Only study guide for
FAC2601

FINANCIAL ACCOUNTING FOR COMPANIES

2020

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INTRODUCTION

1. INTRODUCTION

Dear Student

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3 USE OF ICONS

The icons that are used in this study guide are listed below, together with an explanation of what each one means:

Icon	Description
	**Learning outcomes**: This icon indicates what aspects of the particular learning unit you have to understand. You should be able to demonstrate your understanding.
	**Assessment criteria**: This icon explains what will be expected form you once done with the learning unit.
	**Overview**: This icon indicates what will be discussed under the different sections.
	**Study.** This icon indicates the relevant sections of the prescribed textbook or the study guide that you need to study and internalise.
	**Lecturer's comment:** This icon provides more detailed explanations with regards to difficult concepts.
	**Required**: This icon indicates what needs to be done in order to answer or solve a specific question.

FAC2601

LEARNING UNIT 1

INTRODUCTION TO COMPANY FINANCIAL STATEMENTS

Financial Accounting
for Companies

Learning outcomes

- Learners must have the basic knowledge and background of the theory behind annual financial statements (as covered in Accounting I). They must also understand the goal of IFRS.

Assessment criteria

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

- record the accounting entries applicable to the issue of shares.
- record the issue of capitalisation shares.
- know the types of companies.
- name the users of annual financial statements.
- understand the background of companies, the Companies Act and IFRS.

Overview

This learning unit will be discussed under the following sections:

STUDY

No reference to the prescribed textbook, just the study material.

1.1 INTRODUCTION

In Accounting I you were introduced to company annual financial statements. You studied aspects such as the format and layout of a statement of financial position, statement of comprehensive income and cash flow statement. In Accounting II you will be studying the above aspects in greater detail and you will be acquiring knowledge of International Financial Reporting Standards (hereafter called IFRS). IFRS are being developed by the International Accountants Standards Board (IASB) and will form part of your study material in future.

What is IFRS?

IFRS is a set of international accounting standards stating how particular types of transactions and other events should be recognized, measured and reported in annual financial statements.

Goal of IFRS?

From your Accounting I studies you'll remember that the goal of IFRS is to provide a global framework for how public companies prepare and disclose their annual financial statements. IFRS provides general guidance for the preparation of annual financial statements, rather than setting rules for industry-specific reporting.

Having international accounting standards is especially important for large companies that have subsidiaries in different countries. Adopting a single set of world-wide standards will simplify accounting procedures by allowing a company to use one reporting language throughout. A single standard will also provide investors and auditors with a cohesive view of finances.

1.2 COMPANY BACKGROUND

In general, a company can be described as an association between persons that work together with the aim to make a profit. A company as an entity is a legal person which is incorporated in terms of the Companies Act 71 of 2008. The entity exists independently from its owners, the shareholders.

Companies as a form of entity were established in order to fulfil the following needs:

- the acquisition of more capital, as it is normally not possible in a sole entity
- to ensure the continued existence of the company
- to provide an easy way to exchange owners
- to provide a procedure to limit the financial liability of the owners

A company can have a multitude of shareholders (e.g. listed company) and it is impractical to open a capital account for each shareholder. To solve this problem, the capital of a company is divided into small units, called shares (See the section "share transactions" below). Each shareholder shares in the profits of the entity in relation to the value of his or her shares. Since the shares of a company are transferable, shareholders change continually, without threatening the company's continuance.

A share certificate serves as evidence of a person's interest in a company. Share certificates are negotiable documents and the shareholder has the power to sell all his or her shares or to purchase additional shares. Each shareholder's interest and rights to vote are determined by the number of shares he or she owns. The right to vote gives the shareholder the voice to appoint directors and determines the objectives of the company.

A company is formed by its founders. The establishment of a company is regulated by the provisions of the Companies Act 71 of 2008.

A company is incorporated by the lodging of the following main forms:

- Notice of incorporation
- Memorandum of incorporation (MOI)

The MOI is the most important document governing the company. The Act imposes certain specific requirements on the content of a Memorandum of incorporation (MOI) to protect the interest of shareholders in the company, and provides for a number of default company rules, which companies may accept or alter as they wish, as long as they are in line with the Companies Act.

A company is deemed to be a juristic person from the date and time that its incorporation is registered.

Two types of companies may be formed in South Africa: **(Study par 3 of chapter 18 of the prescribed textbook.)**

- a profit company
- a non-profit company

Incorporating a company requires costs such as registration fees and related legal costs. All these costs are described collectively as "preliminary expenses". Preliminary expenses are debited to the "preliminary expenses" account.

The name of the public company ends with the word "Limited", whereas the private company ends with the words "(Proprietary) Limited". The minimum number of directors of a public company is three. The minimum number of directors of a private company is one. Public companies may be listed on the Johannesburg Securities Exchange, which will promote the marketability of the shares.

1.3 HISTORY OF THE COMPANIES ACT (NOT EXAMINABLE)

The Companies Act 61 of 1973, as amended, came into being after the Commission of Enquiry into the Companies Act tabled the Supplementary Report and Draft Bill in Parliament on 1 June 1972. The commission, which was appointed on 14 October 1963 under the chairmanship of Mr Justice J van Wyk de Vries, operated chiefly on a temporary basis.

The principal report of the commission, dated 15 April 1970, which deals with principles, new concepts and important amendments, was tabled in Parliament on 17 September 1970 and formed the basis for the Draft Companies Bill and eventually for the Companies Act of 1973.

The terms of reference of the Commission of Enquiry into the Companies Act were not only to report on the various aspects of company law, but also "to submit a draft bill in order to implement any recommendations made for the amendment of the present Act" (our translation). During the 60 years that intervened since the Transvaal Companies Act was passed in 1909 – an act that was largely ratified as the Companies Act of 1926 – numerous amendments were made without the Act ever having been consolidated. The

members of the commission decided that the Act simply did not lend itself to further amendment and set themselves the task of drafting the *draft consolidated* companies bill. The Consolidated Companies Act was finally approved by Parliament in 1973 and was given the title of the Companies Act 61 of 1973. This act was replaced by new Companies Act 71 of 2008.

The Companies Amendment Bill (B40—2010) was tabled in Parliament on 9 November 2010. The Bill was published in the *Government Gazette* for public comment and public hearings were held on 30 November and 1 December 2010. The Bill proposed the amendment of the Companies Act 71 of 2008 to correct errors, legal-technical and grammatical issues. The Companies Amendment Bill was approved on 10 March 2011 by the Portfolio Committee on Trade and Industry.

The new Companies Act was signed by the President on 8 April 2009 and tabled in Gazette No. 32121 (Notice No 421). This Act is called the Companies Act 71 of 2008.

1.4 ANNUAL FINANCIAL STATEMENTS

Companies are obliged to draw up annual financial statements, using ledger accounts, cash receipts and payment journals.

Annual financial statements are a structured representation of the financial position and financial performance of an entity. The objective of annual financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users.

Annual financial statements provide information about an entity's assets, liabilities, equity, income and expenses, including gains and losses, contributions by and distributions to owners and cash flows. Users use this information to base realistic business and economic decisions. The numerous groups of users who rely for information on these statements of financial reporting include:

- owners (shareholders)
- potential investors
- management
- borrowers
- suppliers
- creditors
- tax authorities
- bankers
- employers

For users, the annual financial statements of a company form the basis for conclusions and eventual decision-making. To help the user draw sensible conclusions from his or her investigation and analysis of these statements, the Companies Act 71 of 2008 contains certain specific requirements regarding the disclosure of information in the annual financial statements of companies.

According to the Act, a company's annual financial statements have to be drawn up in accordance with International Financial Reporting Standards (IFRS) or IFRS for small and medium-sized enterprises (SME), depending on the category of the company.

Although the sections of the Companies Act of 2008 and Companies Regulations are very important for your studies, you are not expected to read them all. In order to cover the ground thoroughly, we shall, however, refer to them from time to time in the study guide.

Company annual financial statements are drafted, published and submitted to the annual general meeting of shareholders. These statements are therefore drafted mainly for and directed to the shareholders.

These statements must reflect the state of affairs of the company and its business at the end of the financial year in question as well as the profit or loss for that financial year.

Annual financial statements must comply with four qualitative requirements.

It is clear that these statements must be drafted in accordance with pre-existing guidelines and legislation. After you have completed your study of this study guide, you will be able to draft such statements yourself, using our guidelines.

1.5 SHARE TRANSACTIONS

1.5.1 Introduction

Before we can continue our account of the drafting of the annual financial statements of a company, there are certain matters regarding the share capital of companies that we must discuss in more detail.

Since share capital represents an important item on the statement of financial position of any company, the procedure applicable to any amendment to share capital is prescribed by the Companies Act 71 of 2008. It is important that you should be familiar with the legal requirements.

1.5.2 Share capital structures

Before we proceed, we need to revise the concepts discussed in Accounting I.

Capital contributed by the shareholders of a company is known as share capital. The maximum number of shares and the classes of shares a company is authorised to issue, as set out in the Memorandum of Incorporation, is known as the authorised share capital. A company is not obliged to issue all the authorised share capital. The share capital that the company does issue, is known as the issued share capital.

EXAMPLE 1

The disclosure of share capital:

	R
Authorised share capital	
100 000 Ordinary shares	100 000
Issued share capital	
80 000 Ordinary shares	80 000

Share capital

> **Please note:** According to the Companies Act 71 of 2008, shares no longer have nominal values. Consequently, shares cannot be issued at a premium any more. Share premium and stated capital are not applicable any more.

EXAMPLE 2

ABC Ltd issues 1 000 ordinary shares at R1,80 per share.

The journal entry in the financial records will be recorded as follows:

	Dr R	Cr R
Journal entry	1 800	
Bank (1 000 x R1,80)		1 800
Share capital (1 000 x R1,80)		

1.5.3 Types of shares

Ordinary shares (Equity shareholders)

Ordinary shares are the most common type of shares. Ordinary shares represent equity ownership in a company and give you full voting rights at annual general meetings as well as dividends (should the company pay these), and allow you to benefit from capital growth should the company do well.

Ordinary shares do not bear a fixed dividend and the payment of dividends on ordinary shares is considered only after provision has been made for preference dividends. Depending on the availability of profits, there is no limit to the share of the profits of a company that can be apportioned to ordinary shares. This is, however, subject to the dividend that is recommended and approved for payment. Dividends are discussed later in this learning unit.

Preference shares

Preference shares are instruments that have debt (fixed dividends) and equity (capital appreciation) characteristics. Preference shareholders have a higher claim on assets (repayment of capital if company is wound up) and earnings (dividends) than ordinary shareholders. Preference shareholders are paid fixed-rate dividends before dividends are paid to ordinary shareholders.

In the event of a company bankruptcy, preference share shareholders have a right to be paid company assets first. Preference shares typically pay a fixed dividend, whereas ordinary shares do not. Unlike ordinary shareholders, preference share shareholders usually do not have voting rights.

Preference shares may be issued with various rights. In classifying a preferred share as a liability or equity, an entity assesses the particular rights attaching to the share to determine whether or not it exhibits the fundamental characteristic of a financial liability.

There are four types of preference shares: cumulative preferred, for which dividends must be paid, including skipped dividends; non-cumulative preferred, for which skipped dividends are not included; participating preferred, which give the holder dividends plus extra earnings based on certain conditions; and convertible, which can be exchanged for a specified number of ordinary shares.

When preference shares are non-redeemable, the appropriate classification is determined by the other rights that may attach to them. When distributions to holders of the preference shares are at the discretion of the issuer, the shares are equity instruments.

Cumulative preference shares

This class of preference shares differs slightly from ordinary preference shares in that the fixed preferential dividend accumulates if it is not paid out annually. A company is therefore obliged to pay all cumulative preference shares that are in arrears as soon as sufficient funds become available. Cumulative preference dividends not declared or paid should be disclosed.

A cumulative preference shareholder retains his or her right to dividends from year to year, even if no dividends are declared. Therefore, when the company has sufficient distributable reserves and cash flow available to declare a dividend, arrear and current cumulative preference dividends have first to be paid in full before ordinary preference dividends and then dividends on ordinary share capital can be paid.

Redeemable preference shares

A preference share that provides for redemption on a specific date or at the option of the holder meets the definition of a financial liability if the issuer has an obligation to transfer financial assets to the holder of the share. An option of the issuer to redeem the share does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders. Redemption of the shares is solely at the discretion of the issuer.

Preference shares with other rights might include the following, but do not form part of this module:

- convertible preference shares
- participating preference shares

1.5.4 Issue of capitalisation shares

Occasionally, companies build up large reserves from profits. For one reason or another, it may not be desirable to distribute these reserves in the form of dividends, since this could adversely affect the cash position of the company. To enable the shareholders to derive some tangible benefits from these reserves, the company may decide to capitalise these reserves and distribute them among the shareholders in the form of *capitalisation shares*. No cash is paid out, but each shareholder receives his or her rightful share of the reserves in the form of capitalisation shares.

A capitalisation issue is frequently also referred to as a bonus issue, since no payment is received from shareholders for an issue of this kind. The shares are issued in the same proportion as the existing shareholding and are merely a book entry which converts the reserves into share capital.

The number of shares held will increase, but the total value of the share portfolio will remain the same. In other words, the value per share declines, whilst the total value of the share portfolio remains constant.

The only entry that the investor will make in its accounting records is to increase the number shares held and to reduce the value per share.

In issuing these shares, the issuer will convert reserves into share capital. The journal entries when capitalisation shares are issued:

Debit the retained earnings account with the amount of the capitalisation.

Credit the share capital account.

EXAMPLE 3

Capitalisation shares issued

The following balances were taken from the books of XYZ Ltd on 31 December 19.0:

	R
Issued ordinary share capital (R1 shares)	150 000
Retained earnings	160 000

On 1 January 19.1, the directors decided to make a capitalisation issue at R1 of one share for every three shares previously issued, with the minimum effect on distributable reserves.

Number of shares in issue 150 000/3 = 50 000 shares to be issued.

	Dr R	Cr R
Journal entry		
Retained earnings	50 000	
Issued ordinary share capital		50 000
Capitalisation issue of one share for every three shares held		

LECTURER'S COMMENT

Capitalisation shares may be issued by utilising the following reserve: retained earnings.

1.5.5 Rights issues and options

One of the ways in which a company can raise cash funds is to have a rights issue. In terms of this rights issue, rights/options to new shares are offered to existing shareholders based on their existing shareholdings. To ensure that the options/rights to acquire new shares are exercised by existing shareholders, the issue price of the new shares is usually set at a price below the current market price. New shares obtained at the lower price can normally be sold at a higher price just after they have been acquired, and the existing shareholder can thus make a quick profit. Alternatively, existing shareholders acquiring these "rights", can, should they not wish to acquire additional shares in the issuing company, sell these rights to other investors and may thus also make a further profit. By doing this, the issuing company also expands its shareholder base.

The issue price of new shares in respect of a rights issue should be carefully determined. It should be set as high as possible so that the minimum number of shares will be required to be issued to raise the cash needed, but nonetheless it should be as low as possible to ensure that the shareholders will exercise their rights acquired and convert these rights/options into new shares.

Since new shares are offered to existing shareholders based on existing shareholdings, these shareholders obtain the right to subscribe for a certain number of shares. When these new shares are subscribed for, this right is exercised – hence the description given to this type of share issue, a rights issue.

The procedure in respect of a rights issue is as follows:

- The company announces that it intends to have a rights issue.
- The rights issue then takes place, which means that the rights certificates are issued to existing shareholders.
- Following the issue of the rights certificates, a right with a value separated from the shares which produced that right usually exists and it is traded separately on the securities exchange.
- The shareholder can then do the following:
  - exercise the right by paying the rights issue price and acquire new shares at the lower than market price, as stipulated in the rights issue, or

– sell the right to a member of the public, who can then acquire shares in the company by converting the rights into shares subject to the conditions of this rights issue.

Before the rights certificates are issued, shares are traded cum rights (that means that the share and the right are inseparable). This cum rights value of the shares that the shareholder held on the date of the announcement is divided into a rights (option) value and an ex-rights share value on the date on which the "Rights certificates" are issued. The "right" obtained can be traded on its own and the share will then trade without the right, i.e. ex rights. The value of an ex-rights share is therefore lower than the value (cum rights value) of the share on the date on which the rights are announced. The right to buy new shares at the rights issue price applies only for a certain period of time as was determined by the company, following which the rights expire and cannot be exercised.

1.5.6 Underwriting of share issues

Underwriting of shares was dealt with in detail in Accounting I and is summarised here to refresh your memory.

As already explained, when a company requires funds from the public, such funds are obtained by means of a shares issue. The company would normally avail themselves of the services of a financial institution to handle the issue. Financial institutions frequently underwrite such issues. This means that the underwriter guarantees that if the whole issue of shares is not taken up by the public, the financial institution will itself take up the remainder.

The underwriter's commission is the commission the underwriter receives in return for furnishing a guarantee that the whole issue will be taken up. This commission is stipulated in the underwriting agreement and is payable in the form of either cash or paid-up shares in the company concerned. The commission is calculated on the portion being underwritten, irrespective of whether the entire issue is taken up or not.

According to the Companies Act 71 of 2008, a company may pay remuneration to the underwriter for his or her underwriting or his or her undertaking to subscribe for shares in the company provided that the commission does not exceed 10% of the price at which the shares are issued, or a lower rate provided in the articles of association.

Underwriter's commission is calculated as follows:

Broker Ltd underwrites an issue of 50 000 ordinary shares at R2 each in Shortage Ltd. The underwriting commission is 7%. The public takes up 45 000 shares.

The commission is calculated as follows:

- (50 000 x R2) x 7% = R7 000

The commission is therefore not affected by the number of shares the public took up.

If the full issue is underwritten, the underwriter is liable for the difference between the value of the full issue and the amount for which the public subscribed.

In the example above, the public subscribed for 45 000 shares and Broker Ltd is therefore liable for 5 000 shares x R2 = R10 000.

If the issue is partly underwritten, the underwriter has a pro rata liability. Suppose that, in the example above, Broker Ltd underwrites only 50% of the issue, his or her liability is as follows:

50% of the shortfall = (50% x 5 000) x R2 = R5 000.

The commission will be adjusted accordingly: (50% x 50 000) x R2 x 7% = R3 500.

An issue may also be *underwritten by joint underwriters,* that is, a single issue is underwritten by more than one body. If there is an undersubscription, each of the underwriters is responsible for taking up that portion of the shares that corresponds to his or her portion of the underwriter's obligation.

1.5.7 Dividends

The profit of a company is divided among the shareholders of the company in the form of dividends. A dividend can therefore be defined as that portion of the profit of a company which is divided among the shareholders (paid out to them). In other words, it indicates the pro rata portion which each shareholder receives on his or her shares – say, for example, 10% or 5c per share.

Dividends will be discussed in more detail in Learning unit 3.

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LEARNING UNIT 2

THE FRAMEWORK OF ACCOUNTING

Financial Accounting
for Companies

Learning outcomes

The International Accounting Standards Board issued the revised Conceptual Framework for Financial Reporting, a comprehensive set of concepts for financial reporting, in March 2018.

When preparing this study guide, the prescribed textbook had not yet been updated with this revision and it was therefore not possible to cross-reference between study material.

A separate tutorial letter will be issued at a later stage to address this and discuss this learning unit in more detail.

Overview

This learning unit will be discussed under the following sections:

2.1 Introduction
2.2 Effective date
2.3 Summary

STUDY

The applicable references to the prescribed textbook will be included in the tutorial letter that will be issued in this regard.

2.1 INTRODUCTION

In March 2018, the International Accounting Standards Board (Board) issued a comprehensive set of concepts for financial reporting, the revised *Conceptual Framework for Financial Reporting* (*Conceptual Framework*), replacing the previous version of the *Conceptual Framework* issued in 2010.

A brief history of the Framework:

April 1989:	*Framework for the Preparation and Presentation of Financial Statements* (the Framework) was approved by the IASC Board
July 1989:	Framework was published
April 2001:	Framework adopted by IASB
September 2010:	*Conceptual Framework for Financial Reporting 2010* approved by the IASB
March 2018:	*Conceptual Framework for Financial Reporting 2018* (the Framework) published

Purpose:

- To assist the Board in developing IFRS standards (standards) based on consistent concepts that will result in financial information being useful to users of financial statements

- To assist preparers of financial reports to develop consistent accounting policies for transactions, when no standard applies, or if a standard allows for a choice of policies
- To assist all parties to better understand and interpret standards

Status:

- It provides concepts for guidance that demonstrates the decisions the Board makes when developing standards.
- It is not a standard on its own.
- It does not override any other standard.

2.2 EFFECTIVE DATE

The revised *Conceptual Framework* has an effective date of 1 January 2020, with earlier adoption and application permitted, for companies that use the *Conceptual Framework* to develop accounting policies when no IFRS standard applies to a particular transaction.

Therefore, if preparers develop an accounting policy based on the *Conceptual Framework,* it will only apply to annual periods beginning or after this date.

2.3 SUMMARY

The *Conceptual Framework* required revision, as the Board strives to find a balance between providing high-level concepts and sufficient detail, in order for the framework to be useful to the Board and others using it.

The Board views the *Conceptual Framework* as a tool to assist in developing new standards and therefore concepts are also included, to provide guidance in making judgements when application of the concepts does not lead to a single answer.

The revision was identified as a priority to ensure a comprehensive set of concepts for financial reporting, hence addressed:

Filling gaps: provide more guidance on presentation and disclosure
Updating: definitions of an asset and liability to be clearer
Clarifying: uncertainty regarding measurement to eliminate confusion

The full details of this new revised *Conceptual Framework* will be discussed in more detail, as indicated, in a separate learning unit that will be issued at a later stage.

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LEARNING UNIT 3

PRESENTATION OF ANNUAL FINANCIAL STATEMENTS – IAS 1

Financial Accounting
for Companies

Learning outcomes

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

Assessment criteria

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

- state the purpose of, and responsibility for, preparing annual financial statements
- explain and describe the overall considerations to be taken into account during the preparation of the annual financialstatements
- prepare a comprehensive set of annual financial statements from given information in accordance with the requirements of IAS1

Overview

This learning unit is divided into the following:

3.1 Purpose of annual financial statements
3.2 General features
3.3 Structure and content
3.4 Structure and content: Statement of financial position
3.5 Structure and content: Statement of profit or loss and other comprehensive income
3.6 Structure and content: Statement of changes in equity
3.7 Structure and content: Notes to the annual financial statements
3.8 Dividends
3.9 Example: presentation of annual financial statements
3.10 Comprehensive example

STUDY

PRESCRIBED TEXTBOOK

Introduction to IFRS – Latest edition

Chapter 2

Categories of companies

STUDY

Study paragraphs 2, 3 and 4 of chapter 18 of the prescribed textbook.

Section 8 of the Companies Act 2008 states that two types of companies may be formed and incorporated under the Act, namely profit companies and non-profit companies.

Please work through this section of the textbook to familiarise yourself with this, before continuing with the actual annual financial statements.

OVERVIEW OF LEARNING UNIT

IAS 1 covers the presentation of annual financial statements. This includes the layout of general purpose annual financial statements and the considerations to be taken into account when preparing the content of these annual financial statements.

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

This accounting standard (IAS 1) refers to general purpose annual financial statements and annual financial statements, and forms the basis for the preparation of annual financial statements (i.e. the starting point). If another accounting standard requires additional disclosure, this is in addition to that required by this accounting standard.

This accounting standard does not apply to the preparation of condensed interim annual financial statements, but it does apply equally to the annual financial statements of individual entities, as well as the preparation of group annual financial statements.

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

3.1 PURPOSE OF ANNUAL FINANCIAL STATEMENTS

STUDY

Study paragraphs 2, 3 and 4 of chapter 2 of the prescribed textbook.

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

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

A complete set of annual financial statements consists of the following:

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

- a statement of financial position at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its annual financial statements or when it reclassifies items in its annual financial statements
- Comparative information in respect of the preceding periods

3.2 GENERAL FEATURES

STUDY

Study paragraph 5 of chapter 2 of the prescribed textbook.

When preparing the annual financial statements, the following general features must be considered:

- **Fair presentation and compliance with IFRS**

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

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

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

- **Going concern**

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

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

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

- **Accrual basis of accounting**

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

- **Consistency of presentation**

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

Consistency consists of two important aspects:

- Consistency over time and consistency of disclosure of similar items
- Materiality and aggregation

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

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

- **Offsetting**

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

- **Comparative financial information**

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

3.3 STRUCTURE AND CONTENT

STUDY

Study paragraphs 2, 3, 4 & 6 of chapter 2 of the prescribed textbook.

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

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

- **Identification of annual financial statements**

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

- **Frequency of reporting**

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

- the reason for using the longer or shorter period should be given; and
- the fact that the comparative amounts of the annual financial statements are not entirely comparable, should be explained.

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

3.4 STRUCTURE AND CONTENT: STATEMENT OF FINANCIAL POSITION

- **Share capital**

Needs specific disclosure, in the notes to the annual financial statements, for each class **– please see paragraph 6.2.3 of chapter 2 of the prescribed textbook.**

ISSUE OF CAPITALISATION SHARES

STUDY

Study paragraph 8.1.1. in chapter 17 of the prescribed textbook and also refer to paragraph 1.5.4 of learning unit 1.

- **Current/non-current distinction**

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

- **Current assets**

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

- it is expected to be realised in, or is intended for sale or consumption in, the entity's normal operating cycle
- it is held primarily for the purpose of being traded;
- it is expected to be realised within twelve months after the year-end date; or
- it is cash or cash equivalent.

All other assets are classified as non-current.

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

- **Current liabilities**

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

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

All other liabilities are classified as non-current.

- **Information to be presented on the statement of financial position**

STUDY

Study paragraph 6.2.2 of chapter 2 of the prescribed textbook.

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

(a) property, plant and equipment

(b) investment property
(c) intangible assets
(d) financial assets (excluding e, h and i)
(e) investments accounted for using the equity method
(f) biological assets
(g) inventories
(h) trade and other receivables
(i) cash and cash equivalents
(j) the total of assets classified as held for sale and assets included in disposal groups classified as held for sale
(k) trade and other payables
(l) provisions
(m) financial liabilities (excluding k and l)
(n) liabilities and assets for current tax
(o) deferred tax liabilities and deferred tax assets
(p) liabilities included in disposal groups classified as held for sale
(q) non-controlling interest presented within equity
(r) issued capital and reserves attributable to owners of the parent

LECTURER'S COMMENT

Financial instruments will be discussed in detail in learning unit 8, but a basic explanation is required now to provide you with some background, as they form part of annual financial statements.

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

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

- cash
- any equity instrument of another entity
- a contractual right:
  - to receive cash or another financial asset from another financial entity; or
  - to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
- a contract that will or may be settled in the entity's own equity instruments and is:
  - a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
  - a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

LECTURER'S COMMENT

Please take note that derivatives are not applicable for second-year Accounting and you should therefore only be aware of them.

Examples of financial assets are:

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

In terms of paragraph 54 of IAS 1, financial assets other than "investments accounted for using the equity method, trade and other receivables, and cash and cash equivalents" are grouped together under the heading "Financial assets".

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.

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

The following are not examples of financial assets:

- Property, plant and equipment
- Leased assets
- Inventories
- Goodwill, patents and trademarks
- Prepaid expenses (i.e. an insurance premium paid in advance. This is not the right to receive cash or another financial asset but the right to the receipt of goods or services in the future.)
- Income taxes that are created as a result of statutory requirements imposed by government

A **financial liability** is defined as any liability that is a contractual obligation:

- to deliver cash or another financial asset to another entity, or
- to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or a contract that will or may be settled in the entity's own equity instruments and is:
- a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
- a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include instruments

that are themselves contracts for the future receipt or delivery of the entity's own equity instruments. **Please remember, however, that derivatives are not covered in second-year Accounting.**

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

Where the rights of a preference share:

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

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

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

Examples of financial liabilities are:

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

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

Information to be presented either on the statement of financial position or in the notes

STUDY

Study paragraph 6.2.2 & 6.2.3 of chapter 2 of the prescribed textbook.

