satisfies any of the following criteria:

(a) it is expected to be realised in, or is intended for sale or consumption in, the entity's normal operating cycle;
(b) it is held primarily for the purpose of being traded;
(c) it is expected to be realised within twelve months after the reporting period; or
(d) it is cash or a cash equivalent asset unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

A discontinued operation is a component of an entity that either has been disposed of or is classified as held for sale and:

(a) represents a separate major line of business or geographical area of operations,
(b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or
(c) is a subsidiary acquired exclusively with a view to resale.

A disposal group is a group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. The group includes goodwill acquired in a business combination if the group is a cash-generating unit to which goodwill has been allocated in accordance with the requirements of paragraphs 80 to 87 of IAS 36 *Impairment of assets* or if it is an operation within such a cash-generating unit.

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.

A firm purchase commitment is an agreement with an unrelated party, binding on both parties and usually legally enforceable, that:

(a) specifies all significant terms, including the price and timing of the transactions, and
(b) includes a disincentive for non-performance that is sufficiently large to make performance highly probable.

Highly probable means significantly more likely than probable.

A non-current asset is an asset that does not meet the definition of a current asset. Note that current assets were defined earlier under this heading.

Probable means more likely than not.

Recoverable amount is the higher of an asset's fair value less (minus) costs to sell and its value in use.

Value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

5.3 CLASSIFICATION OF A NON-CURRENT ASSET (OR DISPOSAL GROUP) AS HELD FOR SALE

An entity shall classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. (IFRS 5.06)

5.3.1 Criteria to qualify as held for sale

IFRS 5 requires non-current assets that are to be disposed of to be reclassified from non-current to current. IFRS 5 makes it clear that items should only be classified as held for sale once they have met **all** the criteria as set out in IFRS 5.07 to .11. These criteria are:

- The asset (or disposal group) must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and its sale must be highly probable.
- For the sale to be highly probable, the appropriate level of management must be committed to a plan to sell the asset (or disposal group), and an active programme to locate a buyer and complete the plan must have been initiated.
- The asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value.
- The sale should be expected to qualify for recognition as a completed sale within one year from the date of classification, except if there are acceptable grounds for extension of the sales period beyond 1 year as permitted by IFRS 5.09. (Refer to 5.3.2.)
- Actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

5.3.2 Extension of the period required to complete a sale IFRS 5 Appendix B (Application supplement)

As noted in 5.3.1 above, an extension of the period required to complete a sale beyond one year does not preclude an asset (or disposal group) from being classified as held for sale if the delay is caused by events or circumstances beyond the entity's control and if there is sufficient evidence that the entity remains committed to its plan to sell the asset (or disposal group).

An exception to the one-year requirement mentioned in 5.3.1 point 4 shall therefore apply in the following situations in which such events or circumstances arise:

- at the date an entity commits itself to a plan to sell a non-current asset (or disposal group) it reasonably expects that others (not a buyer) will impose conditions on the transfer of the asset (or disposal group) that will extend the period required to complete the sale, and:

  - actions necessary to respond to those conditions cannot be initiated until after a firm purchase commitment is obtained, and
  - a firm purchase commitment is highly probable within one year; or

- an entity obtains a firm purchase commitment and, as a result, a buyer or others unexpectedly impose conditions on the transfer of a non-current asset (or disposal group) previously classifi8ed as held for sale that will extend the period required to complete the sale, and;

  - timely actions necessary to respond to the conditions have been taken, and
  - a favourable resolution of the delaying factors is expected; or

- during the initial one-year period, circumstances arise that were previously considered unlikely and, as a result, a non-current asset (or disposal group) previously classified as held for sale is not sold by the end of that period, and

  - during the initial one-year period the entity took action necessary to respond to the change in circumstances,
  - the non-current asset (or disposal group) is being actively marketed at a price that is reasonable, given the change in circumstances, and
  - the criteria in 5.3.1 above, are met.

5.3.3 Other matters to consider with regard to classification as held for sale

Sale transactions include exchanges of non-current assets for other non-current assets when the exchange has commercial substance in accordance with IAS 16 *Property, plant and equipment*. (IFRS 5.10)

When an entity acquires a non-current asset (or disposal group) exclusively with a view to its subsequent disposal, it shall classify the non-current asset (or disposal group) as held for sale at the acquisition date, only if the one-year or a permitted extended period requirement is met and it is highly probable that any other criteria in point 5.3.1 above that are not met at acquisition date will be met within a short period following the acquisition (usually limited to three months). (IFRS 5.11)

5.4 THE CRITERIA IN 5.3.1 ARE MET AFTER THE REPORTING PERIOD (IFRS 5.12)

If the criteria in 5.3.1 are met after the reporting period, an entity shall not classify a non-current asset (or disposal group) as held for sale in those financial statements when issued.

However, when the criteria in 5.3.1 are met after the reporting period but before the authorisation of the financial statements for issue, the entity shall disclose the following information by way of a note:

(a) a description of the non-current asset (or disposal group);
(b) a description of the facts and circumstances of the sale, or leading to the expected disposal, and the expected manner and timing of that disposal;
(c) if applicable, the reporting segment in which the non-current asset (or disposal group) is presented in accordance with IFRS 8 *Operating segments*.

5.5 SCOPE OF IFRS 5

5.5.1 Included in the scope

The classification and presentation requirements of IFRS 5 applies to all recognised non-current assets and disposal groups of an entity.

The measurement requirements of IFRS 5 apply to all recognised non-current assets and disposal groups except for those listed in 5.5.2 below which shall continue to be measured in accordance with the standard noted. (IFRS 5.2)

Assets classified as non-current assets in accordance with IAS 1 *Presentation of financial statements* shall not be reclassified as current assets until they meet the criteria to be classified as held for sale in accordance with IFRS 5 (refer 5.3.1). Assets of a class that an entity would normally regard as non-current that are acquired exclusively with a view to resale shall not be classified as current assets until they meet the criteria to be classified as held for sale in accordance with IFRS 5 (refer 5.3.1). (IFRS 5.3)

Sometimes an entity disposes of a group of assets, possibly with some directly associated liabilities, together in a single transaction. Such a disposal group may be a group of cash-generating units, a single cash generating unit or part of a cash generating unit. (IFRS 5.4)

EXAMPLE 2

You may decide to sell any of the following:

- a factory comprising three manufacturing plants with carrying amounts of respectively R200 000, R300 000 and R400 000 representing a group of three cash-generating units, **OR**
- one of the three manufacturing plants representing a single cash-generating unit, for instance the plant with a carrying amount of R200 000, **OR**
- two machines with carrying amounts of R80 000 each forming part of one manufacturing plant and replace it by two more modern machines.

Each of the above alternatives will represent a disposal group as defined in 5.2.

If a non-current asset within the scope of the measurement requirements of IFRS 5 is part of a disposal group, the measurement requirements apply to the group as a whole, so that the group is measured at the lower of its carrying amount and fair value less costs to sell. (IFRS 5.4)

The **requirements for measuring** the individual assets and liabilities within the disposal group are set out below:

- Immediately **before the initial classification** of the asset (or disposal group) as held for sale, the **carrying amounts of the asset** (or all the assets and liabilities within the group) shall be **measured in terms of the Standards** (IASs) **normally applicable to them**. (IFRS 5.18)

For instance, if a company wants to sell a machine (PPE item) carried at historical cost, the carrying amount of the machine must be determined immediately before the initial classification as held for sale. Depreciation will have to be written off on the machine right up to the point of reclassification, to determine its carrying amount in terms of IAS 16 *Property, plant and equipment*, the applicable standard.

- On subsequent measurement of a disposal group, the carrying amounts of any assets and liabilities that are **not within the scope** of the measurement requirements of IFRS 5, but are **included in a disposal group** classified as held for sale, shall be **remeasured in accordance with the applicable IFRSs** before the fair value less costs to sell of the disposal group is remeasured. (IFRS 5.19)

In terms of certain standards, some non-current items are already measured at fair value with fair value adjustments being included in profit or loss. For other non-current items it could be difficult to determine the fair value less costs to sell. IFRS 5 excludes several items from the measurement requirements contained in IFRS 5.

5.5.2 Items excluded from the scope of IFRS 5 regarding measurement requirements

Assets already carried at fair value with changes in fair value recognised in profit or loss. The assets affected are:

- financial assets within the scope of IFRS 9 *Financial instruments*
- non-current assets that have been accounted for using the fair value model in IAS 40 *Investment property*
- non-current assets that have been measured at fair value less costs to sell in accordance with IAS 41 *Agriculture* (not part of your syllabus).

Assets for which there might be difficulties in determining their fair value. The assets affected are:

- deferred tax assets from IAS 12 *Income Taxes*.
- assets arising from employee benefits in terms of IAS 19 *Employee benefits* (not part of your syllabus)
- assets arising from insurance contracts as defined in IFRS 4 (not part of your syllabus).

The above-mentioned assets will be carried at the values determined by applying their applicable standards.

5.5.3 Disposal group containing both items included and excluded from the measurement requirements of IFRS 5

A disposal group may include any assets and any liabilities of an entity – therefore current and non-current assets and liabilities as well as some assets that are excluded from the measurement requirements of IFRS 5 (see 5.5.2) could form part of a disposal group.

EXAMPLE 3

A disposal group could consist of the following items:

Item	**R**
– Land: cost	120 000
– Factory building: carrying amount	450 000
– Plant: carrying amount	200 000
– Inventories: carrying amount	55 000
– Payables associated with the plant, inventory and factory building	40 000
– Share investments: fair value	120 000

The first three items listed above would be non-current assets included in the scope of measurement requirements of IFRS 5, being the lower of carrying amount and fair value less costs to sell. The next item, being inventories, is a current asset being disposed of as part of the disposal group. The payables represent an associated liability, while the share investment represents a non-current asset excluded from the scope of measurement requirements of IFRS 5. Irrespective of the diverse nature of the items in the disposal group, the items involved still comprise a single disposal group.

5.6 MEASUREMENT OF A NON-CURRENT ASSET HELD FOR SALE (OR DISPOSAL GROUP)

5.6.1 Measurement immediately before initial classification as held for sale

According to IFRS 5.18 (refer 5.5.1) the carrying amount of a non-current asset (or all the assets and liabilities in a disposal group) shall, immediately before the **initial** classification as held for sale, be measured in accordance with the applicable IFRSs.

An entity shall measure a non-current asset (or disposal group) classified as held for sale at the lower of its carrying amount (at the moment of reclassification) and fair value less costs to sell – this adjustment is an impairment loss. (IFRS 5.15)

If a non-current asset held for sale (or disposal group) **falls outside the scope of IFRS 5** in respect of measurement requirements, the individual item shall not be restated to the lower of carrying amount and fair value less costs to sell, but shall instead be carried at the value determined by applying the relevant standard relating to that asset.

5.6.2 Application of IFRS 5 to an existing individual asset

The following examples illustrates the principles of IFRS 5 applicable on individual assets.

EXAMPLE 4

Individual asset carried at historical cost

Chuck Ltd has a PPE item with a cost of R400 000 and a historical cost carrying amount of R320 000 at 1 January 20.12. PPE is depreciated at 10% per annum on the straight-line basis. Chuck Ltd has a 31 December year-end.

On 30 June 20.12 management decides to dispose of the asset within the next year and all other criteria to facilitate the classification of the asset as a non-current asset held for sale, are met. The fair value of the PPE item amounts to R290 000 and the direct costs to sell amount to R15 000.

SOLUTION 4

Applying the requirement in IFRS 5.18 (refer 5.5.1) that non-current assets to be reclassified as held for sale need to have their carrying amounts measured in terms of applicable standards immediately before initial classification as held for sale, would mean that IAS 16 would be applied to determine the carrying amount on 30 June 20.12 of the PPE item involved. Consequently the carrying amount of the PPE item should be calculated as R300 000 (R320 000 – (R400 000 x 10% x 6/12)) raising a depreciation expense of R20 000 in respect of this asset in 20.12 at point of initial classification as held for sale.

In terms of IFRS 5.15 (refer 5.6.1), this newly determined carrying amount of R300 000 should be compared to the fair value less costs to sell of the PPE item involved of R275 000, and be shown at the lower of the two. In this case it will result in an impairment loss of R25 000 as prescribed by IFRS 5.20.



LECTURER'S COMMENT

Guidelines applying IFRS 5 on an individual asset carried at historical cost

- The carrying amount of the asset to be disposed of is measured at date of initial classification in accordance with the applicable standard, for instance by applying IAS 16 – the Standard applicable – to the type of item (property, plant and equipment) disposed of.
- Once the item has been classified as held for sale, no further depreciation is written off on the specific asset.
- The comparison of the newly measured carrying amount with the fair value less costs to sell, will result in the recognition of an impairment loss.

EXAMPLE 5

Individual asset carried at fair value

On 1 January 20.12 (beginning of the year) Digit Ltd owns a property which is rented out under an operating lease agreement (investment property) and is carried at fair value of R500 000. The fair value of the investment property is R510 000 at 30 June 20.12, while costs to sell at that date would amount to R15 000. Assume all amounts to be material.

On 30 June 20.12 management decides to dispose of the investment property within the next year and all other criteria to facilitate the classification of the asset as a non-current asset held for sale, have been met.

SOLUTION 5

Applying the requirement in IFRS 5 that non-current assets to be classified as held for sale need to have their carrying amounts measured in terms of applicable standards immediately before classification as held for sale, would mean that IAS 40 would be applied to determine the carrying amount of the investment property on 30 June 20.12.

However, **investment properties fall outside the scope of the measurement requirements of the standard** in terms of IFRS 5.5 and should therefore be carried as a current asset at fair value only (without deducting costs to sell) once classified as held for sale (see 5.5.1 and 5.5.2). Consequently this newly determined carrying amount of R510 000 (fair value) should not be compared to the fair value less costs to sell of the item involved [being R495 000 (R510 000 – R15 000)], as the exception to measurement requirements applies. The investment property shall now be carried as a current asset at its new fair value of R510 000.



LECTURER'S COMMENT

Guidelines applying IFRS 5 on an individual asset carried at fair value

- The carrying amount of the asset to be disposed of is measured at date of initial classification as held for sale in accordance with the applicable standard, for instance by applying the fair value model in IAS 40 – the Standard applicable – to the type of item (investment property) disposed of.
- Since the fair value model is used, no depreciation is written off on the investment property. However, if the cost model was used, the carrying amount at initial classification as held for sale would be determined writing off depreciation to the point of initial classification. Thereafter the carrying amount is remeasured to the lower of this new carrying amount and fair

	value less costs to sell. No further depreciation is written off after remeasurement. • No comparison of the newly measured carrying amount of the asset with the fair value less costs to sell is made, as the item under discussion is excluded from the measurement requirements of IFRS 5. • The classification and presentation requirements of IFRS 5 will still apply and the investment property will **be carried as a current asset** once classified as held for sale.

5.6.3 Application of IFRS 5 to a disposal group at initial classification as held for sale

A disposal group is a group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction.

Sometimes an entity disposes of a group of assets possibly with some directly associated liabilities, together in a single transaction (IFRS 5.4). Immediately before the initial classification of the disposal group as held for sale, the carrying amounts of the assets (or all the assets and liabilities in the group), shall be measured in accordance with the applicable IFRSs. (IFRS 5.18)

EXAMPLE 6

Measurement of a disposal group

Candy Ltd (year-end 31 December 20.10) decides on 30 September 20.10 to dispose of a disposal group within the next year. All the requirements for classification as held for sale have been met and consequently the disposal group can be classified as held for sale. The carrying amounts of the items included in the disposal group are the following (please take note of the dates involved):

- Land (at 1 January 20.10):
  Carrying amount R150 000
- Factory building (at 1 January 20.10):
  Carrying amount R520 000 (depreciate: reducing balance at 6,667% per annum)
- Plant (at 1 January 20.10):
  Carrying amount R200 000 (depreciate: reducing balance at 13,3333% per annum)
- Inventories:
  Carrying amount R50 000 (at 30 September 20.10 with a net realisable value (NRV) of R45 000)
- Payables associated with the plant, inventories and factory building:
  R25 000 (at 30 September 20.10)
- Share investment:
  Fair value R110 000 (30 September 20.10)

The fair value of the disposal group at 30 September 20.10, date of initial classification as held for sale, amounted to R980 000 (amount assumed), while costs associated with selling the disposal group amounted to:

- Commission on sale of all items in disposal group = R50 000
- Capital gains tax (CGT) on disposal of factory = R20 000

SOLUTION 6

In this case, although the share investments fall outside the scope of IFRS 5 regarding measurement requirements, the disposal group as a whole will be subject to the measurement requirements since other non-current assets within the scope of IFRS 5 form part of the group and the whole disposal group will thus be measured at the lower of carrying amount and fair value less costs to sell.

Step 1:

Determine the carrying amount of all the individual assets in the disposal group at 30 September 20.10

	R
Land at cost	150 000
Factory building [520 000 – (520 000 x 6,667% x 9/12)] (IAS 16 applicable)	494 000
Plant [200 000 – (200 000 x 13,3333% x 9/12)] (IAS 16 applicable)	180 000
Inventories – use NRV since lower than cost (IAS 2 applicable)	45 000
Payables – cost (IFRS 9 applicable)	(25 000)
Share investments – fair value (IFRS 9 applicable)	110 000
Total carrying amount	954 000

Step 2:

Determine the fair value less costs to sell of the disposal group at 30 September 20.10

	R
Fair value less costs to sell (980 000 – 50 000)	930 000

Note: CGT is excluded specifically per the definition of costs to sell (see 5.2)

Step 3:

Determine the lower of carrying amount and fair value less costs to sell at 30 September 20.10

	R
Fair value less costs to sell (980 000 – 50 000)	930 000
Carrying amount	954 000
Measure the disposal group held for sale at the fair value less costs to sell, as this is the lower of the two figures calculated	930 000

Step 4:

Calculate the impairment loss at 30 September 20.10

	R
Carrying amount less fair value less costs to sell (954 000 – 930 000)	24 000



LECTURER'S COMMENT

Guidelines approaching this question:

- All the assets and liabilities in the disposal group initially classified as held for sale will first be measured to their carrying amounts by applying the IFRSs applicable to them. Note the applicable Standard in brackets.
- The fair value less costs to sell of the whole disposal group is then determined. Note the calculation of fair value less costs to sell per definition.
- The disposal group will then be measured to the lower of its carrying amount and fair value less costs to sell. This is done by allocating the impairment loss of R24 000 to non-current assets within the scope of the measurement requirements of IFRS 5 (a detailed discussion and examples of the matter appears hereafter).

Note: if none of the assets in a disposal group falls within the scope of measurement requirements of IFRS 5, then the measurement requirement of IFRS 5 will not be applicable to the disposal group and the assets in the group will merely be carried at their values determined by applying their applicable standards.

EXAMPLE 7

Eish-Deish Ltd decides on 30 June 20.10 to dispose of all its share investments in one transaction at some point during the next year. All the requirements for classification as held for sale of this disposal group have been met. Consequently the disposal group can be classified as held for sale. Eish-Deish Ltd has a 31 December year-end and accounts for their share investments according to IFRS 9. The share investments are designated as financial assets at fair value through profit or loss.

The carrying amounts of the items included in the disposal group are the following:

- Speculative share investments at fair value at 1 January 20.10: R85 000; 30 June 20.10: R90 000
- Long-term share investments at fair value at 1 January 20.10: R95 000; 30 June 20.10: R105 000

The fair value of the disposal group at 30 June 20.10 amounted to R195 000, while costs associated with selling amounted to:

- Commission on sale of both investments = R23 000 (assumed)
- CGT on disposal of investments = R10 000 (assumed)

SOLUTION 7

Share investments fall outside the scope of IFRS 5 regarding measurement requirements, and thus the disposal group as a whole will be excluded from the scope of IFRS 5 in respect of measurement requirements. Consequently the investments will be shown at fair value without deducting costs to sell and not the lower of carrying amount and fair value less costs to sell.

Step 1:

Determine the carrying amount of the individual assets in the disposal group at 30 June 20.10

	R
Speculative share investments – fair value (IFRS 9)	90 000
Other share investments – fair value (IFRS 9)	105 000
Total carrying amount	195 000



LECTURER'S COMMENT

Guidelines for approaching this question:

- The assets in the disposal group reclassified as held for sale will first be measured to their carrying amounts at the point of classification as held for sale by applying the IFRSs applicable to them. In this case the fair value adjustment to the investments will be R15 000 in total (R195 000 – R180 000) and this amount is taken to profit or loss.
- The fair value less costs to sell of the whole disposal group is not determined as all assets in the disposal group fall outside the scope of the measurement requirements of IFRS 5.

5.6.4 Other matters in respect of measurement

Non-current assets are sometimes acquired with a view to dispose of in the short-term.

If a newly acquired non-current asset (or disposal group) meets the criteria to be classified as held for sale, applying the measurement requirements of IFRS 5 (refer IFRS 5.15) will result in the asset (or disposal group) being measured on initial recognition at the lower of its carrying amount had it not been classified as held for sale (for example its cost) and its fair value less costs to sell. If the asset (or disposal group) is acquired as part of a business combination, it shall be measured at acquisition at fair value less costs to sell. (IFRS 5.16)

EXAMPLE 8

Titan Ltd buys a non-current asset (PPE item) with a cost price of R105 000 and a fair value of R110 000 cash. Costs to resell the asset amounts to R10 000. The asset was acquired with a view to dispose of it within the next six months. All other criteria necessary for classification as a non-current asset held for sale have been met.

SOLUTION 8

Following the general principles discussed above, this asset will be measured at the lower of its cost and fair value less costs to sell at initial recognition. This means that the asset will be recognised at initial recognition at R100 000 (R110 000 – R10 000). Presumably this will lead to the asset being recorded at R100 000, the bank being credited by R105 000 and an impairment loss of R5 000 being recognised immediately.

5.6.5 Subsequent remeasurement of an individual asset or disposal group

Assets or disposal groups classified as held for sale will have to be remeasured to its fair value less costs to sell if a year-end occurs between the date of initial classification as held for sale and the final date of disposal.

Assets that fall outside the scope for measurement requirements for IFRS 5

Individual non-current assets that fall outside the scope of the measurement requirements of IFRS 5 will subsequently be measured by merely applying the applicable standards.

On subsequent remeasurement of a disposal group, the carrying amounts of any assets and liabilities that are not within the scope of the measurement requirements of this IFRS, but are included in a disposal group classified as held for sale (including current assets such as inventories), shall be remeasured in accordance with applicable Standards before the fair value less costs to sell of the disposal group is remeasured. (IFRS 5.19)

Assets that fall within the scope for measurement requirements for IFRS 5

On subsequent remeasurement of an individual asset or disposal group, the carrying amounts of non-current assets that fall within the scope of the measurement requirements of IFRS 5.5 will be the fair values less costs to sell less any impairment losses that were determined at initial classification. If the fair value less costs to sell at subsequent remeasurement is different from the fair value less costs to sell at initial classification it should be remeasured to the "new" fair value less costs to sell, resulting in a further impairment loss or a reversal of a previous impairment loss. (Refer 5.7.)

5.7 RECOGNITION OF IMPAIRMENT LOSSES AND REVERSALS

5.7.1 Impairment loss for an individual non-current asset

At initial classification and measurement as well as subsequent remeasurement

An entity shall recognise an impairment loss for any initial or subsequent write-down of the non-current asset to fair value less costs to sell. (IFRS 5.20)

The impairment loss calculated will be treated in terms of IFRS 5. Therefore, regardless of whether the assets are carried at the cost model or the revaluation model, the impairment loss will be treated the same. **The carrying amount of the asset affected will be credited and the impairment loss will be debited in P/L in the statement of profit or loss and other comprehensive income (not revaluation surplus).**

5.7.2 Impairment loss for a disposal group

At initial classification and measurement as well as subsequent remeasurement leading to an impairment loss

The impairment loss recognised for a disposal group shall reduce the carrying amount of the non-current assets that fall within the scope of the measurement requirements of IFRS 5 (see 5.5.2 for exclusions) in the order of allocation set out in IAS 36.104(a), (b) and .122 *Impairment of assets*. (IFRS 5.23)

The impairment loss shall be allocated to reduce the carrying amounts of the assets (group of assets) in the following order: first against goodwill and the remainder against other assets in proportion to their carrying amounts. (IAS 36.104 (a), (b) and .122). Current assets forming part of the disposal group will not be reduced by the impairment loss.

EXAMPLE 9

The information in example 6 in 5.6.3 will be used here to illustrate the accounting treatment of an impairment loss.