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

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

3.5 STRUCTURE AND CONTENT: STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

STUDY

Study paragraph 6.3 of chapter 2 of the prescribed textbook.

The statement of profit or loss and other comprehensive income shall present, in addition to profit or loss and other comprehensive income sections:

(a) profit or loss
(b) total comprehensive income
(c) comprehensive income for the period, being the total of profit or loss and other comprehensive income

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

In addition to the mentioned items, an entity shall present the following items as allocation of profit or loss and other comprehensive income for the period:

(a) profit or loss for the period attributable to:

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

(b) comprehensive income for the period attributable to:

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

LECTURER'S COMMENT

Non-controlling interests and parent interest in profit are dealt with in detail in FAC 2602.

If an entity presents profit or loss in a separate statement, it shall present profit or loss attributable to non-controlling interests and owners of the parent in that statement.

Information to be presented in the profit or loss section or the statement of profit or loss

STUDY

Study paragraph 6.3 and 6.3.1 of chapter 2 of the prescribed textbook.

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

- revenue
- gains and losses arising from the derecognition of financial assets measured at amortised cost
- finance costs
- share of the profit or loss of associates and joint ventures accounted for using the equity method
- if a financial asset is reclassified so that it is measured at fair value, any gain or loss arising from a difference between the previous carrying amount and its fair value at the reclassification date
- tax expense
- a single amount for the total of discontinued operations **(Not covered in second-year Accounting)**

Information to be presented in the other comprehensive income section

STUDY

Study paragraphs 6.3, 6.3.1 to 6.3.3 of chapter 2 of the prescribed textbook.

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

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

For second-year Accounting we will only deal with the following two other comprehensive income items:

– Revaluation surpluses and deficits against existing revaluation surpluses
– Gains or losses on remeasuring equity instruments classified as financial assets at fair value through other comprehensive income

Profit or loss for the period

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

Information to be presented either in the statement of profit or loss and other comprehensive income or in the notes

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

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

- inventories written down to net realisable value and reversals of these write-downs

- property, plant and equipment written down to recoverable amount and reversals of these write-downs
- discontinued operations
- the settlement of litigation
- other reversals of provisions
- disposal of property, plant and equipment
- disposal of investments
- the restructuring of the activities of an entity, and the reversal of any provisions for the cost of restructuring

LECTURER'S COMMENT

The statement of profit or loss and other comprehensive income can be presented in two ways: either by classifying income and expenditure in terms of the functions which give rise to them, or by classifying income and expenditure in terms of their nature.

THIS MODULE'S PREFERENCE IS THE CLASSIFICATION OF INCOME AND EXPENSES ACCORDING TO FUNCTION.

When income and expenditure are classified in terms of the functions which give rise to them, additional information of the nature of the expenditure should be provided in the notes to the statement of profit or loss and other comprehensive income, including:

- depreciation
- amortisation
- employee benefit expense (**Not covered in second-year Accounting**)

LECTURER'S COMMENT

The remuneration of directors and prescribed officers requires additional disclosure.

Please study thoroughly paragraphs 5 to 5.1.4 and 5.2, as well as example 18.1, in chapter 18 of *Introduction to IFRS*.

3.6 STRUCTURE AND CONTENT: STATEMENT OF CHANGES IN EQUITY

STUDY

Study paragraph 6.4 of chapter 2 of the prescribed textbook.

A statement of changes in equity forms part of the annual financial statements. What is essentially required, is a reconciliation of equity at the beginning of the financial year with equity at the end of the financial year.

The statement should include the following:

- Total comprehensive income for the period, showing separately the total amounts attributable to owners of the parent and non-controlling interest. **(Not covered in second-year Accounting)**
- The effects of retrospective application or retrospective restatement recognised in accordance with IAS 8 for each component of equity **(Not covered in second-year Accounting)**
- For each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period

Dividends paid for the period and related dividend per share can be disclosed either in the statement of changes in equity or in the notes.

3.7 STRUCTURE AND CONTENT: NOTES TO THE ANNUAL FINANCIAL STATEMENTS

STUDY

Study paragraph 6.5 of chapter 2 of the prescribed textbook.

The notes to the annual financial statements should:

- contain a statement that the financial statements comply with International Financial Reporting Standards
- present information about the basis of preparation of the annual financial statements
- present the specific accounting policies selected and applied for significant transactions and events
- disclose information required that is not presented elsewhere in the annual financial statements
- provide additional information that is not presented elsewhere in the annual financial statements, but that is relevant to an understanding of any of them, for example contingent liabilities

Notes to the annual financial statements should be:

- presented in a systematic manner; and
- each item on the statements cross-referenced to the notes.

An entity should disclose in the summary of significant accounting policies:

- the measurement basis (or bases) used in preparing the annual financial statements, for example, historical costs, net realisable value, fair value
- the other accounting policies used that are relevant to an understanding of the annual financial statements

3.8 DIVIDENDS

As we mentioned previously in **learning unit 1** , the profit of a company is divided among the shareholders of the company in the form of dividends. A dividend can therefore be defined as that portion of the profit of a company which is divided among the shareholders (paid out to them). In other words, it indicates the pro rata portion which each shareholder receives on his or her shares – say, for example, 10% or 5c per share.

When dividends are declared, the rights of minority shareholders should always be taken into account. If preference shares were issued at a fixed percentage of future income – for example 8% preference shares – dividends for these shareholders should always be declared at the fixed percentage. There are no restrictions on the profit share of ordinary shareholders and the declaration of dividends will depend on the available profit. If the profit is large, a large dividend can be declared, but if the profit is small, the dividend will naturally also be small. Note that the preference shareholders have preference over the ordinary shareholders as far as dividends are concerned. If an ordinary dividend is declared or paid, the board of directors is obliged to recommend a preference dividend and the shareholders are obliged to approve it.

It should also be noted that any dividends declared must be proportionate, in other words all the shareholders holding the same class of shares must receive the same dividend amount or percentage. The size of the dividend could naturally be different for the holders of different classes of shares, but within each class the amount of the dividends will be in the ratio of shares held. Dividends need not necessarily be paid out in cash; they can be in the form of capitalisation shares (bonus shares).

If there is profit available for distribution and sufficient cash flow, the dividends must still be declared at the annual general meeting. Thereafter, the dividends become a liability in the company's books in that they have not yet been paid over to the shareholders and the shareholders have the right to demand payment. The general procedure when dividends are declared, is that the directors recommend a percentage or an amount as a basis for declaring dividends. The shareholders have the final say in this matter, however, and they are free to declare a lower dividend than the directors recommended.

It should be mentioned that the dividends need not be declared solely from the profit of the current year. The profit made during previous trading periods and not yet paid out (retained earnings) may be added to the profit of the current year to arrive at a sum on which the dividends can be based, as long as the entity has sufficient cash flow available to pay the declared dividend.

For this reason, it is always necessary to bear the cash reserves of the company in mind when determining the amount of the dividends, because if all the available cash is absorbed by this item, it means that the company might experience a shortage of operating capital during the next financial period and consequently be unable to realise the same high profit.

You should bear in mind that dividends may not be paid from capital, but only from realised profit and only after all expenses and losses that may have arisen in the past have been redeemed.

The availability of profit for dividends has been the subject of many court cases. In many cases it is not easy to determine the available profit, but at present we can mainly assume that the profit is that amount that remains of the operating result after provision has been made for all expenses and for the depreciation of assets. Provision must be made for all losses or possible losses so that the amount which is eventually shown as profit is pure and accurate and does not include a portion of the capital or capital profits.

Preference shareholders have a preferential right to dividends. This means that before an ordinary dividend can be declared, preference shareholders have to receive their dividend, which represents a fixed percentage of the nominal value of preference share capital. If no distributable reserves are available in the particular year to declare a dividend, both ordinary and preference shareholders forego their right to dividends, unless the preference shares are cumulative. A cumulative preference shareholder retains his or her right to dividends from year to year even if no dividends are declared. Therefore, when the company has sufficient distributable reserves and cash flows available to declare a dividend, arrear and current cumulative preference dividends have first to be paid in full before ordinary preference dividends and then dividends on ordinary share capital can be paid.

Since preference dividends make up a fixed percentage of preference share capital, the calculation of the dividends is done on the same basis as the calculation of interest – in other words, for the period for which the shares were in issue. For the calculation of an ordinary dividend, it makes no difference how long the holder of a share certificate has held the shares. As soon as a dividend is declared to all registered shareholders, a shareholder is entitled to the full ordinary dividend, even if he or she only became a registered shareholder the previous day.

There are two kinds of dividends:

Interim dividends

An interim dividend is one which is declared before the end of the year from either (a) profit carried over from the previous year, or (b) profit which accumulated during the current period. The declaration of interim dividends is subject to the same requirements regarding available profit as is the declaration of annual dividends. The right to declare interim dividends is usually reserved for the directors of the company, but any such declaration must be ratified at the annual general meeting by the shareholders of the company.

No interim dividends can be paid by a company before all outstanding declared dividends from previous years have been paid.

Annual final dividends

Dividends of this kind are declared at the end of the year from available profit, and are therefore the kind of dividends we have been discussing so far. When the amount of the annual (final) dividends is determined, the amount of the interim dividend which has already been taken from the profit should be duly taken into account.

Dividends should be declared before they become a liability for the company in favour of the shareholders.

Debit	Retained earnings	with the total amount of the dividend declared
Credit	Dividends payable	
Debit	Dividends payable	with the amount paid
Credit	Bank	

EXAMPLE 1

Issued
10 000 ordinary shares at R1 each
Dividend declared: 10c per share
Dividend payable
10 000 x 10c = R1 000

Issued
10 000 8% preference shares at R1 each
Dividend payable
10 000 x R1 x 8% = R800

or

Issued
20 000 12% preference shares at R2 each
Dividend payable
20 000 x R2 x 12% = R4 800

Work through the following examples to comprehend the calculation and treatment of dividends.

EXAMPLE 2

The issued share capital of A Ltd consists of:

- 10 000 8% preference shares at R1 each
- 20 000 12% preference shares at R2 each

Required

Calculate the dividends payable annually to preference shareholders.

SOLUTION 2

- 10 000 8% preference shares at R1 each:

- Dividend payable:
  10 000 x R1 x 8% = R800
  20 000 12% preference shares at R2 each:
- Dividend payable:
  20 000 x R2 x 12% = R4 800

EXAMPLE 3

ABC Ltd's issued share capital includes 10 000 10% **cumulative** preference shares at R2 each. ABC Ltd did not have sufficient funds available to pay the preference dividend for the financial years ended 28 February 20.1 and 20.2. However, the directors decided on 28 February 20.3 that sufficient funds were available and consequently declared and paid all dividends.

Required

Calculate the dividend to be disclosed in the company's annual financial statements for the 20.3 year.

SOLUTION 3

ABC LTD
EXTRACT FROM STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 28 FEBRUARY 20.3

	20.3 **R**	**20.2** **R**
Dividends declared and paid		
Cumulative preference shares (10 000 x R2 x 10% x 3 years)	6 000	–

EXAMPLE 4

The issued share capital of B Ltd on 31 December 20.16 consists of:

	R
Ordinary shares	5 000

Additional information:

- All the ordinary shares were issued at R1,00.
- At the annual general meeting held on 28 December 20.16, the directors decided to issue a capitalisation share of 1 ordinary share for every 10 held at R1,00. This transaction was not yet recorded in the 20.16 financial records of B Ltd.
- After the capitalisation issue, the company declared an ordinary dividend of 5c per share.

Required

Calculate the ordinary dividend to be disclosed in the company's annual financial statements for the year ended 20.16.

SOLUTION 4

First calculate the number of ordinary shares at year end:

Issued: 5 000 ordinary shares

Ordinary shares issued (5 000 shares/R 1,00)	5 000	shares
Capitalisation shares (5 000 shares/10)	500	shares
Total number of ordinary shares	5 500	shares

Calculate ordinary dividend for the year:

	R
5 500 shares x 5c	275

3.9 EXAMPLE: PRESENTATION OF ANNUAL FINANCIAL STATEMENTS

The following is an example of annual financial statements prepared in terms of the requirements of IAS 1. **Please note that this is a very detailed example and all the items in this example are not covered in this module.**

XYZ GROUP
STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20.16

	20.16 R'000	20.15 R'000
ASSETS		
Non-current assets	X	X
Property, plant and equipment	X	X
Investment property	X	X
Goodwill	X	X
Other intangible assets	X	X
Investments in associates	X	X
Financial assets	X	X
Deferred tax	X	X
Current assets	X	X
Inventories	X	X
Trade and other receivables	X	X
Financial assets	X	X
Cash and cash equivalents	X	X
Total assets	X	X

	20.16 R'000	20.15 R'000
EQUITY AND LIABILITIES		
Total equity	X	X
Equity attributable to owners of the parent	X	X
Share capital	X	X
Retained earnings	X	X
Other components of equity	X	
		X
Non-controlling interest	X	
Total liabilities	X	X
Non-current liabilities	X	X
Long-term borrowings	X	X
Other financial liabilities	X	X
Long-term provisions	X	X
Deferred tax	X	X
Current liabilities	X	X
Trade and other payables	X	X
Short-term borrowings	X	X
Current portion of long-term borrowings	X	X
Short-term provisions	X	X
Other financial liabilities	X	X
Current tax payable	X	X
Total equity and liabilities	X	X

LECTURER'S COMMENT

Some of the above items require additional disclosure in the form of notes to the annual financial statements and will be discussed in detail, when the applicable item is discussed in more detail in later learning units.

XYZ GROUP
STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.16

(Illustrating the classification of expenses by function – this method is preferred by Unisa)

	20.16 R'000	20.15 R'000
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
PROFIT FOR THE YEAR	X	X
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	X	X
Remeasurements on defined benefit pension plans	X	X
Share of gain (loss) on property revaluation of associates	X	X
Income tax relating to items that will not be reclassified	(X)	(X)
	X	X
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations	X	X
Available for sale financial assets	X	X
Cash flow hedges	X	X
Income tax relating to items that may be reclassified	(X)	(X)
	X	X
Other comprehensive income for the year, net of tax	X	X
TOTAL COMPEHENSIVE INCOME FOR THE YEAR	X	X
Profit attributable to:		
Owners of the parent	X	X
Non-controlling interest	X	X
	X	X
Total comprehensive income attributable to:		
Owners of the parent	X	X
Non-controlling interest	X	X

XYZ GROUP
STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.16

(Illustrating the classification of expenses by nature)

	20.16 R'000	20.15 R'000
Revenue	X	X
Other income	X	X
Changes in inventories of finished goods and work in progress	(X)	X
Work performed by the entity and capitalised	X	X
Raw material and consumables used	(X)	(X)
Employee benefits expense	(X)	(X)
Depreciation expense	(X)	(X)
Amortisation expense	(X)	(X)
Impairment of property, plant and equipment	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
PROFIT FOR THE YEAR	X	X
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	X	X
Remeasurements on defined benefit pension plans	X	X
Share of gain (loss) on property revaluation of associates	X	X
Income tax relating to items that will not be reclassified	(X)	(X)
	X	X
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations	X	X
Available for sale financial assets	X	X
Cash flow hedges	X	X
Income tax relating to items that may be reclassified	(X)	(X)
	X	X
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	X	X
Profit attributable to:		
Owners of the parent	X	X
Non-controlling interest	X	X
	X	X
Total comprehensive income attributable to:		
Owners of the parent	X	X
Non-controlling interest	X	X
	X	X

LECTURER'S COMMENT

In a statement of profit or loss and other comprehensive income in which expenses are classified by nature, an impairment of property, plant and equipment is shown as a separate line item. By contrast, if expenses are classified by function, the impairment is included in the function(s) to which it relates, and separately disclosed in the note on profit before tax. The same applies to employees' costs, depreciation and amortisation.

In the above example, the individual components of other comprehensive income are disclosed on a pre-tax basis (i.e. before taking into account their related tax effect). The combined tax effect is then reflected as a single line item immediately following these components. An alternative presentation would be to disclose each of these components net of tax. In second-year Accounting, the effect of tax is not dealt with. The illustration of the tax effect is for cognisance only.

The following notes accompany this statement to provide more useful information:

NOTES FOR THE YEAR ENDED	R
1. Profit before tax is disclosed after taking the following disclosable items into account, amongst others	
Income	
Revenue consists of:	
Continuing operations – turnover	X
Fair value adjustment – financial asset at fair value through profit or loss	
Profit on the sale of non-current assets	
Profit on financial instruments	X
Income from subsidiaries	X
– Dividends	X
– Interest	X
– Management and other fees	X
– Other specified income	X
Income from other financial assets	
Listed investments – Financial asset at fair value through profit or loss	X
– Dividends	X
– Interest	X
– Other income	X
Unlisted investments – Financial asset at fair value through other comprehensive income	X
– Dividends	X
– Interest	X
– Other income	X
Expenses	
Significant (material) items	X
Fair value adjustment – financial asset at fair value through profit or loss	X
Losses on the sale of non-current assets	X
Loss on financial instruments	X
Depreciation on non-current assets	X
Remuneration (other than bona fide employees) for:	
– Management services	X
– Technical services	X
– Administrative services	X
– Secretarial services	X
Staff cost	X
Auditors' remuneration	X
– Auditing fees	X
– Fees for other services, e.g. accounting services	X
– Expenses	X
2. Income tax expense	
SA Normal tax	X
– Current year	X
– Deferred	X

LECTURER'S COMMENT

The entity should also include notes on accounting policy to disclose the measurement basis used in the compilation of the annual financial statements (e.g. historical cost, current cost, net realisable value, fair value and recoverable amount, as well as each specific accounting policy matter that is relevant to an understanding of the annual financial statements.

Please read through par. 6.5.1 of the prescribed textbook, but please take note that the preparation of accounting policy notes is not required in second-year Accounting.

An entity may choose to split the statement of profit or loss and other comprehensive income into two separate statements. The one statement, called a statement of profit or loss, then deals with the profit for the year, while the other statement, called a statement of profit or loss and other comprehensive income, shows the total profit for the year as well as the components of other comprehensive income.

XYZ GROUP
STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20.16

	20.16 R'000	**20.15 R'000**
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
PROFIT FOR THE YEAR	X	X
Profit attributable to:		
Owners of the parent	X	X
Non-controlling interest	X	X
	X	X

XYZ GROUP
STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.16

	20.16 R'000	20.15 R'000
Profit for the year	X	X
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	X	X
Remeasurements on defined benefit pension plans	X	X
Share of gain (loss) on property revaluation of associates	X	(X)
Income tax relating to items that will not be reclassified	(X)	(X)
	X	X
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations	X	X
Available for sale financial assets	X	X
Cash flow hedges	X	X
Income tax relating to items that may be reclassified	(X)	(X)
	X	X
Other comprehensive income for the year, net of tax	X	X
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	X	X
Total comprehensive income attributable to:		
Owners of the parent	X	X
Non-controlling interest	X	X
	X	X

XYZ GROUP
STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20.16

	Share capital	Retained earnings	Translation of foreign operations	Investment in equity instruments	Cash flow hedges	Revaluation surplus	Total	Non-controlling interest	Total equity
	R'000	R'000	R'000	R'000	R'000	R'000	R'000	R'000	R'000
Balance at 1 January 20.15	X	X	X	X	X	–	X	X	X
Changes in accounting policy	–	**X**	–	–	–	–	**X**	**X**	**X**
Restated balance	X	X	X	X	X	X	X	X	X
Changes in equity for 20.15									
Dividends	–	**X**	–	–	–	–	**X**	–	**X**
Total comprehensive income for the year	–	**X**	**X**	**X**	**X**	**X**	**X**	**X**	**X**
Balance at 31 December 20.15	**X**	**X**	**X**	**X**	**X**	**X**	**X**	**X**	**X**
Changes in equity for 20.16									
Issue of share capital	X	–	–	–	–	–	**X**	–	**X**
Dividends	–	**X**	–	–	–	–	**X**	–	**X**
Total comprehensive income for the year	–	**X**	**X**	**X**	**X**	**X**	**X**	**X**	**X**
Transfer to retained earnings	–	**X**	–	–	–	**X**	–	–	–
Balances at 31 December 20.16	**X**	**X**	**X**	**X**	**X**	**X**	**X**	**X**	**X**

LECTURER'S COMMENT

Statement of changes in equity

IAS 1 requires disclosure of dividend per share in the statement of changes in equity, or alternatively in the notes.

The statement of changes in equity reflects the opening and closing balances of all the share capital and reserve accounts, the effects of changes in accounting policies/correction of prior period errors, the total comprehensive income for the period (reported as a single line item), the issue of shares, the repurchase of shares, dividends paid, as well as transfers between reserves.

3.10 COMPREHENSIVE EXAMPLE

EXAMPLE 5

The following information was taken from the books of Rainbow Ltd for the year ended 28 February 19.4:

	Dr R	Cr R
Ordinary shares (issued at R1 each)		500 000
8% Preference shares		100 000
Proceeds of 50 000 new shares issued		65 000
Share issue expenses incurred on the above shares issued	4 000	
Preliminary expenses	3 000	
Debenture issue expenses	2 000	
8% Debentures of R100 each (secured by a first mortgage bond over land and buildings)		100 000
Bank overdraft		65 000
Trade and other payables		47 000
Land at cost	50 000	
Buildings at cost	500 000	
Investments at cost	86 000	
Long-term loan – Purple Bank		50 000
Loan to personnel	4 500	
Profit before tax for the year		54 500
Retained earnings – 1 March 19.3		151 900
Trade and other receivables	43 000	
Inventories – finished goods	46 000	
Inventories – work-in-progress	4 000	
Machinery and equipment at cost	800 000	
Accumulated depreciation – 28 February 19.4		
– Machinery and equipment		400 000
– Buildings		18 500
Provisional taxation payments	8 100	
Dividends receivable (except received from subsidiary)		
– Blue Ltd	900	
– Cream (Pty) Ltd	400	
	1 551 900	1 551 900

Additional information:

1. On 1 March 19.3 the directors of Rainbow Ltd decided on the following, which must still be accounted for in the following order:

1.1 The issue of 80 000 fully paid-up ordinary capitalisation shares to the amount of R80 000.

1.2 To write off all share issue expenses, preliminary expenses and debenture issue expenses.

2. The existing land (owner occupied and situated at erf 14, Rooihout Park) was purchased on 1 March 19.1 for R50 000. Buildings at a cost of R450 000 were completed on 1 March 19.2. On 1 March 19.3 the land was revalued by a sworn appraiser, Mr White, for R200 000 on the net replacement basis. No entry to record the revaluation was done. Since then, the directors approved plans to modernise the buildings for R150 000. Work to the amount of R50 000 was completed and paid for on 31 August 19.3, while contracts to the value of R50 000 were already entered into for the following accounting period.

3. The company signed surety for a bank overdraft of Aubegine Ltd.

4. Investments consist of the following:

		R
4.1	Aubegine Ltd – subsidiary of Rainbow Ltd 10 000 Ordinary shares	30 000
4.2	Blue Ltd – listed on the Johannesburg Securities Exchange (Bought for speculative purposes): 1 000 Ordinary shares Market value on 28 February 19.4 was R50 per share	40 000
4.3	Cream (Pty) Ltd – unlisted company (designated as not held for trading): 200 Ordinary shares Directors' valuation on 28 February 19.4 amounts to R20 000 In previous years, the fair value of all the investments above was equal to their cost prices.	16 000

5. The unsecured long-term loan originated on 1 March 19.3 and is repayable in annual instalments of R10 000 on 1 March every year. Interest for the current year at the current rate of 10% must still be provided for and is payable on 5 March 19.4. Rainbow Ltd uses the settlement basis of accounting to account for its financial instruments.

6. Loans to personnel consist of:

6.1 A loan of R3 000 to Mr Green, the managing director. No repayment was made during the current year.

6.2 R1 500 owing by Mr Terracotta, the company secretary. The original advance on 1 June 19.3 amounted to R3 000. Both these loans are short-term and interest free.

7. Profit before tax for the year was determined after taking the following into account, amongst others:

	R
Income from subsidiary:	
– Dividends	500
– Administration fees	3 500
Profit on sale of delivery motor cycle	750
Auditors' remuneration (including R800 travelling	2 000
expenses) Travelling allowance of the managing director	1 900
Entertainment allowance of the managing director	1 500
Directors' remuneration for attendance of meetings	
– managing director	1 800
(An additional R2 000 was paid by the subsidiary for attendance of meetings)	
Directors' remuneration for attendance of meetings	
– non-executive directors (Mr Red)	1 800
Salaries (including R70 000 paid to the managing director, as well as the	
company's pension fund contributions of 5% on all salaries)	200 000
Bank charges	700
Depreciation	
– Machinery and equipment	100 000
– Buildings	9 500
Interest on overdraft	6 900
Interest on debentures	8 000

8. Normal company taxation of R11 368 and dividends on ordinary shares of 5c per share must still be provided for.

9. Rainbow Ltd only owned one delivery motor cycle which was sold on 1 March 19.3. The transaction was entered correctly in the books of Rainbow Ltd. The original cost price of this asset was R20 000 and the carrying amount at date of sale was R2 000.

10. It is Rainbow Ltd's policy to write off depreciation on machinery and equipment at 20% per annum according to the diminishing balance method. No purchase or sale of machinery took place during the year.

11. Revenue for the year amounted to R4 500 000 and represents net sales to third parties of goods purchased for resale. Rainbow Ltd maintained a 40% gross profit percentage throughout the year.

12. Debentures are redeemable before 1 March 19.10 at par.

13. The authorised share capital of Rainbow Ltd on 1 March 19.3 was as follows:

    700 000 Ordinary shares
    250 000 8% Preference shares

14. Buildings are depreciated at 2% per annum on the straight-line basis.

15. Included in profit before tax are distribution expenses amounting to R26 800.

Required

Prepare the statement of financial position, the statement of profit or loss and other comprehensive income, the statement of changes in equity and the relevant notes thereto of Rainbow Ltd for the year ended 28 February 19.4 according to the requirements of International Financial Reporting Standards. (Ignore accounting policy notes and comparative figures. Show all calculations.)