SOLUTION 9

The impairment loss calculated in example 6 amounted to R24 000 and the whole amount will appear in the statement of comprehensive income (P/L). Since the total non-current assets subject to impairment amounted to R824 000 (= 150 000 + 494 000 + 180 000), the allocation of the impairment loss to the individual assets will be as follows:

	Carrying amounts on classification	Impairment loss allocated	CA after im-pairment loss
	R	R	R
Land	150 000	(4 369) (1)	145 631
Factory building	494 000	(14 388) (2)	479 612
Plant	180 000	(5 243) (3)	174 757
Inventories	45 000	NIL (4)	45 000
Payables	(25 000)	NIL (5)	(25 000)
Share investment	110 000	NIL (6)	110 000
Total carrying amount	954 000	(24 000)	930 000

It is vital that you understand the arguments set out in the calculations and explanations below:

(1) 24 000 x 150 000/824 000
(2) 24 000 x 494 000/824 000
(3) 24 000 x 180 000/824 000
(4) Asset already subjected to a net realisable value test in terms of IAS 2 – the equivalent of impairment tests for current assets – and IFRS 5.23 specifically refers to only non-current assets for allocation of impairment loss.
(5) Not an asset and not subject to impairment.
(6) Since IFRS 5.23 specifically states that only non-current assets that fall within the scope of the measurement requirements of IFRS 5.5 should be reduced by the impairment loss for the disposal group and investments fall outside the scope of measurement requirements of IFRS5.5, no portion of the impairment loss is allocated to the share investments. This would also have been the case if the share investments were, say, an investment property carried under the fair value model. The reasoning presumably being that the fair value of the asset (not less costs to sell) will reflect any drop in fair value in any case.

5.7.3 Reversal of an impairment loss/gain on remeasurement of an individual asset

An entity shall recognise a gain for any subsequent increase in fair value less costs to sell of an asset, but not in excess of the cumulative impairment loss that has been recognised either in accordance with IFRS 5 or previously under IAS 36 *Impairment of assets*. (IFRS 5.21)

5.7.4 Recognition of gains and losses at date of sale of a non-current asset

A gain or loss not previously recognised at either initial classification or subsequent remeasurement shall be recognised at the date of derecognition.

Requirements of non-current assets falling within the scope of IFRS 5 relating to derecognition are set out in IAS 16.67 to 72 *Property, plant and equipment* and IAS 38.112 to 117 – *Intangible assets*. The derecognition requirements are:

- The gain or loss arising from derecognition of an item of property, plant and equipment/intangible asset shall be included in profit or loss (the statement of profit or loss and other comprehensive income) when the item is derecognised. Gains shall not be classified as revenue. (IAS 16.68)
- In determining the date of disposal of an item, an entity applies the criteria in IFRS 15 *Revenue from contracts with customers* for recognising revenue from the sale of goods – all the criteria must be met. (IAS 16.69)
- The gain or loss arising from the derecognition of an item of property, plant and equipment shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the item. (IAS 16.71)
- The consideration receivable on disposal of an item of property, plant and equipment is recognised initially at its fair value. If payment for the item is deferred, the consideration received is recognised initially at the cash price equivalent. The difference between the nominal amount of the consideration and the cash price equivalent is recognised as interest revenue under IFRS 15 *Revenue from contracts with customers* reflecting the effective yield on the receivable. (IAS 16.72)

EXAMPLE 10

Purple Heather Ltd has classified an item as held for sale on 30 June 20.10 after all the criteria for classification have been met and an impairment loss of R50 000 was recognised in profit or loss. This resulted in a carrying amount of R850 000. At 31 December 20.10 (year-end) the fair value less costs to sell of the PPE item was once again lower than its carrying amount at that date and consequently the item was subsequently remeasured at fair value less costs to sell of R810 000, recognising an impairment loss of R40 000 in profit or loss. The asset is finally disposed of at R830 000 at 30 April 20.11 after all the criteria for derecognition have been met.

The effect of the above scenario on the statement of profit or loss and other comprehensive income in 20.10 and 20.11 is the following:

20.10:

A first impairment loss of R50 000 was recognised at initial classification as held for sale on 30 June 20.10. A second impairment loss of R40 000 (850 000 – 810 000) was recognised at remeasurement on 31 December 20.10.

20.11:

A final gain of R20 000 (830 000 – 810 000) is recognised at derecognition on final disposal.

5.8 NON-CURRENT ASSETS TO BE ABANDONED

An entity shall not classify as held for sale a non-current asset (or disposal group) that is to be abandoned. This is because its carrying amount will be recovered principally through continuing use.

This difference in treatment arises since the carrying amount of the abandoned asset (or disposal group) will be recovered principally through continuing use, while that of an asset (or disposal group) held for sale will be recovered through sale. Consequently, an entity shall not classify as held for sale a non-current asset (or disposal group) that is to be abandoned.

Non-current assets (or disposal groups) to be abandoned include non-current assets (or disposal groups) that are to be used to the end of their economic life as well as non-current assets (or disposal groups) that are to be closed down rather than sold. (IFRS 5.13)

An entity shall not account for a non-current asset that has been temporarily taken out of use as if it had been abandoned. (IFRS 5.14)

5.9 CHANGES TO A PLAN OF SALE

5.9.1 General

If an entity has previously classified an asset (or disposal group) as held for sale, but the criteria for classification as held for sale are no longer met, the entity shall cease to classify the asset (or disposal group) as held for sale. (IFRS 5.26)

The entity shall measure a non-current asset that ceases to be classified as held for sale (or ceases to be included in a disposal group classified as held for sale) at the **lower** of:

(a) its carrying amount before the asset (or disposal group) was classified as held for sale, adjusted for any depreciation, amortisation or revaluations that would have been recognised had the asset (or disposal group) not been classified as held for sale, and
(b) its recoverable amount at the date of the subsequent decision not to sell. (IFRS 5.27)

5.9.2 Individual assets no longer classified as held for sale

The entity shall include any required adjustment to the carrying amount of a non-current asset that ceases to be classified as held for sale in income from continuing operations in the period in which the criteria for classification are no longer met.

The adjustment must be included in the same caption in the statement of comprehensive income used to present a gain or loss, if any, that is recognised on measuring an item that has been classified as held for sale but that is not a discontinued operation. However, if the asset under consideration is either a PPE item or intangible asset that has been carried under the revaluation model per IAS 16 or IAS 38, the adjustment shall be treated as a revaluation increase or decrease. (IFRS 5.28)

EXAMPLE 11

Monty Ltd classified a patent as held for sale on 30 June 20.10 (its year-end) as it had met all the criteria for classification as held for sale on that date. The patent had a carrying amount and fair value less costs to sell of R960 000 at year-end, an original cost of R1 600 000 and amortisation on the item is written off at 20% per annum on the straight-line basis with no residual value anticipated at any time in the future.

Due to a change in patent rights promulgated on 1 April 20.11, Monty Ltd decided to no longer dispose of the patent and consequently the asset had to be reclassified. The recoverable amount of the asset under consideration amounted to R700 000 on 1 April 20.11 and its useful life on that date was 2,25 years.



REQUIRED

Calculate the carrying amount at which the patent should be reinstated on 1 April 20.11 due to the decision to no longer sell the asset, the adjustment to the carrying amount, as well as the applicable amortisation for 20.11. Also state under which caption in the statement of profit or loss and other comprehensive income the adjustment to the carrying amount should be reflected.

SOLUTION 11

The asset no longer classified as held for sale should be reinstated at the lower of what its carrying amount would have been had it never been classified as held for sale and its recoverable amount.

Step 1:

Calculate what the carrying amount would have been on 1 April 20.11 if the intangible asset had never been classified as held for sale

	R
Carrying amount on 30 June 20.10	960 000
Amortisation from 1 July 20.10 to 31 March 20.11 (1 600 000 x 20% x 9/12)	(240 000)
Carrying amount at 1 April 20.11	720 000
Recoverable amount at 1 April 20.11	700 000

The lower of the two is the recoverable amount of R700 000 and therefore the asset should be remeasured to this amount at 1 April 20.11

Step 2:

Calculate the adjustment to the existing carrying amount on reclassification

	R
Held for sale item carried at	960 000
Carrying amount on 1 April 20.11 once no longer held for sale	700 000
Adjustment to carrying amount – write-off	260 000

Amortisation during 20.11

The new carrying amount at 1 April 20.11 from the previous calculation is R700 000 and the remaining useful life would be 2,25 years on that date. Since the patent has no residual value, the amortisation for 20.11 will be R77 778 (R700 000/2,25 x 3/12).

The adjustment of R260 000 should be disclosed as a deduction from other income or as part of other expenses.

5.9.3 Individual item part of disposal group, no longer classified as held for sale

If an entity removes an individual asset or liability from a disposal group classified as held for sale, the remaining assets and liabilities of the disposal group still to be sold shall continue to be measured as a group only if the group still meets the criteria in 5.3.1. Otherwise, the remaining non-current assets of the group that individually still meet the criteria to be classified as held for sale shall be measured individually at the lower of their carrying amounts and fair values less costs to sell at that date. Any non-current assets that no longer meet the criteria shall cease to be classified as held for sale. (IFRS 5.29)

EXAMPLE 12

Widget Ltd (year-end 31 December 20.9) classified the following group of assets as a disposal group held for sale on 2 January 20.10, having met all the criteria for classification as held for sale required by IFRS 5. The effect of the classification as held for sale and measurement at initial classification is set out in the table below:

	Carrying amounts on classification	**Impairment loss allocated**	**CA after impairment loss**
	R	**R**	**R**
Land	100 000	5 759	94 241
Factory building	475 000	27 356	447 644
Widget plant[1]	189 000	10 885	178 115
Inventories	45 000	Nil	45 000
Payables	(35 000)	Nil	(35 000)
Share investments	110 000	Nil	110 000
Total carrying amount	884 000	44 000	840 000

[1] Depreciation provided for at 15% per annum straight-line based on a cost of R240 000 (no residual value). The recoverable amount of the widget plant based on value in use is R180 000 at 31 May 20.10, and the remaining useful life of the widget plant on 31 May 20.10 is 5 years and 3 months. The residual value of the asset has not changed and is still RNil.

On 31 May 20.10 the directors reconsidered and decided to no longer dispose of the widget plant as they unexpectedly secured a large contract for the production of widgets for the next five years – consequently the widget plant was removed from the disposal group. The inventories retained their net realisable value determined on 2 January 20.10 and all payables have been repaid since initial classification as held for sale. The fair value of the share investments has not changed. The group still meets the criteria for classification as a disposal group after the removal of the widget plant.



REQUIRED

Determine the carrying amount of the widget plant after the decision to no longer sell it has been made, the adjustment to the statement of profit or loss and other comprehensive income due to the reclassification, the depreciation charge for 20.10, as well as the carrying amount of the disposal group after the removal of the widget plant.

SOLUTION 12

Step 1:

Calculate the carrying amount of the widget plant on removal from the disposal group on 31 May 20.10:

	R
Carrying amount as it would have been if the disposal group was never classified as held for sale [R189 000 – (240 000 x 15% x 5/12)]	174 000
Recoverable amount (given)	180 000

The lower of the two alternatives should be taken, thus the carrying amount of R174 000.

Step 2:

Calculate the adjustment in the statement of profit or loss and other comprehensive income of 20.10 due to reclassification:

	R
Carrying amount determined on 2 January 20.10	178 115
Carrying amount determined on 31 May 20.10	174 000
Adjustment to statement of profit or loss and other comprehensive income – loss recognised	4 115



LECTURER'S COMMENT

Note that the adjustment in respect of reclassification of the widget plant would have been different if the recoverable amount was say R160 000 (ie lower than the carrying amount at 31 May of R174 000).

Depreciation charge for 20.10 on the widget plant:

	R
Carrying amount on 31 May 20.10	174 000
Depreciation charge (174 000/5,25 x 7/12)	19 333

Carrying amount of disposal group after removal of the widget plant on 31 May 20.10:

	R
Carrying amount including the widget plant	840 000
Carrying amount excluding the widget plant (840 000 – 178 115 + 35 000 (payables))	696 885

5.10 PRESENTATION AND DISCLOSURE OF A NON-CURRENT ASSET OR DISPOSAL GROUP CLASSIFIED AS HELD FOR SALE

5.10.1 Presentation

- An entity shall present a non-current asset classified as held for sale and the assets of the disposal group classified as held for sale separately from other assets in the statement of financial position. The liabilities of a disposal group classified as held for sale shall be presented separately from other liabilities in the statement of financial position. Those assets and liabilities shall not be offset and presented as a single amount. The major classes of assets and liabilities classified as held for sale shall be separately disclosed either on the face of the statement of financial position or in the notes. An entity shall present separately any cumulative income or expense recognised in other comprehensive income relating to a non-current asset (or disposal group) classified as held for sale. (IFRS 5.38)
- If the disposal group is a newly acquired subsidiary that meets the criteria to be classified as held for sale on acquisition, disclosure of the major classes of assets and liabilities is not required. (IFRS 5.39)
- An entity shall not reclassify or re-present amounts presented for non-current assets or for the assets and liabilities of disposal groups classified as held for sale in the statement of financial position for prior periods to reflect the classification in the statement of financial position for the latest period presented. (IFRS 5.40)

5.10.2 Additional disclosures – IFRS 5.41

- An entity shall disclose the following information in the **notes** in the period in which a non-current asset (or disposal group) has been either classified as held for sale or sold:

  – a description of the non-current asset (or disposal group);
  – a description of the facts and circumstances of the sale, or leading to the expected disposal, and the expected manner and timing of that disposal;
  – the gain or loss recognised and, if not separately presented on the face of the statement of comprehensive income, the caption in the statement of comprehensive income that includes that gain or loss;
  – if applicable, the reportable segment in which the non-current asset (or disposal group) is presented in accordance with IFRS 8 *Operating segments*.

Refer to the integrated example at the end of the learning unit for a model disclosure of non-current assets or disposal group held for sale.

PART II: DISCONTINUED OPERATIONS

5.11 INTRODUCTION

5.11.1 Objective

The objective of this standard is to specify the accounting for assets held for sale and the presentation and disclosure of discontinued operations. (IFRS 5.01)

5.11.2 Definition

As per the definitions under 5.2 above a discontinued operation is a component of an entity that either has been disposed of or is classified as held for sale and

- represents a major line of business or geographical area of operations;
- is a part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations; or
- is a subsidiary acquired exclusively with a view to resale. (IFRS 5.32)

5.11.3 Classification as discontinued operation

The IFRS classifies an operation as discontinued at the date that the operation meets the criteria to be classified as held for sale or when the entity has disposed of the operation.

5.12 PRESENTATION AND DISCLOSURE

An entity shall present and disclose information that enables users of the financial statements to evaluate the financial effects of discontinued operations and disposals of non-current assets (or disposal groups). (IFRS 5.30)

5.12.1 Disclosure

An entity shall disclose:

- a single amount on the face of the statement of comprehensive income comprising the **total** of:

  - the post-tax profit or loss of discontinued operations and
  - the post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operations.

- an analysis[1] of the above-mentioned single amount into:

  - the revenue, expenses and pre-tax profit or loss of discontinued operations;
  - the related income tax expense as required by paragraph 81(h) of IAS 12;
  - the gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation.

1. The analysis may be presented in the notes or on the face of the statement of comprehensive income. For the purpose of this module, we will present it on the face of the statement of comprehensive income. (IFRS 5.33)

   If an entity presents the components of profit or loss in a separate statement of profit or loss and other comprehensive income as described in IAS 1.81, a section identified as relating to discontinued operations is presented in that separate statement.

- an entity shall re-present the disclosures in IFRS 5.33 (above) for prior periods presented in the financial statements so that the disclosures relate to all operations that have been discontinued by the end of the reporting period for the latest period presented. (IFRS 5.34)

- adjustments in the current period to amounts previously presented in discontinued operations that are directly related to the disposal of a discontinued operation in a prior period shall be classified separately in discontinued operations. The nature and amount of such adjustments shall be disclosed. Examples of circumstances in which these adjustments may arise include the following:

  - the resolution of uncertainties that arise from the terms of the disposal transaction, such as the resolution of purchase price adjustments and indemnification issues with the purchaser;
  - the resolution of uncertainties that arise from and are directly related to the operations of the component before its disposal, such as environmental and product warranty obligations retained by the seller;
  - the settlement of employee benefit plan obligations, provided that the settlement is directly related to the disposal transaction. (IFRS 5.35)

If an entity ceases to classify a component of an entity as held for sale, the results of operations of the component previously presented in discontinued operations in accordance with IFRS 5.33–35 shall be reclassified and included in income from continuing operations for all periods presented. The amounts for prior periods shall be described as having been re-presented. (IFRS 5.36)

5.13 GAINS OR LOSSES RELATING TO CONTINUING OPERATIONS

Any gain or loss on remeasurement of a non-current asset (or disposal group) classified as held for sale that does not meet the definition of a discontinued operation, shall be included in profit or loss from continuing operations. (IFRS 5.37)

5.14 MODEL FOR DISCLOSURE

XXX LTD

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.10

	Notes	R
CONTINUING OPERATIONS		
Revenue		XXXX
Cost of sales		(XXX)
Gross profit		XXXX
Other expenses		(XXX)
Finance costs		(XX)
Profit before tax		XXX
Income tax expense		(XX)
Profit for the year from continuing operations		XXX
DISCONTINUED OPERATIONS		
Revenue		XXX
Expenses		(XXX)
Loss before tax		(XXX)
Income tax benefit		XX
Loss after tax		XXX
Loss after tax on measurement of non-current asset held for sale/disposal group		(XX)
Loss on measurement of non-current asset held for sale to fair value less costs to sell		(XX)
Income tax benefit		X
Loss for the year from discontinued operations		(XX)
PROFIT FOR THE YEAR		XXXXXX

EXAMPLE 13

Aqua Ltd manufactures and sells water sports equipment and has branches in Cape Town, Port Elizabeth and East London. The East London branch, whose results were previously reported in the Eastern Cape geographical segment, incurred losses over the past two years. On 31 March 20.10 the board of directors approved a detailed formal disposal plan for the discontinuance of the branch and on the same date made a public announcement. The approved formal plan regarding the **piecemeal sale of the assets**, was at a stage of completion on 30 September 20.10 where no realistic possibility of withdrawal existed. Binding sale agreements regarding **property and plant** were concluded. It is expected that the plan for the discontinuance of the East London branch will be completed on 28 February 20.11. Aqua Ltd's year-end is 31 December. All the remaining assets and liabilities were taken over by the continuing operation.

The following information is presented to you on 31 December 20.10 (before taking into account any adjustments due to the discontinuance):

Balances in the statement of financial position:

	East London R	**Cape Town and Port Elizabeth R**
Property, plant and equipment	200 000	1 000 000
Current assets	40 000	200 000
Long-term liabilities	90 000	300 000
Current liabilities	60 000	150 000

Actual results – continuing operations:

	Cape Town 01/01/20.10 to 31/12/20.10 R	**Port Elizabeth 01/01/20.10 to 31/12/20.10 R**	**Cape Town and Port Elizabeth 01/01/20.9 to 31/12/20.9 R**
Income	800 000	770 000	1 250 000
Cost of sales	350 000	355 000	500 000
Other expenses	325 000	297 000	515 000

Actual results – discontinued operations:

	East London 01/01/20.10 to 31/03/20.10 R	**East London 01/04/20.10 to 30/09/20.10 R**	**East London 01/10/20.10 to 31/12/20.10 R**	**East London 01/01/20.9 to 31/12/20.9 R**
Income	75 000	100 000	60 000	250 000
Cost of sales	60 000	70 000	45 000	200 000
Other expenses	20 000	30 000	20 000	60 000

Discontinuance cost of discontinued operations:

	01/01/20.11 to 28/02/20.11 Estimated R	31/03/20.10 to 31/12/20.10 Actual R
Direct costs of discontinuance	3 000	4 500
Severance pay payable to employees	20 000	–
Fines (discontinuance of contracts)	3 000	–
Income	30 000	–
Cost of sales	25 000	–
Other expenses	10 000	–

Other information:

	20.10 R	20.9 R
Finance cost (continuing operations)	15 000	15 000
Tax (continuing and discontinued operations)	65 240	63 000
Current tax	65 240	63 000
Dividends paid	50 000	40 000

Tax was calculated before taking into account the finance cost paid and the direct costs to discontinue the East London branch as well as the estimated gross discontinuance loss in 20.11.

Additional information

1. The direct cost of discontinuance is tax deductible. Assume that the severance pay and fines are not deductible for tax purposes.
2. On 30 September 20.10 information regarding the piecemeal sale of property and plant to two independent parties relating to the discontinued operation was as follows:

	Tax base R	Carrying amount R	Contract price R	Contract settlement date R
Property	120 000	120 000	105 000	28 February 20.11
Plant	80 000	80 000	80 000	28 February 20.11
	200 000	200 000	185 000	

3. On 30 September 20.10 the plant was withdrawn from operations.
4. Assume an income tax rate of 28%. 80% of all capital gains are taxable.
5. There is no difference between the carrying amount and the tax base of the property.
6. There are no non-taxable income, non-deductible expenses or temporary differences other than those evident from the question.



REQUIRED

(a) Prepare the statement of profit or loss and other comprehensive income of Aqua Ltd for the year ended 31 December 20.10; and
(b) prepare the tax note, as well as the note on non-current assets held for sale for the year ended 31 December 20.10. Accounting policy notes are not required.

Your answer must comply with *International Financial Reporting Standards.*

SOLUTION 13

AQUA LTD

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.10

	Notes	20.10 R	20.9 R
CONTINUING OPERATIONS			
Revenue (1)		1 570 000	1 250 000
Cost of sales (2)		(705 000)	(500 000)
Gross profit		865 000	750 000
Other expenses (3)		(622 000)	(515 000)
Finance costs		(15 000)	(15 000)
Profit before tax		228 000	220 000
Income tax expense (6)	**2**	(63 840)	(61 600)
Profit for the year from continuing operations		164 160	158 400
DISCONTINUED OPERATIONS			
Revenue (4)		235 000	250 000
Expenses (5)		(275 500)	(260 000)
Loss before tax		(40 500)	(10 000)
Income tax benefit (7)	**2**	4 900	2 800
Loss after tax		(35 600)	(7 200)
Loss after tax on measurement		(10 800)	–
Loss on measurement of non-current asset held for sale to fair value less costs to sell (9)		(15 000)	–
Income tax benefit (9)		4 200	–
Loss for the year from discontinuing operations		(46 400)	(7 200)
PROFIT FOR THE YEAR		117 760	151 200

AQUA LTD

NOTES FOR THE YEAR ENDED 31 DECEMBER 20.10

1. Accounting policy

1.1 Non-current assets held for sale

Non-current assets or disposal groups are classified as non-current assets held for sale when the carrying amount of the asset or the disposal group will be recovered through a sale transaction rather than through use of the asset or the disposal group.

Immediately before the classification of the asset or disposal group as held for sale, the carrying amount of the assets or the carrying amount of the assets and liabilities in the disposal group are measered in accordance with the applicable IFRSs. Subsequently the asset or the disposal group measured at the lower of its carrying amount and the fair value less cost to sell of the asset or the disposal group. Any adjustment is recorded in profit or loss.

2. Income tax expense

	20.10 R	20.9 R
Major components of tax expense		
Current tax	59 780	58 800
Continuing operations (calc 6)	63 840	61 600
Discontinued operations (calc 7)	(4 060)	(2 800)
Deferred tax	(5 040)	–
Continuing operations	–	–
Discontinued operations (840 (calc 8) + 4 200 (calc 9))	(5 040)	–
Tax expense	54 740	58 800

3. Non-current assets held for sale

A decision to dispose of property and plant, due to the fact that the branch incurrend losses for the past two years, was taken in March 20.10 after approval of a detailed formal disposal plan for the discontinuance of the East London branch. The plan regarding the piecemeal sale of the assets was at a stage of completion on 30 September 20.10 where no realistic possibility of withdrawal existed. It is expected that the assets will be sold for cash and that the disposal will be completed by 28 February 20.11.

The non-current assets held for sale comprise:

	20.10 R
Assets:	
Property (calc 9)	105 000
Plant	80 000
	185 000

An impairment loss of R15 000 (pre-tax) was recognised on initial classification of the property as held for sale and this amount was included under loss after tax on measurement on the face of the statement of profit or loss and other comprehensive income.

The assets are part of the Eastern Cape geographical segment.



LECTURER'S COMMENT

The information regarding the disposal of the property and plant of the East London branch is disclosed in the note "Non-current assets held for sale" because **the assets were sold independently (piecemeal) to two different parties and no liabilities directly associated with these assets were transferred.** Therefore it does not qualify to be classified as a disposal group.

CALCULATIONS

1. 800 000 + 770 000 = 1 570 000
2. 350 000 + 355 000 = 705 000
3. 325 000 + 297 000 = 622 000
4. 75 000 + 100 000 + 60 000 = 235 000
5. (60 000 + 70 000 + 45 000)[1] + (20 000 + 30 000 + 20 000)[2] + (3 000 + 20 000 + 3 000)[3] + 4 500[4] = 275 500

[1] Cost of sales
[2] Other expenses
[3] Provision for costs related to discontinuance
[4] Actual cost of discontinuance

6. Tax on continuing operations

	20.10 R	20.9 R
Profit before tax	228 000	220 000
Temporary differences	–	–
Non-taxable/non-deductible differences	–	–
Taxable income	228 000	220 000
Tax @ 28%	63 840	61 600

7. Tax on discontinued operations

	20.10 R	20.9 R
Profit/(loss) before tax	(40 500)	(10 000)
Exempt differences	23 000	–
– Severance pay to employees	20 000	
– Fines	3 000	
Temporary differences		
Provision for direct cost of discontinuance	3 000	–
Taxable income/(loss)	(14 500)	(10 000)
Current tax @ 28%	(4 060)	(2 800)

8. Deferred tax on discontinued operations

	20.10 R	20.9 R
Deferred tax balance beginning of year	–	–
Deferred tax balance end of year (asset	840[1]	–
Deferred tax movement (Cr to P/L)	840	–

Deferred tax balance:

	Carrying amount R	Tax base R	Temporary difference R	Deferred tax asset/ (liability) R
Provision for direct cost of discontinuance	3 000	–	3 000	840

9. Carrying amount of property and plant to be sold

	20.10 R
Property – impairment loss	
– Original carrying amount	120 000
– Contract price ("new" carrying amount)	(105 000)
Impairment loss	15 000
Deferred tax thereon	4 200



LECTURER'S COMMENT

Provisions are made for the following future expenses:

- Severance pay
- Fines on discontinuance of contracts
- Estimated direct future cost of discontinuance

The provisions were made because

(i) there exist a present obligation at year-end as a result of a past event (the approval and announcement of a formal disposal plan for the discontinued operation),
(ii) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and
(iii) a reliable estimate of these amounts of obligations can be made. (IAS37.14)

There is no tax on the severance pay and fines, but deferred tax must be provided for on the provision for direct future discontinuance costs. The reason is that the South African Revenue Service will not allow the provision as a deduction in the current year, but will allow it when the expense is actually paid.

An impairment loss is a temporary difference. Deferred tax is calculated thereon at 28%.

EXAMPLE 14

Aqua Ltd manufactures and sells water sports equipment and has branches in Cape Town, Port Elizabeth and East London. The East London branch, whose results were previously reported in the Eastern Cape geographical segment, incurred losses over the past two years. On 31 March 20.10 the board of directors approved a detailed formal disposal plan for the discontinuance of the branch and on the same date made a public announcement. The approved formal plan regarding the **once-off sale** of **assets and liabilities**, was at a stage of completion on 30 September 20.10 where no realistic possibility of withdrawal existed. A binding sale agreement regarding the assets and liabilities were concluded. It is expected that the plan for the discontinuance of the East London branch will be completed on 28 February 20.11. Aqua Ltd's year-end is 31 December.

The following information is presented to you on 31 December 20.10 (before taking into account any adjustments due to the discontinuance):

Balances in the statement of financial position

	East London R	**Cape Town and Port Elizabeth R**
Property, plant and equipment	200 000	1 000 000
Current assets	40 000	200 000
Long-term liabilities	90 000	300 000
Current liabilities	60 000	150 000

Actual results – continuing operations:

	Cape Town 01/01/20.10 to 31/12/20.10 R	**Port Elizabeth 01/01/20.10 to 31/12/20.10 R**	**Cape Town and Port Elizabeth 01/01/20.9 to 31/12/20.9 R**
Income	800 000	770 000	1 250 000
Cost of sales	350 000	355 000	500 000
Other expenses	325 000	297 000	515 000

Actual results – discontinued operations:

	East London 01/01/20.10 to 31/03/20.10 R	**East London 01/04/20.10 to 30/09/20.10 R**	**East London 01/10/20.10 to 31/12/20.10 R**	**East London 01/01/20.9 to 31/12/20.9 R**
Income	75 000	100 000	60 000	250 000
Cost of sales	60 000	70 000	45 000	200 000
Other expenses	20 000	30 000	20 000	60 000

Discontinuance cost of discontinued operations:

	01/01/20.11 to 28/02/20.11 Estimated R	31/03/20.10 to 31/12/20.10 Actual R
Direct costs of discontinuance	3 000	4 500
Severance pay payable to employees	20 000	–
Fines (discontinuance of contracts)	3 000	–
Income	30 000	–
Cost of sales	25 000	–
Other expenses	10 000	–

Other information:	**20.10 R**	**20.9 R**
Finance cost (continuing operations)	15 000	15 000
Tax (continuing and discontinued operations)	65 240	63 000
Current tax	65 240	63 000
Dividends paid	50 000	40 000

Tax was calculated before taking into account the finance cost paid and the direct costs to discontinue the East London branch as well as the estimated gross discontinuance loss in 20.11.

Additional information

1. The direct cost of discontinuance is tax deductible. Assume that the severance pay and fines are not deductible for tax purposes.
2. The assets and liabilities of the East London branch meet all the criteria to be classified as a disposal group. On 30 September 20.10 the fair value less costs to sell of the disposal group was R49 000.
3. On 30 September 20.10 the plant was withdrawn from operations.
4. Assume an income tax rate of 28%. 80% of all capital gains are taxable.
5. There is no difference between the carrying amount and the tax base of the property.
6. There are no non-taxable income, non-deductible expenses or temporary differences other than those evident from the question.



REQUIRED

(a) Prepare the statement of profit or loss and other comprehensive income of Aqua Ltd for the year ended 31 December 20.10.
(b) Prepare the tax note as well as the note on the disposal group for the year ended 31 December 20.10.

Your answer must comply with *International Financial Reporting Standards*.

Accounting policy notes are not required.

SOLUTION 14

AQUA LTD

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.10

	Notes	20.10	20.9
	R	R	R
CONTINUING OPERATIONS			
Revenue (1)		1 570 000	1 250 000
Cost of sales (2)		(705 000)	(500 000)
Gross profit		865 000	750 000
Other expenses (3)		(622 000)	(515 000)
Finance costs		(15 000)	(15 000)
Profit before tax		228 000	220 000
Income tax expense (6)	**2**	(63 840)	(61 600)
Profit for the year from continuing operations		164 160	158 400
DISCONTINUED OPERATIONS			
Revenue (4)		235 000	250 000
Expenses (5)		(275 500)	(260 000)
Loss before tax		(40 500)	(10 000)
Income tax benefit (7)	**2**	4 900	2 800
Loss after tax		(35 600)	(7 200)
Loss after tax on measurement		(10 800)	–
Loss on measurement of non-current asset held for sale to fair value less costs to sell (9)		(15 000)	–
Income tax benefit (9)		4 200	–
Loss for the year from discontinuing operations		(46 400)	(7 200)
PROFIT FOR THE YEAR		117 760	151 200

2. Income tax expense

	20.10 R	20.9 R
Major components of tax expense		
Current tax	59 780	58 800
Continuing operations (calc 6)	63 840	61 600
Discontinued operations (calc 7)	(4 060)	(2 800)
Deferred tax	(5 040)	–
Continuing operations	–	–
Discontinued operations (840 (calc 8) + 4 200 (calc 9))	(5 040)	–
Tax expense	54 740	58 800

3. Disposal group

A decision to dispose of assets, due to the fact that the branch incurred losses for the past two years, was taken in March 20.10 after approval of a detailed formal disposal plan for the discontinuance of the East London branch. The plan regarding the once-off sale of assets and liabilities was at a stage of completion on 30 September 20.10 where no realistic possibility of withdrawal existed. It is expected that the disposal group will be sold for cash and that the disposal will be completed by 28 February 20.11.

The disposal group under discussion comprise:

	R
Assets	
Property, plant and equipment (200 000 – 15 000)	185 000
Current assets	40 000
	225 000
Liabilities	
Long-term liabilities (given)	90 000
Current liabilities	60 000
Provision for discontinuance costs (20 000 + 3 000 + 3 000)	26 000
	176 000

An impairment loss of R15 000 (pre-tax) was recognised on initial classification of the disposal group as held for sale. This amount was included under loss after tax on measurement on the face of the statement of profit or loss and other comprehensive income. The disposal group is presented as part of the Eastern Cape geographical segment.



LECTURER'S COMMENT

The information regarding the disposal of the assets and liabilities of the East London branch is disclosed in the note "disposal group" because **the whole group of assets and liabilities associated with those assets are disposed of in a single transaction**. Therefore it qualifies to be classified as a disposal group.

CALCULATIONS

1. 800 000 + 770 000 = 1 570 000
2. 350 000 + 355 000 = 705 000
3. 325 000 + 297 000 = 622 000
4. 75 000 + 100 000 + 60 000 = 235 000
5. (60 000 + 70 000 + 45 000)[1] + (20 000 + 30 000 + 20 000)[2] + (3 000 + 20 000 + 3 000)[3] + 4 500[4] = 275 500

[1] Cost of sales
[2] Other expenses
[3] Provision for costs related to discontinuance
[4] Actual cost of discontinuance

6. Tax on continuing operations

	20.10 **R**	**20.9** **R**
Profit before tax	228 000	220 000
Temporary differences	–	–
Non-taxable/non-deductible differences	–	–
Taxable income	228 000	220 000
Tax @ 28%	63 840	61 600

7. Tax on discontinued operations

	20.10 **R**	**20.9** **R**
Profit/(loss) before tax	(40 500)	(10 000)
Exempt differences	23 000	–
– Severance pay to employees	20 000	–
– Fines	3 000	–
Temporary differences		–
– Provision for direct cost of discontinuance	3 000	–
Taxable income/(loss)	(14 500)	(10 000)
Current tax @ 28%	(4 060)	(2 800)

8. Deferred tax on discontinued operations

	20.10 **R**	**20.9** **R**
Deferred tax balance beginning of year	–	–
Deferred tax balance end of year (asset)	840	–
Deferred tax movement (Cr to P/L)	840	–

Deferred tax balance:

	Carrying amount R	Tax base R	Temporary difference R	Deferred tax asset/ (liability) R
Provision for direct cost of discontinuance	3 000	–	3 000	840

9. Carrying amount of disposal group

	20.10 R
Carrying amount of disposal group on classification	
Property, plant and equipment	200 000
Current assets	40 000
Long-term liabilities	(90 000)
Current liabilities	(60 000)
Provision for discontinuance costs (20 000 + 3 000 + 3 000)	(26 000)
	64 000
Fair value less costs to sell	49 000
Impairment loss (64 000 – 49 000)	15 000
Allocated as follows:	
– Property, plant and equipment	15 000
Deferred tax thereon (cr to P/L)	(4 200)



ASSESSMENT CRITERIA

After having studied this learning unit you should be able to:

- define what a non-current asset held for sale or disposal group is in terms of IFRS 5 is;
- describe the principles for the recognition and measurement of non-current assets held for sale;
- disclose the information relating to non-current assets held for sale and disposal groups in the financial statements of an entity in accordance with the requirements of *International Financial Reporting Standards*.
- define what a discontinued operation and the initial disclosure event is in terms of IFRS 5;
- describe the principles for the recognition and measurement of discontinued operations;
- disclose the information relating to discontinued operations in the financial statements of an entity in accordance with the requirements of *International Financial Reporting Standards*.

FAC3702

LEARNING UNIT 6

FINANCIAL INSTRUMENTS: [IAS 32], [IFRS 7], [IFRS 9]



Distinctive Financial Reporting

LEARNING UNIT 6 – FINANCIAL INSTRUMENTS: PRESENTATION, RECOGNITION AND MEASUREMENT

LEARNING OUTCOMES

Once you have studied this learning unit you should be able to:

- describe financial instruments and indicate how it should be accounted for in the financial statements of an entity in accordance with the requirements of *International Financial Reporting Standards* (IFRS), and
- apply the theory in practice.

OVERVIEW

This learning unit will be discussed under the following sections:

A BACKGROUND

B OBJECTIVES

C DEFINITIONS WITH BRIEF EXPLANATIONS – IAS 32.11–.14 & Appendix A (IFRS 9)

D CLASSIFICATION

E RECOGNITION AND DERECOGNITION

6.1 Initial recognition
6.2 Derecognition of a financial asset
6.3 Derecognition of a financial liability

F MEASUREMENT

6.4 Initial measurement of financial assets and financial liabilities – IFRS 9.5.1
6.5 Subsequent measurement of financial assets – IFRS 9.5.2
6.6 Subsequent measurement of financial liabilities – IFRS 9.5.3
6.7 Gains and losses
  6.7.1 Financial Assets – IFRS 9.5.7
  6.7.2 Financial Liabilities – IFRS 9.5.7
6.8 Impairment and uncollectibility of financial assets – IFRS 9.5.5

G PRESENTATION – IAS 32.15–50

6.9 Liabilities and equity
  6.9.1 No contractual obligation to deliver cash or another financial asset
  6.9.2 Settlement in the entity's own equity instruments
  6.9.3 Contingent settlement provisions
6.10 Compound financial instruments - IAS 32.28-.32
6.11 Treasury shares
6.12 Interest, dividends, losses and gains
6.13 Offsetting a financial asset and a financial liability

H DISCLOSURE – IFRS 7

6.14 General

STUDY

PRESCRIBED:
Descriptive Accounting
Chapter 30
The syllabus of FAC3702 encompasses only the basic elements of financial instruments as indicated in this learning unit.
You will be examined on these principles only.

RECOMMENDED:
A Guide Through IFRS
Relevant sections of IFRS 7, IFRS 9 and IAS 32

A. BACKGROUND

The standards IFRS 9, IAS 32 and IFRS 7 discuss the disclosure, presentation, recognition and measurement of financial instruments.

B. OBJECTIVES

Financial markets use a variety of financial instruments ranging from traditional primary instruments (ie debtors, creditors, equity) to derivative instruments (ie financial options, futures and forwards, interest rate swaps and currency swaps). The objective of IAS 32 *Financial Instruments: Presentation* is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities.

IAS 32 prescribes requirements for:

- presentation of financial instruments as liabilities or equity;
- offsetting financial assets and liabilities;
- classification of financial instruments into financial assets, financial liabilities and equity instruments;
- classification of related interest, dividends, losses and gains; and
- circumstances in which financial assets and financial liabilities should be offset.

The objective of IFRS 7 is to require entities to provide disclosures in their financial statements that enable users to evaluate:

- the significance of financial instruments for the entity's financial position and performance; and
- the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

The objective of IFRS 9 is to establish principles for the financial reporting of financial assets and financial liabilities that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of the entity’s future cash flows.



LECTURER’S COMMENT

Note: except for foreign exchange contracts, derivative instruments do not form part of this syllabus.

C. DEFINITIONS WITH BRIEF EXPLANATIONS – IAS 32.11–14 and APPENDIX A (IFRS 9)

Definitions in IAS 32.11–.14

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. (IAS 32.11)

A **financial asset** is any asset that:

(a) is cash;
(b) is an equity instrument of another entity (example: investments);
(c) has a contractual right:
- to receive cash or another financial asset from another entity (example: accounts receivables); or
- to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity (example: purchased options); or

(d) is 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. (IAS 32.11)

A **financial liability** is any liability that is:

(a) a contractual obligation:
- to deliver cash or another financial asset to another entity (example: creditors); or
- to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity (example: written options); 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.

An **equity instrument** is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.



LECTURER'S COMMENT

An entity's own equity instrument is not a financial asset or liability. If an entity has an obligation to deliver its own equity instruments, or the right to reacquire its own equity instruments, it is seen as a form of equity instrument, rather than financial assets or financial liabilities.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

DEFINITIONS IN IFRS 9 (Appendix A)

A **derivative** is a financial instrument or other contract within the scope of this standard with all three of the following characteristics:

- its value changes in response to the change in a specified interest rate, financial instrument's price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the "underlying");
- it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- it is settled at a future date.



LECTURER'S COMMENT

Note:
Except for foreign exchange contracts, derivative instruments do not form part of this syllabus.

Definitions relating to recognition and measurement

The **amortised cost of a financial asset or financial liability** is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between the initial amount and the maturity amount, and for financial assets, adjusted for any loss allowance.

The **effective interest method** is a method of calculating the amortised cost of a financial asset or a financial liability and of allocating the interest income or interest expense over the relevant period.

The **effective interest rate** is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayments, call and similar options) but shall not consider future credit losses.

The calculation includes:

- all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate,
- transaction costs, and
- all other premiums or discounts.

EXAMPLE 1

Example of effective interest rate (a Hewlett Packard 10BII financial calculator was used)

Party Pops Ltd issued a bond on 1 January 20.10. The following information regarding the bond is applicable:

- Nominal value R200 000
- Coupon rate (annually in arrears) 10%
- Date to be redeemed 31 December 20.12

The effective interest rate on this bond will be calculated by using a financial calculator, as follows:

N = 3
PV = – 200 000
FV = 200 000
PMT = 200 000 x 10% = 20 000
P/YR = 1 (payment per year)
Comp i = 10%

If the transaction costs of the bond amounted to R5 000, the effective interest rate will change as follows:

N = 3
PV = – (200 000 – 5 000)
FV = 200 000
PMT = 200 000 x 10% = 20 000
Comp i = 11,02%

If the transaction costs remained at R5 000, but redemption takes place at a premium of 105% of par, the effective interest rate will change as follows:

N = 3
PV = – (200 000 – 5 000)
FV = (200 000 x 1,05) = 210 000
PMT = 200 000 x 10% = 20 000
Comp i = 12,52%

Derecognition is the removal of a previously recognised financial asset or financial liability from an entity's statement of financial position.

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

EXAMPLE 2

Examples of financial assets and financial liabilities – IAS 32 Appendix: Application Guidance (AG) 3–9

Financial asset/financial liability	Reason
• Currency (cash) is a financial asset	It represents the medium of exchange and is therefore the basis on which all transactions are measured and recognised in financial statements.
• A deposit of cash with a bank or similar financial institution is a financial asset	It represents the contractual right of the depositor to obtain cash from the institution or to draw a cheque or similar instrument against the balance in favour of a creditor in payment of a financial liability.
• Common financial assets and financial liabilities - trade accounts receivable and payable - notes receivable and payable - loans receivable and payable - bonds receivable and payable	In each case, one party's contractual right to receive (or obligation to pay) cash is matched by the other party's corresponding obligation to pay (or right to receive).
• A note payable in government bonds	It gives the holder the contractual right to receive and the issuer the contractual obligation to deliver government bonds, but not cash. The bonds are financial assets because they represent obligations of the issuing government to pay cash. The note is, therefore, a financial asset of the note holder and a financial liability of the note issuer.



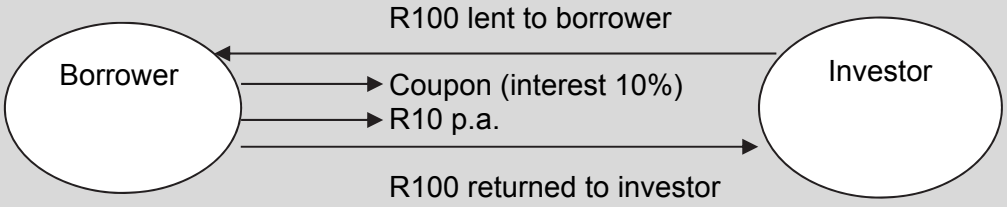
LECTURER'S COMMENT

Note:
Except for foreign exchange contracts, derivative instruments do not form part of this syllabus.

LECTURER'S COMMENT

Bonds

A bond is a debt security, similar to an IOU. When a bond is purchased, money is being lent to a government, municipality, federal agency, corporation or other entity known as the issuer. In return for the loan, the issuer promises to pay a specified rate of interest during the life of the bond and to repay the face value of the bond (the principal) when it "matures", or becomes due.





- Newly issued bonds normally sell at or close to their face value. The face value is calculated as follows:
  - quoted in % of R1 000 or R1 000 000
  - For example a bond selling for 94,25% costs:
    R1 000 x 94,25% = R943
    R1 000 000 x 94,25% = R942 500.
- Bonds traded in the secondary market fluctuate in price in response to changing interest rates.
  - When the price of a bond increases above its face value, the bond is selling at premium.
  - When the price of a bond decreases below face value, it is selling at a discount.
- A bond's maturity refers to the specific future date on which the investor's principal amount will be repaid, for example a bond maturing in 2010 has a term of 5 years if the year of issue was 2005.
- Bonds pay interest that can be fixed, floating or payable at maturity.

EXAMPLE 3

The following are NOT financial assets and financial liabilities – IAS 32.AG9–12

Item	**Reason**
• Physical assets • Inventories • Property, plant and equipment • Intangible assets	Control of such physical and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset.

Item	Reason
• Leased assets (operating lease)	An operating lease is an uncompleted contract committing the lessor to provide the use of an asset in future periods, in exchange for consideration similar to a fee for a service. The lessor continues to account for the leased asset itself (rather than any amount receivable in the future under the contract, ie a finance lease).
• Prepaid expenses	The future economic benefit is the receipt of goods or services, rather than the right to receive cash or another financial asset.
• Deferred revenue and most warranty obligations are not financial liabilities	The outflow of economic benefits associated with them is the delivery of goods and services rather than a contractual obligation to pay cash or another financial asset.
• Income taxes created as a result of statutory requirements imposed by government	Liabilities or assets (such as income taxes) are not contractual, therefore they are not financial assets or liabilities.

Definitions relating to hedge accounting (refer to learning unit 7)

D. CLASSIFICATION

FINANCIAL ASSETS

Unless paragraph 4.1.5 of IFRS 9 applies, an entity shall classify financial assets as subsequently measured at either **amortised cost** or **fair value** on the basis of both:

(a) An entity's business model for managing financial assets
(b) The contractual cash flow characteristics of the financial asset (IFRS 9.4.1)

A financial asset shall be measured at **amortised cost if both** of the following conditions are met (IFRS 9.4.1.2)

(a) The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.
(b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

IFRS 9 paragraphs B4.1.1 – B4.1.26 gives guidance on how to apply these conditions.

A financial asset shall be measured at fair value **unless** it is measured at amortised cost in accordance with paragraph 4.1.2 of IFRS 9.

IFRS 9 allows an entity the option to designate a financial asset which otherwise qualifies for amortised cost accounting, as measured at fair value through profit or loss (P/L) if:

- This treatment eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognizing the gains and losses on them on different bases (Refer to B4.1.29 – B4.1.32 of IFRS 9)
- This election is only available on initial recognition and is irrevocable.

At initial recognition, an entity may make an **irrevocable election** to present changes in the fair value of an investment in equity instruments (that is not held for trading), in other comprehensive income (OCI) (IFRS 9.5.7.5)

- This selection is done on an instrument-by-instrument basis
- Amounts included in other comprehensive income (OCI) shall not be subsequently transferred to profit or loss (P/L)
- The entity may, however, transfer the cumulative gain or loss within equity
- Dividends on such investments are recognised in profit or loss in accordance with IFRS 15: *Revenue from contracts with customers*, unless the dividend clearly represents a recovery of part of the cost of an investment (IFRS 9 B5.7.1)

FINANCIAL LIABILITIES

Financial liabilities will be classified at amortised cost using the effective interest method, except for:

- Liabilities held for trading, including derivatives (measured at fair value)
- Financial liabilities designated upon initial recognition at fair value through profit or loss (P/L) (measured at fair value)
- Liabilities that arise when a transfer of a financial asset does not qualify for derecognition.
- Financial guarantee contracts
- Commitments to provide a loan at a below market interest rate. (IFRS 9.4.2.1–2)

A financial liability is classified as held for trading if it is:

- acquired or incurred principally for the purpose of selling or repurchasing it in the near term; or
- on initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
- a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument). (IFRS 9 Appendix A)

The irrevocable designation of financial liabilities at initial recognition under the fair value option, will only be allowed when one of three conditions is met (see the three bullets below). The three conditions can broadly be classified into two categories, namely, where designation will result in more relevant information (IFRS 9.4.2.2(a) and (b)) and on the other hand where such designation is justified on grounds of reducing complexity or increasing measurement reliability (IFRS 9.4.3.5)

More relevant information will arise when:

- designation at fair value through profit and loss will eliminate or significantly reduce a measurement or recognition inconsistency (sometimes referred to as "an accounting mismatch") that would otherwise arise from measuring liabilities or recognising the gains and losses on them on different bases. (IFRS 9.4.2.2(a));
- a group of financial liabilities or financial assets is managed and its performance evaluated on a fair value basis in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel. (IFRS 9.4.2.2(b))

Complexity will be reduced or measurement reliability will be increased in instances:

- where an instrument contains one or more embedded derivatives and an entity designate the entire combined contract as a financial liability at fair value through profit or loss. (IFRS9.4.3.5)

Investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured, shall not be designated as at fair value through profit or loss (P/L).

E. RECOGNITION AND DERECOGNITION

6.1 Initial recognition

An entity shall recognise a financial asset or a financial liability on its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the instrument. (IFRS 9.3.1.1)

EXAMPLE 4

At what stage shall an entity recognise the following items on its statement of financial position?

1. Unconditional receivables and payables

Recognised as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash.

2. Assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services

It is generally not recognised until at least one of the parties has performed under the agreement.

For example:

- An entity that receives a firm order does not generally recognise an asset (and the entity that places the order does not recognise a liability) at the time of the commitment but, rather, delays recognition until the ordered goods or services have been shipped, delivered or rendered.
- If a firm commitment to buy or sell non-financial items is within the scope of this standard, its net fair value is recognised as an asset or liability on the commitment date.
- If a previously unrecognised firm commitment is designated as a hedged item in a fair value hedge, any change in the net fair value attributable to the hedged risk is recognised as an asset or liability after the inception of the hedge (refer to learning unit 7).