SOLUTION 5

RAINBOW LTD
STATEMENT OF FINANCIAL POSITION AS AT 28 FEBRUARY 19.4

ASSETS	**Notes**	**R**
Non-current assets		1 131 500
Property, plant and equipment	1	1 081 500
Investment in subsidiary	2	30 000
Financial assets	3	20 000
Current assets		148 800
Inventories	4	50 000
Trade and other receivables (43 000 + 900 + 400)	3	44 300
Financial assets (4 500 + 50 000)	3	54 500
Total assets		1 280 300
EQUITY AND LIABILITIES		
Equity attributable to owners		970 532
Share capital	5	745 000
Retained earnings		71 532
Other components of equity (150 000 + 4 000)		154 000
Total liabilities		309 768
Non-current liabilities		140 000
Long-term borrowings	6	40 000
Financial liabilities at amortised cost	7	100 000
Current liabilities		169 768
Trade and other payables (47 000 + 5 000)		52 000
Current portion of long-term borrowings		10 000
Current tax payable (11 368 – 8 100)		3 268
Dividends payable (31 500 + 8 000)		39 500
Bank overdraft		65 000
Total equity and liabilities		1 280 300

RAINBOW LTD

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 28 FEBRUARY 19.4

	Notes	R
Revenue		4 500 000
Cost of sales (4 500 000 – 1 800 000)		(2 700 000)
Gross profit (40% x 4 500 000)		1 800 000
Other income		16 050
Distribution costs		(26 800)
Administration expenses (calculation 1)		(1 711 850)
Finance costs (6 900 + 8 000 + 5 000)		(19 900)
Profit before tax (calculation 1)	10	57 500
Income tax expense	12	(11 368)
PROFIT FOR THE YEAR		46 132
Other comprehensive income:		154 000
Gain on financial assets at fair value through other comprehensive income (20 000 – 16 000)		4 000
Gain on property revaluation (200 000 – 50 000)		150 000
TOTAL COMPREHENSIVE INCOME FOR THE YEAR		200 132
Profit attributable to:		
Owners of the parent		46 132
Total comprehensive income attributable to:		
Owners of the parent		154 000
		200 132

RAINBOW LTD

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 28 FEBRUARY 19.4

	Ordinary share capital R	Preference share capital R	Revaluation surplus R	Mark-to–market reserve R	Retained earnings R	Total R
Balance at 1 March 19.3	500 000	100 000	–	–	151 900	751 900
Total comprehensive income for the year			150 000	4 000	46 132	200 132
Issue of capitalisation shares	80 000				(80 000)	–
Issue of ordinary shares	65 000					65 000
Share issue expenses written off					(4 000)	(4 000)
Preliminary expenses written off					(3 000)	(3 000)
Dividends						
– preference (100 000 x 8%)					(8 000)	(8 000)
– ordinary (630 000[1] x 5c)					(31 500)	(31 500)
Balance at 28 February 19.4	645 000	100 000	150 000	4 000	71 532	970 532

[1] (500 000 + 80 000 + 50 000)

RAINBOW LTD
NOTES FOR THE YEAR ENDED 28 FEBRUARY 19.4

1. Property, plant and equipment

	Buildings R	Land R	Machinery and equipment R	Delivery vehicle R	Total R
Carrying amount at 1 March 19.3	441 000	50 000	500 000[1]	2 000	993 000
Cost price	450 000	50 000	800 000	20 000	1 320 000
Accumulated depreciation	(9 000)[2]	–	(300 000)	(18 000)	(327 000)
Revaluation surplus for the year	–	150 000	–	–	150 000
Depreciation for the year	(9 500)[3]	–	(100 000)	–	(109 500)
Additions at cost	50 000	–	–	–	50 000
Disposals at carrying amount	–	–	–	(2 000)	(2 000)
Carrying amount at 28 February 19.4	481 500	200 000	400 000	–	1 081 500
Cost/Revaluation	500 000	200 000	800 000	–	1 500 000
Accumulated depreciation	(18 500)	–	(400 000)	–	(418 500)

[1] $400\,000 \times \frac{100}{80} = 500\,000$ [3] $(450\,000 \times \frac{6}{12} \times 2\%)$ $(500\,000 \times \frac{6}{12} \times 2\%) = 9\,500$

[2] $450\,000 \times 2\% = 9\,000$

On 1 March 19.3 land, with a building, situated at erf 14, Rooihout Park, was revalued by Mr White, a sworn appraiser, according to the net replacement basis for R200 000. Additions during the year amounted to R50 000. The land and buildings serve as security for the debentures. (See note 6.)

	R
2. Investment in subsidiary	
Shares at cost	30 000

	R
3. Financial assets	
Non-current financial assets	20 000
Financial assets at fair value through other comprehensive income Unlisted	
– 200 Ordinary shares (cost R16 000)	20 000
Current financial assets	98 800
Trade receivables (43 000 + 900 + 400)	44 300
Loans and receivables	4 500
Loan to a director (The loan is interest free and repayable in the following year)	3 000
Staff loans (The loans are interest free and repayable in the following year)	1 500
Financial assets at fair value through profit or loss – held for trading Listed	
– 1 000 Ordinary shares in Blue Ltd (cost R40 000)	50 000
	118 800

		R
4.	**Inventories**	
	Finished goods	46 000
	Work-in-progress	4 000
		50 000

		R
5.	**Share capital**	
	Authorised	
	700 000 Ordinary shares	
	250 000 8% Preference shares	
	Issued	
	630 000 Ordinary shares	645 000
	100 000 8% Preference shares	100 000
		745 000

During the accounting period, 50 000 ordinary shares were issued for R65 000.

		R
6.	**Non-current liabilities**	
	Long-term borrowings:	
	Long-term loan	40 000
	Total long-term loan	50 000
	Current portion of long-term loan	(10 000)

The long-term loan is unsecured, carries interest at 10% per annum and is repayable in annual instalments of R10 000 on 1 March each year.

		R
7.	**Financial liabilities at amortised cost**	
	1 000 8% debentures of R100 each at amortised cost	100 000

The debentures are secured by a first mortgage bond over land and buildings with a carrying amount of R681 500 and are redeemable at par before 1 March 19.10. (See note 1.)

		R
8.	**Commitments for capital expenditure**	
	Contracted	50 000
	Approved by the directors not yet contracted	50 000
		100 000

These expenses will be financed from …

9. Contingent liability

The company signed a suretyship for a bank overdraft for its subsidiary company.

10. Profit before tax

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

	R
Income	
Revenue consists of sales of goods	4 500 000
Profit on sale of non-current asset	750
Fair value adjustment – financial asset at fair value through profit or loss	10 000
Dividend income	1 300
– Financial assets at fair value through profit or loss – listed investment	900
– Financial assets at fair value through other comprehensive income – unlisted investment	400
Income from subsidiary	4 000
– Dividends	500
– Administration fee	3 500
Expenses	
Staff cost	200 000
Auditors' remuneration	2 000
– Audit fees	1 200
– Expenses	800
Depreciation	109 500
Write-off of debenture issue expenses	2 000

11. Remuneration of directors and prescribed officers

Name	Directors' fees R	Salary R	Other benefits R	Pension fund R	Loss of office R	Less: Paid by sub–sidiaries R	Total R
Executive director:							
Mr Green	3 800	70 000	3 400	3 500	–	(2 000)	78 700
Non-executive director:							
Mr Red	1 800	–	–	–	–	–	1 800
	5 600	70 000	3 400	3 500	–	(2 000)	80 500

Other benefits Name	Travel R	Entertainment allowance R	Total R
Mr Green	1 900	1 500	3 400

12. Income tax expense

	R
SA normal taxation	
– Current	11 368

Calculation 1

	R
Gross profit (4 500 000 x 40%)	1 800 000
Profit before tax	(57 500)
Profit before tax per list of balances	54 500
Fair value adjustment – held-for-trading financial assets [(50 x 1 000) – 40 000)]	10 000
Interest on loan still to be provided (50 000 x 10%)	(5 000)
Write-off of debenture issue expenses	(2 000)
	1 742 500
Interest paid to be disclosed separately (6 900 + 8 000 + 5 000)	(19 900)
Other income to be disclosed separately (10 000 + 750 + 3 500 + 500 + 900 + 400)	16 050
Distribution expenses disclosed separately	(26 800)
Administrative expenses	1 711 850

The United Nations Global Compact (UNGC) was launched in 2000 and consists of ten principles to improve corporate citizenship amongst public, private and civil-society entities. Specifically applicable to this module, is the principle on anti-corruption, in that businesses should work against corruption in all its forms, including extortion and bribery. The annual financial statements that are prepared should therefore be a true reflection of activities and comply with all relevant ethical principles.

FAC2601

LEARNING UNIT 4

INVENTORY – IAS 2

Financial Accounting for Companies

Learning outcomes

Learners should be able to account for inventory and disclose it in annual financial statements in accordance with the requirements of International Financial Reporting Standards (IFRS).

Assessment criteria

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

- apply all the applicable definitions to different scenarios
- calculate the historical cost of inventories
- apply the different cost formulas to measure the cost of inventories
- calculate the net realisable value of inventories
- present and disclose inventories in the annual financial statements in accordance with the requirements of IAS 2.

Overview

This learning unit is divided into the following:

4.1 Nature of inventories
4.2 Measurement of inventories
4.3 Cost of inventories
  4.3.1 Purchasing costs
  4.3.2 Conversion costs
4.4 Cost allocation techniques and cost formulas
  4.4.1 First-in-first-out
  4.4.2 Weighted average method
  4.4.3 Specific identification
4.5 Determining net realisable value and recognition at lower-of-cost and net realisable value
  4.5.1 Firm sales contracts
  4.5.2 Raw materials
4.6 Recognition of expense
4.7 Disclosure requirements
4.8 Examples

STUDY

PRESCRIBED TEXTBOOK

Introduction to IFRS – Latest edition

Chapter 3

Overview of learning unit

The valuation and disclosure of inventories is important in the determination and presentation of financial position and results. The objective of IAS 2 is to prescribe:

How to determine the cost and net realisable value of inventories

Which useful and understandable information needs to be provided in annual financial statements

STUDY

Study paragraphs 1, 2 and 3 of the prescribed textbook.

4.1 NATURE OF INVENTORIES

STUDY

Study paragraph 4 of the prescribed textbook.

Inventories include both tangible and intangible assets that are:

- Held for sale in the ordinary course of business
- In process of production for sale
- Consumed during the production of saleable goods or services. IAS 2 does not apply to certain categories of inventories and applies only partially to certain inventories. **Work through paragraph 3 of the prescribed textbook.**

The purpose of the entity will determine whether an item is classified as inventories or not. **Work through example 3.1 of the prescribed textbook.**

4.2 MEASUREMENT OF INVENTORIES

STUDY

Study paragraph 5 of the prescribed textbook.

Inventories are always measured at the lower of cost and net realisable value. The steps to determine this, will now be addressed in 4.3 to 4.6.

4.3 COST OF INVENTORIES

STUDY

Study paragraph 6 of the prescribed textbook.

Historical cost includes:

4.3.1 Purchasing costs

- Purchase price
- Import duties and other appropriate taxes
- Transport costs
- Handling costs
- Any other costs directly attributable to the acquisition of the inventories

LECTURER'S COMMENT

Remember to deduct any trade discounts and rebates from the original cost price!

The following are specifically excluded:

- Abnormal spillage
- Allocation of fixed production overhead costs that were not allocated to production
- Storage costs, unless it is essential in the production process Administrative expenses not related to the location and condition
- Selling expenses

Take note that even though abnormal spillage and fixed production overhead costs not allocated should be excluded from the cost of inventories, they are included in the cost of sales. **Work through example 3.2 and 3.3 of the prescribed textbook**.

4.3.2 Conversion costs

These costs are incurred in the conversion of raw materials into finished products and include the following:

- direct labour
- variable production overhead costs
- fixed production overhead costs based on normal capacity
- other costs

The correct allocation of overhead costs is essential to ensure that the cost of inventories is accurate. The following distinction is therefore very important:

Production overhead costs: Incurred in the manufacturing process, but do not form part of direct material or direct labour costs, for example depreciation of production machinery.

Variable overhead costs can be allocated with ease by using the number of units manufactured, but fixed production costs should use normal capacity as basis.

Since the production overhead costs are incurred in the process to their present location and condition, they should be included in the costs.

Other overhead costs: Normally incurred in running the operations of an entity that do not relate to the production process, for example, office rental and salaries of administrative personnel.

Other overhead costs are therefore not incurred to bring inventories to their present location and condition and should not be included in the cost of inventories, but recognised as expenses.

The following, however, are exceptions and if applicable, should be included in the cost of inventories:

- Design costs, research and development that clearly relate to bringing inventories to their present location and condition
- Borrowing costs that have been capitalised in respect of inventory where long ageing processes are required
- Storage costs that are necessary in the production process prior to the further production stage

The general principle is that only those costs involved in bringing the inventories to their present location and condition should be included in the cost of inventories.

Work through examples 3.4 to 3.9 of the prescribed textbook to illustrate the above.

4.4 COST ALLOCATION TECHNIQUES AND COST FORMULAS

STUDY

Study paragraph 7 of the prescribed textbook.

Up until this point we have discussed the calculation of the actual cost of inventories, but as this is now always possible, the following options are alternatives:

Standard cost: Based on normal levels of operations, the expected costs are estimated by using predetermined information.

Retail method: Used when complete records of purchases and inventories are not kept. Determine the values of inventories by using the selling price and then reducing it by average profit margin, to get the cost.

Work through example 3.10 of the prescribed textbook.

The value of inventories on hand at the end of a financial period should be determined by using one of the following cost formulas:

4.4.1 First-in, first-out

Values on assumption that items will be sold in the order that they were purchased.

Work through example 3.11 of the prescribed textbook.

4.4.2 Weighted average method

Weighted average is calculated after each purchase or periodically, by taking price and number of items into consideration.

Work through example 3.12 of the prescribed textbook.

4.4.3 Specific identification

Allocate costs to separately identified items that were acquired or manufactured for a specific project.

The determination of cost can be subject to manipulation in practice, especially with regard to the allocation of overhead costs and application of cost formulas, as the choice of cost formula can significantly impact on the profit for the year.

The same cost formula should thus be used for inventories with the same nature and use.

Work through example 3.13 of the prescribed textbook.

4.5 DETERMINING NET REALISABLE VALUE AND RECOGNITION AT LOWER OF COST AND NET REALISABLE VALUE

STUDY

Study paragraph 8 of the prescribed textbook.

It is the estimated selling price in the normal course of business, less:

- costs to complete the inventories
- trade and other discounts allowed
- advertising
- sales commission
- packaging costs
- transport costs

Inventories are therefore valued at cost at the end of a reporting period, which should not exceed the net amount expected to be realised from sales. Should the cost exceed this estimated amount, it implies that inventories are expected to be sold at a loss, and this estimated loss should be recognised in accordance with the prudence concept as it is probable and can be measured. The cost is then reduced to net realisable value and the write-off is immediately shown in the statement of profit or loss and other comprehensive income.

The write-off is normally done on an item-by-item basis, but if the following is applicable, it can be done on a group-by-group basis:

– Items that relate to the same product range and
– Have a similar purpose
– That are marketed in the same geographical area

A new assessment of net realisable value is made each financial year-end and adjustments might be as a result of:

– damaged inventories
– obsolete inventories
– decline in selling prices
– increases in costs to complete products
– increases in selling costs

LECTURER'S COMMENT

Net realisable value is an entity-specific amount realised from the sale of inventories in the ordinary course of business, and therefore does not represent the fair value.

Work through examples 3.14 to 3.16 of the prescribed textbook.

The following are exceptions to this general rule:

4.5.1 Firm sales contracts

The net realisable value of these inventories should be based on contract price and not on the normal sales price – **work through example 3.17 of the prescribed textbook.**

4.5.2 Raw materials

If it will be incorporated in the finished product and the finished product is expected to sell at more than the original cost, the raw material is not written down below their cost. If, however, the finished product is expected to sell at less than cost, it should be written down to net realisable value. **Work through example 3.18 of the prescribed textbook.**

4.6 RECOGNITION OF EXPENSE

STUDY

Study paragraph 10 of the prescribed textbook.

Recognise the carrying amount of inventories as an expense when sold, and revenue is recognised.

Perpetual inventories system: recognise sales and corresponding expenses throughout the financial period.

Periodic inventories system: only recognise sales and corresponding expenses at the end of the financial period.

Write-down to net realisable value:

Included in cost of sales expense and recognised in statement of profit or loss and other comprehensive income and disclosed separately in the notes to the annual financial statements.

Write-down due to inventory losses as a result of the difference between physical inventories on hand and the inventories records:

Included in cost of sales expense and recognised in statement of profit or loss and other comprehensive income, but not necessary to disclose separately in the notes to the annual financial statements.

Reversal of net realisable write-downs:

Reduce the cost of sales expense and recognised in statement of profit or loss and other comprehensive income with separate disclosure.

Work through example 3.19 of the prescribed textbook.

4.7 DISCLOSURE REQUIREMENTS

STUDY

Study paragraph 11 of the prescribed textbook.

In short, disclosure entails the following:

- Accounting policy with regard to measurement and cost formula used
- Total carrying amount of inventories, with applicable classification
- The carrying amount of inventories carried at fair value less costs to sell
- Amount recognised as cost of sales in current financial year
- Amount of any write-downs recognised as an expense
- The reversal of any subsequent write-downs in previous financial period
- Amount of any inventories pledged as security

Please note: It is not required to disclose the fact that carrying amount of inventories is at net realisable value.

Since we prefer to prepare the profit or loss section of the statement of profit or loss and other comprehensive income according to the functions of income and expenditure rather than according to the nature of income and expenditure, the cost of sales will be disclosed as a separate line item.

Work through example 3.20 of the prescribed textbook.

LECTURER'S COMMENT

Cost of inventories therefore includes all costs incurred in bringing the inventories to their present location and condition and will be disclosed in the statement of financial position at the end of the financial period and then carried forward to the following financial period, until the revenue is recognised.

4.8 EXAMPLES

QUESTION 1

XYZ (Pty) Ltd manufactures Product A for resale. The manufacturing cost per Product A is R1 350. Finished units of Product A are sold at R1 550 per unit. The following costs accrued with the manufacturing of Product A:

	R
Cost to complete inventories	260 per unit
Packaging cost	40 per unit
Advertising	35 per unit
Salaries of administrative staff	1 000 per month
Sales commission	90 per unit
Trade discount allowed	55 per unit

The closing inventories of Product A on hand for the year ended 31 December 20.9 amounted to 5 000 units.

Required

Calculate the value of the inventories (Product A) according to the requirements of IAS 2.

QUESTION 2

Doggy Ltd manufactures dog baskets and dog kennels. The following information on inventory is available:

	Total net cost price R	Total net realisable value R
Dog baskets	46 000	44 000
Small	18 000	20 000
Large	28 000	24 000
Dog kennels	175 000	164 000
Small	78 000	54 000
Medium	65 000	72 000
Large	32 000	38 000
Total	221 000	208 000

Required

Calculate the possible acceptable values at which inventory could be valued in order to comply with International Financial Reporting Standards.

SOLUTIONS

SOLUTION 1

	R
Net realisable value (NRV) of product A:	
Selling price	1 550
Cost to complete inventories	(260)
Packaging cost	(40)
Advertising	(35)
Sales commission	(90)
Trade discount allowed	(55)
	1 070

The carrying amount of closing inventories is measured at the lower of cost or NRV. Therefore, it is measured at the NRV of R1 070 per unit.

Value of inventories at 31 December 20.9.

Closing inventories 5000 units x R1 070 (NRV) = R5 350 000

SOLUTION 2

According to IAS 2, paragraph 28, decreases in the value of inventory are calculated separately for individual items, groups of similar items, inventory categories, etc.

Alternative 1 (individual items)

Type of product		**Lower of cost price or net realisable value R**
Dog baskets	– Small	18 000
	– Large	24 000
Dog kennels	– Small	54 000
	– Medium	65 000
	– Large	32 000
		193 000

Alternative 2 (groups of similar items)

Group	**Lower of cost price or net realisable value R**
Dog baskets	44 000
Dog kennels	164 000
	208 000

STUDY

Study paragraph 12 of the prescribed textbook.

FAC2601

LEARNING UNIT 5

PROPERTY, PLANT AND EQUIPMENT – IAS 16

Financial Accounting
for Companies

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 annual financial statements of an entity in terms of the requirements of International Financial Reporting Standards (IFRS).
- account for revaluations of property, plant and equipment of non-depreciable assets in the annual financial statements of an entity in terms of the requirements of International Financial Reporting Standards (IFRS).

Assessment criteria

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

- apply all the applicable definitions to different scenarios
- calculate the following:
  - cost price of PPE item
  - depreciable amount of each item and the annual depreciation
  - revaluation surplus or deficit on non-current assets revaluation
  - carrying amount or revalued amount of each PPE item
- present and disclose property, plant and equipment in the annual financial statements in accordance with the requirements of IAS 16.

Overview

This learning unit will be discussed under the following sections:

STUDY

PRESCRIBED TEXTBOOK:

Introduction to IFRS – Latest edition

Chapter 8

5.1 OBJECTIVE

STUDY

Study paragraphs 2 to 3 of the prescribed textbook.

IAS 16 contains prescriptions for the accounting treatment for property, plant and equipment (PPE) so that users of the annual 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
- the determination of their carrying amounts
- the related depreciation charges and impairment losses

5.2 BACKGROUND

STUDY

Study paragraph 4 of prescribed textbook.

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

The standard **does not** apply to (this does not form part of this module):

- PPE items classified as held for sale in accordance with IFRS 5 Non-current assets held for sale and discontinued operations (discussed in later studies)
- biological assets related to agricultural activity
- the recognition and measurement of exploration and evaluation assets

- mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources

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 (e.g. 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 6 for investment properties.)

5.3 DEFINITIONS

Study the following terms 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. (Impairment does not form part of this module.)

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 IFRS.

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.

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.

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
(b) are expected to be used during more than one period

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

5.4 RECOGNITION

STUDY

Study paragraphs 5.1 to 5.2 and paragraph 5.4 of the prescribed textbook. (Ignore par 5.3 and par 5.5.)

5.4.1 Introduction

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 annual 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)
- 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).

5.4.2 Components and spare parts

STUDY

Study paragraphs 5.1 and 5.2 of the textbook.

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, significant components 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.

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.

Work through examples 8.1 and 8.2 of the prescribed textbook.

5.4.3 Replacement at regular intervals

STUDY

Study paragraph 5.4 of the prescribed textbook.

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 (e.g. the furnace, aircraft and building) has a much longer useful life than the respective components (e.g. 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.

Work through example 8.4 of the prescribed textbook.

5.5 MEASUREMENT

STUDY

Study paragraph 6.1 of the prescribed textbook. (Ignore paragraphs 6.2 to 6.4.)

MEASUREMENT AT RECOGNITION

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

5.5.1 Elements of cost

STUDY

Study paragraph 6.1 of the prescribed textbook.

The cost of a PPE item comprises:

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts
(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. (Dismantling cost does not form part of this module.)

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)
(f) professional fees
(g) depreciation capitalised **(See example 3 in this learning unit.)**

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)
(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
(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.

Work through example 8.6 of the prescribed textbook.

EXAMPLE 1

A Ltd buys a delivery vehicle to deliver ice-cream to various branches. The following expenses are applicable:

	R
Cost price of delivery vehicle	400 000
Financing costs for first year	50 000
Refrigeration system to keep the ice-cream cold	5 000
Painting of name on the sides of delivery vehicle	1 500
Fuel	200

Required

Calculate the initial cost price of the delivery vehicle.

SOLUTION 1

The cost price of the delivery vehicle is calculated as follows:

Cost price of vehicle	400 000
Refrigeration system	5 000
Sign painting	1 500
	406 500

LECTURER'S COMMENT

- Financing costs are not taken as part of the cost price of the asset, but are written off against income over the financing period of the asset.
- Fuel is written off directly as an expenditure item on the statement of profit or loss and other comprehensive income (SOPL-OCI).

5.5.2 Subsequent measurement

STUDY

Study paragraph 6.5 of the prescribed textbook. (Ignore example 8.10.)

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.

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.

Revaluation model (See par 5.7 [revaluation] of this learning unit.)

5.6 DEPRECIATION

STUDY

Study paragraph 7 of the prescribed textbook.

5.6.1 Allocation of cost

In terms of IAS 16, depreciation is a process of **cost allocation**. It 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 paragraph 5.7 in this learning unit 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 (see example 8.1 of the prescribed textbook).

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. **(See par 5.1 and 5.2 of the prescribed textbook.)**

Depreciable amount

Work through example 8.11 of the prescribed textbook.

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. **(Ignore example 8.12 and 8.13 of the prescribed textbook.)**

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.

5.6.2 Useful life

STUDY

Study paragraph 7.2 of the prescribed textbook.

The future economic benefits embodied in an asset are consumed by an entity principally through its use. 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 wear and tear. 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.

Take note: Change in estimate useful life does not form part of this module.

5.6.3 Useful life of land and buildings

STUDY

Study paragraph 7.3 of the prescribed textbook.

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.

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.

5.6.4 Depreciation methods

STUDY

Study paragraph 7.5 of the textbook.

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

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:

(a) 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.
(b) 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.
(c) 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.

Work through example 8.14 of the prescribed textbook.

EXAMPLE 2

Cost of equipment (1 March 20.13)	R400 000
Residual value (remains unchanged)	R25 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 (Assume an annual rate of 50%)
- the sum of the units method

SOLUTION 2

	Annual depreciation	Carrying amount on 28 February
	R	R
(i) Straight-line method: (400 000 – 25 000)/4 = 93 750 annually		
Year 1:	93 750	306 250
Year 2:	93 750	212 500
Year 3:	93 750	118 750
Year 4:	93 750	25 000

Journal:

Year 1:	R	R
Dr Depreciation (P/L)	93 750	
Cr Accumulated depreciation (SFP)		93 750

Year 2 – 4 : Same as above

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

Year 1: (400 000 x 50%)	200 000	200 000
Year 2: (200 000 x 50%)	100 000	100 000
Year 3: (100 000 x 50%)	50 000	50 000
Year 4: (50 000 x 50%)	25 000	25 000

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

Year 1: 4/10 x (400 000 – 25 000)	150 000	250 000
Year 2: 3/10 x (400 000 – 25 000)	112 500	137 500
Year 3: 2/10 x (400 000 – 25 000)	75 000	62 500
Year 4: 1/10 x (400 000 – 25 000)	37 500	25 000

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 to 40 as well as the effect on the current and future periods.

5.6.5 Accounting treatment

STUDY

Study paragraph 7.6 of the prescribed textbook. (Ignore example 8.15.)

The depreciation charge for each period shall be recognised in **profit or loss,** unless it is included in the **carrying amount** of another asset. (See example 3 below.)

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 (depreciation capitalised).

The following serves as an example of what would happen if depreciation is capitalised to the cost price of another asset at initial recognition.

EXAMPLE 3

Capitalisation of depreciation:

1. X Ltd withdrew a crane A from normal construction operations for the period 1 October 19.3 to 31 December 19.3 and used it in the construction of a new plant which was commissioned on 1 January 19.4. X Ltd's financial year-end is 28 February.

2.	Crane A at cost	R200 000
	Crane A at carrying amount on 1 March 19.3	R100 000
3.	Depreciation	
	– cranes	20% on reducing balance
	– plant	2% fixed instalment method
4.	Cost price of new plant	R550 000 before capitalisation of depreciation

Required

Show the journal entries, the profit before tax note, and the property, plant and equipment note in the financial records of X Ltd for the year ending 28 February 19.4.

SOLUTION 3

Total depreciation of crane A

	R
20% on carrying amount for a year (100 000 x 20%)	20 000
Depreciation capitalised	
R20 000 for 3 months (1/10/19.3 – 31/12/19.3) (20 000 x $^{3}/_{12}$)	5 000

	R
Cost price of plant	
Other costs (given)	550 000
Capitalised depreciation	5 000
Total cost price	555 000
Depreciation on plant	
R555 000 x 2% for 2 months (1/1/19.4 – 28/02/19.4)	1 850

Journal entries	**Dr**	**Cr**
	R	**R**
Depreciation	20 000	
Accumulated depreciation on cranes		20 000
Depreciation written off at 20% of carrying amount		
Plant	5 000	
Depreciation		5 000
Depreciation for 3 months capitalised		
Depreciation	1 850	
Accumulated depreciation on plant		1 850
Depreciation written off at 2% on cost price		
Income	16 850	
Depreciation (20 000 – 5 000 + 1 850)		16 850
Depreciation written off to SOPL – OCI		

X LTD
NOTE FOR THE YEAR ENDED 28/2/19.4

Profit was shown after taking the following into account:

	R
Depreciation (see calculation)	16 850
Calculations Depreciation	
– Crane A	15 000
Total depreciation	20 000
Capitalised	(5 000)
– Plant	1 850

NOTE AS AT 28/2/19.4

Non-current assets

	Crane	Plant	Total
	R	R	R
Carrying amount – beginning of the year	100 000	–	100 000
Cost price	200 000	–	200 00
Accumulated depreciation	(100 000)	–	(100 000)
Depreciation for the year	(15 000)	(1 850)	(16 850)
Depreciation capitalised	(5 000)	–	(5 000)
Additions during the year		555 000	555 000
Carrying amount – end of the year	80 000	553 150	633 150
Cost price	200 000	–	200 000
Additions	–	(555 000)	555 000
Accumulated depreciation	(120 000)	(1 850)	(121 850)

5.7 REVALUATION

STUDY

Study paragraph 8 of the prescribed textbook.