3. A forward contract

It is recognised as an asset or a liability on the commitment date, rather than on the date on which settlement takes place. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero. If the net fair value of the right and obligation is not zero, the contract is recognised as an asset or liability (refer to learning unit 7).

4. Planned future transactions

No matter how likely they are, they are not assets and liabilities because the entity has not become a party to a contract. (IFRS 9 B3.1.2)

6.2 Derecognition of a financial asset

An entity shall derecognise a financial asset when, and only when:

(a) the **contractual rights** to the cash flows from the financial asset expire; or
(b) it **transfers the financial asset and the transfer qualifies** for derecognition. (IFRS 9.3.2.3)

6.3 Derecognition of a financial liability – IFRS 9.3.3 and B3.3.1–7

An entity shall remove a financial liability (or a part of a financial liability) from its statement of financial position (SFP) when, and only when, it is extinguished, that is, when the obligation specified in the contract is:

(a) discharged; or
(b) cancelled; or
(c) expires.

A financial liability (or a part of it) is extinguished when the debtor:

(a) either discharges the liability (or part of it) by paying the creditor, normally with cash other financial assets, goods or services; or
(b) is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (If the debtor has given a guarantee this condition may still be met.)

F. MEASUREMENT

6.4 Initial measurement of financial assets and financial liabilities – IFRS 9.5.1

At initial recognition, **financial assets** shall be measured at its **fair value** plus, in the case of a financial asset **not at** fair value through profit or loss (P/L), transaction costs directly attributable to the acquisition of a financial asset. (IFRS 9.5.1.1)

When a **financial liability** is recognised initially, an entity shall measure it at its **fair value** plus, in the case of a financial liability **not at fair value through profit or loss (P/L)**, transaction costs that are directly attributable to the acquisition or issue of the financial liability. (IFRS 9.5.1.1)

In case of a financial asset or financial liability **at fair value through profit or loss (P/L)**, transaction costs that are directly attributable to the acquisition or issue of the liability are excluded from initial measurement.

The fair value of a financial instrument on initial recognition is normally the transaction price (ie the fair value of the consideration given or received). (IFRS 9.5.1.1)

When an entity uses settlement date accounting for an asset that is subsequently measured at amortised cost, the asset is recognised initially at its fair value on the trade date. (IFRS 9.5.1.2)

6.5 Subsequent measurement of financial assets – IFRS 9.5.2

After initial recognition, an entity shall measure a financial asset at:

- Amortised cost; or
- Fair value through profit or loss (P/L) (IFRS 9.4.1.1-5); or
- Fair value through other comprehensive income (OCI) (only when it is an investment in an equity instrument and other comprehensive income (OCI) is elected by the entity at initial recognition)

The accounting treatment of financial assets can be summarised as follows:

Financial asset category	Initial measurement	Subsequent measurement	Gains and losses on re-measurement
1. Financial assets at fair value through profit or loss (P/L)	Cost (being fair value but **excluding** transaction costs)	Fair value	Recognised in profit or loss (P/L)
2. Amortised cost	Cost (being fair value, **including** transaction costs)	Amortised cost	Recognised in profit or loss (P/L)
3. Financial assets at fair value through other comprehen-sive income (OCI) (Investments in equity – not held for trading)	Cost (being fair value, **including** transaction costs)	Fair value	Recognised in other comprehensive income (OCI)

EXAMPLE 5

Financial assets at fair value through profit or loss (settlement date accounting)

A Ltd bought 100 shares in B Ltd when the cost was R10 per share on 29 December 20.10. Costs to finalise the transaction amounted to R50. The share price was R10,02 at the 31 December 20.10 year-end. The price was R10,03 on 1 January 20.11 when the amount was paid by A Ltd to B Ltd. The shares were purchased as part of A Ltd's trading portfolio.

The journal entries to account for the above transaction are:

	Dr	Cr
	R	R
29 December 20.10		
Investment in shares (100 x R10) (SFP)	1 000	
Liability/Creditor (SFP)		1 000
31 December 20.10		
Investment in shares [(R10,02 – R10,00) x 100] (SFP)	2	
Profit on trading portfolio		2
1 January 20.11		
Investment in shares [(R10,03 – R10,02) x 100] (SFP)	1	
Profit on trading portfolio		1
Liability/Creditor(SFP)	1 000	
Bank (SFP)		1 000

EXAMPLE 6

Financial assets at amortised cost

The following terms are applicable to this example:

- coupon rate – the rate used to calculate the fixed payment (interest) on the bond each year (see example below: R1 000 000 x 12% = R120 000);
- discounted bond – a bond where the coupon rate is less than the applicable market rate;
- amortised cost – refers to the difference between the coupon payment and the interest income (calculated at market rates) that is amortised over the lifetime of the asset;
- effective interest rate – this is the rate (market rate) which, when multiplied by the present value of the bond will arrive at the interest income of the bond.

On 1 January 20.9 Mon Ltd purchased a discounted bond from Day Ltd and paid R914 350 for it. The date of maturity is 31 December 20.12.

The following details are applicable to the bond:

Market rate	15%
Coupon rate	12%
Future value	R1 000 000
Period	4 years
Payment per annum	R120 000



REQUIRED

1. Prepare the amortisation table for the above bond.
2. Prepare the journal entries to account for the bond in the accounting records of Mon Ltd for the period of the investment.

SOLUTION 6

1. Amortisation table for the above-mentioned effect by using the following information:

Calculation of the initial measurement (present value) of the bond:
FV = 1 000 000
i = 15%
N = 4
PMT = (1 000 000 x 12%) = 120 000
Comp PV = 914 350

Amortisation table:

	Opening balance R	Market interest rate at 15% R	Payment at 12% R	Diffe-rence (capital growth) R	Closing balance R
31 December 20.9	914 350	137 153	120 000	17 153	931 503
31 December 20.10	931 503	139 726	120 000	19 726	951 229
31 December 20.11	951 229	142 684	120 000	22 684	973 913
31 December 20.12	973 913	146 087	120 000	26 087	1 000 000

2. Journal entries

	Dr R	Cr R
Initial measurement		
1 January 20.9		
Bond (SFP)	914 350	
Bank (SFP)		914 350
Subsequent measurement		
31 December 20.9		
Bank (SFP)	120 000	
Bond (SFP)	17 153	
Interest received (P/L)		137 153
31 December 20.10		
Bank (SFP)	120 000	
Bond (SFP)	19 726	
Interest received (P/L)		139 726
31 December 20.11		
Bank (SFP)	120 000	
Bond (SFP)	22 684	
Interest received (P/L)		142 684
31 December 20.12		
Bank (SFP)	120 000	
Bond (SFP)	26 087	
Interest received (P/L)		146 087
On maturity of bond		
31 December 20.12		
Bank (SFP)	1 000 000	
Bond (SFP)		1 000 000

EXAMPLE 7

Viva-Voo Ltd acquired 1 000 shares in Waterloo Ltd at a price of R15,00 per share. The shares were acquired on 1 July 20.10 and are held for trading. Transaction costs amounted to R1 000. At year-end (31 December 20.10), the market value of one Waterloo Ltd share was R17,00.

SOLUTION 7

	Dr R	Cr R
Initial measurement - 1 July 20.10		
Investment in shares (1 000 x R15) (SFP)	15 000	
Transaction costs (Profit/Loss)	1 000	
Bank (SFP)		16 000
Subsequent measurement		
31 December 20.10		
Investment in shares [(1 000 x R17) – 15 000] (SFP)	2 000	
Fair value adjustment (Profit/Loss)		2 000

6.6 Subsequent measurement of financial liabilities – IFRS 9.5.3

The accounting treatment of financial liabilities can be summarised as follows:

Financial liability category	Initial measurement	Subsequent measurement	Gains and losses on remeasurement
1.Financial liability at fair value through profit or loss	At cost (being fair value but **excluding** transaction costs)	Fair value	Recognised in profit or loss (unless the fair value changes are due to credit risk, then in other comprehensive income)
2.Amortised cost	At cost (being fair value **including** transaction costs)	Amortised cost	Not applicable, but an interest component will be recognised in profit or loss (P/L).

6.7 Gains and losses

6.7.1 Financial assets – IFRS 9.5.7

A gain or loss (P/L) on financial assets that are measured at **fair value** and is not part of a hedging relationship, shall be recognised:

- In profit or loss (P/L); unless
- the financial asset is an investment in an equity instrument and the entity has elected to present gains and losses in other comprehensive income in accordance with IFRS 9.5.7.1.

A gain or loss on a financial asset that is measured at **amortised cost** and is not part of a hedging relationship, shall be recognised:

- In profit or loss (P/L)
- When the financial asset is
    - derecognised;
    - impaired; or
    - reclassified; and
    - through the amortisation process

If an entity recognises financial assets using settlement date accounting, any change in the fair value of the asset to be received during the period between the trade date and the settlement date is not recognised for assets carried at cost or amortised cost (other than impairment losses). For assets carried at fair value, however, the change in fair value shall be recognised in profit or loss or in equity, as appropriate under this section.

6.7.2 Financial liabilities – IFRS 9.5.7

A gain or loss arising from a change in the fair value of a financial liability measured at fair value through profit or loss (P/L) that is not part of a hedging relationship, shall be recognised in profit or loss. If the change in fair value is attributable to changes in the credit risk of that liability, the gain or loss shall be presented in other comprehensive income.

For financial liabilities measured at amortised cost, a gain or loss is recognised in profit or loss (P/L) when the financial liability is derecognised and through the amortisation process.

For financial assets or financial liabilities that are **hedged items,** the accounting for the gain or loss shall follow hedge accounting. (See learning unit 7)

6.8 Impairment and uncollectibility of financial assets – IFRS 9.5.5

Study paragraph 30.11 of *Descriptive Accounting*, **only** from paragraph 30.11.1 to 30.11.2 **including** example 30.21.

G. PRESENTATION (Classification of financial instruments) – IAS 32.15–50

6.9 Liabilities and equity

The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with:

- the substance of the contractual arrangement, and
- the definitions of a financial liability, a financial asset and an equity instrument.(IAS 32.15)

Equity instrument

To determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if both the following conditions are met:

(a) The instrument includes **no** 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 issuer.

(b) If the instrument will or may be settled in the issuer's own equity instruments, it is:

- a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
- a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose the issuer's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the issuer's own equity instruments (IAS 32.16)

6.9.1 No contractual obligation to deliver cash or another financial asset ((a) above)

A critical feature in differentiating a financial liability from an equity instrument is the **existence of a contractual obligation** of one party to the financial instrument (the issuer) either to:

- deliver cash or another financial asset to the other party (the holder), or
- to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer.

Although the holder of an equity instrument may be entitled to receive a pro rata share of any dividends or other distributions of equity, the issuer does not have a contractual obligation to make such distributions because it cannot be required to deliver cash or another financial asset to another party. (IAS 32.17)

The substance of a financial instrument, rather than its legal form, governs its classification on the entity's statement of financial position. (IAS 32.18). This stipulation has the effect that some items that at face value would appear to be equity, would actually constitute debt.

For example, a preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability. (IAS 32.18(a)).

EXAMPLE 8

Lula-Lee Ltd issued 1 000 redeemable preference shares on 1 January 20.10. The shares are redeemable in cash at the option (choice) of the holder. If the options are not exercised, the shares will be redeemable on 31 December 20.12.

Should the preference shares be presented as a financial liability or equity in the financial statements of Lula-Lee Ltd?

The preference shares redeemable in cash at the option of the holder, or redeemable by the issuer on 31 December 20.12, creates an obligation on the part of the issuer to deliver cash to the holder. Therefore it meets the definition of a financial liability.

EXAMPLE 9

Lula-Lee Ltd issued 1 000 redeemable preference shares on 1 January 20.10. Lula-Lee Ltd has the option (choice) to redeem the shares at any time.

Should the preference shares be presented as a financial liability or equity in the financial statements of Lula-Lee Ltd?

Lula-Lee Ltd does not have a present obligation to transfer cash or financial assets to the holder and therefore it does not meet the definition of a financial liability. The preference shares will be presented as equity in the financial statements of Lula-Lee Ltd.

EXAMPLE 10

Lula-Lee Ltd issued 1 000 convertible preference shares on 1 January 20.9. The shares will be converted to ordinary shares on 31 December 20.12.

Should the preference shares be presented as a financial liability or equity in the financial statements of Lula-Lee Ltd?

If the criteria for classification of an equity instrument is applied:

- the instrument includes **no** contractual obligation to deliver cash or another financial asset, or to exchange a financial asset, or to exchange financial asset or liabilities; and
- the instrument will be settled in the entity's own equity instruments (ordinary shares)

Therefore this is an equity instrument.

The latter represents a non-derivative that presents no contractual obligation to be settled by the issuer by issuing a variable number of its ordinary shares (equity instruments).

If any entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability. (IAS32.19)

A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions, for example:

(a) a financial instrument may contain a non-financial obligation that must be settled if, and only if:
    - the entity fails to make distributions, or
    - to redeem the instrument.

If the entity can avoid a transfer of cash or another financial obligation only by settling the non-financial obligation, the financial instrument is a financial liability.

(b) a financial instrument is a financial liability if it provides that on settlement, the entity will deliver either:
   - cash or another financial asset, or
   - its own shares whose value is determined to exceed substantially the value of the cash or other financial asset. (IAS 32.20)

6.9.2 Settlement in the entity's own equity instruments ((b) above)

A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments.

An entity may have a contractual right or obligation to receive/deliver a number of its own shares or other equity instruments that varies so, that the fair value of the entity's own equity instruments to be received/delivered equals the amount of the contractual right or obligation. Such a contractual right or obligation may be for a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity's own equity instruments (eg an interest rate, a commodity price or a financial instrument price).

The following are examples of such a contract. It is a **financial liability** of the entity even though the entity must or can settle it by delivering its own equity instruments, for example:

- a contract to deliver as many of the entity's own equity instruments as are equal in value to R100;
- a contract to deliver as many of the entity's own equity instruments as are equal in value to the value of 100 ounces of gold.

The contract is not an equity instrument because the entity uses a variable number of its own equity instruments as a means to settle the contract. Accordingly, the contract does not evidence a residual interest in the entity's assets after deducting all of its liabilities. (IAS 32.21)

A contract that will be settled by the entity receiving/delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument, for example:

- an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond is an equity instrument. (IAS 32.22)

The difference between the above two situations can be summarised as follows:

Financial liability	Settlement equals the amount of the contractual right/obligation and may be **affected by changes in the fair value** of the contract.
Equity instrument	The amount of settlement is fixed and is **not affected by changes in the fair value** of a contract.

6.9.3 Contingent settlement provisions

A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument, such as:

- a change in a stock market index;
- consumer price index;
- interest rate;

- taxation requirements;
- the issuer's future revenues;
- net income; or
- debt-to-equity ratio.

The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer, unless:

- the part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine; or
- the issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer. (IAS 32.25)

If a part of a contingent settlement provision that could require settlement in cash or another financial asset (or in another way that would result in the instrument being a financial liability) is **not genuine**, the settlement provision does **not** affect the classification of a financial instrument. Thus, a contract that requires settlement in cash or a variable number of the entity's own shares only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur is an equity instrument. (IAS 32 AG 28)

6.10 Compound financial instruments – IAS 32.28–32

The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components shall be classified separately as financial liabilities, financial assets or equity instruments. (IAS 32.28)

An entity recognises separately the components of a financial instrument that:

(a) creates a financial liability of the entity; and
(b) grants an option to the holder of the instrument to convert it into an equity instrument of the entity.

An example of a compound financial instrument is a bond or similar instrument convertible by the holder into a fixed number of ordinary shares of the entity. (IAS 32.29)

EXAMPLE 11

Debentures convertible at the option of either the issuer or holder

An entity issues 2 000 convertible bonds at the start of year 1. The bonds have a three-year term, and are issued at a face value of R1 000 per bond, giving total proceeds of R2 000 000. Interest is payable annually in arrears at a nominal annual interest rate of 6%. Each bond is convertible at any time up to maturity into 250 ordinary shares. When the bonds are issued, the prevailing market interest rate for similar debt without a conversion option is 9%.

SOLUTION 11

The liability component is measured first, and the difference between the proceeds of the bond issue and the fair value of the liability is assigned to the equity component. The present value of the liability component is calculated using a discount rate of 9%, the market interest rate for similar bonds having no conversion rights.

	R
Present value of the principal (PV) (R2 000 000 payable at the end of three years) FV = 2 000 000 i = 9% n = 3 PMT = 0	1 544 367
Present value of the interest (PV) (R120 000 payable annually in arrears for three years) FV = 0 PMT = 120 000 (2 000 000 x 6%) n = 3 i = 9%	303 755
Total liability component	1 848 122
Equity component (balancing figure)	151 878
Proceeds of the bond issue	2 000 000

OR

	R
Present value of the principal (PV) (R2 000 000 payable at the end of three years) FV = 2 000 000 i = 9% n = 3 PMT = 120 000 (2 000 000 x 6%)	1 848 122
Total liability component	1 848 122
Equity component (balancing figure)	151 878
Proceeds of the bond issue	2 000 000

Amortisation table:

	Opening balance R	Effective interest rate at 9% R	Payment at 6% R	Difference (capital growth) R	Closing balance R
Year 1	1 848 122	166 331	120 000	46 331	1 894 453
Year 2	1 894 453	170 501	120 000	50 501	1 944 954
Year 3	1 944 954	175 046	120 000	55 046	2 000 000

Journal entries	Dr	Cr
	R	R
Year 1		
Bank (SFP)	2 000 000	
Equity component of convertible bond (SFP)		151 878
Liability component of convertible bond (SFP)		1 848 122
Initial recognition of convertible bond		
Finance cost (P/L)	166 331	
Liability component of convertible bond (SFP)		46 331
Bank (SFP)		120 000
Recognition of finance cost and increase in the liability component		
Year 2		
Finance cost (P/L)	170 501	
Liability component of convertible bond (SFP)		50 501
Bank (SFP)		120 000
Recognition of finance cost and increase in the liability component		
Year 3		
Finance cost (P/L)	175 046	
Liability component convertible bond (SFP)		55 046
Bank (SFP)		120 000
Recognition of finance cost and increase in the liability component		



LECTURER'S COMMENT

The carrying amount (amortised cost) of the liability at the end of Year 3 is:
(1 848 122 + 46 331 + 50 501 + 55 046) = R2 000 000.

If the holder/issuer wishes to redeem the bond by repaying the cash at the end of year 3, the following journal entry will be made:

	Dr	Cr
	R	R
Liability component of convertible bond (SFP)	2 000 000	
Bank (SFP)		2 000 000
Redeem convertible bond in cash		

If the holder/issuer wishes to redeem the bond by converting the bond to ordinary shares at the end of year 3, the following journal entry will be made:

	Dr	Cr
	R	R
Liability component of convertible bond (SFP)	2 000 000	
Share capital		2 000 000
Convert bond to ordinary shares		

In both instances the equity component of R151 878 may be transferred to another reserve in equity. (IAS 32)

EXAMPLE 12

Automatically convertible debentures

An entity issues 2 000 automatically convertible bonds at the start of year 1. The bonds have a three year term, and are issued with a face value of R1 000 per bond, giving total proceeds of R2 000 000. Interest is payable annually in arrears at a nominal annual interest rate of 6%. Each bond is automatically convertible to 250 ordinary shares at maturity.

When the bonds were issued, the prevailing market interest rate for similar debt without conversion option is 9%.

SOLUTION 12

The liability component is valued first, and the difference between the proceeds of the bond issue and the fair value of the liability is assigned to the equity component. The present value of the liability component is calculated using a discount rate of 9%, being the market interest rate for similar bonds having no conversion rights.

	R
Present value of the principal (PV) (No lumpsum will be payable i.r.o. the automatically convertible bonds as they will be converted to shares and therefore no cash flow will result from repayment).	Nil
Present value of the interest (PV) (R120 000 payable annually in arrears for three years) FV = 0 PMT = 120 000 (2 000 000 x 6%) n = 3 i = 9%	303 755
Total liability component	303 755
Equity component (balancing figure)	1 696 245
Proceeds of the bond issue	2 000 000

Amortisation table:

	Opening balance	**Effective interest rate at 9%**	**Payment at 6%**	**Difference (capital growth)**	**Closing balance**
	R	**R**	**R**	**R**	**R**
Year 1	303 755	27 338	120 000	92 662	211 093
Year 2	211 093	18 998	120 000	101 002	110 092
Year 3	110 092	9 908	120 000	110 092	-

Journal entries

	Dr	Cr
	R	R
Bank (SFP)	2 000 000	
Equity component of convertible bond (SFP)		1 696 245
Liability component of convertible bond (SFP)		303 755
Initial recognition of convertible bond		
Finance cost (P/L)	27 338	
Liability component of convertible bond (SFP)	92 662	
Bank (SFP)		120 000
Recognition of finance cost, interest paid and partial redemption of liability		
Finance cost (P/L)	18 998	
Liability component of convertible bond (SFP)	101 002	
Bank (SFP)		120 000
Recognition of finance cost, interest paid and partial redemption of liability		
Finance cost (P/L)	9 908	
Liability component of convertible bond (SFP)	110 092	
Bank (SFP)		120 000
Recognition of finance cost, interest paid and partial redemption of liability		
Equity component of convertible bond	1 696 245	
Share capital		1 696 245
Convert debentures to ordinary shares		

6.11 Treasury shares

If an entity reacquires its own equity instruments, those instruments are called treasury shares.

Treasury shares shall be accounted for as follows:

- it shall be deducted from equity; and
- no gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments; and
- consideration paid or received shall be recognised directly in equity.

Treasury shares may be acquired and held by the entity or by other members of the consolidated group.

Treasury shares held shall be disclosed separately either on the face of the statement of financial position or in the notes, in accordance with IAS 1 *Presentation of financial statements*. An entity provides disclosure in accordance with IAS 24 *Related party disclosures* if the entity reacquires its own equity instruments from related parties. (IAS 32.33–34)

6.12 Interest, dividends, losses and gains

(a) Items such as interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss.

Dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on a bond.

Gains and losses associated with redemption or refinancing of financial liabilities are recognised in profit or loss.

(b) Distributions to holders of an equity instrument shall be debited by the entity directly to equity, net of any related income tax benefit. Transaction costs of an equity transaction, other than costs of issuing an equity instrument that are directly attributable to the acquisition of a business (which shall be accounted for under IFRS 3 *Business Combinations*) shall be accounted for as a deduction from equity, net of any related income tax benefit.

Redemption or refinancing of equity instruments are recognised as changes in equity.

Changes in fair value of an equity instrument are not recognised in the financial statements. (IAS 32.35–36)

6.13 Offsetting a financial asset and a financial liability

A financial asset and a financial liability shall be offset and the net amount presented in the statement of financial position when, and only when, an entity:

- currently has a legally enforceable right to set off the recognised amounts, and
- intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. (IAS 32.42)

H. DISCLOSURE – IFRS 7

6.14 General

The disclosure requirements of IAS 32 have been scrapped and have been replaced by a new standard, namely IFRS 7. Although the old standard has been scrapped, many of the principles contained in the new standard are similar to those in the old standard.

The disclosure requirement of IFRS 7 is very specialised and will not be handled in this module. It will however, be handled in detail on honours-level.



ASSESSMENT CRITERIA

After having studied this learning unit you should be able to:

- State the definitions contained in IFRS 7, IFRS 9 and IAS 32 and be able to apply them to problems posed.
- Describe the classifications of financial instruments.
- Describe the principles for the recognition, measurement and derecognition of financial instruments.
- Disclose the information relating to financial instruments in the financial statements of an entity in accordance with the requirements of *International Financial Reporting Standards*.

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LEARNING UNIT 7

THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES [IFRS 7, IFRS 9, IAS 21, IAS 32]



Distinctive Financial Reporting

LEARNING UNIT 7 – THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

LEARNING OUTCOMES

Once you have studied and completed this learning unit, you should be able to:

- calculate, journalise and disclose all aspects of the effects of changes in foreign exchange rates in terms of the requirements of *International Financial Reporting Standards*.