5.7.1 Introduction

In terms of the alternative accounting treatment provided for in IAS 16, PPE 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. (Impairment losses are dealt with in later studies.) 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.

5.7.2 Fair value

STUDY

Study paragraph 8.1 of the prescribed textbook.

The revalued amount of property is usually the market value and is usually obtained from independent valuators.

5.7.3 Non-depreciable assets

STUDY

Study paragraph 8.2 of the prescribed textbook.

Work through example 8.16 of the prescribed textbook.

LECTURER'S COMMENT

For the purpose of this module (FAC2601), only the net replacement value basis of revaluation will be examinable.

5.7.4 Revaluation surplus

STUDY

Study paragraph 8.3 of the prescribed textbook.

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 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, in other words, 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 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)
- any restrictions on the distribution of the balance of the revaluation surplus to shareholders (e.g. 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)

Work through example 8.17 of the prescribed textbook.

5.8 DERECOGNITION

STUDY

Study paragraph 10 of the prescribed textbook.

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

(a) on disposal
(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 (e.g. by sale, by entering into a finance lease or by donation).

If, under the recognition principle, 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.

EXAMPLE 8

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.
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.

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 8

Machine 1

	R
Proceed on disposal	210 000
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)	60 000

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)

5.9 DISCLOSURE

STUDY

Study paragraph 11 of the prescribed textbook.

5.9.1 Requirements for the cost and revaluation models

The annual 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 for each class of PPE
(c) the useful lives or the depreciation rates used for each class of PPE
(d) information regarding revaluations
(e) a reconciliation of the carrying amount at the beginning and end of the period showing:

    (i) additions
    (ii) increases resulting from revaluations
    (iii) depreciation
    (iv) other changes

5.9.2 Further disclosure requirements

The annual financial statements shall also disclose:

(a) the existence and amounts of

- restrictions on title
- 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

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 annual 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
(b) accumulated depreciation at the end of the period

5.9.3 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 last revaluation
(b) whether an independent valuator 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)
(d) the revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders (i.e. whether it is considered non-distributable or not)

5.10 COMPREHENSIVE EXAMPLES

Now work through the following examples:

EXAMPLE 9

The following information was taken from the records of A (Pty) Ltd on 1 March 19.8.

	R
Computer equipment – Carrying amount	12 000
Vehicles – Carrying amount	65 000
– Accumulated depreciation	32 000
Furniture and equipment – Carrying amount	34 000
– Accumulated depreciation	14 000
Machinery and plant – Carrying amount	300 000
Land and buildings	100 000
Land	100 000
Buildings	–

Additional information

1. The following rates of depreciation are applicable:

Computer equipment	$33^{1}/_{3}$%	Straight-line
Vehicles	25%	Reducing balance
Furniture and equipment	15%	Reducing balance
Machinery and plant	20%	Straight-line
Buildings	2%	Straight-line

2. Computer equipment was purchased on 28 February 19.7.
3. Machinery has already been depreciated for 2 years.
4. During the year, plant and machinery were used for 3 months to build a new plant. The plant was commissioned on 1 January 19.9. The following expenses were incurred in building the plant and were posted to the various accounts.
   Labour costs R 55 000
   Materials R130 000
5. The land and buildings consist of the factory buildings and offices in Trading Park, Erf 101. Land and buildings are owner occupied. The building was completed on 28 February 19.9 at R1 000 000.
6. Furniture and equipment with a cost price of R10 000 and an accumulated depreciation of R6 000 at 28 February 19.8 was sold for R3 000 on 31 December 19.8. The total amount received was taken to the furniture and equipment sales account.
7. No other transactions regarding non-current assets took place during the year.

Required

Disclose non-current assets and depreciation in the annual financial statements of A (Pty) Ltd for the year ended 28 February 19.9 in order to comply with the requirements

of International Financial Reporting Standards (IFRS) and the Companies Act, 71 of 2008. Ignore the reconciliation of the carrying amount note.

EXAMPLE 10

The following balances were taken from the books of B (Pty) Ltd on 31 December 19.4:

	Accumulated depreciation R	Cost price R
Land	–	185 000
Furniture	60 200	86 000
Catering equipment	36 840	128 400
Motor vehicles	25 400	134 000
Office equipment	8 800	45 300

Additional information

1. Catering equipment to the amount of R41 952 was purchased on 31 March 19.5. VAT of R5 152 was included in the amount. Since B (Pty) Ltd is registered for VAT purposes, this amount can be claimed as an input taxation.
2. A delivery vehicle was sold on 31 August 19.5 for R54 000 (excluding VAT). The cost price and accumulated depreciation at 31 December 19.4 was R74 000 and R12 800 respectively.
3. The company decided to buy an additional photocopy machine for the business. It was calculated that the machine would have a residual value of R4 000. The cost price of the machine at 30 June 19.5 was R28 600 (excluding VAT).
4. Depreciation rates and methods:

   Furniture – sum-of-the-digits method over 4 years
   Catering equipment – 20% per annum, straight-line method
   Vehicles – 20% per annum, reducing balance method
   Office equipment – 10% per annum, reducing balance method

5. Land is situated at Erf 662, Middeltown.
6. All the furniture was purchased on 2 January 19.3.
7. There were no other transactions relating to the non-current assets during the year.

Required

Disclose all the relevant notes in the annual financial statements of B (Pty) Ltd for the year ended 31 December 19.5. Your answer should comply with the requirements of the Companies Act, 71 of 2008 and International Financial Reporting Standards.

SOLUTION 9

A (PTY) LTD

EXTRACT FROM THE STATEMENT OF FINANCIAL POSITION AS AT 28 FEBRUARY 19.9

ASSETS	**Notes**	**R**
Non-current assets	5	1 583 250

EXTRACT FROM THE NOTES FOR THE YEAR ENDED 28 FEBRUARY 19.9

1. Accounting policy

- Depreciation and non-current assets
- Other non-current assets are shown at cost price less accumulated depreciation and are depreciated over their expected life in accordance with the following rates and methods:
- Computer equipment at 33,3% per annum according to the straight-line method.
- Vehicles at 25% per annum according to the reducing balance method.
- Furniture and equipment at 15% per annum according to the reducing balance method.
- Machinery and plant at 20% per annum according to the straight-line method.
- Buildings at 2% per annum according to the straight-line basis.

2. Non-current assets

	Land	**Buildings**	**Computer equip-ment**	**Vehicles**	**Furniture and equip-ment**	**Machinery and plant**	**Total**
	R	**R**	**R**	**R**	**R**	**R**	**R**
Carrying amount – beginning of the year	100 000	–	12 000	65 000	34 000	300 000	511 000
Cost price	100 000		18 000	97 000	48 000	500 000	763 000
Accumulated depreciation	–	–	(6 000)	(32 000)	(14 000)	(200 000)	(252 000)
Depreciation during year	–	–	(6 000)	(16 250)	(5 000)	(82 000)	(109 250)
Additions during the year	–	1 000 000	–	–	–	210 000	1 210 000
Sales at carrying amount	–	–	–	–	(3 500)	–	(3 500)
Depreciation capitalised	–	–	–	–	–	(25 000)	(25 000)
Carrying amount – end of year	100 000	1 000 000	6 000	48 750	25 500	403 000	1 583 250
Cost price	100 000	1 000 000	18 000	97 000	38 000	710 000	1 963 000
Accumulated depreciation	–	–	(12 000)	(48 250)	(12 500)	(307 000)	(379 750)

The land and buildings, situated at Erf 101, Trading Park, consist of factory buildings and offices.

3. The following items are included in profit before tax:

	R
Depreciation (calculation 9)	109 250
Loss on sale of furniture (calculation 5)	500

Calculations

1. Computer	R
Purchased on 28 February 19.7	
Depreciation written off for 1 year (33,33%) 66,66% of cost not yet written off.	
Original cost = $\frac{12\,000}{.6666}$ = 18 000	
Depreciation 18 000 x 33,33% =	6 000
2. Vehicles	
65 000 x 25% =	16 250
3. Furniture	
Furniture sold	500
(10 000 – 6 000) x 15% x $\frac{10}{12}$	
Furniture kept	4 500
(34 000 – 4 000) x 15%	
Total depreciation	5 000
4. Machinery and plant	
Depreciation for 2 years – straight-line (20% x 2 = 40%)	
60% of the cost price must still be written off over the next 3 years (20% per annum on the straight-line basis). Original cost price is	
300 000 x $\frac{100}{60}$ or 300 000 x $\frac{5}{3}$ = 500 000	
500 000 x 20% =	100 000
Capitalised portion	(25 000)
(100 000 x $\frac{3}{12}$)	
	75 000
5. Loss on sale of furniture	
Carrying amount (10 000 – 6 000 – 500)	3 500
Proceeds	(3 000)
Loss	500
6. New plant	
Depreciation capitalised	25 000
Labour costs	55 000
Materials	130 000
Cost price of new plant	210 000
Depreciation (210 000 x 20% x $\frac{2}{12}$)	7 000
7. Total costs of machinery and equipment	
Original cost price (calculation 4)	500 000
New plant (calculation 6)	210 000
	710 000

8. No depreciation was written off on the buildings since it was only completed on 28 February 19.9. Had the building been completed before the end of the year, depreciation had to be calculated on the buildings at 2% per annum on the straight-line basis.

9.

	Calculation	R
Depreciation		109 250
– Computer equipment	1	6 000
– Vehicles	2	16 250
– Furniture and equipment	3	5 000
– Machinery and plant		82 000
Provided	4, 6	107 000
Capitalised portion	4	(25 000)

SOLUTION 10

B (PTY) LTD
NOTES FOR THE YEAR ENDED 31 DECEMBER 19.5

1. Accounting policy
Depreciation and non-current assets

Other non-current assets are shown at cost price less accumulated depreciation and are written off over their expected economic life according to the following rates and methods:

- Furniture according to the sum-of-the-digits method over 4 years
- Catering equipment at 20% per annum according to the straight-line method
- Motor vehicles at 20% per annum according to the reducing balance method
- Office equipment at 10% per annum according to the reducing balance method

2. Non-current assets

	Land	Furniture	Catering equip-ment	Motor vehicles	Office equip-ment	Total
	R	R	R	R	R	R
Carrying amount beginning of year	185 000	25 800	91 560	108 600	36 500	447 460
Cost	185 000	86 000	128 400	134 000	45 300	578 700
Accumulated depreciation	–	(60 200)	(36 840)	(25 400)	(8 800)	(131 240)
Depreciation during year	–	(17 200)	(31 200)	(17 640)	(4 880)	(70 920)
Additions at cost price	–	–	36 800	–	28 600	65 400
Sales at carrying amount	–	–	–	(53 040)	–	(53 040)
Carrying amount end of year	185 000	8 600	97 160	37 920	60 220	388 900
Cost	185 000	86 000	165 200	60 000	73 900	570 100
Accumulated depreciation	–	(77 400)	(68 040)	(22 080)	(13 680)	(181 200)

Land and buildings, situated at Erf 662, Middletown.

3. **The following are included in profit before tax:**

	R
Income	
Profit on sale of motor vehicle	960
Expenses	
Depreciation (calculation 5)	70 920

Calculations

	Depreciation R	Accumulated depreciation R	Cost R
1. Furniture			
Opening balance	–	60 200	86 000
Sum-of-the-digits (4 + 3 + 2 + 1 = 10)			
19.5 ($\frac{2}{10}$ x 86 000)	17 200	17 200	–
	17 200	77 400	86 000
2. Catering equipment			
Opening balance	–	36 840	128 400
Depreciation (128 400 x 20%)	25 680	25 680	–
New purchases			
Cost (41 952 – 5 152)	–	–	36 800
Depreciation (36 800 x $\frac{9}{12}$ x 20%)	5 520	5 520	–
	31 200	68 040	165 200
3. Motor vehicles			
Opening balance	–	25 400	134 000
Motor vehicle sold	–	(12 800)	(74 000)
	–	12 600	60 000
Depreciation on motor vehicle sold [(74 000 – 12 800) x $\frac{8}{12}$ x 20%]	8 160	–	–
Depreciation on remaining motor vehicle [(60 000 – 12 600) x 20%]	9 480	9 480	–
	17 640	22 080	60 000
Profit on sale of motor vehicle [(74 000 – 12 800 – 8 160) – 54 000]			960
4. Office equipment			
Opening balance	–	8 800	45 300
Depreciation [(45 300 – 8 800) x 10%]	3 650	3 650	–
Photocopy machine			
Cost less residual value	–	–	28 600
Depreciation (24 600 x $\frac{6}{12}$ x 10%)	1 230	1 230	–
	4 880	13 680	73 900

		R
5.	Total depreciation	70 920
	Furniture	17 200
	Catering equipment	31 200
	Motor vehicles	17 640
	Office equipment	4 880

FAC2601

LEARNING UNIT 6

INVESTMENT PROPERTY – IAS 40

Financial Accounting
for Companies

Learning outcomes

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

- account for investment property in the annual financial statements of an entity in terms of the requirements of International Financial Reporting Standards (IFRS).

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
- properly disclose investment property and its tax implications in the annual financial statements of a company in accordance with International Financial Reporting Standards

Overview

This learning unit will be discussed under the following sections:

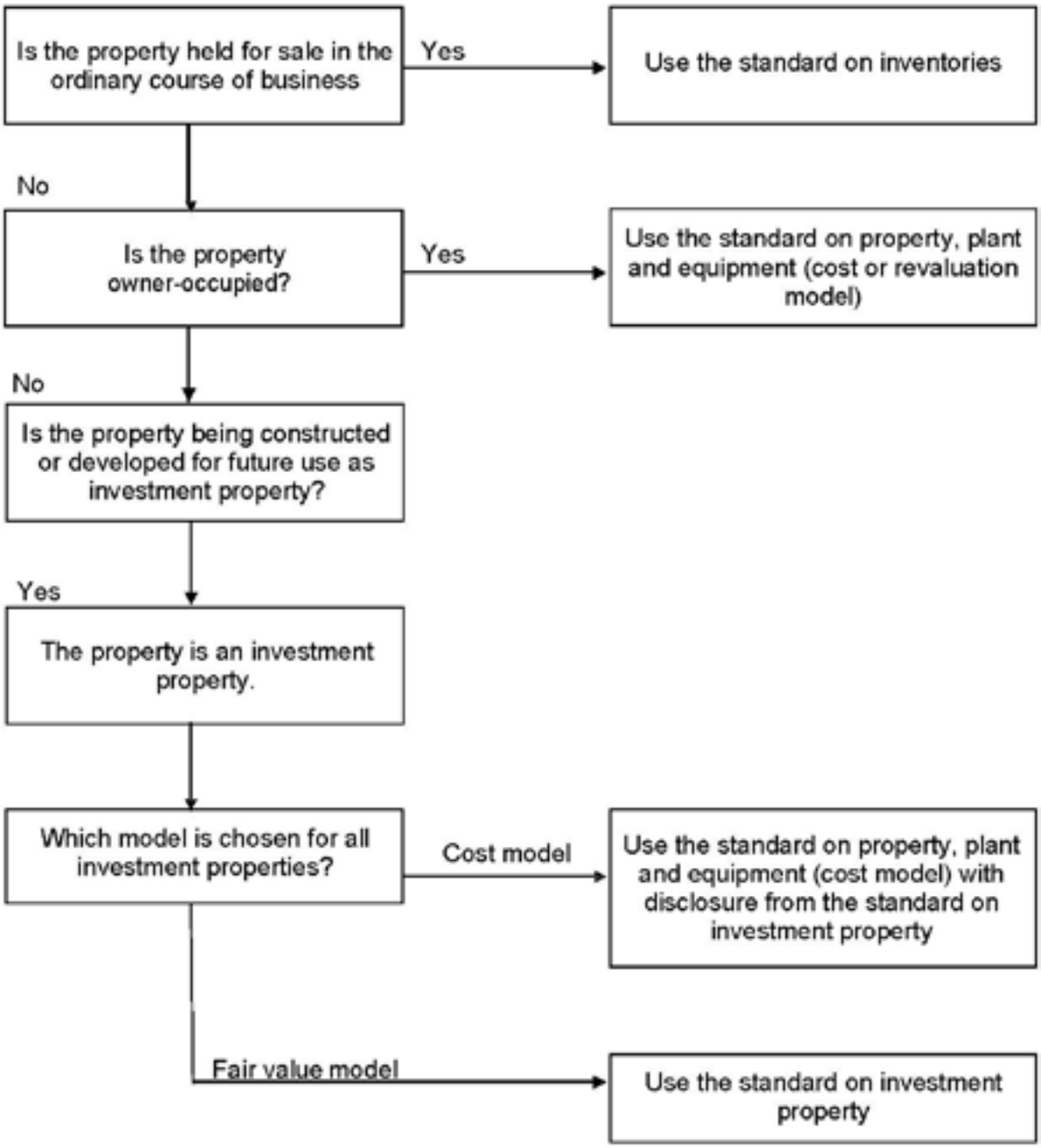
STUDY

PRESCRIBED TEXTBOOK

Introduction to IFRS – Latest edition
Chapter 16

6.1 DECISION DIAGRAM

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



6.2 OBJECTIVE

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

6.3 BACKGROUND

STUDY

Study paragraph 3 of the prescribed textbook.

This standard deals, inter alia, with the measurement in a lessee's annual financial statements of investment property interests held under a finance lease and with the measurement in a lessor's annual 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
(b) mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources (Note that a) and b) do not form part of this module.)

6.4 DEFINITIONS

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 recognised in accordance with the specific requirements of other IFRS.

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

It 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
(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.

6.5 NATURE OF INVESTMENT PROPERTY

STUDY

Study paragraph 4 of the prescribed textbook.

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 5) 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 (not covered on second-year level)
(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)
(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 annual financial statements, because it is owner occupied from the perspective of the group, but in its individual annual financial statements it would be shown as investment property. Group annual financial statements are dealt with in FAC2602.

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. The flatlet 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 eventually construct its head offices on the stand. Tinta Ltd has decided to wait for the final decision of the local council before constructing 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 constructed and that the existing building will then be held until it can be sold for a market-related 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 annual 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.

6.6 RECOGNITION AND INITIAL MEASUREMENT

STUDY

Study paragraph 5 of the prescribed textbook.

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 all its investment property costs at the time they are incurred. These costs include:

- costs incurred initially to acquire an investment property
- 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.

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
(c) abnormal amounts of wasted material, labour or other resources incurred in constructing or developing the property

Work through example 16.1 of the prescribed textbook.

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 15%. The expenditure incurred was necessary because of the neglected state of the property 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 15/115)	(90 704)
Agent's commission	36 600
Legal fees	8 300
Expenditure incurred to upgrade the property	73 000
	722 596

6.7 SUBSEQUENT MEASUREMENT

STUDY

Study paragraph 6 of the prescribed textbook.

6.7.1 Introduction

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 annual 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. IAS 8 will be dealt with in later studies.

6.7.2 Fair value model

STUDY

Study paragraph 6.1 of the prescribed textbook.

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.

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

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 valuator who holds a recognised and relevant professional qualification and has recent experience in the location and category of the investment property being valued.

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.

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.

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
- 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.

In the absence of current prices in an active market, other sources need to be considered.

Work through examples 16.2 and 16.3 of the prescribed textbook.

6.7.3 Cost model

STUDY

Study paragraph 6.2 of the prescribed textbook.

After initial recognition, an entity that chooses the cost model shall measure **all** its investment property at cost less accumulated depreciation and accumulated impairment losses, according to IAS 16 Property, plant and equipment.

Work through example 16.4 of the prescribed textbook.

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 R	Cr 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.

6.7.4 Derecognition

STUDY

Study paragraph 6.4 of the prescribed textbook.

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.

If, in accordance with the recognition principle (see 6.5 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.

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.

Work through example 16.5 of the prescribed textbook.

6.8 DISCLOSURE

STUDY

Study paragraph 7 of the prescribed textbook.

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.
(c) when classification is difficult, 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 annual 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 (statement of profit or loss and other comprehensive income) for:

    (i) rental income from the investment property
    (ii) direct operating expenses (including repairs and maintenance) arising from the investment property that generated rental income during the period
    (iii) direct operating expenses (including repairs and maintenance) arising from the investment property that did not generate rental income during the period
    (iv) the cumulative change in fair value recognised 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) **contractual obligations to purchase, construct or develop investment property or for repairs, maintenance or** enhancements

Fair value model

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) net gains or losses from fair value adjustments
(d) other changes

In the exceptional cases 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
(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
    (iii) the amount of gain or loss recognised

Cost model

In addition to the disclosures required for the fair value model and the cost model (as described above), 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 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) depreciation
    (iii) the amount of impairment losses recognised, and the amount of impairment losses reversed, during the period in accordance with IAS 36 Impairment of assets (Impairment is covered in later studies.)
    (iv) the net exchange differences arising on the translation of the annual 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)
    (v) other changes

6.9 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 for capital appreciation. 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, which 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. 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).

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 (IFRS).

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 annual 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.

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

Building – 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.

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. 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)

4. 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 property was valued by an independent sworn appraiser on 30 June 20.13.

Calculations

1. Property 1 – Land

	Total R	Cost R	Fair value adjustment R
Cost 1 April 20.12	100 000	100 000	–
Fair value adjustment	45 000	–	45 000
Carrying amount 30 June 20.12	145 000	100 000	45 000
Disposal	(145 000)	(100 000)	(45 000)
Carrying amount 30 June 20.13	–	–	–

2. Property 2 – Land

	Total R	Cost R	Fair value adjustment R
Cost 1 July 20.12	500 000	500 000	–
Fair value adjustment	100 000	–	100 000
Carrying amount 30 June 20.13	600 000	500 000	100 000

3. Property 2 – Office building

	Total R	Cost R	Fair value adjustment R
Cost 1 July 20.12	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

4. Property 3 – Land

	Total R	Cost R	Fair value adjustment R
Cost 30 June 20.12	400 000	400 000	–
Fair value adjustment	80 000	–	80 000
Carrying amount 30 June 20.13	480 000	400 000	80 000

5. Property 3 – Building

	Total R	Cost R	Fair value adjustment R
Carrying amount 30 June 20.12	1 420 000	1 420 000	–
Additions due to construction	370 000	370 000	–
Additions	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

6. Property 4 – Land

	Total R	Cost R	Fair value adjustment R
Carrying amount 30 June 20.12	180 000	180 000	–
Carrying amount 30 June 20.13	180 000	180 000	–

7. Property 4 – Building

	Total R	Cost R	Fair value adjustment R
Carrying amount 30 June 20.12	918 000	918 000	–
Depreciation	(51 000)	(51 000)	–
Carrying amount 30 June 20.13	867 000	867 000	–

LECTURER'S COMMENT

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.

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.

The company shows a profit before tax of R450 000, including all the above information, for the year ended 31 December 20.13.

Required

Disclose the following notes to the annual 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. 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. 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 annual financial statements was based on a valuation performed on 31 December 20.13 by an independent valuer.

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 and 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. Net replacement valuations and revaluations are only applicable to non-depreciable assists.
6. Assume all amounts are material.

Required

Disclose the following notes to the annual 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 R	Buildings R	Machinery R	Total R
Carrying amount beginning of the year	790 000	3 324 404	–	4 114 404
Gross carrying amount	790 000	3 750 000		4 540 000
Accumulated depreciation (calc 1)	–	(425 596)	–	(425 596)
Additions	–	–	670 000	670 000
Depreciation (calc 2) (calc 3)	–	(69 643)	(79 342)	(148 985)
Revaluation (calc 4)	60 000	–	–	60 000
Fair value adjustment (calc 5)	–	245 239	–	245 239
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.

Calculations:

Year 1: 1 August 20.5 – 28 February 20.6 = 7 months
4 Years: 1 March 20.6 – 28 February 20.10 = 4 years
Current year: 1 March 20.10 – 30 November 20.10 = 9 months

1. 3 750 000 – 500 000 = 3 250 000
   Year 1: 3 250 000/35 x 7/12 = 54 167 [A]
   4 Years: 3 250 000/34 x 4 years = 371 429 [B]
   Total accumulated depreciation: [A] + [B] = 425 596
2. Current year depreciation: 1 March 20.10 – 30 November 20.10 = 9 months
   3 250 000/35 x 9/12 = 69 643
3. 670 000 x 45 000/380 000 = 79 342
4. 850 000 – 790 000 = 60 000
5. (R3 500 000 – (R3 324 404 – R69 643)) = R245 239 Fair value
6. 900 000 – 850 000 = 50 000
7. 3 560 000 – 3 500 000 = 60 000

FAC2601

LEARNING UNIT 7

LEASES – IFRS 16

Financial Accounting
for Companies

Learning outcomes (IFRS 16)

Learners should be able to account for and disclose leases in the financial statements of lessees ***(only)*** in accordance with the International Financial Reporting Standards (IFRS).

Assessment criteria

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

- recognise a right-of-use asset and a lease liability for all leases at the commencement of the lease or elect not to apply this requirement for short-term leases and leases for which the underlying asset is of low value
- initially measure a right-of-use asset and the lease liability on a present value basis
- calculate the amortisation table using the interest rate implicit in the lease
- subsequently measure the right-of-use asset and lease liability
- record, present and disclose a lease in the financial statements of the lessee according to the requirements of the International Financial Reporting Standards

Overview

This learning unit will be discussed under the following sections:

STUDY

PRESCRIBED TEXTBOOK

Introduction to IFRS – Latest edition

Chapter 9

7.1 SCHEMATIC REPRESENTATION OF IFRS 16

STUDY

Paragraph 2 of the prescribed textbook *Introduction to IFRS – Latest Edition*

Objective
• To ensure that lessees provide relevant information in a manner that faithfully represents those transactions.
Definition
• A lease is a contract, or part of a contract that conveys the right to use an asset (the underlying asset) for a period of time (lease term) in exchange for consideration.
Identifying a lease
• Assess at inception of a contract whether the contract is, or contains, a lease. • A contract is, or contains a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration, meaning that the customer has both of the following: – the right to obtain substantially all of the economic benefits from use of the identified asset – the right to direct the use of the identified asset
Accounting by lessee
• Single lessee accounting model • Recognise a right-of-use asset and a lease liability for all leases at the commencement of the lease or elect not to apply this requirement for short-term leases and leases for which the underlying asset is of low value. • Initially measure a right-of-use asset and the lease liability on a present value basis. • Include initial direct costs, lease payments made at or before the commencement date, less any lease incentives received, and estimates of costs to be incurred by the lessee in dismantling and removing the underlying asset or restoring the site on which it is located, in the carrying amount of the right-of-use asset. The lease payments shall be discounted over the lease term using the interest rate implicit in the lease, if that rate can be readily determined. If this rate cannot be readily determined, the lessee shall determine and use its own incremental borrowing rate. • Subsequently measure a right-of-use asset similarly to other non-financial assets. • Subsequently measure the lease liability similarly to other financial liabilities.

7.2 IDENTIFYING A LEASE

STUDY

Study paragraph 3 of the prescribed textbook.

IFRS 16 Leases will be applied if a contract contains a lease.

Therefore, at inception of a contract, an entity will need to determine whether a contract is or contains a lease. As per the lease definition, a contract is or will contain a lease when the contract conveys:

- **the right to control the use** of an **identified asset**
- for a **period of time**
- in exchange for **consideration**

A contract conveys the **right to control the use** of an identified asset for a period of time when the customer (lessee) has both of the following:

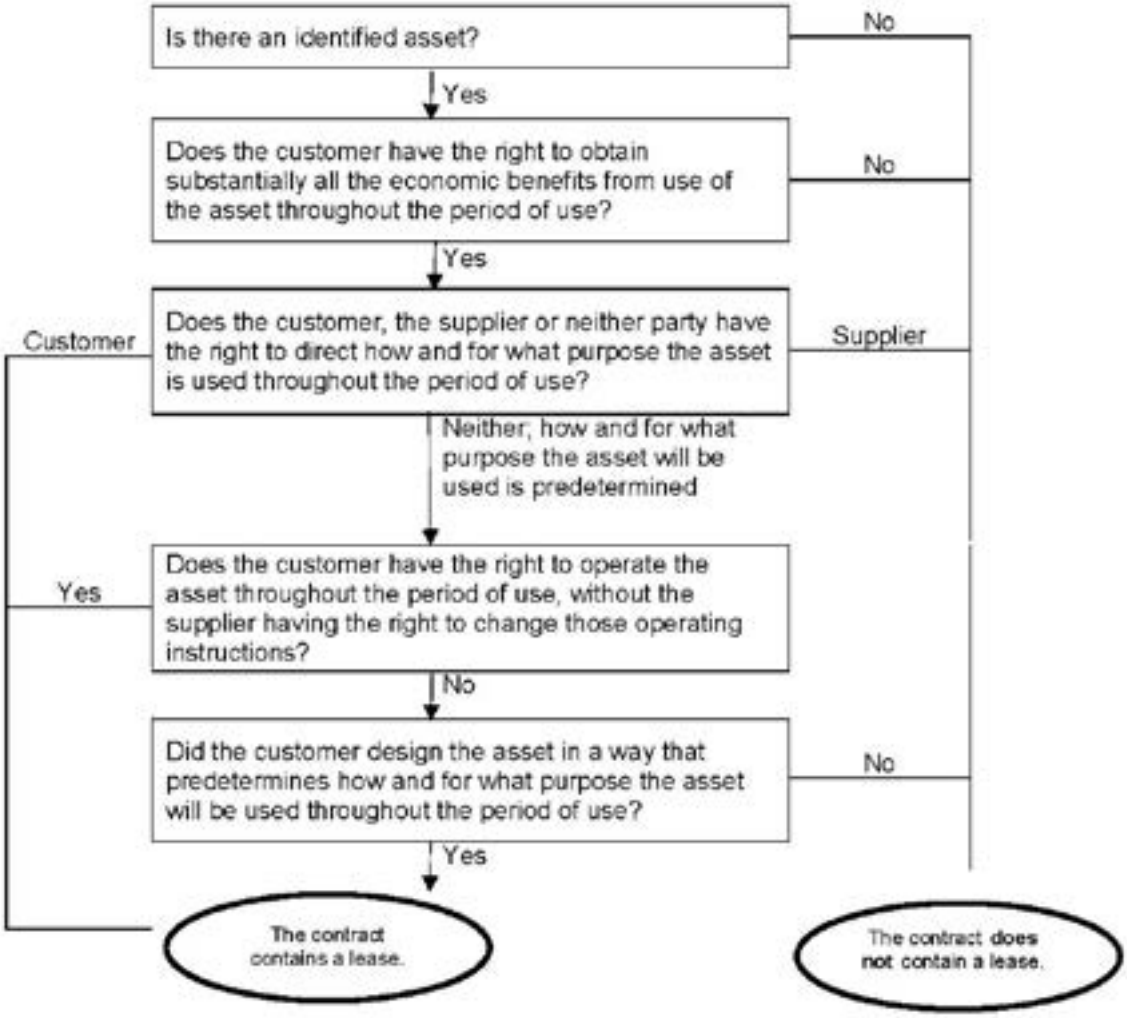
- the right to obtain substantially all economic benefits from the identified asset
- the right to direct the use of the identified asset

If a customer only has the right to control the use of an asset for a portion of the term of the contract, only that portion of the contract will contain a lease.

A period of time refers to the time or amount of use of an identified asset (e.g. the number of production units that the equipment will be used to produce).

An entity is only required to reassess whether a contract is or contains a lease when the terms or conditions of the lease have changed.

7.2.1 Steps to follow to determine whether a contract contains a lease



Source: IFRS 16.B31

EXAMPLE 1: Does a contract contain a lease?

Sunshine Ltd (lessee) entered into a contract with Energex Ltd (lessor) to rent property space of 20 m^2 of Energex Ltd's 100 m^2 property to sell its solar panel for a period of three years. Energex Ltd has the right to change the location allocated to Sunshine Ltd at any time during the period of use. There are minimal costs to Energex Ltd associated with changing the space used by Sunshine Ltd. Sunshine Ltd makes use of a mobile truck (which it owns) to sell solar panels that can be easily moved. Sunshine Ltd will pay Energex Ltd R8 500 per month to make use of the property space.

Required

Discuss if the contract between Sunshine Ltd and Energex Ltd contains a lease.

SOLUTION 1

As per IFRS 16 Leases, a contract contains a lease when the contract conveys the following:

- the right to control the use of an identified asset
- for a period of time
- in exchange for consideration

Discussion of lease definition components:

Right to control the use of an identified asset

As per IFRS 16 Leases, a contract conveys the right to control the use of an identified asset when the customer (lessee) has both of the following:

- the right to obtain substantially all economic benefits from the identified asset
- the right to direct the use of the identified asset

The contract specifies the amount of property space that Sunshine Ltd is entitled to use of the entire property space owned by Energex Ltd. However, the property space is not fixed and as a result there is **no identified asset.**

Even though Sunshine Ltd controls its owned mobile truck, the contract is for property space on Energex Ltd's property and has the right to change the property space allocated at any time. Sunshine Ltd does not control the asset because:

- Sunshine Ltd does not have substantially all the economic benefits from the property space. Energex Ltd could benefit economically from substituting the property space as there are minimum costs involved in moving the mobile truck used by Sunshine Ltd. Energex Ltd benefits from substituting the property space at its own property for something else that will be most effective in increasing its own economic benefits.
- Energex Ltd has the right and practical ability to change the property space used by Sunshine Ltd anytime during the entire period, thereby directing the use.

For a period of time

- The contract is for a three-year period.

In exchange for consideration

- Sunshine Ltd will pay Energex Ltd an amount of R8 500 per month.

Conclusion:

There is no identified asset and Sunshine Ltd does not have the right to control an identified asset. Not all the conditions have been met and as a result, the **contract does not contain a lease**.

EXAMPLE 2: Does the contract contain a lease?

Boat Ltd (customer) is a manufacturer of luxury motorboats. On 1 June 20.12, Boat Ltd (lessee) singed a long-term agreement with Part Ltd (supplier). In terms of the agreement,

Part Ltd must supply portholes to Boat Ltd daily for a period of ten years. To ensure that Part Ltd fulfils its obligations in terms of the agreement, the management of Part Ltd decided to construct a plant for manufacturing portholes on the premises of Boat Ltd. The close proximity of the plant will ensure that portholes can be supplied as and when needed by Boat Ltd.

Other relevant matters:

- To ensure the continuous availability of portholes, the arrangement stipulates that Boat Ltd must pay an annual fixed charge of R150 000 (at the end of the year) to Part Ltd.
- Since the portholes are unique, the plant has no other purpose and will be demolished at the end of the agreement.
- The purchases by Boat Ltd for the first year of production amounted to 500 portholes at R2 500 per unit – not yet transferred to work-in-progress.
- The incremental borrowing rate of Boat Ltd is 11,5% per annum.

Required

Discuss whether the contract between Boat Ltd and Part Ltd contains a lease.

SOLUTION 2

As per IFRS 16 Leases, a contract contains a lease when the contract conveys the following:

- a right to control the use of an identified asset
- for a period of time
- in exchange for consideration

Discussion of lease definition components:

Right to control the use of an identified asset

As per IFRS 16 Leases, a contract conveys the right to control the use of an identified asset when the customer (lessee) has both of the following:

- the right to obtain substantially all economic benefits from the identified asset
- the right to direct the use of the identified asset

There is an identified asset:

- Although the portholes manufacturing plant is not mentioned in the long-term agreement between Boat Ltd and Part Ltd, this asset is implicitly specified, because for Part Ltd to fulfil the requirements of the agreement, it must erect the plant. It is also unlikely that Part Ltd can/would substitute the plant with an alternative plant. Part Ltd would also not benefit economically from substituting the asset – the costs associated with substituting the plant would be too high.
- Boat Ltd has the right to obtain all the economic benefits from the plant – the portholes are unique and Boat Ltd is the only user thereof.

- Boat Ltd has the right to direct how and for what purposes the plant is used throughout the period of use – Boat Ltd has the decision-making rights to, for example, change the type of portholes that is produced, whether portholes are produced and how many are produced.

Boat Ltd has the right to control the use of the plant throughout the ten-year period of use because:

- The plant is an identified asset, a manufacturing plant.
- **Boat Ltd has the right to obtain substantially all the economic benefits** from the use of the manufacturing plant over the ten-year period of use. Boat Ltd has exclusive use of the plant throughout the period of use.
- Within the scope of its right of use defined in the contract, **Boat Ltd makes the relevant decisions about how and for what purpose** portholes are used by being able to decide, for example, the change of type of portholes, whether portholes are being produced and how many. Boat Ltd has the right to change these decisions during the ten-year period of use.

Therefore, Boat Ltd has the right to benefit economically from the manufacturing plant and has the right to direct the use thereof.

For a period of time

- The contract is for a ten-year period.

In exchange for consideration

- Boat Ltd will pay Part Ltd an annual fixed amount of R150 000 at the end of the year.

Conclusion:

All the conditions of the lease definition have been met. The arrangement coveys the right to Boat Ltd to control the use of the plant and it can be concluded that the arrangement contains a lease.

7.2.2 Separating components of a contract

STUDY

Study paragraph 4 of the prescribed textbook.

Each lease component within a contract that is, or contains, a lease must be accounted for as a lease separately from the non-lease components of the contract. This **does not** apply to entities applying the practical expedient. As a practical expedient, lessees don't have to separate non-lease components from lease components, and instead account for each lease component and any associated non-lease components as a single lease component.

The right to use an underlying asset is a separate lease component if both of the following criteria are met:

- The lessee can benefit from use of the underlying asset either on its own or together with other resources that are readily available (goods and services that are sold or leased separately or resources that the lessee has already obtained) to the lessee.
- The underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying asset in the contract.

The lessee may elect (as a practical expedient), by class of underlying asset, not to separate the non-lease components from the lease component.

Components of contract

Lessee **does not elect** practical expedient.	Lessee **elects** practical expedient.
For contracts that contain a lease component and one or more additional lease or non-lease components, the lessee is required to: • **Allocate** the **consideration** in the contract to each **lease component** on the basis of the **relative stand-alone price** of the **non-lease components** • Account for non-lease components applying other applicable standards.	The lessee accounts for lease and non-lease components as a single lease component. • Lease liability will increase with the non-lease components (which will result in an increase in the right-of-use-asset).

Relative stand-alone prices

The relative stand-alone price of lease and non-lease components is determined on the basis of the price the lessor, or a similar supplier, would charge an entity for that component, or a similar component.

IF an observable stand-alone price is **not available**, the **lessee** will estimate the stand-alone price, maximising the use of observable information.

Work thoroughly through example 9.1 of the prescribed textbook.

7.2.3 Lease term

STUDY

Study paragraph 5 of the prescribed textbook.

An entity will determine the lease term as the non-cancellable period of a lease together with both the:

- period covered by an option to **extend** the lease if it is **reasonably certain** the lessee will exercise that option; and
- periods covered by an option to **terminate** the lease if it is **reasonably certain** the lessee will **not** exercise that option.

The lease term begins at the commencement date and includes any rent-free periods provided to the lessee by the lessor. The **commencement date** of the **lease** is the date on which a lessor makes an underlying asset available for use by a lessee.

7.3 RECOGNITION AND MEASUREMENT: LESSEE

STUDY

Study paragraph 6 of the prescribed textbook.

Legally, the lessee is not the owner of the leased asset and is not required to take ownership of the leased asset at the end of the lease term. However, the **substance** of the agreement and its financial reality is that the lessee obtains the **right to use the asset** to generate economic benefits for itself over the lease term. For this reason, the lessee is required to recognise both:

- an asset (right-to-use asset) and;
- a liability (lease liability);

on its statement of financial position for all assets leased by it under lease agreements.

7.3.1 Recognition exemptions

A **lessee may elect** not to recognise underlying assets and liabilities for:

- Leases of 12 months or less (short-term leases); and
- Leases for which the underlying assets are low-value assets, for example tablets, personal computers and small office furniture and items.

> **"Low value"** = IFRS 16.BC100 states that assets, when new, with a value of $5 000 would be considered low-value assets.

Assets that are *highly dependent, highly interrelated* with other assets **will not qualify** as low-value assets.

For the exam

We will always state in a question if an asset is a low-value asset and whether or not the company applies the recognition exemption to its low-value and short-term assets.

7.3.1.1 Short-term leases

An option to extend or the terminate a lease that is reasonably certain to be exercised should be considered when determining whether the lease term is 12 months or less. A lease that contains a purchase option is not a short-term lease.

When the recognition exemption is considered, low-value assets should elect the exemption on a lease-by-lease basis and short-term assets by class of underlying assets.

7.3.1.2 Low-value underlying assets

An underlying asset can also only be of low value if:

- The lessee can benefit from the use of the underlying asset on its own or in combination with other resources that are readily available to the lessee; and
- The underlying asset is not highly dependent on, or highly interrelated with, other assets

When the recognition exemption is elected, the accounting treatment for these specific short-term and low-value assets are as follows:

Recognition of lease payments

The lessee will recognise the lease payments associated with leases as an expense on:

- Straight-line basis over the lease term; or
- Another systematic basis if it is more representative of the pattern of the lessee's benefit

Where the straight-line basis is used and cash flows are not equal, the difference between the cash flows and the expense in the statement of profit or loss and other comprehensive income will end up in the statement of financial position as an accrued or prepaid expense.

Disclosure

- A lessee must disclose the following amounts in a tabular format for the reporting period, unless another format is more appropriate:
  - The expense relating to the short-term lease. This expense may exclude leases with a lease term of one month or less;
  - The expense relating to leases of low-value assets, excluding expenses relating to short-term leases included above;
  - Total cash outflow for leases.
- A lessee shall disclose additional qualitative and quantitative information about its leasing activities necessary to give users of the Annual Financial Statements a basis to assess the effect of the lease on the lessee.
- A lessee that accounts for short-term leases or leases of low-value assets applying the exemption criteria of 7.3.1 must state that fact.
- A lessee is required to disclose the amount of its lease commitments for short-term leases if the portfolio of short-term leases to which it is committed at the end of the

reporting period is different to the portfolio of short-term leases to which the short-term lease expense is already disclosed in terms of the disclosure above.

Work thoroughly through examples 9.2 and 9.3 of the prescribed textbook.

7.3.2 Initial measurement of a lease: Lessee

STUDY

Study paragraphs 6.2 and 6.3 of the prescribed textbook thoroughly.

At commencement of the lease, a lessee shall recognise a right-of-use asset (e.g. machinery) and a lease liability (future lease instalments payable) in its statement of financial position.

LESSEES	
RIGHT-OF-USE OF ASSET	**LEASE LIABILITY**
Initial recognition:	**Initial recognition:**
At commencement date, the lessee will recognise the right-of-use asset at cost.	At commencement date, the lessee will recognise the lease liability at the present value (using the interest rate implicit in the lease of the lease payments not paid at that date).
Cost comprises: • the amount at which the lease liability is initially measured • any lease payments made at or before the commencement date, excluding any lease incentives received • **initial direct costs** incurred by the lessee • an estimate of the costs that will be incurred by the lessee to dismantle or remove the underlying asset, restoring the site on which the asset is located or restoring the underlying asset to the condition required in terms of the lease, unless those costs are incurred to produce inventory	*Lease payments used to measure the lease liability comprise:* • fixed payments (includes in-substance fixed payments) less lease incentives receivable • variable lease payments that depend on an index or a specific rate, initially to be measured using the index or rate as at commencement date • amounts payable in terms of residual value guarantees • exercise price of a purchase option if it is reasonably certain that the lessee will exercise that option • penalty payments for terminating the lease

Work thoroughly through examples 9.5 to 9.9 of the prescribed textbook.

7.3.3 Interest rate implicit in the lease

STUDY

Study paragraph 6.3.2 of the prescribed textbook.

The interest rate implicit in the lease is calculated from the perspective of the **lessor** and therefore takes the unguaranteed residual value into account.

The **interest rate implicit in the lease** is the rate of interest that causes the present value of:

- the lease payments; and
- the unguaranteed residual value

to equal the sum of the FV of the underlying asset and any **initial direct costs of the lessor,** for example legal costs and commissions in negotiating and arranging a lease. Consequently, both the guaranteed residual value and the unguaranteed residual value are taken into account when calculating the interest rate implicit in the lease.

Work thoroughly through example 9.10 of the prescribed textbook.

See annexure A (at the end of this learning unit) for examples and explanations on amortisation tables, interest rates and present value calculations.

7.3.4 Subsequent measurement of a lease: Lessee

STUDY

Study paragraphs 6.4 and 6.5 of the prescribed textbook thoroughly.

RIGHT-OF-USE OF ASSET	LEASE LIABILITY		
Subsequent measurement:	**Subsequent measurement:**		
After the commencement date of the lease, the lessee will measure the right-of-use asset applying the **cost model** UNLESS another measurement model applies. *Cost* Right-of-use asset measured at **cost**. • Less accumulated depreciation; • Less accumulated impairment (IAS 36); AND • Adjusted for any remeasurement of the lease liability (e.g. to reflect lease modifications or revised in-substance fixed lease payments). *Other measurement models* Right-of-use asset measured at **fair value** if: • Right-of-use assets meets IAS 40 *Investment property* definition; **AND** • Lessee accounts for investment property on the fair value model. • Revaluation Model: (Excluded from FAC2601)	After commencement date, the **lease liability is measured by:** • Increasing the carrying amount to reflect interest on the lease liability; • Reducing the carrying amount to reflect the lease payments (PMT) made; and • Remeasuring the carrying amount to reflect lease modifications or revised in-substance fixed lease payments. **The following** will be **included in profit/loss, UNLESS** it is included in the carrying amount of another asset**:** • Interest on the lease liability; AND • Variable lease payments not included in the measurement of the liability in the period in which the event or condition that triggers those payments occur.		
	DR Finance costs (P/L) DR Lease liability (SFP) CR Bank (SFP) *Payment of lease instalment on….* ***OR*** *DR Finance costs (P/L)* *CR Bank (SFP)* *DR Lease liability (SFP)* *CR Bank (SFP* *Payment of lease instalment on….* DR Variable lease payments expenses (P/L) CR Bank (SFP) *Payment of variable lease payments on …..*	xx xx xx xx xx xx xx	 xx xx xx xx

A lease gives rise to a depreciation expense for the leased asset (e.g. depreciation on machinery) as well as a finance cost for each accounting period. The depreciation policy for depreciable leased assets should be consistent with that for depreciable assets which are owned, and the depreciation recognised shall be calculated in accordance with IAS 16 Property, plant and equipment, IAS 38 Intangible Assets and IAS 40 Investment Property.

The right-of-use asset is depreciated over its useful life if ownership transfers at the end of the lease term. If the transfer of ownership is not certain, the right-of-use asset shall be depreciated over the shorter of its useful life or lease term.

Work thoroughly through examples 9.11 of the prescribed textbook.

7.3.5 Reassessment of lease liability: lessee

STUDY

Study paragraph 6.6 of the prescribed textbook.

If lease payments **change after** the commencement date, the lease liability should be remeasured to reflect such changes. The amount of the remeasurement of the lease liability is an adjustment to the right-of-use asset, limited to Rnil (the remaining amount shall be recognised in profit or loss).

A lessee shall remeasure the lease liability by discounting such revised lease payments using an **unchanged discount rate, if:**

- There is a change in the amounts expected to be payable under a **residual value guarantee; or**
- There is a change in future lease payments to reflect market rates (e.g. based on a market rent review) or **a change in an index or rate used to determine** the lease payments.

Work thoroughly through example 9.12 of the prescribed textbook.

7.4 PRESENTATION AND DISCLOSURE: LESSEE

IFRS 16 Leases requires an entity to disclose information relating to its leases for which it is a lessee in a separate note or section in the financial statements. However, lessees are not required to duplicate information disclosed elsewhere, provided that the information is cross-referenced in the single note or separate section.

- A lessee must disclose the following amounts in a tabular format for the reporting period, unless another format is more appropriate.

  (a) Depreciation charge for right-of-use assets by class of underlying asset;
  (b) Interest expense on lease liabilities;

(c) Expenses relating to variable payments not included in the measurement of the lease liabilities;
(d) Income from subleasing right-of-use assets;
(e) Total cash outflow for leases;
(f) Additions to right-of-use assets;
(g) Gains or losses arising from sale and leaseback transactions (only examinable on postgraduate level); and
(h) The carrying amount of right-of-use assets at the end of the reporting period.

Please see 7.3.1 for the disclosure required when the lessee has elected to make use of recognition exemptions for the lease of low-value assets and short-term leases.

- For right-of-use assets that meet the definition of investment property, a lessee will apply IAS 40 Investment property disclosure requirements. In this case, the disclosures above (a,d,f,h) are not required.
- For right-of-use assets revalued amounts applying IAS 16 Property, plant and equipment, the lessee will apply IAS 16 disclosure requirements relating to revalued assets. **(Excluded from FAC 2601).** ***Revaluations are only dealt with regards to non-depreciable assets.***
- A lessee must disclose a maturity analysis of lease liabilities by applying IFRS 7 Financial instruments: Disclosures, separately from the maturity analyses of other financial liabilities that show the remaining contractual maturities.
- A lessee shall disclose additional qualitative and quantitative information about its leasing activities. This information may include, but is not limited to, information that help users of financial statements to assess:
  - The nature of the lessee's leasing activities;
  - Future cash outflows to which the lessee is potentially exposed that are not reflected in the measurement of lease liabilities. This includes exposure arising from:
    - ◊ Variable lease payments;
    - ◊ Extension and termination options;
    - ◊ Residual value guarantees; and
    - ◊ Lease not yet commenced to which the lessee is committed.
  - Restrictions or covenants imposed by leases; and
  - Sale and leaseback transactions.

DISCLOSURE EXAMPLE – LESSEE (See example 9.13 in the prescribed textbook.)

NOTES FOR THE YEAR ENDED 31 DECEMBER 20.16

1. Leases

1.1 Right-of-use assets	**Equipment**	**Total**
	R	**R**
Carrying amount at beginning of year	xxx	Xxx
Additions	xxx	Xxx
Depreciation for the year	xxx	Xxx
Adjustments for lease remeasurements	xxx	Xxx
Adjustments for lease modifications	xxx	Xxx
Carrying amount at end of year	xxx	Xxx

1.2 Maturity analysis of future lease payments outstanding at the reporting date

	20.16
Future lease payments (undiscounted)	R
– For 20.17	Xxx
– For 20.18	Xxx
– For 20.19	Xxx
– For 20.20	Xxx
– Remaining years after 20.20	Xxx
Total future lease payments	Xxx
Total future finance costs	(xxx)
Lease liability	Xxx
Short-term portion presented under current liabilities	Xxx
Long-term portion presented under non-current liabilities	Xxx

1.3 Potential future lease payments relating to periods following the exercise date of termination options are summarised below:

	Lease liabilities recognised (discounted)	Payable during 20.20 – 20.21 (undiscounted)	Payable during 20.22	Total
Business segment	xxxx	xxxx	xxxx	Xxxx
Business segment A	xxx	xxx	xxx	Xxx
Business segment B	xxx	xxx	xxx	Xxx
Total	xxxx	xxxx	xxxx	Xxxx

1.4 Income and expenses related to leases

Income	R
Income from subleasing right-of-use assets	Xxx
Gain from sale and leaseback (will only be tested on postgraduate level)	Xxx
Expenses	
Variable lease payments	Xxx
Short-term lease expense – recognition exemption	Xxx
Low-value lease expense – recognition exemption	Xxx

X Ltd elected the recognition exemption on short-term leases of office equipment (example) and low-value leases of office furniture (example).

2. Finance cost

	R
Finance cost on financial liabilities	Xxx
Finance cost on lease liabilities	Xxx
Other finance costs	Xxx
Borrowing cost capitalised	(xxx)
Finance costs capitalised in profit or loss	**Xxx**

Borrowing cost has been capitalised to qualifying assets using a capitalisation rate of x,xx% per annum. The portfolio of short-term leases to which X Ltd is committed at

31 December 20.16 is similar to the portfolio of short-term lease expenses recognised during the year.

Disclosure of finance costs

Finance costs can be disclosed as a separate note as shown above or as part of the profit before tax note.

7.5 COMPREHENSIVE EXAMPLES: LESSEE

EXAMPLE 3 – Low-value assets – recognition exemption

Acca Ltd entered into a contract with Beta SA Ltd to make use of a specialised printer and computer, starting on 1 January 20.17. The contract meets the requirements of a lease in terms of IFRS 16 Leases. The asset is classified as a low-value asset. Acca Ltd makes use of the recognition exemption in terms of IFRS 16 Leases, for all short-term and low-value assets.

The terms of the lease are as follows:

Lease term	4 years
Initial payment	R1 440
Instalment payable monthly in arrears:	
Months 1–24	R800
Months 25–48	R600
The lessee incurred R500 in legal fees for negotiating the lease.	
Useful life of computer and the printer:	3 years

Required

(a) Discuss the accounting treatment of Acca Ltd for the year ended 31 December 20.17.
(b) Calculate:

1. Equalised monthly instalments
2. Prepaid expense or accrued expense as at 31 December 20.17
3. Prepaid expense or accrued expense as at 31 December 20.18

(c) Disclose the low-value lease asset in the following notes to the annual financial statements of Acca Ltd for the year ended 31 December 20.18.

- Prepaid expense
- IFRS 16 Leases (low-value assets)

Your answers must comply with the International Financial Reporting Standards (IFRS).

Ignore any income tax and VAT implications.

Round all amounts to the nearest rand.

SOLUTION 3

(a) Discussion of accounting treatment

As per IFRS 16 Leases, a lessee may elect to apply the recognition exemption to short-term leases (less than 12 months) and low-value assets (less than $5 000). It is the policy of Acca Ltd to apply the recognition exemption to all short-term and low-value assets.

As per IFRS 16 Leases, low-value assets are accounted for on a lease-by-lease basis.

Recognition

When the recognition exemption is applied, the lessee will recognise the lease payments on a low-value asset lease as an expense on:

- A straight-line basis over the lease term; or
- Another systematic basis if it is more representative of the pattern of the lessee's benefit.

The lessee will only consider the lease to be a new lease when:

- There is a lease modification; or
- There is any change in lease term.

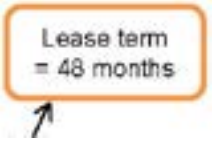
Conclusion:

The lease payments for low-value assets must be recognised as an expense on a straight-line basis over the lease term of four years, as Acca Ltd elected to make use of the recognition exemption.

(b) Calculations

1. The equalised monthly instalment is calculated as follows:

	R
Initial payment	1 440
Instalments: 1–24 months (24 x 800)	19 200
Instalments: 25–48 months (24 x 600)	14 400
	35 040
Equalisation of lease instalments **per month** (35 040/48)	730



The implication of the equalisation of lease payments is that a portion of lease payments will be a prepaid expense or accrued expense in the statement of financial position.

2. *At the end of the first year (31 December 20.17):*

	R
Initial payment	1 440
Instalments paid (12 x 800)	9 600
Total lease instalments paid in cash for the first year	11 040
Equalised lease expense **per year** (730 [C1] x 12 months)	8 760
Prepaid expense (asset) (SFP) (11 040 – 8 760)	2 280

The initial direct cost of R500 is expensed immediately in profit or loss (P/L).