OVERVIEW

This learning unit will be discussed under the following sections:

A GENERAL

7.1 Introduction
7.2 Work excluded
7.3 Objectives
7.4 Definitions – IAS 21.8
7.5 Elaboration on the definitions

B UNCOVERED FOREIGN CURRENCY TRANSACTIONS

7.6 Reporting foreign currency transactions in the functional currency
- 7.6.1 Initial recognition
- 7.6.2 Subsequent reporting periods
- 7.6.3 Recognition of exchange differences
- 7.6.4 Impairment of non-monetary assets

7.7 Disclosure of uncovered foreign currency transactions
- 7.7.1 Disclosure in terms of IAS 21

C HEDGE ACCOUNTING

7.8 Covered transactions (FEC taken out)
- 7.8.1 Definitions relating to hedge accounting
- 7.8.2 Hedging instrument
- 7.8.3 Hedged items

7.9 General
7.10 Requirements to use hedge accounting
7.11 Accounting treatment of fair value hedges
7.12 Accounting treatment of cash flow hedges
7.13 Applying hedge accounting to a firm commitment
7.14 Disclosure of covered foreign currency transactions

D TAX IMPLICATIONS

STUDY
PRESCRIBED: **Descriptive Accounting** Chapter 14 and 30 (excluding examples 30.32–30.34, 30.35 and 30.37–30.39) **RECOMMENDED:** **A guide through IFRS** IAS 21, IAS 32, IFRS 7 and IFRS 9

A GENERAL

7.1 INTRODUCTION

An entity may have transactions in foreign currencies and/or foreign operations.

When an entity undertakes transactions denominated in foreign currencies, for example, buying or selling goods overseas denominated in foreign currencies, then the results of these transactions are translated into the presentation currency (Rand) for incorporation into the financial statements of the entity.

The entity can be conducting business through foreign operations, for example, establishing a foreign branch to handle the marketing and selling of its products overseas. The results of the foreign operations (branch) will be accounted for in the functional currency (rand). (IAS 21.1)

7.2 WORK EXCLUDED

IAS 21 distinguishes between the accounting treatment for foreign transactions and foreign operations. The following aspects fall outside the scope of this module:

– foreign operations (IAS 21.11–15 and .44–49)

7.3 OBJECTIVES

The principal issues in accounting for foreign currency transactions are:

- which exchange rate to use, and
- how to report the effects of changes in exchange rates in the financial statements.
  IAS 21.1–2.

7.4 DEFINITIONS – IAS 21.8

Functional currency – the currency of the primary economic environment in which the entity operates.

Presentation currency – the currency in which the financial statements are presented.

Foreign currency – a currency other than the functional currency of the entity.

Exchange rate – the ratio of exchange for two currencies.

Exchange difference – the difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Spot exchange rate – the exchange rate for immediate delivery.

Closing rate – the spot exchange rate at the end of the reporting period.

Monetary items – units of currency held, and assets and liabilities to be received or paid, in a fixed or determinable number of units of currency, for example, bank accounts, fixed deposits, trade receivables, loans, and trade payables.

Non-monetary items – the essential feature is the absence of a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency, for example inventories and property, plant and equipment.

Fair value – the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

7.5 ELABORATION ON THE DEFINITIONS

Functional currency

The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash.

In determining the functional currency of an entity, they need to consider the following factors:

- the currency that mainly influences sales prices for goods and services and the currency of the country whose competitive forces and regulations mainly determine the sales price of its goods and services;

EXAMPLE:

Sales prices of goods and services are denominated and settled in this currency.

and

- the currency that mainly influences labour, material and other costs of providing goods or services.

EXAMPLE:

The costs are denominated and settled in this currency.

The following additional supporting evidence may also provide evidence of an entity's functional currency:

- the currency in which funds from financing activities are generated, and
- the currency in which receipts from operating activities are usually retained.

If the functional currency is not obvious because the above indicators are mixed, management must use its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions.

The primary indicators need to be given priority before considering the additional supporting evidence to determine an entity's functional currency. (IAS 21.12)

Once the functional currency of an entity is determined, it is not changed unless there is a change in the underlying transactions, events and conditions that are relevant to the functional currency and reflected by it. (IAS 21.13)

If the entity's functional currency is that of a hyper inflationary economy, the entity's financial statements are restated in accordance with *IAS 29 Hyper inflationary economies*. (IAS 21.14)

Monetary items

The essential feature of a monetary item is a right to receive (or obligation to deliver) a fixed or determinable number of units of currency.

Examples:

- pensions and other employee benefits to be paid in cash;
- provisions that are to be settled in cash; and
- cash dividends that are recognised as a liability.

Similarly, a contract to receive (or deliver) a variable number of the entity's own equity instruments or a variable amount of assets in which the fair value to be received (or delivered) equals a fixed or determinable number of units of currency, is a monetary item.

Non-monetary item

The essential feature of a non-monetary item is the absence of a right to receive (or an obligation to deliver) a fixed and determinable number of units of currency, for example:

- amounts prepaid for goods and services (e.g. prepaid rent);
- goodwill;
- intangible assets;
- inventory;
- property, plant and equipment and
- provisions that are to be settled by the delivery of a non-monetary asset.

B UNCOVERED FOREIGN CURRENCY TRANSACTIONS

7.6 REPORTING UNCOVERED FOREIGN CURRENCY TRANSACTIONS IN THE FUNCTIONAL CURRENCY

7.6.1 Initial recognition

A foreign currency transaction is a transaction that is denominated or requires settlement in a foreign currency, including transactions arising when an entity:

(a) buys or sells goods, assets and services whose price is denominated in a foreign currency; or
(b) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency; or
(c) acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency. (IAS 21.20)

A foreign currency transaction shall initially be recorded in the functional currency by applying the **exchange rate (spot rate)** between the functional currency and the foreign currency **at the date of the transaction** to the foreign currency amount. IAS 21.21. Thus, the spot rate on the transaction date is used for translation purposes.

The **date of the transaction** is the date on which the transaction first qualifies for recognition in accordance with IASs. (IAS 21.22)

An entity shall recognise a financial asset or a financial liability on its statement of financial position (SFP) when, the entity becomes a party to the contractual provisions of the instrument, for example, unconditional receivables and payables are recognised as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash. IFRS 9.3.1.14)

Assets to be acquired and liabilities to be incurred as a result of a **firm commitment** to purchase or sell goods or services are generally not recognised until at least one of the parties has performed under the agreement, for example, when the goods or services have been shipped, delivered or rendered. (IFRS 9.B3.1.2)

EXAMPLE 1

SA Ltd placed an order for machinery from a USA company on 15 March 20.10. The transaction was invoiced on 31 March 20.10. The machinery was shipped free on board (FOB) on 20 March 20.10. The machinery was delivered to SA Ltd on 30 June 20.10.



The machinery should be recorded at the spot rate ruling on 20 March 20.10 (the transaction date), since that is the date on which risks and rewards are transferred to the buyer. The exchange rates ruling on 15 March 20.10, 31 March 20.10 and 30 June 20.10 are not relevant.

In the above example, the cost of the machinery and the corresponding financial liability (creditor) must be accounted for separately.

The machinery is a non-monetary asset and its cost will be fixed at the spot rate on the transaction date (20 March 20.10).

The amount of the payment to the creditor (a monetary financial liability) depends on the exchange rate ruling on the date of payment. The amount of the creditor is therefore not fixed as is the case with the machinery. The movement in foreign currency exchange rates subsequent to the transaction date does not affect the cost of the machinery but will affect the creditor until it is paid.

7.6.2 Subsequent reporting periods

At the end of each reporting period:

(a) foreign currency **monetary items** (creditor) shall be translated using the closing rate (the rate at the end of the reporting period). The amount of the monetary items will therefore change at the end of the reporting period when it is converted at the closing rate. (IAS 21 .23(a))

(b) **non-monetary items (inventory, property, plant and equipment) that are measured in terms of historical cost in a foreign currency** shall be translated using the exchange rate at the date of the transaction. For example, a plant that was bought two years ago would have been recorded at the spot rate at that date and will not subsequently be changed to the spot rate at the end of the reporting period. (IAS 21.23(b))

(c) **non-monetary items that are measured at fair value in a foreign currency** shall be translated using the exchange rates at the date when the fair values were determined, ie the date it was revalued. (IAS 21.23(c))

When a gain or a loss on a **non-monetary** item is recognised **in other comprehensive income,** any exchange component of that gain or loss shall be recognised in other comprehensive income.

Conversely, when a gain or a loss on a **non-monetary** item is recognised in profit or loss, any exchange component of that gain or loss shall be recognised in profit or loss. (IAS 21.30)

Other Standards require some gains and losses to be recognised in other comprehensive income, for example *IAS 16 Property, plant and equipment*. Gains and losses arising on the revaluation of property, plant and equipment require to be recognised in other comprehensive income. When

such an item is measured in a foreign currency, paragraph 23(c) of the Standard requires the revalued amount to be translated using the rate at the date the value is determined, resulting in an exchange difference that is also recognised in other comprehensive income. (IAS 21.31)

7.6.3 Recognition of exchange differences

Exchange differences arising upon the **settlement of monetary items** or on translating monetary items at rates different from those at which they were translated on initial recognition during the period, or in previous financial statements, shall be recognised in profit or loss in the period in which they arise. (IAS 21.28)

An exchange difference arises when there is a change in the exchange rate between the initial recognition date of the transaction and the date of settlement of any monetary item arising from a foreign currency transaction. (IAS 21.29)

Exchange differences are dealt with as follows:

- if the transaction is settled within the same accounting period as that in which it occurred, all the exchange differences are recognised in that period; and
- if the transaction is settled in a subsequent accounting period, the exchange difference recognised in each period up to the date of settlement is determined by the change in exchange rates during each period. (IAS 21.29)

EXAMPLE 2

If inventory was bought on 1 January 20.10, the year-end of the company is 31 January 20.10 and the creditor is eventually paid on 28 February 20.10, then there are **two intervening periods:**

- the **first** intervening period is from 1 January 20.10 to 31 January 20.10 and a foreign exchange difference will be recognised as an income or expense on 31 January 20.10;
- the **second** intervening period is from 31 January 20.10 to 28 February 20.10 and it will also give rise to an exchange difference that will be recognised as an income or expense on 28 February 20.10.

7.6.4 Impairment of non-monetary assets

At each reporting date, an entity shall assess whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset. (IAS 36.9)

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount. (IAS 36.6)

The carrying amount of an item is determined in conjunction with other relevant standards. Property, plant and equipment may be measured in terms of fair value or historical cost in accordance with IAS 16.

Whether the carrying amount is determined on the basis of historical cost or on the basis of fair value, if the amount is determined in a foreign currency, it is then translated into the functional currency in accordance with this Standard (IAS 21.24).
When the asset is a non-monetary item and it is measured in a foreign currency, the carrying amount is determined by comparing:

- the cost or carrying amount, as appropriate, translated at the exchange rate at the date when that amount was determined (ie the rate at the date of the transaction for an item measured in terms of historical cost)

and

- the net realisable value (e.g. inventories) or recoverable amount, as appropriate, translated at the exchange rate at the date when that value was determined (e.g. closing rate at the end of the reporting period).

The effect of this comparison may be that an impairment loss is recognised in the functional currency, but would not be recognised in the foreign currency, or vice versa. (IAS 21.25).

7.7 DISCLOSURE OF UNCOVERED FOREIGN CURRENCY TRANSACTIONS

7.7.1 Disclosure in terms of IAS 21

- An entity shall disclose the following:
  - the amount of exchange differences recognised in profit or loss. This excludes those arising on financial instruments measured at fair value through profit or loss in accordance with IFRS 9;
  - the net exchange differences recognised in other comprehensive income and accumulated in a separate component in equity, and a reconciliation of the amount of such exchange differences at the beginning and end of the period. (IAS 21.52)

- When the presentation currency and the functional currency is different:
  - state the fact;
  - disclose the functional currency; and
  - give the reason for using a different presentation currency. (IAS 21.53)

- When there is a change in the functional currency of the entity:
  - state the fact and
  - give the reason for the change in functional currency. (IAS 21.54)

EXAMPLE 3

ALL TRANSACTIONS OCCUR IN THE SAME FINANCIAL YEAR

(a) Payment occurs on delivery date (the transaction is paid immediately)

On 30 June 20.10, a South African company **sold** goods for $100 000 to an American import company. Payment was made on the same day. The year-end of the South African company is 31 December.

Applicable exchange rates were as follows:

30 June 20.10 $1 = R6,80
31 December 20.10 $1 = R6,70



REQUIRED

Provide all the relevant journal entries in the records of the South African company for the year ended 31 December 20.10.

SOLUTION 3(a)

Journal entries	Dr R	Cr R
30 June 20.10		
Bank (SFP)	680 000	
Sales (P/L)		680 000
Recording of cash sales ($100 000 x R6,80)		

(b) Payment made after delivery date

On 30 June 20.10, a South African company sold goods to an American import company for $100 000. Payment was made on 30 September 20.10. The year-end of the South African company is 31 December.

Applicable exchange rates were as follows:

30 June 20.10	$1 = R6,80
30 September 20.10	$1 = R6,75
31 December 20.10	$1 = R6,70



REQUIRED

Provide all the relevant journal entries in the records of the South African company for the year ended 31 December 20.10.

SOLUTION 3(b)

Journal entries	Dr R	Cr R
30 June 20.10		
Trade receivables (SFP)	680 000	
Sales (P/L)		680 000
Recording of credit sales ($100 000 x R6,80)		
30 September 20.10		
Bank (SFP)	675 000	
Trade receivables (SFP)		675 000
Recording of payment received from debtor ($100 000 x R6,75)		
Foreign exchange loss (P/L)	5 000	
Trade receivables (SFP)		5 000
Accounting for foreign exchange difference		
[$100 000 x (R6,80 - R6,75)]		

EXAMPLE 4

TRANSACTIONS OCCUR IN DIFFERENT FINANCIAL YEARS

On 30 June 20.10, a South African company purchased goods from an American export company for $100 000. Payment was made on 30 April 20.11. The year-end of the South African company is 31 December. 30% of the merchandise was still on hand at year-end, and was sold during January 20.11.

Applicable exchange rates were as follows:

30 June 20.10	$1 = R6,80
31 December 20.10	$1 = R6,70
30 April 20.11	$1 = R6,75
31 December 20.11	$1 = R6,85

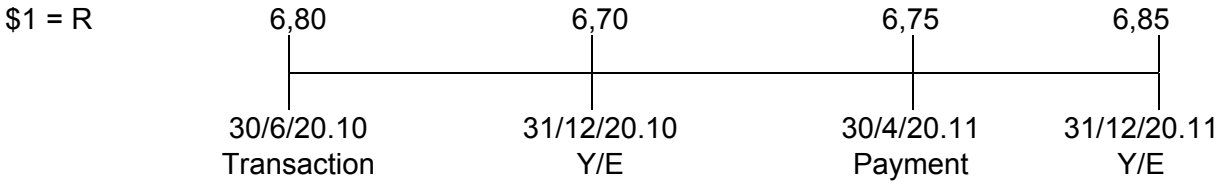


REQUIRED

Provide all the relevant journal entries in the records of the South African company for the years ended 31 December 20.10 and 31 December 20.11.

SOLUTION 4

Calculation



Journal entries		**Dr R**	**Cr R**
30 June 20.10			
Inventory (SFP)		680 000	
Trade payables (SFP)			680 000
Recording of credit purchase ($100 000 x R6,80)			
31 December 20.10			
Cost of sales (P/L)		476 000	
Inventory (SFP)			476 000
Inventory sold during the period (R680 000 x 70%)			
Trade payables (SFP)		10 000	
Foreign exchange profit (P/L)			10 000
Accounting for exchange difference			
Recorded at ($100 000 x R6,80)	R680 000		
Translated at year-end ($100 000 x R6,70)	R670 000		
Foreign exchange profit	R10 000		
31 January 20.11			
Cost of sales (P/L)		204 000	
Inventory (SFP)			204 000
Inventory sold during January 20.11 (R680 000 x 30%)			

		Dr R	Cr R
30 April 20.11			
Trade payables (SFP)		675 000	
Bank (SFP)			675 000
Payment of debt ($100 000 x R6,75)			
Foreign exchange loss (P/L)		5 000	
Trade payables (SFP)			5 000
Accounting for exchange difference			

Year-end balance ($100 000 x R6,70)	R670 000
Payment ($100 000 x R6,75)	R675 000
Foreign exchange loss	R5 000

EXAMPLE 5

COMPREHENSIVE EXAMPLE

A South African company, ABC Ltd, received an order of $100 000 from an American import company, to ship goods free on board (FOB) to America on 30 June 20.10. Payment of $50 000 was made on 30 September 20.10 and the balance was paid on 31 January 20.11.

The company ordered raw materials from the United Kingdom for an amount of £20 000. Payment for the raw material was made on 31 May 20.10. The raw material was shipped FOB on 1 April 20.10. The year-end of the company is 31 December. 20% of the raw material bought from the UK company was still on hand at year-end, and was used during January 20.11.

Applicable exchange rates were as follows:

		$1 = R	£1 = R
01	April 20.10	5,00	9,00
30	April 20.10	5,10	9,10
31	May 20.10	5,15	9,15
30	June 20.10	5,20	9,20
30	September 20.10	5,35	9,35
31	December 20.10	5,40	9,40
31	January 20.11	5,30	9,30
31	December 20.11	5,45	9,45



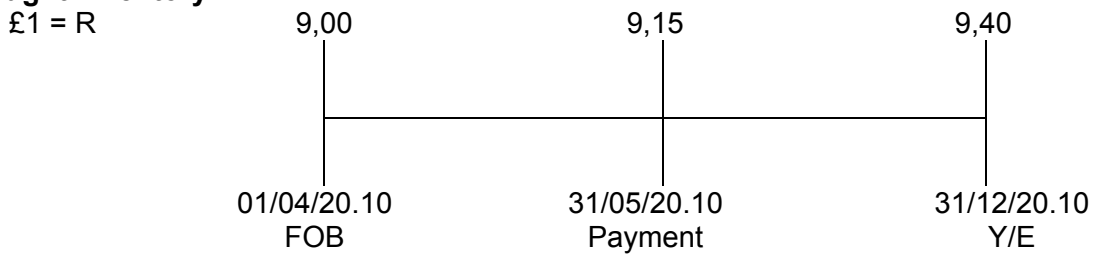
REQUIRED

(a) Provide all the relevant journal entries, in the records of ABC Ltd for the year ended 31 December 20.10 and 31 December 20.11.
(b) Provide the disclosure of the above transactions in the annual financial statements of ABC Ltd for the year ended 31 December 20.10. Your answer should comply with the requirements of *International Financial Reporting Standards*.

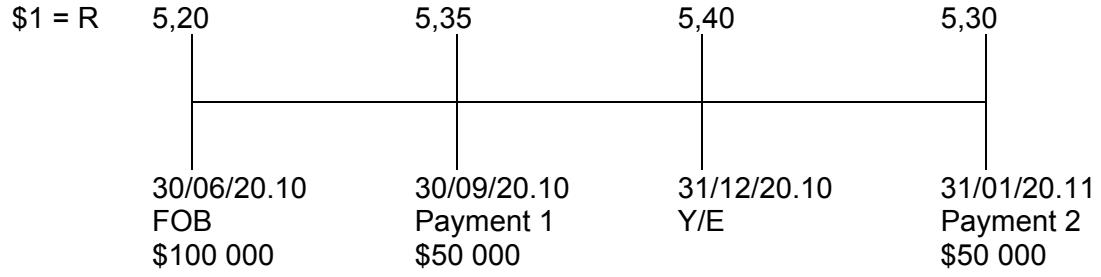
SOLUTION 5

Calculations

1. Bought inventory



2. Sales



(a) Journal entries

		Dr R	Cr R
1 April 20.10			
Inventory (SFP)		180 000	
Trade payables (SFP)			180 000
Recording of credit purchase (£20 000 x R9,00)			
31 May 20.10			
Trade payables (SFP)		183 000	
Bank (SFP)			183 000
Recording of payment to foreign creditor (£20 000 x R9,15)			
Foreign exchange loss (P/L)		3 000	
Trade payables (SFP)			3 000
Accounting for exchange difference			
Recorded at (£20 000 x R9,00)	R180 000		
Payment (£20 000 x R9,15)	R183 000		
Foreign exchange loss	R3 000		
30 June 20.10			
Trade receivables (SFP)		520 000	
Sales (P/L)			520 000
Recording of sale of goods on credit ($100 000 x R5,20)			
30 September 20.10			
Bank (SFP)		267 500	
Trade receivables (SFP)			267 500
Recording of payment received from debtor ($50 000 x R5,35)			

(a) Journal entries

		Dr R	Cr R
Trade receivables (SFP)		7 500	
Foreign exchange profit (P/L)			7 500
Accounting for exchange difference			
Recorded at ($50 000 x R5,20)	R260 000		
Payment ($50 000 x R5,35)	R267 500		
Foreign exchange profit	R7 500		
31 December 20.10			
Cost of sales (P/L)		144 000	
Inventory (SFP)			144 000
80% of inventory sold (R180 000 x 80%)			
Trade receivables (SFP)		10 000	
Foreign exchange profit (P/L)			10 000
Accounting for exchange difference			
Recorded at ($50 000 x R5,20)	R260 000		
Balance at year-end ($50 000 x R5,40)	R270 000		
Foreign exchange profit	R10 000		
31 January 20.11			
Cost of sales (P/L)		36 000	
Inventory (SFP)			36 000
Inventory sold during January 20.11 (R180 000 x 20%)			
Bank (SFP)		265 000	
Trade receivables (SFP)			265 000
Payment received from debtor ($50 000 x R5,30)			
Foreign exchange loss (P/L)		5 000	
Trade receivables (SFP)			5 000
Accounting for exchange difference			
Balance at year-end ($50 000 x R5,40)	R270 000		
Payment ($50 000 x R5,30)	R265 000		
Foreign exchange loss	R5 000		

(b) Disclosure

ABC LTD

EXTRACT FROM THE STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20.10

ASSETS	R
Current Assets	
Trade and other receivables (520 000 – 267 500 + 7 500 + 10 000) or ($50 000 x R5,40)	270 000
Inventory (180 000 – 144 000)	36 000

ABC LTD

EXTRACT FROM THE STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.10

	R
Revenue (520 000 + xxx)	xxx
Cost of sales (180 000 – 36 000)	(144 000)
Gross profit	xxx
Other expenses	xxx
Profit before tax	xxx

ABC LTD

NOTES FOR THE YEAR ENDED 31 DECEMBER 20.10

2. Profit before tax

Included in profit before tax are the following items:

	R
Income:	
Foreign exchange differences (7 500 + 10 000 – 3 000)	14 500

3. Foreign currency exposure

Current assets	**Foreign asset**	**Exchange rate $1 = R**	**R**
Trade receivables (sale of goods)	$50 000	5,40	270 000

C HEDGE ACCOUNTING

7.8 COVERED TRANSACTIONS (FEC taken out)

IAS 21 does not contain guidelines and requirements for the accounting treatment of forward exchange contracts (FECs). The disclosure of FECs is discussed in *IFRS 7 Financial Instruments: Disclosures and the presentation* in *IAS 32 Financial Instruments: Presentation*. The hedging of foreign exchange transactions and the treatment for accounting purposes are addressed in *IFRS 9 Financial Instruments*.

7.8.1 Objective of hedge accounting

The objective of hedge accounting is to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss (or other comprehensive income, in the case of investments in equity instruments for which an entity has elected to present changes in fair value in other comprehensive income in accordance with paragraph 5.7.5 of IFRS 9). This approach aims to convey the context of hedging instruments for which hedge accounting is applied in order to allow insight into their purpose and effect. (IFRS 9.6.1.1)

Hedge accounting involves the following steps:

- **Step 1:** Identify the **hedged item**.
- **Step 2:** Identify a potential **hedging instrument**.
- **Step 3:** Determine if the **qualifying criteria** for hedge accounting have been met.
- **Step 4:** Account for the hedge transaction in terms of the appropriate **hedge accounting model**.

7.8.2 Hedging instruments

A **hedging instrument** is

- a designated derivative, measured at fair value through profit and loss (for a hedge of the risk of changes in foreign currency exchange rates only); or
- a designated non-derivative financial asset, measured at fair value through profit and loss; or
- a non-derivative financial liability, measured at fair value through profit and loss, unless it is a financial liability designated as at fair value through profit or loss for which the amount of its change in fair value that is attributable to changes in the credit risk of that liability is presented in other comprehensive income. (IFRS 9.6.2.1 – 9.6.2.2)

IFRS 9 Appendix A defines a designated **derivative** as a financial instrument or other contract within the scope of this Standard with all three of the following characteristics:

a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').
b) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
c) It is settled at a future date. (IFRS 9 – Appendix A)

For hedge accounting purposes, only contracts with a party external to the reporting entity (ie external to the group or individual entity that is being reported on) can be designated as hedging instruments. (IFRS 9.6.1.3)

Designation of hedging instruments - IFRS 9.6.2.4

A qualifying instrument must be designated in its entirety as a hedging instrument. The only exceptions permitted are:

(a) separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and not the change in its time value;
(b) separating the forward element and the spot element of a forward contract and designating as the hedging instrument only the change in the value of the spot element of a forward contract and not the forward element; similarly, the foreign currency basis spread may be separated and excluded from the designation of a financial instrument as the hedging instrument and
(c) a proportion of the entire hedging instrument, such as 50% of the nominal amount, may be designated as the hedging instrument in a hedging relationship. However, a hedging instrument may not be designated for a part of its change in fair value that results from only a portion of the time period during which the hedging instrument remains outstanding.