3. *At the end of the second year (31 December 20.18):*

	R
Instalments paid (12 x 800)	9 600
Equalised lease expense **per year** (730 [C1] x 12 months)	8 760
Prepaid expense (asset) (9 600 – 8 760)	840
Prepaid expense balance 20.17	2 280
Prepaid expense asset (SFP) 20.18	3 120

Prepaid expense versus accrued expense

A company will recognise a prepaid expense for lease payments when the **actual** annual lease payment **paid exceeds** the annual **equalised** lease payment.

A company will recognise an accrued expense for lease payments when the **actual** annual lease payment **paid is less than** the annual **equalised** lease payment.

If the monthly instalments from example 3 were changed as follows:

Initial payment	1 440
1 – 24 months	600
25 – 48 months	800

the equalised lease payment would still be R730 per month; however, the equalised lease payment of R8 760 (R730 x 12) would be **more** than the actual lease expense of R8 640 (1 440 + 600 x 12). This difference of R120 is an accrued expense for the year ended 31 December 20.17.

(c) Disclosure

ACCA LTD
NOTES TO THE ANNUAL FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 20.18.

2. Prepaid expenses

	20.18 R	20.17 R
Low-value asset lease: prepaid expense [C2 & C3]	3 120	2 280

3. Leases

3.1 Income and expenses related to leases

Expenses		
Low-value lease expense – recognition exemption [C2]	8 760	8 760

Acca Ltd elected the recognition exemption on low-value leases of office equipment.

Important

The computer and printer are not recognised as right-of-use assets. As a result, no depreciation is recognised for the low-value assets.

EXAMPLE 4 – Contract is a lease in terms of IFRS 16

Scottle Ltd entered into a contract with Throttle Ltd on 1 January 20.17, whereby Throttle Ltd will lease a machine for a period of four years. The cash selling price and fair value of the machine was R400 000 on 1 January 20.17 and the instalments amount to R132 000 and are payable annually in **arrears**. The interest rate implicit in the lease is 12.1104% per year. Ownership of the machine will transfer to Throttle Ltd at the end of the lease term at no additional cost. The contract is classified as a lease in terms of IFRS 16 Leases.

The machine has a useful life of five years and it is the company's policy to depreciate the machine over its useful life on the straight-line basis.

The company financial year-end is 31 December.

Required

(a) Calculate the value of the right-of-use asset and the corresponding liability for Throttle Ltd.
(b) Prepare the journal entries in the accounting records of Throttle Ltd for the year ended 31 December 2017.

Your answers must comply with the International Financial Reporting Standards (IFRS).

Round all amounts to the nearest rand.

SOLUTION 4

(a) Calculations:

Right-of-use asset (machine)	**R**
Initial measurement of the lease liability	*400 000
Initial direct costs of lessee	–
Lease payments made at or before commencement date less any incentive received	–
Estimate of dismantling costs	–
	400 000
Lease liability	
Present value of lease payments not paid at lease commencement date	*400 000

* The present value of the lease payments is calculated as follows:

N = 4 (1 payment per year x 4 years) ← Set HP and Sharp EL-738 calculators on 1P/YR, as there is one instalment payable per year.
PMT = 132 000
FV = 0 + 0 (guaranteed and unguaranteed residual values)
I = 12,1104% p.a.
PV = ? 400 000 ← Present value is equal to the fair value of the machine.

Exam hint

Please show calculations for all the amounts used in journals or disclosure so that the marker can follow your calculations and award the marks!

(b) Journals as at:

	DR	CR
1 January 2017	**R**	**R**
Right-of-use asset: Machine (SFP)	400 000	
Lease liability (SFP)		400 000
Recognition of right-of-use asset and lease liability		
31 December 2017		
Depreciation (P/L)	80 000	
Accumulated depreciation (SFP) (400 000/5)		80 000
Recognition of depreciation for the year		
Finance costs (P/L)	48 442	
Lease liability (SFP) (400 000 x 12,1104% x 12/12)		48 442
Recognition of finance costs that accrued from 1 January 2017 – 31 December 2017		
Lease liability (SFP)	132 000	
Bank (SFP)		132 000
Payment of lease instalment on 31 December 20.17		

The lessee obtains ownership at the end of the lease term; therefore use the remaining useful life.

OR

Finance costs (P/L)	48 442	
Lease Liability (SFP)	83 558	
Bank (SFP)		132 000
Payment of lease instalment on 31 December 20.17		

EXAMPLE 5 – amortisation table

Bun Ltd entered into a contract with Doughnut SA Ltd on 1 March 20.16 whereby Doughnut SA Ltd will lease a specialised oven to Bun Ltd. The contract meets the requirements of a lease in terms of IFRS 16 Leases.

The terms of the lease are as follows:

Lease term	4 years
Initial payment	R144 000
Instalment payable monthly in arrears	R20 000
Useful life of oven	6 years
The lessee's incremental borrowing rate on 1 March 20.16:	8% per annum

The lessee incurred R4 800 in legal fees for negotiating the lease. It is impracticable for the lessee to calculate the costs incurred by the lessor and as a result the interest rate implicit in the lease cannot be calculated.

Required

(a) Calculate the value of the right-of-use asset and the corresponding lease liability for Bun Ltd at initial recognition.
(b) Prepare the journal entries in the accounting records of Bun Ltd for the year ended 28 February 20.17.

Your answers must comply with the International Financial Reporting Standards (IFRS).

Round all amounts to the nearest rand.

SOLUTION 5

(a) Calculations:

Right-of-use asset (Oven)	**R**
Initial measurement of the lease liability	*819 238
Initial direct costs of the lessee	4 800
Lease payments made at or before commencement date less any incentive received	144 000
Estimate of dismantling costs	–
	968 038

Lease liability	
Present value of lease payments not paid at lease commencement date	*819 238

* The present value of the lease payments is calculated as follows:

N = 48 (12 payments per year x 4 years

Set HP and Sharp EL-738 calculators on 12P/YR, as there are twelve instalments payable per year.

PMT = 20 000
FV = 0 (residual values guarantee)
I = 8% p.a.
PV = ? 819 238

The lessee's incremental borrowing rate is used as the interest rate implicit in the lease cannot be readily determined.

(b) Journals for the year ended 28 February 20.17:

	DR	CR
1 March 20.16	**R**	**R**
Right-of-use asset: Oven (SFP)	819 238	
Lease liability (SFP)		819 238
Recognise asset and liability		
Right-of-use asset: Oven (SFP)	4 800	
Bank (SFP)		4 800
Recognise initial direct costs (legal fees) as part of cost of asset		
Right-of-use asset: Oven (SFP)	144 000	
Bank (SFP)		144 000
Recognise deposit as part of cost of asset		
OR		
Right-of-use asset: Oven (SFP)	968 038	
Lease liability (SFP)		819 238
Bank (SFP) (4 800 + 144 400)		148 800
Recognise asset, liability and cost of asset paid in cash		
28 February 20.17		
Depreciation (P/L)	242 010	
Accumulated depreciation (SFP) (968 038/4)		242 010
Depreciation for the year		
Finance costs (P/L) [C1]	58 998	
Lease liability (SFP) [C1]		58 998
Total finance costs for the year		
Lease liability (SFP) [C1]	240 000	
Bank (SFP) [C1]		240 000
The total of 12 lease payments for the year		
OR		
Finance costs (P/L) [C1]	58 998	
Lease liability (SFP) [C1]	181 002	
Bank (SFP) [C1]		240 000
The total of 12 lease payments for the year		

There is no reasonable certainty that the lessee will obtain ownership at the end of the lease term; therefore use the shorter of the lease term or its useful life.

The total of all 12 instalments are combined and shown in one journal. Alternatively, the journal can be repeated at the end of every month, taking into account the 12 monthly instalments.

C1. Amortisation table

Payment date	Instalment	Capital	Interest at 8%	Balance
	R	R	R	R
1 March 20.16				819 238
31 March 20.16	20 000	14 538	5 462	804 700
30 April 20.16	20 000	14 635	5 365	790 064
31 May 20.16	20 000	14 733	5 267	775 331
30 June 20.16	20 000	14 831	5 169	760 500
31 July 20.16	20 000	14 930	5 070	745 570
31 August 20.16	20 000	15 030	4 970	730 541
30 September 20.16	20 000	15 130	4 870	715 411
31 October 20.16	20 000	15 231	4 769	700 180
30 November 20.16	20 000	15 332	4 668	684 848
31 December 20.16	20 000	15 434	4 566	669 414
31 January 20.17	20 000	15 537	4 463	653 877
28 February 20.17	20 000	15 641	4 359	638 236
	240 000	181 002	58 998	

Amortisation table

The complete amortisation table includes 48 months/payments. Only the first 12 months were done as only the first 12 months are required to do the journals at 28 February 20.17.

The totals of the amortisation table above can also be retrieved from your financial calculator as follows:

Interest 58 988, Capital 181 002, Balance 638 236

SHARP EL738	HP	SHARP (OLD)
Amort – P1 = 1 enter	1 Amort 12 enter	1 P1/P2 12 account = capital
Arrow down		1 P1/P2 12 account = interest
P2 = 12 enter		12 amort = balance

EXAMPLE 6 – Comprehensive

A manufacturing company, Rubble Ltd, entered into a contract on 1 January 20.16 whereby two machines with a total cash selling price of R412 500 would be leased from a finance company. The contract contains a lease in terms of IFRS 16 Leases. The lessor did not incur any initial direct costs.

The period of the lease is three years and the lease payments of R49 205 are payable **quarterly** in arrears. Rubble Ltd will obtain ownership of the machines at the end of the lease term at no additional cost. Rubble Ltd paid R20 000 in legal fees for negotiating the lease. The interest rate implicit in the lease is 24,00478% per annum.

The profit before tax of Rubble Ltd for the year ended 31 December 20.16 before the above lease transactions, amounted to R300 000. The two machines have Rnil residual value and will be depreciated over their expected useful lives of four years using the straight-line method.

The company's reporting period ends on 31 December each year.

Required

(a) Prepare the journal entries of Rubble Ltd for the abovementioned lease for the financial year ended 31 December 20.16.
(b) Prepare the notes to the financial statements of Rubble Ltd at 31 December 20.16 (excluding the accounting policy notes and IFRS 7 Disclosure) in respect of the above lease. Comparative figures are not required.

Your answers must comply with the International Financial Reporting Standards (IFRS).

Round all amounts to the nearest rand.

SOLUTION 6

(a) Journal entries for the year ended 31 December 20.16

		Dr	Cr
1 January 20.16		**R**	**R**
Right-of-use assets: Machinery (SFP)	[C2]	20 000	
Bank (SFP)			20 000
Capitalise legal fees to the cost of the machinery			
Right-of-use asset: Machinery (SFP)	[C2]	412 500	
Lease liability (SFP)			412 500
Recognise right-of-use assets and the lease liability			
Lease liability (SFP)	[C4]	106 960	
Finance costs (P/L)	[C4]	89 860	
Bank (SFP) (4 x 49 205)	[C4]		196 820
Recognition of four instalments paid during 20.16			
Depreciation (P/L) ((412 500 + 20 000)/4 years)		108 125	
Accumulated depreciation (SFP)			108 125
Recognise depreciation on right-of-use assets			

(b) Disclosure

RUBBLE LTD
NOTES FOR THE YEAR ENDED 31 DECEMBER 20.16

1. Profit before tax

Profit before tax is stated after taking into account the following items:	20.16 R
Expenses	
Depreciation: Right-of-use assets [C5]	108 125

2. Finance costs

Finance cost on lease liabilities [C4]	89 860

3. Leases

3.1 Right-of-use assets

	20.16 Machinery R	20.16 Total R
Carrying amount at beginning of year	–	–
Additions [C2]	432 500	432 500
Depreciation for the year [C5]	(108 125)	(108 125)
Adjustments for lease remeasurements	–	–
Adjustments for lease modifications	–	–
Carrying amount at end of year	324 375	324 375

3.2 Maturity analysis of future lease payments outstanding at the reporting date

		20.16 R
Future lease payments (undiscounted)		
– For the year ended 31 December 20.17 (49 205 x 4)	[C4]	196 820
– For the year ended 31 December 20.18 (49 205 x 4)	[C4]	196 820
– For the year ended 31 December 20.19		–
– For the year ended 31 December 20.20		–
– Remaining years after 31 December 20.20		–
Total future lease payments		393 640
Total future finance costs	[C4]	(88 100)
Lease liability	[C4]	305 540
Short-term portion presented under current liabilities	[C4]	135 042
Long-term portion presented under non-current liabilities	[C4]	170 498

Calculations

C1. Interest rate implicit in the lease

The interest rate implicit in the lease is given as 24,00478% per annum.

C2. Right-of-use asset and lease liability

Right-of-use assets (Machinery)		R
Initial amount of the lease liability	[C3]	412 500
Initial direct costs of the lessee – legal fees		20 000
Lease payments made at or before commencement date		–
		432 500
Lease liability		
Present value of lease payments at lease commencement date	[C3]	412 500

C3. Present value of lease payments

N = 12 (4 payment per year x 3 years)

Set HP and Sharp EL-738 calculators on 4P/YR, as there are four instalments payable per year.

PMT = 49 205

FV = 0 (residual value guarantee)

I = 24,00478%

PV = ? 412 500

C4. Amortisation table

Payment dates	Instalments R	Capital R	Interest at 24,00478% R	Closing balance R
01.01.20.16				412 500
31.03.20.16	49 205	24 450	24 755	388 050
30.06.20.16	49 205	25 917	23 288	362 133
30.09.20.16	49 205	27 472	21 733	334 661
31.12.20.16 (year end)	49 205	29 121	20 084	**305 540**
31.03.20.17	49 205	30 869	18 336	274 671
30.06.20.17	49 205	32 721	16 484	241 950
30.09.20.17	49 205	34 685	14 520	207 265
31.12.20.17	49 205	36 767	12 438	170 498
31.03.20.18	49 205	38 973	10 232	131 525
30.06.20.18	49 205	41 312	7 893	90 213
30.09.20.18	49 205	43 791	5 414	46 422
31.12.20.18	49 205	46 422	2 783	–
	590 460	412 500	177 960	

Finance cost in P/L =89 860

Future lease payments 20.17 =196 820

Future lease payments 20.18 =196 820

Future finance costs =88 100

412 500 x 24,00478% x 3/12 = **24 755**
388 050 x 24,00478% x 3/12 = **23 288**

The carrying amount of the lease liability at 31 December 20.16 is R305 540, which is also used for tax purposes.
Long-term portion: R170 498
This is the closing balance one year AFTER the current year, 31 December 20.17.
Short-term portion: R305 540 – R170 498 = R135 042
This is the difference between the closing balance at year-end (R305 540) and the long-term portion (R170 498).

Use of calculator for amortisation table

Remember the **amortisation table** is just a **calculation**. Therefore, **remember to use** it in your disclosure. If it is not used in your answer, no marks will be awarded.

All the amounts in the amortisation table can be retrieved from you calculator.

Please refer to your calculator manual and ensure that you can retrieve the interest, capital and capital balance from your calculator. For example, the finance cost for the year (R89 860) can be retrieved from your calculator by calculating it as follows:

HP: *1 (Input) 4 (2nd function) (Amort)* = interest, = capital, = capital balance OR

SHARP EL 738: Amort payments 1–4.

If you only make use of your calculator during the exam, write down the inputs and the steps you used to obtain the amounts disclosed.

C5. Accounting profit

	R
Accounting profit (given)	300 000
Depreciation (412 500 + 20 000)/4 years)	(108 125)
Finance costs [C1]	(89 860)
Adjusted accounting profit	102 015

Legal fees of R20 000

The legal fees were capitalised (added) to the asset. Therefore, depreciation of

R108 125 (see note 3 above) includes R5 000 that relates to legal fees (20 000/4 years). The balance of the legal fees that will form part of future depreciation amounts to R15 000 (R20 000 – R5 000).

SCHEDULE A: Basic examples on how to prepare an amortisation table

An amortisation table is prepared to calculate the split between capital and interest of the lease instalments. Please make sure that you can calculate the interest rate implicit in the lease on your financial calculator. You must also be able to calculate the amortisation table manually and to extract the numbers of the amortisation table from your financial calculator.

The four examples below will be used to illustrate important principles when preparing an amortisation table.

EXAMPLE 7

Payments in arrears

Acca Ltd entered into a finance lease agreement with Beta Ltd on 1 January 2017, whereby Beta Ltd will lease a machine from Acca Ltd for a period of two years. The cash selling price and fair value of the machine amounted to R40 000 on 1 January 2017. The instalments

amount to R13 200 each and are payable half-yearly in **arrears**. Acca Ltd didn't incur any initial direct costs. Ownership of the machine will transfer to Beta Ltd at the end of the lease term at no additional cost.

The financial year-end of Acca Ltd is 31 December.

Required

Prepare the amortisation table that Acca Ltd will use to account for the lease of the machine.

SOLUTION 7

In this example 1, Acca Ltd is the lessor and Beta Ltd is the lessee.

Step 1: Calculate the interest rate implicit in the lease.

Set HP and Sharp EL-738 calculators on 2P/YR (as there are two instalments payable per year)

N = 4 (2 payments per year x 2 years)
PV = (40 000 + 0) (fair value + initial direct costs of the lessor)
PMT = 13 200*
FV = 0* + 0* (guaranteed and unguaranteed residual values)
I = ? 24,22% per annum
(Sharp EL-733A will calculate 12,11% per six months
12,11% x 2 = 24,22% for 12 months)

* Important

The amounts for "PMT" and "FV" entered into your financial calculator represent cash in-flows for Acca Ltd and must have the same signs, for example, they must both be positive or negative. The "PV" represents the outflow of the finance provided for the machine to Acca Ltd from Beta Ltd and must have the opposite sign of the "PMT" and "FV".

Step 2: Determine the initial recognition amount.

Recognise the asset and liability at the lower of the:

- present value of the minimum lease payments discounted at the interest rate implicit in the lease (R40 000), or
  N = 4 (2 payments per year x 2 years)
  I = 24,22% per annum (calculated in step 1)
  PMT = 13 200
  FV = 0 (guaranteed residual value **only**)
  PV = ? (40 000)
- fair value of the leased property (R40 000).

Comment

The present value of the minimum lease payments is equal to the fair value of R40 000. As a result, the machine and the finance lease liability will both be recognised at R40 000. Consequently, the amortisation table is prepared at R40 000.

Step 3: Prepare the amortisation table for R40 000.

Payment date	Instalment	Interest at 24,22% p.a.	Capital	Outstanding balance
	R	R	R	R
1 January 20.17				40 000
30 June 20.17	13 200	[a] 4 844	[b] 8 356	[c] 31 644
31 December 20.17	13 200	3 832	9 368	22 276
30 June 20.18	13 200	2 698	10 502	11 774
31 December 20.18	13 200	1 426	11 774	–
	52 800	12 800	40 000	

[a] 40 000 x 24,22% x 6/12 = 4 844 or 40 000 x 12,11% = 4 844
[b] 13 200 – 4 844 = 8 356
[c] 40 000 – 8 356 = 31 644

EXAMPLE 8

Payments in advance

The same information applies as in example 7, except that the instalments are payable half-yearly **in advance**.

Required

Prepare the amortisation table that Acca Ltd will use to account for the lease of the machine.

SOLUTION 8

Step 1: Calculate the interest rate implicit in the lease.

IMPORTANT: Set your calculator on BEGIN mode, as instalments are payable at the beginning of every six months.

Set HP and Sharp EL-738 calculators on 2P/YR (as there are two instalments payable per year)

N = 4 (2 payments per year x 2 years)
PV = (40 000 + 0) (fair value + initial costs of the lessor)
PMT = 13 200
FV = 0 + 0 (guaranteed and unguaranteed residual values)
I = ? 44,77% per annum
(Sharp EL-733A will calculate 22,38% per six months
22,38% x 2 = 44,77% for 12 months)

Step 2: Determine the initial recognition amount.

Recognise the asset and liability at the lower of the:

- present value of the minimum lease payments discounted at the interest rate implicit in the lease (R40 000), or
  N = 4 (2 payments per year x 2 years)
  I = 44,77% per annum (calculated in step 1)
  PMT = 13 200
  FV = 0 (guaranteed residual value **only**)
  PV = ? (40 000)
- fair value of the leased property (R40 000).

Step 3: Prepare the amortisation table for R40 000.

Payment date	Instalment R	Interest at 44,77% p.a. R	Capital R	Outstanding balance R
1 January 20.17				40 000
1 January 20.17	13 200	–	13 200	[a] 26 800
1 July 20.17	13 200	[b] 5 999	[c] 7 201	19 599
1 January 20.18	13 200	4 387	8 813	10 786
1 July 20.18	13 200	2 414	10 786	-
	52 800	12 800	40 000	

[a] 40 000 – 13 200 = 26 800
[b] 26 800 x 44,77% x 6/12 = 5 999 or 26 800 x 22,38% = 5 999
[c] 13 200 – 5 999 = 7 201

Comments on Example 7 and Example 8

Compare the amortisation tables of example 7 and example 8. Note the differences between the interest rates and payment dates as a result of the instalments being payable **in arrears or in advance**.

The payment dates are different for example 8, as the instalments are payable at the **beginning** of the six-month period. The lease was entered into on 1 January 20.17 and in example 8, the first payment was made on the same date. As a result, the first instalment paid on 1 January 20.14 comprises capital only, because no time has passed for interest to accrue.

The interest rates in both example 7 and example 8 were rounded off to two decimals. In a question you will normally be instructed to round off the interest rate to a specific number of decimals, for example, round off the interest rate to two decimals.

EXAMPLE 9

Payments in arrears

Example 9 contains the same information as example 7, except that the financial year-end of Acca Ltd is **30 April and not 31 December**.

Required

Prepare the amortisation table that Acca Ltd will use to account for the lease of the machine.

SOLUTION 9

Step 1 and Step 2 are the same as for example 7.

Step 3: Prepare the amortisation table for R40 000.

Payments do not coincide with year-end

The payments are made on 30 June and 31 December and the financial year-end is 30 April. Although no instalments are made at year-end, interest is accrued at year-end.

Payment date	Instalment	Interest at 24,22% p.a.	Capital	Outstanding balance
	R	R	R	R
1 January 20.17				40 000
30 April 20.17	–	[a] 3 229		*[b] 43 229*
30 June 20.17	13 200	[c] 1 615	[d] 8 356	[e] 31 644
31 December 20.17	13 200	[f] 3 832	[g] 9 368	[h] 22 276
30 April 20.18		[i] 1 799		*[j] 24 075*
30 June 20.18	13 200	[k] 899	[l] 10 502	[m] 11 774
31 December 20.18	13 200	1 426	11 774	
	52 800	12 800	40 000	

[a] 40 000 x 24,22% x 4/12 = 3 229 or 40 000 x 12,11% x 4/6 = 3 229

[b] 40 000 + 3 229 = 43 229. R43 229 is the capital outstanding and the interest accrued as at year-end combined. This amount is only calculated for disclosure in the financial statements and must not be used to calculate interest in the amortisation table.

[c] 40 000 x 24,22% x 2/12 = 1 615 or 40 000 x 12,11% x 2/6 = 1 615
Please note that the interest from 1 January 20.17 until 30 June 20.17 totals R4 844 and is split into R3 229 (for four months) and R1 615 (for two months).

[d] 13 200 – (3 229 + 1 615) = 8 356

[e] 40 000 – 8 356 = 31 644

[f] 31 644 x 24,22% x 6/12 = 3 832 or 31 644 x 12,11% x 6/6 = 3 832

[g] 13 200 – 3 832 = 9 368

[h] 31 644 – 9 368 = 22 276

[i] 22 276 x 24,22% x 4/12 = 1 799 or 22 276 x 12,11% x 4/6 = 1 799

[j] 22 276 + 1 799 = 24 075. R24 075 is the capital outstanding and the interest accrued as at year-end. This amount is only calculated for disclosure in the financial statements and must not be used to calculate interest in the amortisation table.

[k] 22 276 x 24,22% x 2/12 = 899 or 22 276 x 12,11% x 4/6 = 899

[l] 13 200 – (1 799 + 899) = 10 502

[m] 22 276 – 10 502 = 11 774

EXAMPLE 10

Payments in advance

Example 10 contains the same information as example 8, except that the financial year-end of Acca Ltd is **30 April and not 31 December**.

Required

Prepare the amortisation table that Acca Ltd will use to account for the lease of the machine.

SOLUTION 10

Step 1 and Step 2 are the same as for example 8.

Step 3: Prepare the amortisation table for R40 000.

Comment

The payments are made on 30 June and 31 December and the year-end is 30 April. No instalment is paid at year-end and only interest has accrued at year-end.

Payment date	Instalment R	Interest at 44,77% p.a. R	Capital R	Outstanding balance R
1 January 20.17				40 000
1 January 20.17	13 200	–	[a] 13 200	[b] 26 800
30 April 20.17	–	[c] 3 999	-	[d] *30 799*
1 July 20.17	13 200	[e] 2 000	[f] 7 201	[g] 19 599
1 January 20.18	13 200	[h] 4 387	[i] 8 813	[j] 10 786
30 April 20.18	–	[k] 1 609	–	[l] *12 395*
1 July 20.18	13 200	[m] 805	[n] 10 786	[o] –
	52 800	12 800	40 000	

[a] The full instalment of R13 200 is capital.
[b] 40 000 – 13 200 = 26 800
[c] 26 800 x 44,77% x 4/12 = 3 999 OR 26 800 x 22,38% x 4/6 = 3 999
[d] 26 800 + 3 999 = 30 799. R30 799 is the capital outstanding and the interest accrued as at year-end. This amount is only calculated for disclosure in the financial statements and must not be used to calculate interest in the amortisation table.
[e] 26 800 x 44,77% x 2/12 = 2 000 or 26 800 x 22,38% x 2/6 = 2 000
Please note that the interest from 1 January 20.17 until 30 June 20.17 totals R5 999 and is split into R3 999 (for 4 months) and R2 000 (for 2 months).
[f] 13 200 – (3 999 + 2 000) = 7 201
[g] 26 800 – 7 201 = 19 599
[h] 19 599 x 44,77% x 6/12 = 4 387 or 19 599 x 22,38% x 6/6 = 4 387
[i] 13 200 – 4 387 = 8 813
[j] 19 599 – 8 813 = 10 786
[k] 10 786 x 44,77% x 4/12 = 1 609 or 10 786 x 22,38% x 4/6 = 1 609
[l] 10 786 + 1 609 = 12 395. R12 395 is the capital outstanding and the interest accrued as at year-end. This amount is only calculated for disclosure in the financial statements and must not be used to calculate interest in the amortisation table.
[m] 10 786 x 44,77% x 2/12 = 805 or 10 786 x 22,38% x 2/6 = 805
[n] 13 200 – (1 609 + 805) = 10 786
[o] 10 786 – 10 786 = 0

FAC2601

LEARNING UNIT 8

FINANCIAL INSTRUMENTS – IFRS 7, 9 & IAS 32

Financial Accounting for Companies

Learning outcomes

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

- describe financial instruments and indicate how they should be accounted for in the annual financial statements of an entity in accordance with the requirements of International Financial Reporting Standards (IFRS)
- apply the theory in practical examples to illustrate the principles of recognition, measurement and disclosure

Assessment criteria

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

- state the definitions contained in IFRS 7, IFRS 9, IAS 32 and IAS39 and apply them to problems posed
- describe the classifications of financial instruments
- describe the principles for the recognition, measurement and dere– cognition of financial instruments
- disclose the information relating to financial instruments in the annual financial statements of an entity in accordance with the requirements of International Financial Reporting Standards (IFRS)

Overview

This learning unit will be discussed under the following sections:

8.1 Background and current accounting position
8.2 Definitions
  8.2.1 Terminology
  8.2.2 Financial asset
  8.2.3 Financial liability
  8.2.4 Equity instrument
  8.2.5 Financial instrument
  8.2.6 Derivative instrument
8.3 Recognition
  8.3.1 Initial recognition
8.4 Measurement
  8.4.1 Definitions
  8.4.2 Classification of financial assets and financial liabilities
    8.4.2.1 Financial assets at fair value through profit or loss
    8.4.2.2 Financial assets at fair value through other comprehensive income
    8.4.2.3 Financial assets at amortised cost
    8.4.2.4 Financial liabilities at amortised cost
    8.4.2.5 Financial liabilities at fair value through profit or loss
  8.4.3 Initial measurement of financial assets and financial liabilities
  8.4.4 Subsequent measurement of financial assets
  8.4.5 Subsequent measurement of financial liabilities
8.5 Derecognition
  8.5.1 Derecognition of a financial asset
  8.5.2 Derecognition of a financial liability

STUDY

PRESCRIBED TEXTBOOK:
Introduction to IFRS – Latest Edition
Chapter 17
The syllabus of FAC2601 encompasses only the basic elements of financial instruments as indicated in this learning unit. You will be examined on these principles only.

8.1 BACKGROUND AND CURRENT ACCOUNTING POSITION

STUDY

Study paragraphs 1 and 2 of the prescribed textbook.

Financial markets use a variety of financial instruments, ranging from traditional primary instruments (i.e. debtors, creditors, equity) to derivative instruments (i.e. financial options, futures and forwards, interest rate swaps and currency swaps).

The standards IFRS 9, IAS 32, IAS 39 (relevant sections) and IFRS 7 deal with the disclosure, presentation, recognition and measurement of financial instruments. IFRS 9 was issued in November 2009 and replaces certain sections of IAS 39. **IFRS 9 also addresses impairment of financial assets and hedge accounting; however, this falls outside the scope of this module.**

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 assets, 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
- 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 annual financial statements that enable users to evaluate:

- the significance of financial instruments for the entity's financial position and performance
- 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 address the classification, measurement and impairment methodology instruments that will present relevant and useful information to users of annual financial statements for their assessment of the amounts, timing and uncertainty of the entity's future cash flows.

LECTURER'S COMMENT

Note: Foreign exchange contracts and derivative instruments do not form part of this syllabus.

8.2 DEFINITIONS

STUDY

Study paragraph 3 of the prescribed textbook.

8.2.1 Terminology

STUDY

Study paragraph 3.1 of the prescribed textbook to get a better understanding of the different types of financial instruments and related terms.

Take note: Bonds/debentures, cum div and ex div transactions do not form part of this module.

8.2.2 Financial asset

STUDY

Study paragraph 3.2 of the prescribed textbook.

A **financial asset** is any asset that is:

(a) cash;
(b) an equity instrument of another entity (example: investments);
(c) a contractual right:

- to receive cash or another financial asset from another entity (e.g. accounts receivables); or
- to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity (e.g. purchased options); or

(d) a contract that will or may be settled in the entity's own equity instruments (not part of this module)

Work through example 17.1 of the prescribed textbook.

8.2.3 Financial liability

STUDY

Study paragraph 3.3 of the prescribed textbook.

A **financial liability** is any liability that is:

(a) a contractual obligation:

- to deliver cash or another financial asset to another entity (e.g. creditors); or
- to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity (e.g. written options); or

(b) a contract that will or may be settled in the entity's own equity instruments (not part of this module)

Work through example 17.2 of the prescribed textbook.

LECTURER'S COMMENT

Note: No complex financial liability transactions will be dealt with in this module. The most important will be the recognition, measurement and disclosure of long-term loans.

8.2.4 Equity instrument

STUDY

Study paragraph 3.4 of the prescribed textbook.

An **equity instrument** is any contract that evidences a residual interest in the assets of an entity after deducting all its liabilities. An equity instrument is presented as part of total equity on the face of the statement of financial position.

Work through example 17.3 of the prescribed textbook.

8.2.5 Financial instrument

STUDY

Study paragraph 3.5 of the prescribed textbook.

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.

Work through example 17.4 of the prescribed textbook.

LECTURER'S COMMENT

Note: Foreign exchange contracts and derivative instruments do not form part of this syllabus.

8.2.6 Derivative instruments

Ignore paragraph 3.6 and example 17.5 of the prescribed textbook, as they do not part of this module.

EXAMPLE 1

Examples of financial assets and financial liabilities

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 annual 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.

Financial asset/financial liability	Reason
• Common financial assets and financial liabilities – trade accounts receivable and payable – loans 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 financial guarantee	It is a contractual right of the lender to receive cash from the guarantor, and a contractual obligation of the guarantor to the lender, if the borrower defaults. The contractual right and obligation exist because of a past transaction or event (assumption of the guarantee), even though the lender's liability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on a future act of default by borrower. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though such assets and liabilities are not always recognised in the annual financial statements.

EXAMPLE 2

The following are NOT financial assets and financial liabilities – IAS32

Item	Reason
• Physical assets such as: – Inventories – Property, plant and equipment	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.
• 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, i.e. 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.

8.3 RECOGNITION

8.3.1 Initial recognition

STUDY

Study paragraph 4.1 of the prescribed textbook.

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.

EXAMPLE 3

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, consequently, 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 commit–ment 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.

3. Planned future transactions

No matter how likely they are, they are neither assets nor liabilities because the entity has not become a party to a contract.

8.4 MEASUREMENT OF FINANCIAL INSTRUMENTS

8.4.1 Definitions

STUDY

Study paragraph 5.1 of the prescribed textbook.

Fair value

The **fair value** of an instrument would be the price/amount at which the asset (or liability) could be bought or sold in a current transaction between willing parties, or transferred to an equivalent party.

Amortised cost – Ignore paragraph 5.1.2 and examples 17.6 and 17.7 of the prescribed textbook, which will be dealt with in later studies.

Transaction costs

STUDY

Study paragraph 5.1.3 of the prescribed textbook.

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.

8.4.2 Classification of financial assets and financial liabilities

STUDY

Study paragraph 5.2 of the prescribed textbook.

Financial assets

An entity shall classify financial assets as subsequently measured at either **amortised cost** or **fair value** (two subcategories) 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

A financial asset shall be measured at fair value **unless** it is measured at amortised cost.

Take note: For the purpose of this module, only the following financial asset categories will be dealt with:

- At fair value through profit or loss
- At fair value through other comprehensive income

8.4.2.1 Financial assets at fair value through profit or loss

STUDY

Study paragraph 5.2.1 of the prescribed textbook.

This is the default category for purposes of classifying financial assets.

Financial assets will be classified in this category if:

- it is mandatorily measured at fair value
- upon initial recognition, it is designated by the entity as "at fair value through profit or loss". A financial asset can only be designated upon initial recognition if it will eliminate or reduce a measurement or recognition inconsistency.

Financial assets that are classified as held for trading automatically fall into this sub–category. Held for trading means it is a short-term investment and is intended to sell or repurchase in the near future.

Work through example 17.7 of the prescribed textbook. (Ignore case III.)

8.4.2.2 Financial assets at fair value through other comprehensive income

STUDY

Study paragraph 5.2.3 of the prescribed textbook.

This category is only available for equity instruments not held for trading (e.g. investment in another company with the intention not to sell the shares in the near future).

For example:

A Ltd purchased 7 000 ordinary shares in B Ltd. These shares were held as part of a long-term investment portfolio. These shares will then be classified as a financial asset at fair value through other comprehensive income.

Work through example 17.9 of the prescribed textbook.

8.4.2.3 Financial assets at amortised cost

Ignore paragraph 5.2.2 and example 17.8 of the prescribed textbook.

This category financial asset does not form part of this module.

8.4.2.4 Financial liabilities at amortised cost

Ignore paragraph 5.2.4 and example 17.8 of the prescribed textbook.

8.4.2.5 Financial liabilities at fair value through profit or loss

STUDY

Study paragraph 5.2.5 of the prescribed textbook.

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, it 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

8.4.3 Initial measurement of financial assets and financial liabilities

STUDY

Study paragraphs 5.3 and 5.3.1 of the prescribed textbook.

Initial measurement can be summarised as follows:

Financial asset category	Initial measurement
• Financial assets/liability at fair value through profit or loss	At fair value, **excluding** transaction costs
• Financial assets at fair value through other comprehensive income (Investments in equity – not held for trading)	At fair value + transaction costs

The fair value of a financial instrument on initial recognition is normally the transaction price (i.e. the fair value of the consideration given or received).

Work through example 17.10 of the prescribed textbook.

EXAMPLE 4

A Ltd bought 1 000 ordinary shares in B Ltd at R5,00 per share. Transaction costs amounted to R500.

Required

Journal entries at initial recognition in the financial records of A Ltd when the financial asset is recognised:

- at fair value through other comprehensive income
- at fair value through profit or loss

SOLUTION 4

• At fair value through other comprehensive income:	**R**	**R**
Dr Financial asset (SFP) [(1 000 x R5,00) + R500]	5 500	
Cr Bank (SFP)		5 500

• At fair value through profit or loss:	**R**	**R**
Dr Financial asset (SFP) (1 000 x R5,00)	5 000	
Dr Transaction cost (P/L)	500	
Cr Bank (SFP)		5 500

8.4.4 Subsequent measurement of financial assets

STUDY

Study paragraph 5.4 of the prescribed textbook.

After initial recognition, an entity shall measure a financial asset at:

- Amortised cost (not dealt with in this module); or **(Ignore par 5.4.2 and example 17.12 of the prescribed textbook.)**
- Fair value through profit or loss; or **(Study par 5.4.1 and work through example 17.11 of the prescribed textbook.)**
- Fair value through other comprehensive income. **(Study par 5.4.3, 5.4.3.1 and 5.4.3.2 and work through example 17.13 and 17.14 of the prescribed textbook.)**

The accounting treatment of financial assets can be summarised as follows:

Financial asset category	Initial measurement	Subsequent measurement	Gains and losses on remeasurement
1. Financial assets at fair value through profit or loss	Cost (being fair value but **excluding** transaction costs)	Fair value	Recognised in profit or loss
2. Financial assets at fair value through other comprehensive income (Investments in equity – not held for trading)	Cost (being fair value, **including** transaction costs)	Fair value	Recognised in other comprehensive income and accumulated in equity (mark-to-market reserve)

EXAMPLE 5

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), the market value of one Waterloo Ltd share was R17,00.

Required

Journal entries to account for the investment in the financial records of Viva-Voo Ltd for the year ended 31 December 20.10 in accordance with the requirements of International Financial Reporting Standards (IFRS).

SOLUTION 5

	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

EXAMPLE 6

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 **NOT** held for trading. Transaction costs

amounted to R1 000. At year-end (31 December), the market value of one Waterloo Ltd share was R17,00.

Required

Journal entries to account for the investment in the financial records of Viva-Voo Ltd for the year ended 31 December 20.10 in accordance with the requirements of International Financial Reporting Standards (IFRS).

SOLUTION 6

	Dr R	Cr R
Initial measurement–1 July 20.10		
Investment in shares [(1 000 x R15) + 1000] (SFP)	16 000	
Bank (SFP)		16 000
Subsequent measurement 31 December 20.10		
Investment in shares [(1 000 x R17) – 16 000] (SFP)	1 000	
Mark-to-market reserve (OCI)		1 000

8.4.5 Subsequent measurement of financial liabilities

STUDY

Study paragraphs 5.5 and 5.5.2 of the prescribed textbook.

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 FV 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.

Take note: Financial liabilities at amoritised cost do not form part of this module.

8.5 DERECOGNITION

8.5.1 Derecognition of a financial asset

STUDY

Study paragraph 6.1 of the prescribed textbook.

Derecognition is the removal of a previously recognised financial asset from an entity's statement of financial position.

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) **the financial asset is transferred, and the transfer qualifies** for derecognition.

Financial assets recognised as "at fair value through other comprehensive income" **or** "at fair value through profit or loss" must first be restated to fair value before recognition. This will result in no additional profit or loss on derecognition, provided that the asset was sold at fair value.

The entity may decide to reclassify the resultant balance in the mark-to-market reserve (relating to the asset derecognised), directly to retained earnings.

Work through example 17.18 of the prescribed textbook.

8.5.2 Derecognition of a financial liability

STUDY

Study paragraph 6.2 of the prescribed textbook.

An entity shall remove a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished, that is, when the obligation specified in the contract:

(a) is settled/discharged
(b) is cancelled
(c) expires

A financial liability (or a part of it) is extinguished when:

(a) the debtor discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services
(b) the debtor 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.)

(c) an exchange occurs between an existing borrower and lender of debt instruments with substantially different terms
(d) a change occurs to the conditions of an existing debts instrument

Work through example 17.19 of the prescribed textbook.

8.6 PRESENTATION

STUDY

Study paragraph 7 of the prescribed textbook.

8.6.1 Liabilities and equity

STUDY

Study paragraph 7.1 of the prescribed textbook.

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
- the definitions of a financial liability, a financial asset and an equity instrument

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
- 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.

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. (See learning unit 1 par 1.5.3.)

8.6.2 Classification of preference shares

STUDY

Study paragraph 17.1.1 of the prescribed textbook.

LECTURER'S COMMENT

Note: Only the classification of the preference shares and thus the disclosure of preference shares is important for this module. The accounting of redeemable preference shares on redemption date and the conversion of preference shares to ordinary shares do not form part of this module. (Please also work through example 17.20 of the prescribed textbook.)

Refer to learning unit 1.

EXAMPLE 7

Lula-Lee Ltd issued 1 000 redeemable preference shares on 1 January 20.10. The shares are redeemable in cash at the option of the holder. If the options are not exercised, the shares will be redeemable on 31 December 20.12.

Must the preference shares be presented as a financial liability or equity in the annual 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 8

Lula-Lee Ltd issued 1 000 redeemable preference shares on 1 January 20.10. Lula-Lee Ltd has the option to redeem the shares at any time.

Must the preference shares be presented as a financial liability or equity in the annual 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 annual financial statements of Lula-Lee Ltd.

EXAMPLE 9

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.

Must the preference shares be presented as a financial liability or equity in the annual financial statements of Lula-Lee Ltd?

If the criteria for classification of an equity instrument are applied:

- the instrument includes **no** contractual obligation to deliver cash or another financial asset, or to exchange a financial asset, or to exchange a 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 (IAS 32.19).

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).

8.6.3 Interest, dividends, losses and gains

STUDY

Study paragraph 7.2.1 of the prescribed textbook.

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.

Redemption or refinancing of equity instruments are recognised as changes in equity.

Changes in fair value of the entity's equity instruments are not recognised in the annual financial statements.

Work through example 17.21 of the prescribed textbook.

8.6.4 Transaction cost on equity instruments and offsetting

Ignore paragraph 7.2.2 & 7.3 of the prescribed textbook.

8.7 DISCLOSURE

STUDY

Study paragraphs 9, 9.1.1 and 9.1.2 only, of the prescribed textbook.

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 covered in this module. It will however, be studied in detail in later accounting studies.

EXAMPLE 10

Lions Ltd owns 50 000 ordinary shares in Bulls Ltd. These shares were purchased for R50 000. Transaction costs amounted to R1 000. These shares trade on the JSE and the market value at year-end was R3 per share. These shares are held for speculative purposes.

Required

Discuss how the above transaction will be disclosed in the financial statements.

SOLUTION 10

- Identify category: At fair value through profit or loss
- Measurement: Fair value (Excl. transaction cost)

- Initial recognition: R50 000
- Year-end at fair value:
- 50 000 shares x R3 = R150 000
- Fair value adjustment at year-end: R150 000 – R50 000 = R100 000.

Disclosure:

- Recognise the *fair value adjustment* in "profit or loss" in SOCI and profit before tax note
- *Investments* will be disclosed at fair value under "Current assets" in the statement of financial position

EXAMPLE 11

Lions Ltd owns 50 000 ordinary shares in Bulls Ltd. These shares were purchased for R50 000. Transaction costs amounted to R1 000. These shares trade on the JSE and the market value at year-end was R3 per share. This investment was designated as not-held-for-trading.

Required

Discuss how the above transaction will be disclosed in the financial statements.

SOLUTION 11

- Identify category: At fair value through other comprehensive income
- Measurement: Fair value (Incl. transaction costs)
- Initial recognition: R50 000 + R1 000 = R51 000
- Measurement at year-end at fair value: 50 000 shares x R3 = R150 000
- Fair value adjustment: R150 000 – R51 000 = R99 000.

Disclosure:

- Recognise the *fair value adjustment* in "other comprehensive income" in SOCI and mark-to-market reserve in SOCE
- *Investments* will be disclosed at fair value under non-current assets in the statement of financial position

8.8 SUMMARY

These examples illustrate the difference in disclosure and recognition of the different category of financial assets.

FINANCIAL ASSETS:

The three categories of financial assets are as follows:

- **At fair value through profit or loss** (held for trading/speculative purposes)

Measurement: Fair value, excluding transaction costs

Fair value gain/loss – disclose in SOCI under "profit or loss" (other income/expenses)

- **At fair value through other comprehensive income (not held for trading)**

  Measurement: At fair value + transaction costs

  Fair value gain/loss – Disclose in "other comprehensive income" in SOCI and accumulated in mark-to-market reserve in the statement of changes in equity.

- **At amortised cost (not applicable in FAC2601)**

Example 1:

50 000 shares in Bulls Ltd at R50 000. Transaction costs R1 000. The shares trade on the JSE and market value at year-end was R3 per share. These shares are held for speculative purposes.

- Identify category: At fair value through profit or loss
- Measurement: Fair value (**Excl** transaction cost)
- Initial recognition: R50 000
- Year-end at fair value: 50 000 shares x R3 = R150 000

Fair value adjustment at year-end: R150 000 – R50 000 = R100 000.

Disclosure:

- Recognise the *fair value adjustment* in "profit or loss" in SOCI and profit before tax note.
- *Investments* will be disclosed at fair value under current assets in the statement of financial position.

Example 2:

50 000 shares in Bulls Ltd at R50 000. Transaction costs R1 000. These shares trade on the JSE and market value at year-end was R3 per share. This investment was designated as not held for trading.

Identify category: At fair value through other comprehensive income

Measurement: Fair value (**Incl** transaction costs)

Initial recognition: R50 000 + R1000 = R51 000

Measurement at year-end at fair value: 50 000 shares x R3 = R150 000

Fair value adjustment: R150 000 – R51 000 = R99 000.

Disclosure:

- Recognise the *fair value adjustment* in "other comprehensive income" in SOCI and mark-to-market reserve in SOCE.
- *Investments* will be disclosed at fair value under non-current assets in the statement of financial position.

STUDY

Study paragraphs 8.1, 8.1.1, 8.1.3, 8.3.1 and 8.3.2 of the prescribed textbook.

Work through examples 17.22, 17.25 and 17.26 of the prescribed textbook.

FAC2601

LEARNING UNIT 9

REVENUE FROM CONTRACTS WITH CUSTOMERS – IFRS15

Financial Accounting
for Companies

LEARNING OUTCOME

The core principle of IFRS 15 is that an entity should recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. Learners should be able to recognise the above as well as to properly disclose revenue in accordance with the requirements of International Financial Reporting Standards (IFRS).

Assessment criteria

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

- apply all the applicable definitions to different scenarios
- recognise revenue based on the five-step revenue model
- calculate and recognise contract costs
- present and disclose revenue in the annual financial statements in accordance with the requirements of IFRS 15

Overview

IFRS 15 prescribes a five-step revenue model to establish the above learning outcome. This learning unit is divided into the following sections:

9.1 Definitions
9.2 Five steps for revenue recognition
  9.2.1 Step 1 – Identify the contract(s) with a customer
    9.2.1.1 Combination of contracts
    9.2.1.2 Contract modifications
  9.2.2 Step 2 – Identify the separate performance obligations in the contract
  9.2.3 Step 3 – Determine the transaction price
  9.2.4 Step 4 – Allocate the transaction price to the performance obligations in the contract
  9.2.5 Step 5 – Recognise revenue when (or as) the entity satisfies a performance obligation
9.3 Contract costs
9.4 Presentation
9.5 Disclosure
9.6 Short and sweet

STUDY

PRESCRIBED BOOK
Introduction to IFRS – latest edition.
Chapter 10 (IFRS 15)

Overview of learning unit

This standard establishes the principles that an entity must apply to report useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

9.1 DEFINITIONS

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

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

A **contract asset** is an entity's conditional right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (e.g. the entity's future performance).

A **contract liability** is an entity's obligation to transfer goods or services to a customer in the future for which the entity has received consideration (or the amount is due) from the customer.

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

Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets, or decreases of liabilities that result in an increase in equity, other than those relating to contributions from equity participants.

A **performance obligation** is a promise in a contract with a customer to transfer one of the following:

- A good or a service (or a bundle of goods or services) that is distinct; or
- A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

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

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

The **transaction price** (for a contract with a customer) is the amount of consideration to which an entity expects to be entitled, in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (e.g. VAT).

LECTURER'S COMMENT

The above definitions must be studied. They are also provided for ease of reference when working through the examples in both Introduction to IFRS and this learning unit.

9.2 FIVE STEPS FOR REVENUE RECOGNITION

STUDY

Study paragraph 6 of the prescribed textbook.

The core principle of IFRS 15 Revenue from contracts with customers, is that an entity recognises revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services (par 02). To be able to apply this core principle, an entity performs the following five steps for revenue recognition.

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

Each of the five steps will be discussed separately in this learning unit.

9.2.1 Step 1 – Identify the contract(s) with a customer

STUDY

Study paragraph 6.1 of the prescribed textbook.

A contract is an agreement between two or more parties that creates (legally) enforceable rights and obligations. Contracts can be in a written or oral format or can be implied by an entity's customary business practices. An entity accounts for a contract with a customer only when **all** of the following criteria are met:

(a) The parties to the contract have **approved** the contract (in writing, orally or in accordance with other customary business practices) and they are committed to perform their respective obligations;
(b) The entity **can identify** each party's **rights** regarding the goods or services to be transferred;
(c) The entity can identify the **payment terms** of the goods and services to be transferred;

(d) The contract has **commercial substance** (the risk, timing or amount of the entity's future cash flows is expected to change because of the contract);
(e) It is **probable** that the entity will **collect the consideration**.

It is important to note that a contract does not exist if each party has the unilateral enforceable right to **terminate** a wholly unperformed contract **without compensation** (i.e. paying a penalty) to the other party. A contract is wholly unperformed if both of the following criteria are met:

(a) The entity has **not yet transferred any promised goods or services** to the customer.
(b) The entity has **not yet received**, and is not yet entitled to receive, any consideration in exchange for promised goods or services.

Two issues that may complicate the identification of contracts:

- existence of a combination of contracts
- modification of contracts

9.2.1.1 Combination of contracts

STUDY

Study paragraph 6.1.2 of the prescribed textbook.

When two or more contracts are entered into with the same customer at or near the same time, you must determine whether the contracts are to be accounted for as a single contract or as a separate contract.

The contracts must meet one of the following in order to be accounted for as one contract:

- The contracts are negotiated as a package with a **single commercial objective.**
- The amount of consideration paid under one contract is **dependent** on the price or performance under another contract.
- The goods or services promised under the contracts constitute a **single** performance obligation.

9.2.1.2 Contract modifications

STUDY

Study paragraph 6.1.3 of the prescribed textbook.

A contract may be modified after its inception. A contract modification is a change in the **scope** and/or **price** of a contract that is **approved** by the parties to the contract. A contract modification exists when the parties to a contract approve (in writing, orally or implied) a modification that either creates new or changes existing enforceable **rights** and **obligations** of the parties to the contract. An entity accounts for a contract modification as **a separate contract** if both of the following conditions are present:

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

LECTURER'S COMMENT

Work through examples 10.1 of the prescribed textbook, which deal with contract modifications, resulting in a separate contract.

If a contract modification does not result in a new separate contract, an entity accounts for it in one (or a combination) of the following ways:

- A **replacement** of the original contract with a new contract (if the remaining goods or services under the original contract are distinct from those already transferred to the customer before or on the amendment date)
- A **continuation** of the original contract (if the remaining goods or services under the original contract are distinct from those already transferred to the customer, and the performance obligation is partially satisfied at modification date)

9.2.2 Step 2 – Identify the separate performance obligations in the contract

STUDY

Study paragraph 6.2 of the prescribed textbook.

The next step is to identify the performance obligations in the contract at its inception. IFRS 15 requires that an entity recognise revenue as and when performance obligations in a contract are satisfied by the entity. Identifying performance obligations in a contract is therefore an important step in revenue recognition. A promise to deliver a good or a service in terms of a contract, is a performance obligation when the good or service is **distinct**. The term "distinct" means:

(i) The customer can **benefit** from the good or service, either on its **own** or **together with other resources** that are readily available to the customer (i.e. the good or service is capable of being distinct).
(ii) The entity's promise to transfer the good or service to the customer is **separately identifiable** from other promises in the contract (i.e. the good or service is distinct within the context of the contract).

LECTURER'S COMMENT

Please study the principles (i)–(ii) above in more detail in chapter 10 of the prescribed textbook. Also study example 10.2, dealing with identifying separate performance obligations.

(iii) **Non-distinct good or service:** A good or service that is not distinct, should be combined with other goods or services until the entity identifies a **bundle** of goods or services that are distinct.

(iv) **A series of distinct goods or services:** A **series of distinct** goods or services that are **substantially the same** and that have the same **pattern of transfer** to the customers is also a performance obligation.

LECTURER'S COMMENT

Work through example 10.3 of the prescribed textbook, which deals with a non-distinct good or service, and study the diagram on page 298 that illustrates the process of identifying the performance obligations in a contract.

9.2.3 Step 3 – Determine the transaction price

STUDY

Study paragraph 6.3 of the prescribed textbook.

The next step is to determine the transaction price for the contract. It is the amount of consideration that an entity expects to be entitled to (in terms of both the contract and its customary business practices) in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (i.e. VAT). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both. The nature, timing and amount of consideration promised by a customer affect the estimate of the transaction price, and an entity considers the effects of all of the following:

(a) Variable consideration

An amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items or because the entity's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event. For example, an amount of consideration would be variable if either a product was sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone. An entity estimates an amount of variable consideration by using either of the following methods consistently throughout the contract, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

(i) The **expected value** is the sum of probability-weighted amounts in a range of possible consideration amounts. This method may be appropriate if an entity has a large number of contracts with similar characteristics.

(ii) The **most likely amount** is the single most likely amount in a range of possible consideration amounts. This method may be appropriate if the contract has two possible outcomes only (an entity either achieves a performance bonus or does not).

LECTURER'S COMMENT

Work through example 10.4 of the prescribed textbook, which deals with variable consideration.

(b) The existence of a material financing component in the contract (time value of money)

The promised amount of consideration is adjusted for the effects of the **time value of money**.

The objective of the adjustment is for an entity to recognise revenue at an amount that reflects the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services (cash selling price). An entity considers all relevant facts and circumstances in assessing whether a contract contains a significant financing component, including both of the following:

(i) the difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services
(ii) the combined effect of both of the following:

- the expected length of time between transferring the promised goods or services to the customer and payment
- the prevailing interest rates in the relevant market

As a practical expedient, an entity does not have to adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between transfer of a promised good or service to a customer and payment by the customer for that good or service will be **one year or less**.

LECTURER'S COMMENT

Work through example 10.6 of the prescribed textbook, which deals with the financing component, and example 10.7, which deals with the time value of money.

(c) Non-cash consideration

The transaction price for contracts in which a customer promises consideration in a form other than cash is measured at the **fair value** of the non-cash consideration (IFRS 13). If an entity cannot reasonably estimate the fair value of the non-cash consideration, the entity measures the consideration indirectly by reference to the stand-alone selling price of the goods or services promised to the customer.

LECTURER'S COMMENT

Work through example 10.8 of the prescribed textbook, which deals with non-cash consideration.

(d) Consideration payable to a customer

Consideration payable to a customer includes cash, credit or other items (a coupon or voucher) that can be applied against amounts owed to the entity. In determining how to account for the consideration payable, it must first be determined whether the consideration payable is for the purchase of distinct goods or services from the customer.