The hedging instrument for the purpose of this learning unit will be Forward Exchange Contracts (FECs).

A forward exchange contract (FEC) is an agreement between two counter-parties to buy or sell:

- a given amount of currency
- at an agreed rate
- on a specific date in the future.

Importers buy FECs to hedge against rising exchange rates.

Exporters sell FECs to hedge against falling exchange rates



LECTURER'S COMMENT

Refer to:
Descriptive Accounting, example 30.31.

7.8.2 Hedge items

A **hedged item** is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation. The hedged item can be:

a) a single item or
b) a group of items

The hedged item can also be a component of such an item or group of items. (IFRS 9.6.3.1)

A **firm commitment** is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

A **forecast transaction** is an uncommitted but anticipated future transaction.

The hedged item must be reliably measurable. (IFRS 9.6.3.2)

If a hedged item is a forecast transaction (or a component thereof), that transaction must be highly probable. (IFRS 9.6.3.4)

For hedge accounting purposes, only an asset, liability, firm commitment, highly probable forecast transaction with parties external to the reporting entity can be designated as a hedged item. (IFRS 9.6.3.5)



LECTURER'S COMMENT

Refer to:
Descriptive Accounting, example 30.28 – 30.30.

Designation of hedged items – IFRS 9.6.3.7

An entity may designate an item in its entirety or a component of an item as the hedged item in a hedging relationship. An entire item comprises all changes in the cash flows or fair value of an item. A component comprises less than the entire fair value change or cash flow variability of an item.

Hedge ratio is the relationship between the quantity of the hedging instrument and the quantity of the hedged item in terms of their relative weighting.

7.9 Qualifying criteria for hedge accounting

A hedging relationship qualifies for hedge accounting **only if all of the following criteria are met**:

(a) the hedging relationship consists only of eligible hedging instruments and eligible hedged items.
(b) at the inception of the hedging relationship, there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item, the nature of the risk being hedged and how the entity will assess whether the hedging relationship meets the hedge effectiveness requirements; and
(c) the hedging relationship meets all of the following hedge effectiveness requirements:
    i. there is an economic relationship between the hedged item and the hedging instrument;
    ii. the effect of credit risk on fair value changes should be minimal; and
    iii. the hedge ratio for accounting should be the same as for risk management purposes. The relationship between the quantity of the hedging instrument and the quantity of the hedged item in terms of their relative weighting constitutes a hedging relationship. (IFRS 9.6.4.1)

Hedge effectiveness

Hedge effectiveness is the extent to which changes in the fair value or the cash flows of the hedging instrument offset changes in the fair value or the cash flows of the hedged item (for example, when the hedged item is a risk component, the relevant change in fair value or cash flows of an item is the one that is attributable to the hedged risk). Hedge ineffectiveness is the extent to which the changes in the fair value or the cash flows of the hedging instrument are greater or less than those on the hedged item. (IFRS 9 B6.4.1)

When designating a hedging relationship on an ongoing basis, an entity shall analyse the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term. This analysis (including any updates arising from rebalancing a hedging relationship) is the basis for the entity's assessment of meeting the hedge effectiveness requirements. (IFRS 9 B6.4.2)

Hedge ratio

In accordance with the hedge effectiveness requirements, the hedge ratio of the hedging relationship must be the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item. Hence, if an entity hedges less than 100% of the exposure on an item, such as 85%, it shall designate the hedging relationship using a hedge ratio that is the same as that resulting from 85% of the exposure and the quantity of the hedging instrument that the entity actually uses to hedge those 85%. Similarly, if, for example, an entity hedges an exposure using a nominal amount of 40 units of a financial instrument, it shall designate the hedging relationship using a hedge ratio that is the same as that resulting from that quantity of 40 units (ie the entity must not use a hedge ratio based on a higher quantity of units that it might hold in total or a lower quantity of units) and the quantity of the hedged item that it actually hedges with those 40 units. (IFRS 9 B6.4.9)

Frequency of assessing whether the hedge effectiveness requirements are met

An entity shall assess at the inception of the hedging relationship, and on an ongoing basis, whether a hedging relationship meets the hedge effectiveness requirements. At a minimum, an

entity shall perform the ongoing assessment at each reporting date or upon a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first.

The assessment relates to expectations about hedge effectiveness and is therefore only forward-looking. (IFRS 9 B6.4.12)

Methods for assessing whether the hedge effectiveness requirements are met

This Standard does not specify a method for assessing whether a hedging relationship meets the hedge effectiveness requirements. However, an entity shall use a method that captures the relevant characteristics of the hedging relationship, including the sources of hedge ineffectiveness. Depending on those factors, the method can be a qualitative or a quantitative assessment. (IFRS 9 B6.4.13)

7.10 HEDGE ACCOUNTING

There are three types of hedging relationships recognised by IFRS 9.6.5.3:

1. a **fair value hedge (FV hedge)** which **hedges the exposure to changes in fair value** of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss;

2. a **cash flow hedge (CF hedge) which hedges the exposure to variability in cash flows** to a particular risk associated with all, or a component thereof, recognised asset or liability (such as all or some future interest payments on variable-rate debt) or a highly probable forecast transaction, and could affect profit or loss.

3. a **hedge of a net investment in a foreign operation**. This type of hedge need not to be studied for this module.

A hedge of the foreign currency risk of a **firm commitment** may be accounted for as a fair value hedge or as a cash flow hedge.

The following summarises the various scenarios in which fair value hedge accounting and/or cash flow hedge accounting can be applied when **foreign currency risk is hedged**:

Forecast transaction	**Highly probable forecast transaction**	**Firm commitment**	**Recognised foreign currency debtor or creditor**
Hedge accounting may not be applied	Only cash flow hedge accounting	Fair value or cash flow hedge accounting	Fair value or cash flow hedge accounting

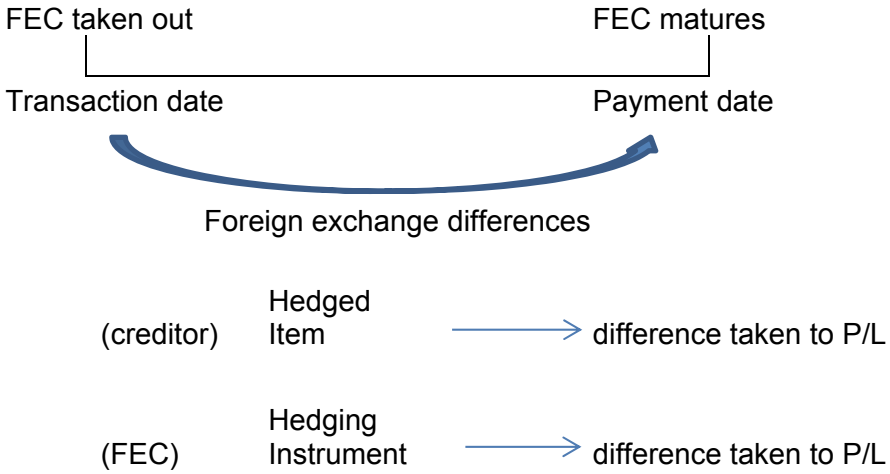
Please note that fair value hedge and cash flow hedge accounting for non-financial items (machinery, etc) will be discussed. Hedging of financial items (foreign loans, etc.) is not part of the syllabus.

7.11 ACCOUNTING TREATMENT OF FAIR VALUE HEDGES

As long as a fair value hedge meets the qualifying criteria in IFRS 9.6.4.1, the hedging relationship shall be accounted for as follows:

(a) the gain or loss on the **hedging instrument** shall be recognised in profit or loss.
(b) the hedging gain or loss on the **hedged item** shall adjust the carrying amount of the hedged item (if applicable) and be recognised in profit or loss. When a hedged item in a fair value hedge is a firm commitment (or a component thereof) to acquire an asset or assume a liability, the initial carrying amount of the asset or the liability that results from the entity meeting the firm commitment is adjusted to include the cumulative change in the fair value of the hedged item that was recognised in the statement of financial position.

FAIR VALUE HEDGE



EXAMPLE 6

AN FEC IS TAKEN OUT ON TRANSACTION DATE (a fair value hedge)

On 1 May 20.10, A Ltd bought inventory from B Ltd, a company incorporated in the United Kingdom. The invoice was for £10 000, payable on 31 July 20.10. The financial year-end of A Ltd is 30 June. A FEC is taken out for the period 1 May 20.10 to 31 July 20.10 to hedge the company against changes in the fair value of the foreign creditor. Assume that none of the inventory was sold at year-end. Applicable exchange rates were as follows:

	£1 = R Spot rate	**£1 = R 3-month FEC**
1 May 20.10	7,10	7,28
30 June 20.10 (year-end)	7,15	
31 July 20.10	7,25	

The forward rate at year-end for a one-month FEC was £1 = R7,29.

Assume that the hedging criteria per IFRS 9.6.4.1 have been met. The company's documented risk management strategy for foreign currency risks provides for the following:

- all exposure to fluctuations in foreign exchange rates **are to be hedged by means of forward exchange contracts (FECs);**
- **hedge effectiveness** is to be assessed on an ongoing cumulative basis from the inception of the hedge by comparing the offsetting effects of gains or losses arising from fluctuations in spot exchange rates to those arising from changes in the fair value of forward exchange contracts designated in their entirety.

The company values inventory according to the first-in-first-out method.



REQUIRED

(a) Provide all the relevant journal entries; and

(b) Provide the disclosure of the above transactions for the year ended 30 June 20.10. Your answer should comply with the requirements of *International Financial Reporting Standards*.

SOLUTION 6



Hint:

Most people will find the events presented in the example overwhelming and confusing. It is recommended that you first plot the events on a time line.

1 May 20.10	30 June 20.10	31 July 20.10
*Transaction date	*Year -end	*Settle creditor of £10 000
*FEC taken out		*FEC matures

(a) Journals

IAS 21			IFRS 9		
	Dr R	**Cr R**		**Dr R**	**Cr R**
1 May 20.10 – Delivery date (risks and rewards transferred)					
Hedged item			**Hedging instrument**		
Inventories (SFP)	71 000		No entry		
Trade payables (SFP)		71 000			
(£10 000 x 7,10)					
Recording of inventory purchased					
30 June 20.10 – Year-end					
Hedged item			**Hedging instrument**		
Foreign exchange difference (P/L)	500		FEC asset (SFP)	100	
Trade payables (SFP)		500	Fair value gain (P/L)		100
Revalued creditor at spot rate at year-end [£10 000 x (7,15 – 7,10)]			Revalue FEC at year-end [£10 000 x (7,29 – 7,28]		

When entering into a forward exchange contract (FEC), no transaction is recorded.

Where the entity's financial year-end occurs before settlement date, the gain or loss (recognised in profit or loss) on the FEC is calculated by multiplying the foreign currency amount of the FEC by the difference between the contracted forward rate and the forward rate available for a similar FEC for the remaining period till maturity of the original contract. A corresponding forward exchange asset or liability (derivative) is recognised.

IAS 21			IFRS 9		
	Dr R	Cr R		Dr R	Cr R
31 July 20.10 – Payment of £10 000 creditor and expiry of 3-month FEC					
Foreign exchange difference (P/L) Trade payables (SFP) [£10 000 x (7,25 – 7,15)] Revalue creditor at spot rate on settlement date	1 000	1 000	Fair value loss (P/L) FEC liability (SFP) [£10 000 x (7,29 – 7,25)] Revalue FEC on settlement date	400	400
FEC Asset (SFP)					100
FEC Liability (SFP)				400	
Trade payables (SFP) (£10 000 x 7,25)				72 500	
Bank (SFP) (£10 000 x 7,28)					72 800
Recording of payment to foreign creditor					

An exchange gain or loss is raised on settlement date of the FEC, being the difference between the monetary item translated at the spot rate on settlement date and the amount paid or received in terms of the FEC on the same date.

Any further exchange gain or loss, being the difference between the equivalent forward cover rate at the end of the reporting period and the spot rate at settlement date, would be recognised in the subsequent period.



LECTURER'S COMMENT

This is an example of a fair value hedge where the changes in fair value of the creditor as a result of currency fluctuations, is offset by fair value changes in the FEC.

(b) Disclosure

A LTD

STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20.10

ASSETS	**R**
Current assets	
Inventories	71 000
Forward exchange contract asset (FEC asset)	100
EQUITY AND LIABILITIES	
Current liabilities	
Trade payables	71 500

A LTD

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 JUNE 20.10

	R
Gross profit	xxx
Other income	100
Other expenses	(500)

A LTD

NOTES FOR THE YEAR ENDED 30 JUNE 20.10

1. Accounting policy

1.1 Inventory

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

1.2 Financial instruments

The company enters into forward exchange contracts to buy specified amounts of various foreign currencies in the future at a predetermined exchange rate. The contracts are entered into in order to manage the company's exposure to fluctuation in foreign currency exchange rates on specific transactions.

Gains and losses arising from fair value hedges are recognised in profit or loss.

2 Profit before tax

Profit before tax includes the following:

	R
Income	
Fair value gain	100
Expenses:	
Foreign exchange differences	500

3. Financial instrument

Fair value

The fair values of forward exchange contracts are determined directly in full by reference to published price quotations in an active market and represent the amounts (using a rate quoted by a bank) that the company would receive to terminate the contracts at the reporting date, thereby taking into account the unrealised gains or losses of open contracts.

Designated fair value hedges

At year-end a forward contract was hedging a trade payable (creditor) relating to the purchase of inventory.

The risk being hedged is an exchange loss due to an unfavourable movement in the exchange rate between the rand and the pound.

The fair value of the forward exchange contract at the reporting date was £10 000 or R72 900 (£10 000 x 7,29). The forward exchange contract matures on 31 July 20.10 and the forward rate is £1 = R7,28.

4. Financial risk management objectives and policies

Foreign currency risk is created due to the influence of exchange rate fluctuations. It is the company's policy to cover all exposure for foreign currency risk by means of forward exchange contracts. The company has exposure to fluctuations in the pound against the rand at year-end of which the total amount is covered.

5. Inventory

	R
Finished goods	71 000

EXAMPLE 7

FEC TAKEN OUT ON TRANSACTION DATE AND RENEWED (fair value hedge "rolled forward")

The same information as provided in example 6 applies, except that cover is taken out for the period 1 May 20.10 to 1 June 20.10, after which cover was extended to 31 July 20.10. Assume that none of the inventory was sold at year-end. The applicable exchange rates were as follows:

	£1 = R	**£1 = R**	**£1 = R**
		1 month	**2 months**
	Spot rate	**FEC**	**FEC**
1 May 20.10	7,10	7,19	
1 June 20.10	7,13		7,28
30 June 20.10 (year-end)	7,15		
31 July 20.10	7,25		

The forward rate at year-end for a one month FEC was £1 = R7,29.



REQUIRED

(a) Provide all the relevant journal entries; and
(b) Provide the disclosure of the above transactions for the year ended 30 June 20.10. Your answer should comply with the requirements of *International Financial Reporting Standards*. Accounting policy notes are not required.

SOLUTION 7



Hint:

Most people will find the events presented in the example overwhelming and confusing. It is recommended that you first plot the events on a time line.

1 May 20.10	1 June 20.10	30 June 20.10	31 July 20.10
*Transaction date *FEC 1 taken out	*FEC 1 matures *FEC 1 extended	*Year-end	*Settle creditor of £10 000 *FEC matures

(a) Journals

IAS 21	Dr R	Cr R	IFRS 9	Dr R	Cr R
1 May 20.10 – Delivery date (Risks and rewards transferred)					
Hedged item			**Hedging instrument**		
Inventories (SFP)	71 000		No entry		
Trade payables (SFP)		71 000			
(£10 000 x 7,10)					
Recording of inventory purchased					
1 June 20.10 – Expiry of FEC					
Hedged item			**Hedging instrument**		
No entry			Fair value loss (P/L)	600	
			Bank (SFP)		600
			Recording of loss on maturity of FEC		
			Sell £10 000 x 7,13 =	71 300	
			Buy £10 000 x 7,19 =	71 900	
			Fair value loss	600	
30 June 20.10 – Year-end					
Hedged item			**Hedging instrument**		
Foreign exchange difference (P/L)	500		FEC asset (SFP)	100	
Trade payables (SFP)		500	Fair value gain(P/L)		100
Revalue creditor at spot rate at year-end			Revalue FEC at year-end		
Recorded at £10 000 x 7,10 =	71 000		FEC taken out £10 000 x 7,28 =	72 800	
Translated at year-end			Similar FEC £10 000 x 7,29 =	72 900	
£10 000 X 7,15 =	71 500				
Foreign exchange loss	500		Fair value gain	100	

On maturity of an FEC it may be renewed or "rolled forward" to ensure further protection against changes in foreign exchange rates. On maturity date, the difference between the original forward rate and the spot rate is received or paid in cash. The difference (profit or loss) is then recognised in profit or loss.

	Dr R	Cr R		Dr R	Cr R
31 July 20.10 – Payment of £10 000 creditor and expiry of FEC					
Hedged item			**Hedging instrument**		
Foreign exchange difference (P/L)	1 000		Fair value loss (P/L)	400	
Trade payables (SFP)		1 000	FEC liability (SFP)		400
[£10 000 x (7,25 – 7,15)]			[£10 000 x (7,29 – 7,25)]		
Revalue creditor at spot rate on settlement date			FEC expires (reverse FEC asset)		
FEC Liability (SFP)				400	
Trade payables (SFP) (71 000 + 500 + 1 000)				72 500	
Bank (SFP) (£10 000 x 7,28)					72 800
FEC Asset					100
Recording of payment to foreign creditor					

(b) Disclosure

A LTD
STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20.10

ASSETS	**R**
Current assets	
Inventories	71 000
Forward exchange contract asset	100
EQUITY AND LIABILITIES	
Current liabilities	
Trade payables	71 500

A LTD
STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 JUNE 20.10

	R
Gross profit	XXX
Other expenses (600 + 500 – 100)	(1 000)

A LTD

NOTES FOR THE YEAR ENDED 30 JUNE 20.10

2. Profit before tax

Profit before tax includes the following:

	R
Expenses:	
Fair value loss (600 – 100)	500
Foreign exchange differences	500

3. Financial instruments

Fair value

The fair values of forward exchange contracts are determined directly in full by reference to published price quotations in an active market and represent the amounts (using a rate quote by a bank) that the company would receive to terminate the contracts at the reporting date, thereby taking into account the unrealised gains or losses of open contracts.

Designated fair value hedges

At year-end, a forward exchange contract was hedging a trade payable (creditor) relating to the purchase of inventory.

The risk being hedged is an exchange loss due to an unfavourable movement in the exchange rate between the rand and the pound.

The fair value of the forward exchange contract at the reporting date was £10 000 or R72 900 (£10 000 x R7,29). The forward exchange contract matures on 31 July 20.10 and the forward rate is £1 = R7,28.

4. Financial risk management objectives and policies

Foreign currency risk is created due to the influence of exchange rate fluctuations. It is the company's policy to cover all exposure to foreign currency risk by means of forward exchange contracts. The company has exposure to fluctuations in the pound against the rand at year-end of which the total amount is covered.

5. Inventory

	R
Finished goods	71 000

EXAMPLE 8

A FORWARD EXCHANGE CONTRACT IS TAKEN OUT AFTER THE TRANSACTION TOOK PLACE (fair value hedge)

The same information as provided in example 6 applies, except that cover is taken out for the period 1 June 20.10 to 31 July 20.10 to hedge the company against changes in the fair value of the foreign creditor. The applicable exchange rates were as follows:

	£1 = R Spot rate	**£1 = R 2 month FEC**
1 May 20.10	7,10	7,28
1 June 20.10	7,13	7,28
30 June 20.10 (year-end)	7,15	
31 July 20.10	7,25	

The forward rate at year-end for a one month FEC was £1 = R7,29.

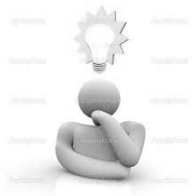


REQUIRED

(a) Provide all the relevant journal entries; and
(b) Provide the disclosure of the above transactions for the year ended 30 June 20.10. Your answer should comply with the requirements of *International Financial Reporting Standards*.

Accounting policy notes are not required.

SOLUTION 8



Hint:

Most people will find the events presented in the example overwhelming and confusing. It is recommended that you first plot the events on a time line.

1 May 20.10	1 June 20.10	30 June 20.10	31 July 20.10
*Transaction date	*FEC 1 taken out	*Year-end	*Settle creditor of £10 000 *FEC matures

(a) Journals

IAS 21	Dr R	Cr R	IFRS 9	Dr R	Cr R
1 May 20.10 Delivery date (Risks and rewards transferred)					
Hedged item			**Hedging instrument**		
Inventory (SFP)	71 000		No entry		
Trade payables (SFP)		71 000			
(£10 000 x 7,10)					
Recording of inventory purchased					
1 June 20.10 FEC taken out					
Hedged item			**Hedging instrument**		
No entry			No entry		
30 June 20.10 Year- end					
Hedged item			**Hedging instrument**		
Foreign exchange difference (P/L)	500		FEC asset (SFP)	100	
Trade payables (SFP)		500	Fair value gain (P/L)		100
[£10 000 x (7,15 – 7,10)]			[£10 000 x (7,28 – 7,29)]		
Revalue creditor at spot rate at year-end			Revalue FEC at year-end		
31 July 20.10 Payment of £10 000 creditor and expiry of FEC					
Hedged item			**Hedging instrument**		
Foreign exchange difference (P/L)	1 000		Fair value loss (P/L)	400	
Trade payables (SFP)		1 000	FEC asset (SFP)		100
[£10 000 x (7,25 – 7,15)]			FEC liability (SFP)		300
			[£10 000 x (7,29 – 7,25)]		
Revalue creditor at spot rate at settlement date			Revalue FEC at settlement date		

	Dr R	Cr R
FEC liability (SFP)	300	
Trade payables (SFP) (£10 000 x 7,25)	72 500	
Bank (SFP) (£10 000 x 7,28)		72 800
Recording of payment of foreign creditor		

(b) Disclosure

A LTD

STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20.10

ASSETS	**R**
Current assets	
Inventories	71 000
Forward exchange contract asset (FEC asset)	100
EQUITY AND LIABILITIES	
Current liabilities	
Trade payables (71 000 + 500)	71 500

A LTD

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 JUNE 20.10

	R
Gross profit	xxx
Other income	100
Other expenses	(500)

A LTD

NOTES FOR THE YEAR ENDED 30 JUNE 20.10

2. Profit before tax

Profit before tax includes the following:

	R
Income	
Fair value gain	100
Expenses:	
Foreign exchange differences	500

3. Financial instruments

Fair value

The fair values of forward exchange contracts are determined directly in full by reference to published price quotations in an active market and represent the amounts (using a rate quote by a bank) that the company would receive to terminate the contracts at the reporting date, thereby taking into account the unrealised gains or losses of open contracts.

Designated fair value hedges

At year-end a forward exchange contract was hedging a trade payable relating to the purchase of inventory.

The risk being hedged is an exchange loss due to an unfavourable movement in the exchange rate between the rand and the pound.

The fair value of the forward exchange contract at the reporting date was £10 000 or R72 900 (£10 000 x 7,29). The forward exchange contract matures on 31 July 20.10 and the forward rate is £1 = R7,28.

4. Financial risk management objectives and policies

Foreign currency risk is created due to the influence of exchange rate fluctuations. It is the company's policy to cover all exposure to foreign currency risk by means of forward exchange contracts. The company has exposure to fluctuations in the pound against the rand at year-end of which the total amount is covered.

5. Inventory

	R
Finished goods	71 000

7.12 ACCOUNTING TREATMENT OF CASH FLOW HEDGES

As long as a cash flow hedge meets the qualifying criteria in IFRS 9.6.4.1, the hedging relationship shall be accounted for as follows:

(a) the separate component of equity associated with the hedged item (cash flow hedge reserve) is adjusted to the **lower of the following** (in absolute amounts):

  (i) the cumulative gain or loss on the hedging instrument from inception of the hedge; and
  (ii) the cumulative change in fair value (present value) of the hedged item (ie the present value of the cumulative change in the hedged expected future cash flows) from inception of the hedge.

(b) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (ie the portion that is offset by the change in the cash flow hedge reserve calculated in accordance with (a)) shall be recognised in other comprehensive income.

(c) any remaining gain or loss on the hedging instrument (or any gain or loss required to balance the change in the cash flow hedge reserve calculated in accordance with (a)) is hedge ineffectiveness that shall be recognised in profit or loss. (IFRS 9.6.5.11)

The cash flow hedge reserve must be measured at the lower of (i) and (ii) above. The lower value is the effective portion and the difference between the two values is the ineffective portion.

The following is an example if there is a gain on the hedging instrument:

- The effective and ineffective portions are recognised as follows:

  Dr FEC Asset
  Cr Cash flow hedge reserve (OCI) (Effective portion)
  Cr Fair value gain (P/L) (Ineffective portion)

(d) The amount that has been accumulated in the cash flow hedge reserve in accordance with (a) shall be accounted for as follows:

  (i) if a hedged forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, or a hedged forecast transaction for a non-financial asset or a non-financial liability becomes a firm commitment for which fair value hedge

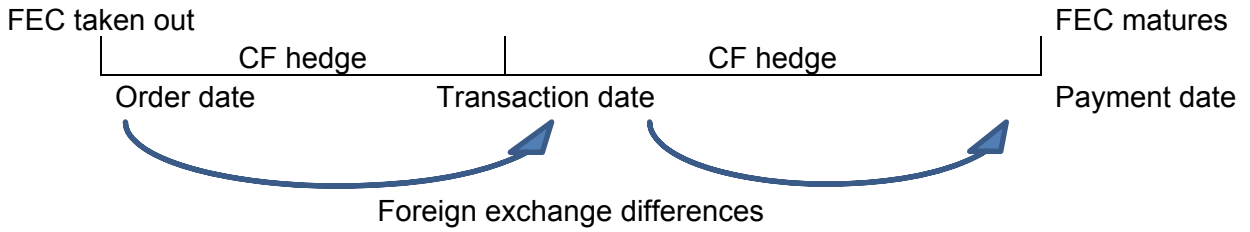
accounting is applied, the entity shall remove that amount from the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or the liability. This is not a reclassification adjustment (see IAS 1) and hence it does not affect other comprehensive income.

(ii) for cash flow hedges other than those covered by (i), that amount shall be reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment (see IAS 1) in the same period or periods during which the hedged expected future cash flows affect profit or loss (for example, in the periods that interest income or interest expense is recognised or when a forecast sale occurs).

(iii) however, if that amount is a loss and an entity expects that all or a portion of that loss will not be recovered in one or more future periods, it shall immediately reclassify the amount that is not expected to be recovered into profit or loss as a reclassification adjustment (see IAS 1). (IFRS 6.5.11(d))

The diagrams that follow explain IFRS 6.5.11(d).

CASH FLOW HEDGE ACCOUNTING – APPLICATION OF CASH FLOW HEDGE ACCOUNTING BEFORE AND AFTER TRANSACTION DATE



Hedged item → Difference is taken to P/L

Hedging Instrument → Difference is taken to the cash flow hedge reserve (CFHR) up to transaction date

On transaction date, the **cash flow hedge reserve (CFHR) is written off against the cost of the asset**

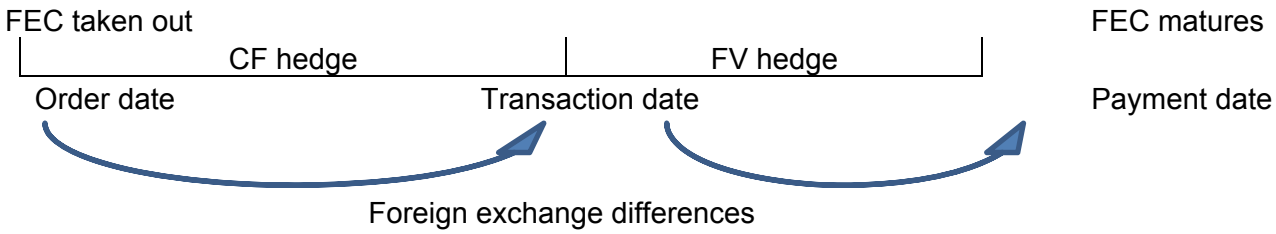
After transaction date, the difference on the hedging instrument is taken to CFHR and then transferred immediately to P/L (in and out)

Note: The accounting treatment depicted in the above diagram is different to the diagram that follows.

The difference in the accounting treatments occurs after transaction date. The diagram above explains the accounting of the foreign exchange differences on the hedged item and hedging instrument when **cash flow hedge accounting is applied before and after transaction date**. See example 13.

The diagram below explains the accounting of the foreign exchange differences on the hedged item and hedging instrument when **cash flow hedge accounting is applied before transaction date AND fair value hedge accounting is applied after transaction date**. Refer to examples 9, 11 and 12.

CASH FLOW HEDGE ACCOUNTING – APPLICATION OF CASH FLOW HEDGE ACCOUNTING BEFORE TRANSACTION DATE AND FAIR VALUE HEDGE ACCOUNTING AFTER TRANSACTION DATE



Hedged item → Difference is taken to P/L

Hedging instrument → Difference is taken to the cash flow hedge reserve (CFHR) up to transaction date

On transaction date, the cash flow hedge reserve (CFHR) is **written off against the cost of the asset**

After transaction date, the difference on the hedging instrument is taken to P/L

EXAMPLE 9

A FORWARD EXCHANGE CONTRACT IS TAKEN OUT IN ANTICIPATION OF A TRANSACTION (cash flow hedge and fair value hedge)

The information provided in example 6 applies, except that cover is taken out for the period 1 March 20.10 to 31 July 20.10 to hedge the company against changes in the cash flows of the highly probable forecast transaction as well as changes in the fair value of the foreign creditor.

The applicable exchange rates were as follows:

	£1 = R Spot rate	**£1 = R Forward rate for an FEC that expires on 31/07/20.10**
1 March 20.10	7,06	7,28
1 May 20.10	7,10	7,30
30 June 20.10 (year-end)	7,15	7,29
31 July 20.10	7,25	–

Assume that the gain or loss on the hedging instrument, regarding the cash flows hedge, is an effective hedge.



REQUIRED

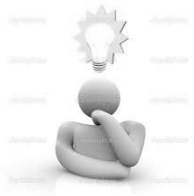
a) Provide all the relevant journal entries if

i. the relevant hedging document reflects that subsequent to transaction date, the hedge of the foreign currency exposure relating to the creditor is accounted for as a fair value hedge.

ii. the relevant hedging document reflects that subsequent to transaction date, the hedge of the foreign currency exposure relating to the creditor is accounted for as a cash flow hedge.

(b) Provide the disclosure of the above transactions for the year ended 30 June 20.10. Your answer should comply with the requirements of *International Financial Reporting Standards*.

SOLUTION 9



Hint:

Most people will find the events presented in the example overwhelming and confusing. It is recommended that you first plot the events on a time line.

1 March 20.10	1 May 20.10	30 June 20.10	31 July 20.10
*FEC taken out	*Transaction date	*Year-end	*Settle creditor of £10 000 *FEC matures

(a) (i) Journals

IAS 21	Dr R	Cr R	IFRS 9	Dr R	Cr R
1 March 20.10 – FEC taken out					
Hedged item No entry			**Hedging instrument** No entry		
1 May 20.10 – Delivery date (Risks and rewards transferred)					
Hedged item Inventories (SFP) Trade payables (SFP) (£10 000 x 7,10) Recording of inventory purchased	71 000	71 000	**Hedging instrument** FEC asset (SFP) Cash flow hedge reserve(OCI) [£10 000 x (7,30 – 7,28)] Revalue FEC at forward rate for a similar FEC with the same maturity date	200	200
			Cash flow hedge reserve (OCI) Inventories (SFP) Hedging gain set off against cost of inventory	200	200

This is a cash flow hedge of a highly probable forecast transaction that resulted in the recognition of a non-financial asset for which fair value hedge accounting is applied AFTER transaction date: The CFHR is written off against the initial carrying amount of the asset. After transaction date, the profit/loss on the FEC is written off against P/L.

IAS 21			IFRS 9		
	Dr R	Cr R		Dr R	Cr R
30 June 20.10 – Year-end					
Hedged item			**Hedging instrument**		
Foreign exchange difference (P/L)	500		Fair value loss (P/L)	100	
Trade payables (SFP)		500	FEC asset (SFP)		100
[£10 000 x (7,15 – 7,10)]			[£10 000 x (7,30 – 7,29)]		
Revalued creditor at spot rate at year-end			Revalue FEC at forward rate for a similar FEC with the same maturity date		
31 July 20.10 – Payment of £10 000 creditor and expiry of FEC					
Hedged item			**Hedging instrument**		
Foreign exchange difference (P/L)	1 000		Fair value loss (P/L)	400	
Trade payables (SFP)		1 000	FEC liability (SFP)		400
[£10 000 x (7,25 – 7,15)]			[£10 000 x (7,29 – 7,25)]		
Revalue creditor at spot rate on settlement date			Revalue FEC on settlement date		
FEC liability (SFP)				400	
Trade payables (£10 000 x 7,25) (SFP)				72 500	
Bank (SFP) (£10 000 x 7,28)					72 800
FEC asset (SFP) (200 –100)					100
Recording of payment to foreign creditor					

(a) (ii) Journals

IAS 21			IFRS 9		
	Dr R	Cr R		Dr R	Cr R
1 March 20.10 – FEC taken out					
Hedged item			**Hedging instrument**		
No entry			No entry		
1 May 20.10 – Delivery date (Risks and rewards transferred)					
Hedged item			**Hedging instrument**		
Inventories (SFP)	71 000		FEC asset (SFP)	200	
Trade payables (SFP)		71 000	Cash flow hedge reserve(OCI)		200
(£10 000 x 7,10)			[£10 000 x (7,30 – 7,28)]		
Recording of inventory purchased			Revalue FEC at forward rate for a similar FEC with the same maturity date		
This is a cash flow hedge of a highly probable forecast transaction that resulted in the recognition of a non-financial asset for which cash flow hedge accounting is applied AFTER transaction date: The CFHR is written off against the initial carrying amount of the asset.			Cash flow hedge reserve (OCI)	200	
			Inventories (SFP)		200
			Hedging gain set off against inventory		
30 June 20.10 – Year-end					
Hedged item			**Hedging instrument**		
Foreign exchange difference (P/L)	500		Cash flow hedge reserve (OCI)	100	
Trade payables (SFP)		500	FEC Asset (SFP)		100
[£10 000 x (7,15 – 7,10)]			[£10 000 x (7,30 – 7,29)]		
Revalued creditor at spot rate at year-end					
Cash flow hedge accounting is applied AFTER transaction date: The profit or loss on the hedging instrument (FEC) is written off against the cash flow hedge reserve and then immediately transferred to profit/loss.			Fair value loss (P/L)	100	
			Cash flow hedge reserve (OCI)		100
			Revalue FEC at forward rate for a similar FEC with the same maturity date		

IAS 21			IFRS 9		
	Dr R	Cr R		Dr R	Cr R
31 July 20.10 – Payment of £10 000 creditor and expiry of FEC					
Hedged item			**Hedging instrument**		
Foreign exchange difference (P/L)	1 000		Cash flow hedge reserve	400	
Trade payables (SFP)		1 000	FEC liability (SFP)		400
[£10 000 x (7,25 – 7,15)]			[£10 000 x (7,29 – 7,25)]		
Revalue creditor at spot rate on settlement date					
			Fair value loss (P/L)	400	
			Cash flow hedge reserve		400
			Revalue FEC on settlement date		
FEC liability (SFP)				400	
Trade payables (£10 000 x 7,25) (SFP)				72 500	
Bank (SFP)(£10 000 x 7,28)					72 800
FEC asset (200 -100) (SFP)					100
Recording of payment to foreign creditor					

(b) Disclosure (NB The disclosure to (a) (i) and (a) (ii) is the same)

A LTD

STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20.10

ASSETS	**R**
Current assets	
Inventories (71 000 – 200)	70 800
Forward exchange contract asset (200 – 100)	100
EQUITY AND LIABILITIES	
Current liabilities	
Trade payables (71 000 + 500)	71 500

A LTD

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 JUNE 20.10

	R
Gross profit	XXX
Other expenses (500 + 100)	(600)

A LTD

NOTES FOR THE YEAR ENDED 30 JUNE 20.10

1. Profit before tax

Profit before tax includes the following:

	R
Expenses:	
Fair value loss	100
Foreign exchange differences	500

2. Financial instruments

Fair value

The fair values of forward exchange contracts are determined directly in full by reference to published price quotations in an active market and represent the amounts (using a rate quote by a bank) that the company would receive to terminate the contracts at the reporting date, thereby taking into account the unrealised gains or losses of open contracts.

Designated fair value hedges

At year-end, a forward exchange contract was hedging a trade payable (creditor) relating to the purchase of inventory.

The risk being hedged is an exchange loss due to an unfavourable movement in the exchange rate between the rand and the pound.

The fair value of the forward exchange contract at the reporting date was £10 000 or R72 900 (£10 000 x 7,29). The forward exchange contract matures on 31 July 20.10 and the forward rate is £1 = R7,28.

3. Financial risk management objectives and policies

Foreign currency risk is created due to the influence of exchange rate fluctuations. It is the company's policy to cover all exposure to foreign currency risk by means of forward exchange contracts. The company has exposure to fluctuations in the pound against the rand at year-end of which the total amount is covered.

4. Inventory

	R
Finished goods	70 800

EXAMPLE 10

CASH FLOW HEDGE AT YEAR-END

The same information as in example 9 applies, except that the year-end was 30 April 20.10 and the FEC rate at year-end for a three-month FEC was R7,30. The particulars of the FEC must now be disclosed in a note to the annual financial statements since there is no related item in the statement of financial position at year-end.



REQUIRED

(a) Provide all the relevant journal entries; and
(b) Provide the disclosure of the above transactions for the year ended 30 April 20.10. Your answer should comply with the requirements of *International Financial Reporting Standards*. Accounting policy notes are not required.

SOLUTION 10



Hint:

Most people will find the events presented in the example overwhelming and confusing. It is recommended that you first plot the events on a time line.

1 March 20.10	30 April 20.10	1 May 20.10	31 July 20.10
*FEC taken out	*Year-end	*Transaction date	*Settle creditor of £10 000 *FEC matures

(a) Journals

IAS 21	Dr R	Cr R	IFRS 9	Dr R	Cr R
1 March 20.10 – FEC taken out					
Hedged item No entry			**Hedging instrument** No entry		
30 April 20.10 – Year-end					
Hedged item No entry			**Hedging instrument** FEC Asset (SFP) Cash flow hedge reserve (OCI) [£10 000 x (7,28 – 7,30)] Revalue FEC at year-end	200	200

(b) Disclosure

A LTD
STATEMENT OF FINANCIAL POSITION AS AT 30 APRIL 20.10

ASSETS	**R**
Current assets	
Forward exchange contract asset	200
EQUITY AND LIABILITIES	
Equity attributable to equity holders	
Hedging gain	200

A LTD
STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 30 APRIL 20.10

	Cash flow hedge reserve R
Balance at 30 April 20.9	
Cash flow hedge reserve:	-
Hedging gain recognised in other comprehensive income (OCI)	200
Balance at 30 April 20.10	200

A LTD

NOTES FOR THE YEAR ENDED 30 APRIL 20.10

3. Foreign currency exposure

	Amount	Forward rate £1 = R	Maturity date
Purchase of inventory on 1 May 20.10	£10 000	7,28	31 July 20.10

A hedging gain resulted from the revaluation of the forward exchange contract at year-end. It is expected that the hedging gain will be recognised as income in the next financial year.

4. Financial risk management objectives and policies

Foreign currency risk is created due to the influence of exchange rate fluctuations. It is the company's policy to cover all exposure to foreign currency risk by means of forward exchange contracts. The company has exposure to fluctuations in the pound against the rand at year-end of which the total amount is covered.

EXAMPLE 11

RENEW THE FEC BEFORE THE TRANSACTION DATE (cash flow hedge "rolled forward" and fair value hedge)

The same information as in example 6 applies, except that cover in this example is taken out for the period 1 March 20.10 to 1 April 20.10, after which cover is extended to 31 July 20.10 to hedge the company against changes in the cash flows of the highly probable forecast transaction as well as changes in the fair value of the foreign creditor.

The applicable exchange rates were as follows:

	£1 = R Spot rate	£1 = R 1 month FEC	£1 = R 4 month FEC
1 March 20.10	7,06	7,08	
1 April 20.10	7,13		7,27
1 May 20.10	7,10		
1 June 20.10	7,13		
30 June 20.10 (year-end)	7,15		
31 July 20.10	7,25		

The forward rate at year-end for a one month FEC was £1 = R7,29. On 1 May 20.10, the forward rate for a three month FEC was £1 = R7,28.

Assume that the gain or loss on the hedging instrument, regarding the cash flow hedge, is an effective hedge. The relevant hedging document reflects that subsequent to transaction date, the hedge on the foreign currency exposure relating to the creditor is accounted for as a fair value hedge.



REQUIRED

(a) Provide all the relevant journal entries; and

(b) Provide the disclosure of the above transactions for the year ended 30 June 20.10. Your answer should comply with the requirements of *International Financial Reporting Standards*.

Accounting policy notes are not required.

SOLUTION 11



Hint:

Most people will find the events presented in the example overwhelming and confusing. It is recommended that you first plot the events on a time line.

1 March 20.10	1 April 20.10	1 May 20.10	30 June 20.10	31 July 20.10
*FEC taken out	*FEC matures *FEC extended	*Transaction date	*Year-end	*Settle creditor of £10 000 *FEC matures

(a) Journals

IAS 21	Dr R	Cr R	IFRS 9	Dr R	Cr R
1 March 20.10 – FEC taken out					
Hedged item No entry			**Hedging instrument** No entry		
1 April 20.10 – FEC matures and extended					
Hedged item No entry			**Hedging instrument** Bank (SFP) Cash flow hedge reserve (OCI) £10 000 x (7,13 – 7,08) Recording of hedging gain on maturity of FEC	500	 500
1 May 20.10 – Delivery date (Risks and rewards transferred)					

Hedged item
Inventory (SFP)
  Trade payables (SFP)
(£10 000 x 7,10)
Recording of inventory purchased
	71 000	
		71 000
			Hedging instrument
			FEC asset (SFP)
			  Cash flow hedge reserve (OCI)
			[£10 000 x (7,27 – 7,28)]
			Revalue FEC at forward rate for a similar FEC with the same maturity date
			Cash flow hedge reserve (OCI) (500 + 100)
			  Inventory (SFP)
			Set-off hedging gain against cost of inventory
				100
				
				600
					
					100
					
					600

30 June 20.10 Year-end					

Hedged item
Foreign exchange difference (P/L)
  Trade payables (SFP)
[£10 000 x (7,15 – 7,10)]
Revalue creditor at spot rate at year-end
	500	
		500
			Hedging instrument
			FEC asset (SFP)
			  Fair value gain (P/L)
			[£10 000 x (7,28 – 7,29)]
			
			Revalue FEC at forward rate for a similar FEC with the same maturity date
				100	
					100

IAS 21			IFRS 9		
	Dr R	Cr R		Dr R	Cr R
31 July 20.10 Payment of £10 000 creditor and expiry of FEC					
Hedged item			**Hedging instrument**		
Foreign exchange difference			Fair value loss (P/L)	400	
(P/L)	1 000		FEC asset (SFP)		200
Trade payables (SFP)		1 000	FEC liability (SFP)		200
[£10 000 x (7,25 – 7,15)]			[£10 000 x (7,29 – 7,25)]		
Revalue creditor at spot rate on settlement date			Revalue FEC on settlement date		
FEC liability (SFP)				200	
Trade payables (SFP) (£10 000 x 7,25)				72 500	
Bank (SFP) (£10 000 x 7,27)					72 700
Recording of payment of foreign creditor					

(b) Disclosure

A LTD

STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20.10

ASSETS	**R**
Current assets	
Inventories (71 000 – 600)	70 400
Forward exchange contract asset (100 + 100)	200
EQUITY AND LIABILITIES	
Current liabilities	
Trade payables (71 000 + 500)	71 500

A LTD

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 JUNE 20.10

	R
Gross profit	XXX
Other income	100
Other expenses	(500)

A LTD

NOTES FOR THE YEAR ENDED 30 JUNE 20.10

2. Profit before tax

Profit before tax includes the following:

	R
Income:	
Fair value gain	100
Expenses:	
Foreign exchange differences	500

3. Financial instruments

Fair value

The fair values of forward exchange contracts are determined directly in full by reference to published price quotations in an active market and represent the amounts (using a rate quote by a bank) that the company would receive to terminate the contracts at the reporting date, thereby taking into account the unrealised gains or losses of open contracts.

Designated fair value hedges

At year-end, a forward exchange contract was hedging a trade payable (creditor) relating to the purchase of inventory.

The risk being hedged is an exchange loss due to an unfavourable movement in the exchange rate between the rand and the pound.

The fair value of the forward exchange contract at the reporting date was £10 000 or R72 900 (£10 000 x 7,29). The forward exchange contract matures on 31 July 20.10 and the forward rate is £1 = R7,28.

4. Financial risk management objectives and policies

Foreign currency risk is created due to the influence of exchange rate fluctuations. It is the company's policy to cover all exposure to foreign currency risk by means of forward exchange contracts. The company has exposure to fluctuations in the pound against the rand at year-end of which the total amount is covered.

5. Inventory

	R
Finished goods	70 400

EXAMPLE 12

A FORWARD EXCHANGE CONTRACT IS TAKEN OUT IN ANTICIPATION OF A TRANSACTION – INEFFECTIVE PORTION OF CASH FLOW HEDGE (cash flow hedge and fair value hedge)

The information in example 6 applies, except that:

- cover is taken out for the period 1 March 20.10 to 31 July 20.10 to hedge the company against changes in the cash flow of the highly probable forecast transaction as well as changes in the fair value of the foreign creditor;
- the gain or loss on the hedging instrument, regarding the cash flow hedge, is only 75% effective; and
- The relevant hedging document reflects that subsequent to transaction date, the hedge of the foreign currency exposure relating to the creditor is accounted for as a fair value hedge.

The applicable exchange rates were as follows:

	£1 = R Spot rate	£1 = R Forward rate for an FEC that expires on 31/07/20.10
1 March 20.10	7,06	7,28
1 May 20.10	7,09	7,32
30 June 20.10 (year-end)	7,15	7,29
31 July 20.10	7,25	–

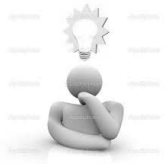


REQUIRED

(a) Provide all the relevant journal entries; and
(b) Provide the disclosure of the above transactions for the year ended 30 June 20.10. Your answer should comply with the requirements of *International Financial Reporting Standards*.

Accounting policy notes are not required.

SOLUTION 12



Hint:

Most people will find the events presented in the example overwhelming and confusing. It is recommended that you first plot the events on a time line.

1 March 20.10	1 May 20.10	30 June 20.10	31 July 20.10
*FEC taken out	*Transaction date	*Year-end	*Settle creditor of £10 000 *FEC matures

(a) Journals

IAS 21	Dr R	Cr R	IFRS 9	Dr R	Cr R
1 March 20.10 – FEC taken out					
Hedged item No entry			**Hedging instrument** No entry		
1 May 20.10 – Inventory ordered					
Hedged item Inventories (SFP) Trade payables (SFP) (£10 000 x 7,09) Recording of inventory purchased	70 900	70 900	**Hedging instrument** FEC Asset (SFP) Cash flow hedge reserve(OCI) Fair value gain (P/L) Cash flow hedge reserve Inventory [£10 000 x (7,32 – 7,28) = R400][R400 x 75%)] Revalue FEC at forward rate for a similar FEC with the same maturity date – 75% effective and adjust initial carrying amount of asset.	400 300	 300 100 300
30 June 20.10 – Year-end					
Hedged item Foreign exchange difference (P/L) Trade payables (SFP) [£10 000 x (7,15 – 7,09) Revalue creditor at spot rate at year-end	600	600	**Hedging instrument** Fair value loss (P/L) FEC asset (SFP) [£10 000 x (7,32 – 7,29)] Revalue FEC at forward rate for a similar FEC with the same maturity date	300	300
31 July 20.10 – Payment of £10 000 creditor and expiry of 5 month FEC					
Hedged item Foreign exchange difference (P/L) Trade payables (SFP) [£10 000 x (7,25 – 7,15)] Revalue creditor at spot rate on settlement date	1 000	1 000	**Hedging instrument** Fair value loss (P/L) FEC asset (SFP) FEC liability (SFP) [£10 000 x (7,29 – 7,25)] Revalue FEC on settlement date	400	 100 300
FEC liability (SFP) Trade payables (SFP) (£10 000 x 7,25) Bank (SFP) (£10 000 x 7,28) Recording of payment to foreign creditor				300 72 500	 72 800

(b) Disclosure

A LTD

STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20.10

ASSETS	**R**
Current assets	
Inventory (70 900 – 300)	70 600
Forward exchange contract asset (400 – 300)	100
EQUITY AND LIABILITIES	
Current liabilities	
Trade payables (70 900 + 600)	71 500

A LTD

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 JUNE 20.10

	R
Gross profit	XXX
Other income	100
Other expenses (600 + 300)	(900)

2. Profit before tax

Profit before tax includes the following:

	R
Income	
Fair value gain	100
Expenses:	
Foreign exchange differences	(600)
Fair value loss	(300)

3. Financial instruments

Fair value

The fair values of forward exchange contracts are determined directly in full by reference to published price quotations in an active market and represent the amounts (using a rate quote by a bank) that the company would receive to terminate the contracts at the reporting date, thereby taking into account the unrealised gains or losses of open contracts.

Designated fair value hedges

At year-end, a forward exchange contract was hedging a trade payable relating to the purchase of inventory.

The risk being hedged is an exchange loss due to an unfavourable movement in the exchange rate between the rand and the pound.

The fair value of the forward exchange contract at the reporting date was £10 000 or R72 900 (£10 000 x 7,29). The forward exchange contract matures on 31 July 20.10 and the forward rate is £1 = R7,28.

4. Financial risk management objectives and policies

Foreign currency risk is created due to the influence of exchange rate fluctuations. It is the company's policy to cover all exposure to foreign currency risk by means of forward exchange contracts. The company has exposure to fluctuations in the pound against the rand at year-end of which the total amount is covered.

5. Inventory

	R
Finished goods	70 600

EXAMPLE 13

On 1 February 20.13, a company ordered machinery to the value of £32 900 from the United Kingdom. The machinery was shipped FOB on 1 May 20.13 and was received and brought into use on 1 July 20.13. The creditor is payable on 1 June 20.13. Machinery is written off on the straight-line method over three years.

On 1 February 20.13, a four-month FEC was concluded for the full amount payable to hedge the company against changes in the cash flows of the highly probable forecast transaction as well as changes in the fair value of the foreign creditor.

The applicable foreign exchange rates were as follows:

Date	**Spot rate £1=R**	**Forward rate £1=R**
1 February 20.13	10,99	11,03 (4 months)
31 March 20.13 (year-end)	11,10	11,14 (2 months)
1 May 20.13	11,20	11,22 (1 month)
1 June 20.13	11,25	

The relevant hedging document reflects that, subsequent to transaction date, the hedge of the foreign currency exposure relating to the creditor is accounted for as a cash flow hedge.

The year-end of the company is 31 March 20.13.



REQUIRED

Provide all the relevant journal entries. Your answer should comply with the requirements of *International Financial Reporting Standards*.

SOLUTION 13



Hint:

Most people will find the events presented in the example overwhelming and confusing. It is recommended that you first plot the events on a time line.

1 Feb 20.13	**31 March 20.13**	**1 May 20.13**	**1 June 20.13**
*Order placed	*Year-end	*Transaction date	*Settle creditor of £10 000
*FEC taken out			*FEC matures

IAS 21	Dr R	Cr R	IFRS 9	Dr R	Cr R
1 February 20.13 – Order machine					
Hedged item			**Hedging instrument**		
No entry			No entry		
31 March 20.13 – Year-end					
Hedged item			**Hedging instrument**		
No entry			FEC Asset (SFP)	3 619	
			Cash flow hedge reserve (OCI)		3 619
			[£32 900 x (11,14 – 11,03)]		
			Revalue FEC at forward rate for a similar FEC with the same maturity date		
1 May 20.13 – Transaction recorded – Machine is shipped					
Hedged item			**Hedging instrument**		
Machinery(SFP)	368 480		FEC Asset (SFP)	2 632	
Trade payables (SFP)		368 480	Cash flow hedge reserve (OCI)		2 632
(£32 900 x 11,20)			[£32 900 x (11,22 – 11,14)]		
Recording of machine purchased			Revalue FEC at forward rate for a similar FEC with the same maturity date		
			Cash flow hedge reserve (OCI)	6 251	
			Machinery		6 251
			Adjust the carrying amount of the asset		
1 June 20.13 – Payment of creditor and expiry of FEC					
Hedged item			**Hedging instrument**		
Foreign exchange difference (P/L)	1 645		FEC Asset (SFP)	987	
Trade payables (SFP)		1 645	Cash flow hedge reserve		987
[£32 900 x (11,20 – 11,25)]			[£32 900 x (11,25 – 11,22)]		
			Cash flow hedge reserve	987	
			Fair value gain (P/L)		987
Revalue creditor at spot rate on settlement date			Revalue FEC on settlement date		
Trade payables (£32 900 x 11,03) (SFP)				370 125	
Bank (£32 900 x 11,03) (SFP)					362 887
FEC Asset (SFP)					7 238
Recording of payment to foreign creditor					
31 March 20.14 – Year-end					
Depreciation (P/L)				90 557	
Accumulated depreciation (SFP)					90 557
(362 229 /3 years x 9/12)					
Recognise depreciation on the machinery					

7.13 APPLYING HEDGE ACCOUNTING TO A FIRM COMMITMENT

A firm commitment is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates (IFRS 9 – Appendix A). An example of this will be where an entity has entered into a legally binding agreement to purchase inventory at a future date.

A hedge of a firm commitment is a hedge of an exposure to a change in fair value. Accordingly, such a hedge is a fair value hedge. However, in accordance with IFRS 9, paragraph 6.5.4, a hedge of the **foreign currency risk of a firm commitment** could alternatively be accounted for as a cash flow hedge. (IFRS 9 B6.5.3)

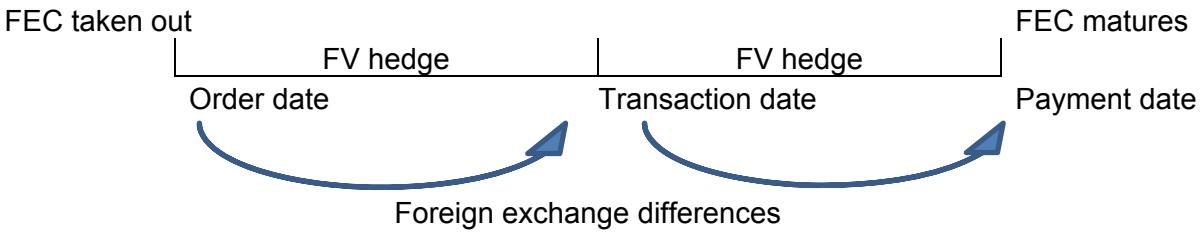
Subsequent to transaction date, any hedge of the foreign currency exposure relating to the debtor/creditor can be accounted for as either a fair value hedge or a cash flow hedge, as long as the relevant hedging document reflects that the hedge is used as a variability in fair value or a variability in cash flows, as the case may be.

When a hedged item in a fair value hedge is a firm commitment (or a component thereof) to acquire an asset or assume a liability, the initial carrying amount of the asset or the liability that results from the entity meeting the firm commitment is adjusted to include the cumulative change in the fair value of the hedged item that was recognised in the statement of financial position. (IFRS9.6.5.9)

When an unrecognised firm commitment is designated as a hedged item in a cash flow hedge, normal cash flow hedge accounting is applied.

Exception: Should the firm commitment result in a financial item for which cash flow hedge accounting is applied, then the **cash flow hedge reserve is written off against profit and loss** when the item affects profit and loss. **Hedging of financial items (foreign loans, etc.) is not part of the syllabus.**

FAIR VALUE HEDGE ACCOUNTING



Hedged item → Firm commitment = item

Differences up to transaction date are taken to a firm commitment asset (if profit) OR firm commitment liability (if loss) account.

On transaction date, the **firm commitment account is written off against the cost of the asset**

After transaction date, the differences are taken to P/L

Hedging instrument → Difference is taken to P/L

EXAMPLE 14

FIRM COMMITMENT

On 1 January 20.11, A Ltd placed a non-cancellable order for a new machine from an American supplier for an amount of $50 000. On 1 February 20.11, the order was confirmed in writing and a deposit equal to 10% of the purchase price was paid immediately.

The remainder of the purchase price is payable as follows:

- $20 000 is payable on 1 June 20.11, on date of delivery of the machine; and
- $25 000 is payable on 1 September 20.11 as final settlement.

Upon delivery on 1 June 20.11, all risks and rewards associated with the machine were transferred to A Ltd.

In order to hedge themselves against fluctuations in exchange rates, A Ltd entered into the following forward exchange contracts (FEC):

- On 1 February 20.11, a 4-month FEC to cover the first instalment of $20 000; and
- On 1 June 20.11, a new FEC for the outstanding liability of $25 000, expiring on 1 September 20.11.

On 1 February 20.11, A Ltd designated the forward exchange contracts as the hedging instruments and any firm commitment or foreign currency creditor that arises as a result of the transaction, as the hedged item. The hedge complied with all the requirements for hedge accounting and the hedge was considered to be highly effective at all times during the period. A Ltd decided to apply fair value hedge accounting to the FECs as a hedge against the exposure to changes **in fair value of the firm commitment and recognised asset/liability.**

A Ltd has a 30 June year-end.

The following exchange rates are applicable:

Date	**Spot Rate $1=R**	**Forward rate for FEC $1=R**	**Period**
1 January 20.11	7,45	–	
1 February 20.11	7,30	7,40	4-month FEC
1 June 20.11	7,33	7,36	3-month FEC
30 June 20.11	7,34	7,38	2-month 1-day FEC
1 September 20.11	7,41	–	



REQUIRED

Prepare all the relevant **journal entries** in the accounting records of A Ltd from order date until final settlement. Your answer should comply with the requirements of *International Financial Reporting Standards*.

SOLUTION 14



Hint:

Most people will find the events presented in the example overwhelming and confusing. It is recommended that you first plot the events on a time line.

1 Jan 20.11	1 Feb 20.11	1 June 20.11	30 June 20.11	1 Sep 20.11
*Non - cancellable order placed	*Firm commitment *10% deposit paid *FEC 1 taken out $20 000	*Transaction date *Settle $20 000 *FEC 1 matures *FEC 2 taken out $25 000	Year-end	*Settle $25 000 *FEC 2 matures

IAS 21	Dr R	Cr R	IFRS 9	Dr R	Cr R
1 January 20.11 – Order date					
Hedged item No entry			**Hedging instrument** No entry		
1 February 20.11 – Deposit paid and FEC taken out					
Deposit (SFP) Bank ($5 000 x 7,30) (SFP) Record deposit made	36 500	36 500	**Hedging instrument** No entry – FEC has no value on the date that it is entered into		
1 June 20.11 – Delivery date (risks and rewards transferred)					
Hedged item Machinery (SFP) ($45 000 x 7,33) + ($5000 x 7,30) Foreign Creditor ($45 000 x 7,33) Deposit (SFP) Recording of machine purchased	366 350	 329 850 36 500	**Hedging instrument** Fair value loss (P/L) FEC liability (SFP) [$20 000 x (7,40 – 7,33)] Recording of hedging loss on FEC	1 400	 1 400
Firm commitment asset (SFP) Fair value gain (P/L) [20 000 x (7,40 – 7,36)] Recording of profit on firm commitment	800	800	A firm commitment is a binding agreement for a future transaction. The forward rate is applied to measure changes in the fair value of the firm commitment.		
Machinery (SFP) Firm commitment asset (SFP) Transfer of firm commitment to the asset now recorded	800	800			
1 June 20.11 – Payment of $20 000 to foreign creditor and 4-month FEC expires					
Foreign creditor (SFP) ($20 000 x 7,33) FEC liability (SFP) [$20 000 x (7,40 – 7,33)] Bank ($20 000 x 7,40) (SFP) Recording of payment to foreign creditor				146 600 1 400	 148 000
30 June 20.11 – Year-end					
Hedged item Foreign exchange difference (P/L) Foreign creditor (SFP) [$25 000 x (7,34 – 7,33)] Revalue creditor at spot rate at year-end	250	250	**Hedging instrument** FEC asset (SFP) Fair value gain (P/L) [$25 000 x (7,36 – 7,38)] Revalue FEC at forward rate for a similar FEC with the same maturity date	500	500

IAS 21			IFRS 9		
	Dr R	Cr R		Dr R	Cr R
1 September 20.11 – Final payment to foreign creditor and 3-month FEC expires					
Hedged item			**Hedging instrument**		
Foreign exchange difference (P/L)	1 750		FEC asset (SFP)	750	
Foreign creditor (SFP)		1 750	Fair value gain (P/L)		750
[$25 000 x (7,41 – 7,34)]			[$25 000 x (7,41 – 7,38)]		
Revalue creditor at spot rate on settlement date			Revalue FEC at spot rate on maturity date		
Foreign creditor ($25 000 x 7,41) (SFP)				185 250	
FEC asset (500 + 750) (SFP)					1 250
Bank ($25 000 x 7,36) (SFP)					184 000
Recording of payment to foreign creditor					



LECTURER'S COMMENT

Refer to:
Descriptive Accounting, example 30.34

CASH FLOW HEDGE ACCOUNTING

Note: When an unrecognised firm commitment is designated as a hedged item in a cash flow hedge, normal cash flow hedge accounting is applied. Refer to paragraph 7.12 above for an explanation of the applicable rules.

EXAMPLE 15

FIRM COMMITMENT

The same information as in example 14 applies, except:

On 1 February 20.11, A Ltd designated the forward exchange contracts as the hedging instruments and any firm commitment or foreign currency creditor that arises as a result of the transaction, as the hedged item. The hedge complied with all the requirements for hedge accounting and the hedge was considered to be highly effective at all times during the period. A Ltd decided to apply cash flow hedge accounting. The relevant hedging document reflects that, **subsequent to transaction date**, the hedge of the foreign currency exposure relating to the creditor is accounted for as a **cash flow hedge**.

A Ltd has a 30 June year-end. Machinery has an estimated useful life of 10 years.

SOLUTION 15



Hint:

Most people will find the events presented in the example overwhelming and confusing. It is recommended that you first plot the events on a time line.

1 Jan 20.11	1 Feb 20.11	1 June 20.11	30 June 20.11	1Sep 20.11
*Non - cancellable order placed	*Firm commitment *10% deposit paid *FEC 1 taken out $20 000	*Transaction date *Settle $20 000 *FEC 1 matures *FEC 2 taken out $25 000	Year-end	*Settle $25 000 *FEC 2 matures

IAS 21	Dr R	Cr R	IFRS 9	Dr R	Cr R
1 January 20.11 – Order date					
Hedged item No entry			**Hedging instrument** No entry		
1 February 20.11 – Deposit paid and FEC taken out					
Deposit (SFP) Bank ($5 000 x 7,30(SFP) Record deposit made	36 500	36 500	**Hedging instrument** No entry – FEC has no value on the date that it is entered into		
1 June 20.11 – Delivery date (risks and rewards transferred)					
Hedged item Machinery (SFP) ($45 000x7,33) + ($5 000x7,30) Foreign Creditor ($45 000 x 7,33) Deposit (SFP) Recording of machine purchased	366 350	329 850 36 500	**Hedging instrument** Cash flow hedge reserve FEC Liability (SFP)] [$20 000 x (7,40 –7,33) Machinery (SFP)] Cash flow hedge reserve Revalue FEC and adjust carrying amount of asset	1 400 1 400	1 400 1 400
1 June 20.11 – Payment of $20 000 to foreign creditor and 4-month FEC expires					
Foreign creditor (SFP) ($20 000 x 7,33) FEC liability (SFP) [$20 000 x (7,40 – 7,33)] Bank ($20 000 x 7,40) (SFP) Recording of payment to foreign creditor				146 600 1 400	148 000
30 June 20.11 – Year-end					
Hedged item Foreign exchange difference (P/L) Foreign creditor (SFP) [$25 000 x (7,34 – 7,33)] Revalue creditor at spot rate at year-end	250	250	**Hedging instrument** FEC asset (SFP) Cash flow hedge reserve [$25 000 x (7,36 – 7,38)] Cash flow hedge reserve Fair value gain (P/L) Revalue FEC at forward rate for a similar FEC with the same maturity date	500 500	500 500

IAS 21			IFRS 9	
	Dr R	**Cr R**	**Dr R**	**Cr R**
Depreciation (P/L) Accumulated depreciation (SFP) (366 350 + 1400)/10 x 1/12) Provision for depreciation	3 064	3 064		
1 September 20.11 – Final payment to foreign creditor and 3-month FEC expires				
Hedged item Foreign exchange difference (P/L) Foreign creditor (SFP) [$25 000 x (7,41 – 7,34)] Revalue creditor at spot rate on settlement date	1 750	1 750	**Hedging instrument** FEC asset (SFP) Cash flow hedge reserve (OCI) [$25 000 x (7,41 – 7,38)] Cash flow hedge reserve (OCI) Fair value gain (P/L) Revalue FEC at spot rate on maturity date	750 750 750	750 750
Foreign creditor ($25 000 x 7,41) (SFP) FEC asset (500 + 750) (SFP) Bank ($25 000 x 7,36) (SFP) Recording of payment to foreign creditor				185 250	1 250 184 000

7.14 DISCLOSURE OF COVERED FOREIGN CURRENCY TRANSACTIONS

IFRS 7 requires the following disclosure regarding hedging:

a) The risk management strategy

Details regarding the following should be provided in terms of risk strategy:

- How does risk arise?
- How is risk managed?
- The extent to which risk exposure is hedged.
- The hedging instruments that are used.
- How was the hedge ratio determined?
- The expected sources of ineffectiveness in the hedging relationship.

b) The **economic relationship** between the hedging instrument and hedged item.

c) **Amount, timing and uncertainty** regarding the hedging instruments' future cash flows. The following information is an example of how this information should be provided for in a tabular format:

Extract of the notes to the financial statement of Phoenix Ltd Group for the year ended 31 December 20.13

Note 30 Hedging instruments

	Time to maturity				Average forward price (in cents)
	<6 months	**6-12 months**	**1-2 years**	**2-5 years**	
Hedging instruments					
Fair value hedge					
Foreign exchange price risk: Forward exchange contract	R20 000	R25 000	-	-	455c

d) The effects of hedging **on financial position and performance**:

The following information is an example of how hedging has impacted the financial position:

Extract of the notes to the financial statement of Phoenix Ltd Group for the year ended 31 December 20.13

Note 30 Hedging instruments

	Notional amount R	**Carrying amount (asset/ (liability) R**	**Line item in statement of financial position where hedging instrument is located**	**Changes in the fair value used for measuring ineffective-ness for the period R**	**Cash flow hedge reserve R**
Hedging instruments					
Fair value hedge					
Foreign exchange price risk: Forward exchange contract	100 000	20 000	Short-term derivative financial assets	20 000	-
Cash flow hedge					
Foreign exchange price risk: Forward exchange contract	150 000	10 000	Short-term derivative financial assets	10 000	10 000

The following information disclosed is an example of how hedging has impacted the financial performance:

Extract of the notes to the financial statement of Phoenix Ltd Group for the year ended 31 December 20.13

Note 30 Hedging instruments

	Hedging gain/loss in OCI R	**Ineffectiveness recognised in P/L R**	**Line item in statement of comprehensive income**	**Amounts reclassified to P/L R**	**Line item that includes reclassification R**
Hedge effectiveness					
Fair value hedge					
Foreign exchange price risk: Forward exchange contract	-	-	Other income	-	-
Cash flow hedge					
Foreign exchange price risk: Forward exchange contract	20 000	-	Other income	-	-

e) A reconciliation of **reserves** created by hedge accounting.

The following is an example of a reconciliation of a cash flow hedge reserve:

Extract of the notes to the financial statement of Phoenix Ltd Group for the year ended 31 December 20.13

Note 35 Reconciliation of reserves

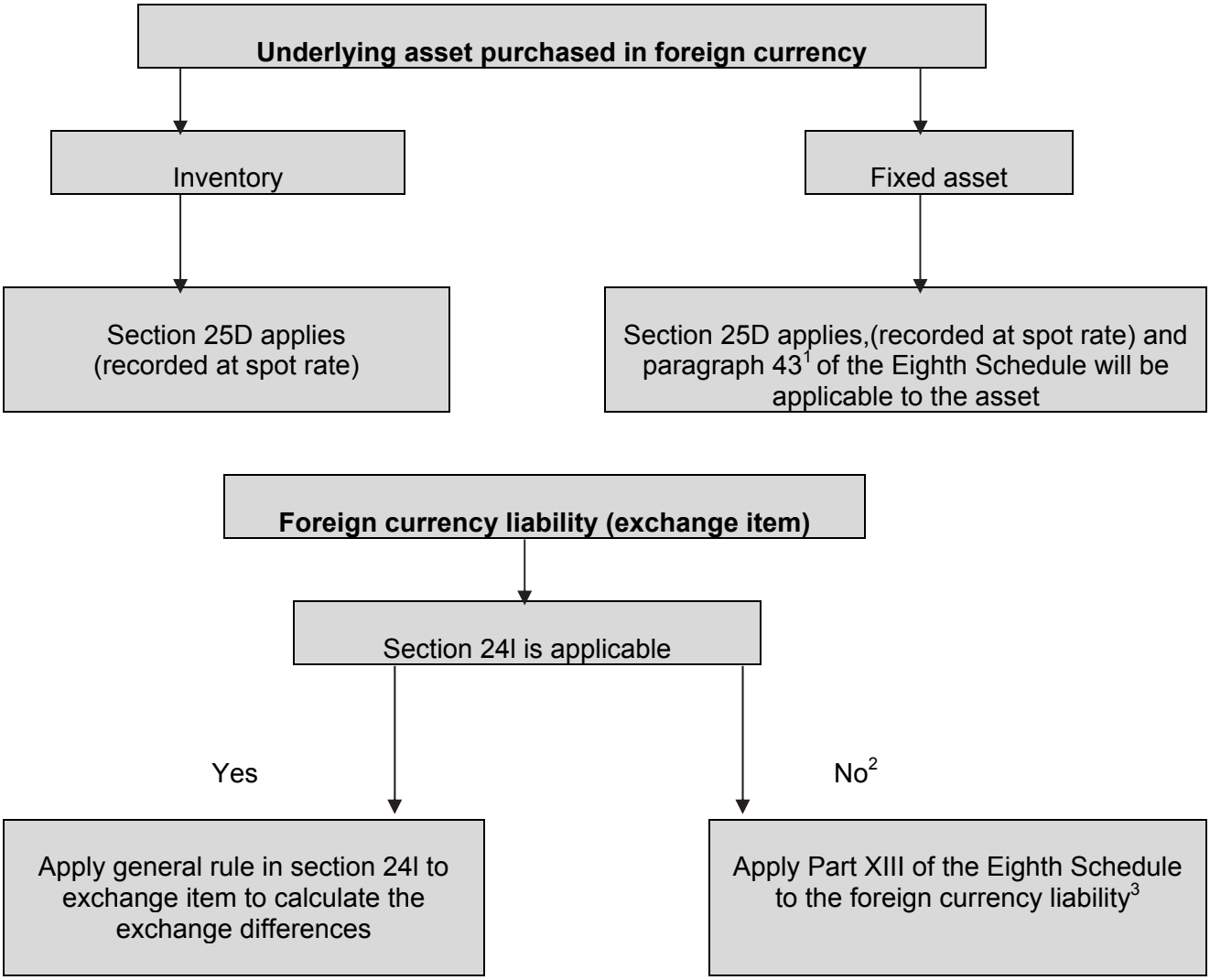
Cash flow hedge reserve	**Foreign exchange risk R**
Opening balance	-
Hedging gain or loss	10 000
Amount reclassified to cost of non-financial item	-
Amount reclassified to P/L due to discontinuation of hedge accounting	-
Closing balance	10 000

D TAX IMPLICATIONS

- The tax treatment of gains and losses on foreign exchange transactions in terms of section 24I of the Income Tax Act will correspond to the accounting treatment thereof for the majority of transactions, with certain exceptions.
- It should be noted from the very start that section 24I only addresses the foreign exchange differences on the exchange items (ie monetary items) and NOT THE UNDERLYING ASSET.
- The underlying asset is treated in terms of section 25D (1) (translated into the local [functional] currency using the spot rate on the date of the transaction). Therefore the cost of the asset (PPE, inventory) will be measured for both tax purposes and for accounting purposes at the spot rate on transaction date (FOB date).
- It should be noted that every foreign currency transaction has two legs, namely the underlying asset (non-monetary item) and the foreign currency liability (exchange [monetary] item).

  Dr Underlying asset (non-monetary item)
  Cr Creditor (monetary item)

The following table illustrates the interaction between sections 24I (foreign exchange), 25D (determination of taxable income in foreign currency) and the Eighth Schedule (capital gains tax) if an item was imported and financed with a loan (creditor) raised in a foreign currency.



1. Paragraph 43 of the Eighth Schedule of the Income Tax Act sets out the rules for determining the capital gains and losses when assets are acquired or disposed of in foreign currency.
2. Section 24I will not be applicable if, for example, the taxpayer is an individual who does not hold the exchange item as part of his trading stock or a trust not carrying on a trade (section 24I(2)) or if section 24I(11) is applicable.
3. Part XIII of the Eighth Schedule of the Act deals with the capital gains and losses of a resident in respect of the acquisition and disposal of a foreign currency asset, or the settlement or part settlement of a foreign currency liability (paragraph 85 of the Eighth Schedule).



ASSESSMENT CRITERIA

After having studied this learning unit, you should be able to:

- define the terms used in IFRS 7, IAS 21, IAS 32 and IFRS 9 (iro hedging);
- explain which exchange rate to use at initial recognition, subsequent reporting and settlement date;
- describe the different accounting treatments in respect of exchange differences on foreign currency transactions;
- state the tax implications of covered and uncovered foreign currency transactions;
- record covered and uncovered foreign transactions in the accounting records of an entity; and
- properly disclose covered and uncovered foreign currency transactions in the financial statements of an entity according to the requirements of IFRS 7, IAS 21, IAS 32 and IFRS 9.