- **Consideration payable is for distinct goods or services**: In this case, the entity's customer is also a supplier to the entity. The consideration payable to the customer for goods or services is therefore accounted as a purchase from a supplier. Revenue from sales to this customer is accounted for at the consideration on which the entity is entitled to in terms of IFRS 15.
- **Consideration payable is not for distinct goods or services:** In this case, the consideration receivable from the customer is reduced by the consideration payable to the customer. Therefore, the revenue recognised from the sale to the customer is reduced by the consideration payable to the customer. The reduction in consideration is at the later date of the revenue recognition or the consideration received from the customer.

9.2.4 Step 4 – Allocate the transaction price to the performance obligations in the contract

STUDY

Study paragraph 6.4 of the prescribed textbook.

Allocating the transaction price

Allocating the transaction price to performance obligations is only necessary where more than one performance obligation exists in a contract with a customer. The allocation of the transaction price to several performance obligations is based on the **stand-alone selling prices** of the underlying goods or services and depicts the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation. The best evidence of a stand-alone selling price is the **observable price** when the entity sells these goods or services separately in similar circumstances and to similar customers. If a stand-alone selling price is not directly observable, an entity estimates the stand-alone selling price based on suitable estimation methods (e.g. expected cost plus relevant profit margin).

LECTURER'S COMMENT

Work through example 10.9 of the prescribed textbook, which deals with the allocation of the transaction price.

Allocating a discount

A customer receives a discount for purchasing a bundle of goods or services if the sum of the stand-alone selling prices of those goods or services promised in the contract exceeds the transaction price. A discount given to a customer is allocated **proportionately** to all performance obligations on a **relative stand-alone selling price basis.**

Allocating variable consideration

Variable consideration promised in a contract may be attributable to the entire contact, or to a specific part of a contract. If variable consideration promised in a contract relates to the **entire contract**, then the variable consideration is allocated to **all** performance obligations in a contract, based on the **stand-alone selling prices of the promised goods or services in the contract.**

9.2.5 Step 5 – Recognise revenue when (or as) the entity satisfies a performance obligation

STUDY

Study paragraph 6.5 of the prescribed textbook.

The next step is to recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (e.g. an asset) to a customer. An asset is transferred when (or as) the customer obtains **control** of that asset. For each performance obligation identified, an entity determines at contract inception whether it satisfies the performance obligation **over time** or **at a point in time**. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

Goods and services are assets, even if only momentarily, when they are received and used. **Control** of an asset refers to the ability to direct the **use** of, and obtain substantially all of the remaining **benefits** from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by:

(a) using the asset to produce goods or provide services (including public services)
(b) using the asset to enhance the value of other assets
(c) using the asset to settle liabilities or reduce expenses
(d) selling or exchanging the asset
(e) pledging the asset to secure a loan
(f) holding the asset

Control may be transferred either over time or at a point in time.

Performance obligations satisfied over time

An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if one of the following criteria is met:

(a) The entity simultaneously receives and consumes the benefits provided by the entity's performance **as the entity performs.**
(b) The entity's performance creates or enhances an asset (work in progress) that the customer controls **as the asset is created or enhanced.**
(c) The entity's performance does not create an asset with an alternative use to the entity, and the entity has an **enforceable right to payment for performance completed to date**.

Measuring progress towards complete satisfaction of a performance obligation

For each performance obligation satisfied over time, an entity recognises revenue over time by measuring the **progress** towards complete satisfaction of that performance obligation to depict the transfer of control of goods or services promised. Appropriate methods of measuring progress include **output methods and input methods**.

- **Output method:** Revenue recognition is based on the goods or services **produced up to date**. This method considers the results of appraisals, milestones reached, or units produced.
- **Input method:** Revenue recognition is based upon the entity's **efforts or inputs**. This method considers the resources consumed, labour hours expended, costs incurred, or time lapsed.

When applying a method for measuring progress, an entity **excludes** from the measure of progress any goods or services for which **it does not transfer control** to a customer. Conversely, an entity **includes** in the measure of progress any goods or services for which **it does transfer control to a customer** when satisfying that performance obligation.

As circumstances change over time, an entity **updates** its measure of progress to reflect any changes in the outcome of the performance obligation. Such changes to an entity's measure of progress is accounted for as a change in accounting estimate in accordance with IAS 8 Accounting policies, changes in accounting estimates and errors.

An entity recognises revenue for a performance obligation satisfied over time only if it can reasonably measure its progress towards complete satisfaction of the performance obligation. In some circumstances (early stages of a contract), an entity may not be able to reasonably measure the outcome of a performance obligation, but it may still expect to recover the costs incurred in satisfying the performance obligation. In these circumstances, the entity recognises revenue only to the extent of the costs incurred until such time that it can reasonably measure the outcome of the performance obligation.

LECTURER'S COMMENT

Work through example 10.10 of the prescribed textbook, which illustrates the measure of progress.

Performance obligations satisfied at a point in time

If a performance obligation is not satisfied over time, an entity satisfies the performance obligation at a point in time. To determine the point in time at which a customer obtains control of a promised asset and the entity satisfies a performance obligation, the entity considers the requirements for control and the indicators of the transfer of control, which include, but are not limited to, the following:

(a) The customer has a **present obligation** to pay for the asset.
(b) The customer has **accepted** the asset.
(c) The customer has significant **risks** and **rewards** of ownership of the asset.
(d) The customer has **physical possession** of the asset.
(e) The customer has **legal title to the asset.**

LECTURER'S COMMENT

Work through example 10.11 of the prescribed textbook, which deals with transfer of control.

9.3 CONTRACT COSTS

STUDY

Study paragraph 7 of the prescribed textbook.

An entity can incur costs in order to obtain a contract and/or to fulfil a contract. The accounting treatment of such costs includes the following:

(i) costs to obtain a contract
(ii) costs to fulfil a contract
(iii) amortisation and impairment

LECTURER'S COMMENT

Study paragraph 7 of the prescribed textbook, which deals with contract costs. Then work through example 10.12 of the prescribed textbook, which also deals with contract costs.

9.4 PRESENTATION

STUDY

Study paragraph 9 of the prescribed textbook.

IFRS 15 provides guidance on the presentation of the following revenue-related items in the statement of financial position:

(i) trade receivable
(ii) contract assets
(iii) contract liabilities

LECTURER'S COMMENT

Study paragraph 9 of the prescribed textbook, which deals with presentation, and work through example 10.14.

9.5 DISCLOSURE

STUDY

Study paragraph 10 of the prescribed textbook.

The objective of the disclosure requirements of IFRS 15 is for an entity to disclose sufficient information to enable users of financial statement to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective, an entity shall disclose qualitative and quantitative information about the following:

(i) Contracts with customers
(ii) Significant judgements, and changes in the judgements
(iii) Assets recognised from the costs to obtain or fulfil a contract

LECTURER'S COMMENT

Study paragraph 10 of the prescribed textbook, which deals with disclosure requirements.

9.6 SHORT AND SWEET

STUDY

Study paragraph 11 of the prescribed textbook for a summary of the five-step revenue model.

FAC2601

LEARNING UNIT 10

MOCK EXAM PAPER

Financial Accounting for Companies

LEARNING OUTCOME

Learners should attempt this paper under normal exam conditions.

Overview

This learning unit is divided into the following:

Question 1 – Statement of profit or loss and other comprehensive income
Question 2 – Statement of financial position
Question 3 – Statement of changes in equity
Question 4 – Leases

QUESTION 1 (34 marks) (41 minutes)

The following balances were extracted from the financial records of Zinger Ltd at 31 August 2013:

	R
Investments at cost (note 2)	530 000
10% Long-term loan (note 11)	630 000
Motor vehicles at cost (01/09/2012) (note 7)	358 800
Equipment at cost (01/09/2012) (note 6) .	228 000
Land at cost	240 000
Buildings at cost (01/09/2012) (note 8)	710 000
Accumulated depreciation (note 5):	
– Equipment (01/09/2012)	50 000
– Buildings (01/09/2012)	142 000
– Motor vehicles (01/09/2012)	203 800
Turnover (note 1)	7 200 000
Other income (note 10)	54 000
Other expenses (excluding depreciation)	490 950
Administrative expenses (note 9)	?
Sales discount (note 1)	150 000
Distribution costs	80 000
Income tax expense	125 900

Additional information:

1. Zinger Ltd maintained an annual gross profit percentage of 40% on turnover.
2. Investments consist of:

   – 120 000 Ordinary shares of R4,00 each in Wings Ltd. Wings Ltd's total issued ordinary share capital consists of 200 000 ordinary shares. Wings Ltd's shares were trading on the JSE at R4,00 per share on 31 August 2013. Each share carries one vote.

– 30 000 Ordinary shares in Wrap'it Ltd at a cost price of R50 000. The issued share capital of Wrap'it Ltd consists of 100 000 ordinary shares. These shares were classified as a "financial asset through profit or loss". The directors valued the shares at R2,00 per share at the current financial year-end, but no fair value adjustment has yet been recorded in the financial records. Each share carries one vote.

3. The key personnel are as follows:

	Zinger Ltd	**Wings Ltd**
Chairmen	Mr Jo	Mrs So
Non-executive directors	Mr Bo, Po	Mr Wo, Go
Marketing managers	Mrs Ho	Mr Ho
Financial directors	Mr Do	Mr Fo
Managing directors	Mr Wo	Mr Po
General secretaries	Mr Go	Mr Co

During the current financial year, the abovementioned directors of Zinger Ltd and Wings Ltd each attended four directors' meetings. The directors of Zinger Ltd received R1 050 per meeting and the directors of Wings Ltd received R525 per meeting.

4. Included in the salaries paid during the year, are the following amounts:

	Zinger Ltd	**Wings Ltd**
	R	**R**
Marketing managers	165 000	135 000
Financial directors	210 000	180 000
Managing directors	240 000	230 000
General secretaries	127 500	105 000

5. The following rates of depreciation are applicable:

Equipment	15% per annum using the reducing balance method
Motor vehicles	25% per annum using the straight-line method
Buildings	5% per annum using the straight-line method

6. On 1 January 2013, equipment with an original cost price of R90 000 and accumulated depreciation of R13 500 as at the beginning of the current financial year, was sold at its carrying amount and replaced with a new machine at a cost of R93 000.

7. On 28 February 2013, a motor vehicle with an original cost of R38 000 and accumulated depreciation of R28 063 as at the beginning of the current financial year, was traded in at R9 000 for a new vehicle with a cost price of R50 000.

8. Zinger Ltd's land was revalued on 1 September 2012 by Mr P Bear, a sworn appraiser, at a net replacement value of R300 000.

9. Administrative expenses include the following:

	R
Salaries and wages	1 500 000
Fees paid to the auditor	
– For travelling expenses	15 000
– For audit work done	85 000
Interest paid on bank overdraft	7 000
Interest paid on long-term loan	?

10. Other income consists of the following:

	R
Dividends received	
– Wings Ltd .	24 000
– Wrap'it Ltd	15 000
Interest received	
– Debtors	15 000

11. The long-term loan from ASBA Bank was entered into on 1 September 2010. The capital portion of the loan is repayable in ten equal annual instalments starting 1 March 2013. Interest, calculated at 10% per annum, is payable bi-annually on 28 February and 31 August each year.

Required

Prepare the statement of profit or loss and other comprehensive income **and** the relevant notes thereto of Zinger Ltd for the financial year ended 31 August 2013. Your answer must comply with the requirements of International Financial Reporting Standards (IFRS).

Ignore the note on accounting policy. Comparative figures are not required.

Show **all** calculations.

QUESTION 2 (34 marks) (41 minutes)

The following information was taken from the financial records of Moonlight Ltd, a manufacturing company, on 31 December 2013:

	R
Ordinary share capital	2 000 000
Land at valuation (note 1)	800 000
Factory buildings at cost (note 1)	960 000
Motor vehicles at carrying amount (31/12/2012) (note 3)	420 000
Plant at cost	480 000
Machinery and equipment at cost (31/12/2013)	360 000
Furniture at cost (31/12/2013)	120 000
Accumulated depreciation:	
– Motor vehicles (31/12/2012)	280 000
– Plant (31/12/2012)	60 000
– Machinery and equipment (31/12/2012)	120 000
– Furniture (31/12/2012)	30 000
Investments at cost (note 6)	172 000
Loans (note 7)	80 000
Inventories (note 5)	340 000
Trade and other receivables (note 8)	150 000
Bank overdraft	340 000
Provisional taxation paid	50 000
Trade and other payables	160 000
Prepaid lease expenses	5 500

Additional information:

The accountant supplied the following information to you in respect of transactions that occurred during the year:

1. The factory buildings are situated on erf 32, Rosslyn, consisting of a factory and office buildings. The land was acquired on 1 January 2004 for R380 000. Buildings were erected on the land during the current financial year and the total material and labour cost of the buildings amounted to R960 000. The company withdrew its plant from normal production for a period of 8 months during the current year and used it for the erection of the buildings. The buildings were completed on 1 October 2013. The buildings are occupied by the owners. The land was revalued on 1 January 2013 at net replacement value by Mr B Shaw, a sworn appraiser.
2. Non-current assets are depreciated as follows:
   - The plant, which was acquired on 1 July 2012, is depreciated according to the straight-line method over a period of 48 months.
   - Machinery and equipment: 20% per annum according to the reducing balance method.
   - Motor vehicles: 20% per annum according to the straight-line method.
   - Furniture: 10% per annum according to the reducing balance method.
   - Buildings: 2% per annum according to the straight-line method.

3. The following and only transactions in respect of property, plant and equipment took place during the year:

   – On 30 June 2013, a motor vehicle with an original cost price of R100 000 and on which R50 000 depreciation was already written off on 1 January 2013, was traded in for R80 000 on a new vehicle costing R140 000.
   – On 2 January 2013, furniture to the value of R28 000 was purchased.

4. SA normal income tax of R140 000 must still be provided for the current year.
5. Inventories (at cost) consist of:

	R
– Raw materials	140 000
– Work in progress	200 000

   Just before year-end, a burst water pipe damaged 50% of the raw material. The company directors estimated the damaged goods to have a net realisable value of 20% lower than the cost price thereof.

   None of the work in progress was damaged by the water and the net realisable value of the work in progress was estimated by the directors to be R230 000.

6. Investments consist of the following:

   – 18 000 Ordinary shares in Silverstar Ltd purchased at R2,00 per share for speculation purposes. The total issued share capital of Silverstar Ltd consists of 200 000 ordinary shares. Each share carries one vote. These shares are traded on the JSE and the fair value of the shares was R4,00 each on 31 December 2013.
   – 60 000 Ordinary shares in Raindrop Ltd at a cost of R80 000. The total issued share capital of Raindrop Ltd consists of 80 000 ordinary shares. Each share carries one vote. These shares are traded on the JSE and the market value of the shares was R80 000 on 31 December 2013.
   – 14 000 Ordinary shares of R4,00 each in Sunblock Ltd. The total issued ordinary share capital of Sunblock Ltd was 100 000 shares. The directors valued the shares at R5,00 each on 31 December 2013. These shares are classified as a "financial asset at fair value through other comprehensive income".

7. Loans consist of the following:

   – Loan to Raindrop Ltd to the amount of R50 000. The loan is interest free and is repayable in 4 equal annual instalments. The first instalment is payable on 31 December 2016.
   – Loan to Lightning Ltd to the amount of R30 000. The loan agreement was entered into on 1 January 2013. Interest is calculated on the loan at 10% per annum and is capitalised annually. The loan is secured by a first mortgage bond over the company's property. The loan plus interest is repayable on 31 December 2015.

8. The directors decided to make provision for credit losses to the amount of R55 000. This provision has not yet been recorded at year-end.

Required:

Prepare the "Asset" section of the statement of financial position **as well as** the relevant notes thereto of Moonlight Ltd at 31 December 2013, to comply with the requirements of International Financial Reporting Standards (IFRS).

Comparative figures are not required.

The note on accounting policy is not required.

Show **all** calculations.

QUESTION 3 (16 marks) (19 minutes)

The following information was obtained from the books of Black Jack Ltd at 31 March 2014:

	R
Share capital – Ordinary shares	4 800 000
– 15% Cumulative preference shares	1 616 000
Retained earnings (01/04/2013)	702 000
Office building at cost	700 000
Land at cost	650 000
Accumulated depreciation – office building (01/04/2013)	140 000
Investment in Top-deck Ltd	1 200 000
Mark-to-market reserve (01/04/2013)	800 000

Additional information:

1. 600 000 Ordinary shares were issued at R8 each by Black Jack Ltd at incorporation on 1 April 2011.

   On 1 July 2011, 200 000 15% cumulative preference shares were issued at R7,00 each.

   On 1 September 2013, Black Jack Ltd issued 24 000 15% cumulative preference shares at R9,00 per share.

2. The following transactions relating to the equity of Black Jack Ltd have not yet been recorded in the accounting records for the current financial year**:**

2.1 200 000 Ordinary shares were issued on 10 April 2013 at R10 per share. Share issue expenses amounted to R2 000. The share issue expenses must be written off against retained earnings.

2.2 On 1 June 2013, a capitalisation issue of one new ordinary share for every ten ordinary shares held, at R8,00 per share was made.

2.3 Total comprehensive income for the year, before the revaluation and depreciation of office buildings were taken into account, was R850 000.

3. An office building was acquired on 1 April 2011 for R700 000. It was depreciated at 10% per annum according to the straight-line method.

The company has decided to revalue the land at the beginning of the financial year on the net replacement basis. The net replacement value of the land on 1 April 2013 was determined to be R990 000 and must still be recorded.

4. On 1 October 2012, Black Jack Ltd purchased 100 000 ordinary shares from Top-deck Ltd at a cost price of R4 per share. The investment was designated as a "financial asset through other comprehensive income". Top-deck Ltd has an issued ordinary share capital of 1 000 000 ordinary shares.

   The market value of ordinary shares in Top-deck Ltd on the JSE was subsequently as follows:

31 March 2013	R12 per share
31 March 2014	R14 per share

   The fair value adjustment of this investment for the current year has not yet been recorded.

5. On 25 March 2014, a final dividend of 24c per share was declared to ordinary shareholders. No dividends were declared or paid during the previous financial year.

Required:

Prepare the statement of changes in equity (excluding the total column) of Black Jack Ltd for the year ended 31 March 2014 to comply with the requirements of International Financial Reporting Standards (IFRS).

Ignore comparative figures.

Show **all** calculations.

QUESTION 4 (16 marks) (19 minutes)

The following information is supplied to you in respect of a machine acquired by Big Ben Ltd from Lighthouse Ltd, in terms of a lease agreement: The cash price of the machine is R180 000. Big Ben Ltd elected to apply the recognition exemption in respect of low-value assets to this lease agreement.

The lease term is from 1 March 2011 to 28 February 2015.

The monthly lease payment is R6 000 per month for the first 24 months, whereafter it is increased by 10% for the next 12 months, and thereafter decreased to R2 400 per month till the end of the lease term.

The lease agreement stipulates that the company may not enter into any other lease agreements without authorisation by the lessor.

The financial year-end of Big-Ben Ltd is 28 February.

Required:

Show all the journal entries **per year** in the accounting records of Big-Ben Ltd **for the full duration of the lease agreement**.

All dates and calculations must be shown.

Ignore income tax implications.

No journal narrations are required.

LECTURER'S COMMENT

Please refer to paragraphs 6.1, 6.1.1 and 6.1.2 in chapter 9 of the prescribed book for a discussion on format and presentation.

SOLUTION 1

ZINGER LTD
STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 AUGUST 2013

	Note	R
Revenue (7 200 000 – 150 000)		7 050 000
Cost of sales (7 050 000 x 60/100)		(4 230 000)
Gross profit (7 050 000 x 40/100)		2 820 000
Other income (54 000 + 10 000 + 3 813)		67 813
Distribution costs		(80 000)
Administrative expenses (1 607 000 – 7 000)		(1 600 000)
Other expenses (490 950 + 169 550)		(660 500)
Finance cost [66 500 (calculation 2) + 7 000)		(73 500)
Profit before tax	1	473 813
Income tax expense		(125 900)
Profit for the year		347 913
Other comprehensive income for the year		60 000
Revaluation of land (calculation 3)		60 000
Total comprehensive income for the year		407 913

LECTURER'S COMMENT

Other income – includes fair value adjustment on current financial asset and profit on sale of non-current asset.

Other expenses – includes the total depreciation expense for the year.

ZINGER LTD
NOTES FOR THE YEAR ENDED 31 AUGUST 2013

		R
1.	**Profit before tax**	
	Profit before tax is shown after the following had been taken into account, amongst others:	
	Income	
	Revenue from sale of goods	7 050 000
	Income from subsidiary	
	– Dividends	24 000
	Income from financial asset	
	– Unlisted – dividends	15 000
	Profit on disposal of non-current asset (calculation 1.4)	3 813
	Fair value adjustment on financial asset through profit or loss [(30 000 x R2) – 50 000]	10 000
	Expenses	
	Auditors' remuneration	100 000
	– Fee for audit	85 000
	– Travelling expenses	15 000
	Depreciation (calculation 1)	169 550
	Staff cost	1 500 000

2. Remuneration of directors and prescribed officers

Name	Directors' fees R	Salary R	Other benefits R	Pension fund R	Loss of office R	Less paid by sub-sidiaries R	Total R
Executive directors							
Mr. Do	4 200	210 000					214 200
Mr. Wo	6 300	240 000				(2 100)	244 200
Non-Executive directors							
Mr. Jo	4 200						4 200
Mr. Bo	4 200						4 200
Mr. Po	6 300	230 000				(232 100)	4 200
Prescribed officers							
Mr. Go		127 500					127 500
Total	25 200	807 500				(234 200)	598 500

LECTURER'S COMMENT

Please remember to list income and expense items separately!

Calculations

1. Depreciation

1.1 Equipment	**R**
[1]Equipment Sold:	3 825
(Depreciation current year):	
[(90 000 – 13 500) x 15% x 4/12]	
[2]New equipment: (93 000 x 8/12 x 15%)	9 300
[3]Old equipment: [228 000 – 90 000] – [50 000 – 13 500] x 15%	15 225
Total depreciation for current year:	28 350

1.2 Motor vehicles – Depreciation	
New (50 000 x 25% x 6/12)	6 250
Sold (38 000 x 25% x 6/12)	4 750
Old (358 800 – 38 000) x 25%	80 200
	91 200

1.3 Total depreciation – All assets	
(91 200 + 50 000 + 28 350)	169 550

1.4 Profit on sale of motor vehicle:	
Carrying amount [38 000 – (28 063 + 4 750)]	5 187
Proceeds on sale	9 000
Profit on sale	3 813

SOLUTION 1 (continued)

2. Interest on long-term loan:

Total payments payable	10
Less: Payments made up to 31/08/2013	(1)
Payments outstanding	9
Outstanding loan as per list of balances	630 000
R630 000 = 9 payments outstanding	
One payment is thus R630 000/9	70 000
Loan at end of year	630 000
Plus: One payment made during the year	70 000
Loan at the beginning of the year	700 000
Finance charges:	
01/09/2012 – 28/02/2013: 700 000 x 10% x 6/12	35 000
01/03/2013 – 31/08/2013: 630 000 x 10% x 6/12	31 500
Total finance charges on long-term loan	66 500

3. Land

Net replacement value	
Cost price	300 000
Revaluation	(240 000)
	60 000

LECTURER'S COMMENT

It is extremely important that you show and cross-reference all calculations!

LECTURER'S COMMENT

Please refer to paragraphs 6.2.2 and 6.2.3 in chapter 2 of the prescribed book as well as paragraphs 3.5 and 3.7 of learning unit 3 for a discussion on format and presentation.

SOLUTION 2

MOONLIGHT LTD
STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2013

	Notes	R
ASSETS		
Non-current assets		3 016 800
Property, plant and equipment	1	2 783 800
Investment in subsidiary	2	130 000
Financial assets	3	103 000
Current assets		498 500
Inventories	4	326 000
Trade and other receivables	5	95 000
Financial assets	3	72 000
Prepaid expenses		5 500
Total assets		3 515 300

MOONLIGHT LTD
NOTES AT 31 DECEMBER 2013

1. Property, plant and equipment

	Land	Buildings	Motor vehicles	Plant	Machinery and equipment	Furniture	Total
	R	R	R	R	R	R	R
Carrying amount 1/1/2013	380 000	–	420 000	420 000	240 000	62 000	1 522 000
Cost	380 000	–	700 000	480 000	360 000	92 000	2 012 000
Accumulated depreciation	–	–	(280 000)	(60 000)	(120 000)	(30 000)	(490 000)
Revaluation	420 000*	–	–	–	–	–	420 000
Additions at cost	–	960 000	140 000	–	–	28 000	1 128 000
Disposals at carrying amount	–	–	(40 000)	–	–	–	(40 000)
Depreciation	–	(5 200)	(144 000)	(40 000)	(48 000)	(9 000)	(246 200)
Plant depr capital		80 000	–	(80 000)	–	–	–
Carrying amount 31/12/2013	800 000	1 034 800	376 000	300 000	192 000	81 000	2 783 800
Cost/Valuation	800 000	1 040 000	740 000	480 000	360 000	120 000	3 540 000
Accumulated depreciation	–	(5 200)	(364 000)	(180 000)	(168 000)	(39 000)	(756 200)

*Balancing figure

Factory buildings are situated on erf 32, Rosslyn, consisting of a factory and an office block. The land was revalued at the beginning of the year at replacement value by Mr B Shaw, a sworn appraiser.

		R
2.	**Investment in subsidiary**	130 000
	Shares at cost	80 000
	Loan to subsidiary	50 000
3.	**Financial assets**	
	Non-current financial assets	
	Unlisted	
	14 000 Ordinary shares in Sunblock Ltd at fair value	70 000
	(classified as at fair value through other comprehensive income)	
	Current financial assets	
	Listed	
	18 000 Ordinary shares in Silverstar Ltd at fair value	72 000
	Financial assets at fair value through profit or loss	
4.	**Inventories**	326 000
	Raw materials [(140 000 x 0.5 x 0.8) + (140 000 x 0.5)]	126 000
	Work in progress	200 000
5.	**Trade and other receivables**	95 000
	Trade receivables	150 000
	Provision for bad debts	(55 000)

Calculations

1. Buildings:
Depreciation
(R960 000 + R80 000) x 0.02 x $^{3}/_{12}$

2. Motor vehicles

2.1 Cost at 1 January 2013

Carrying amount at 31 December 2012	420 000
Accumulated depreciation at 31 December 2012	280 000
	700 000

SOLUTION 2 (continued)

		R
2.2	**Depreciation for the year:**	
	Motor vehicle sold: R100 000 x 20% x 6/12	10 000
	Remaining vehicles: (R700 000 – R100 000) x 20%	120 000
	New vehicle: R140 000 x 20% x 6/12	14 000
2.3	**Cost at 31 December 2013**	
	Cost at 1 January 2013	700 000
	Sales at cost	(100 000)
	Purchases at cost	140 000
		740 000
3.	**Plant**	
3.1	**Depreciation for the year**	120 000
	R480 000/4 years	
3.2	**Depreciation capitalised**	80 000
	R120 000 x 8/12 Thus, R80 000 debited to buildings	
4.	**Furniture**	
4.1	**Cost at 1 January 2013**	
	Cost at 31 December 2013	120 000
	Purchases on 2 January 2013	(28 000)
		92 000
4.2	**Depreciation for the year**	
	R(62 000 + 28 000) x 10%	9 000
5.	**Investments:**	
5.1	**Financial asset at fair value through other comprehensive income:** 14 000 x R5,00	70 000
5.2	**Financial assets at fair value through profit or loss** 18 000 x R4,00	72 000
5.3	**Loan to Lightning Ltd** [R30 000 (capital) + R30 000 x 10% (interest)]	33 000

LECTURER'S COMMENT

It is extremely important that you show and cross-reference all calculations!

LECTURER'S COMMENT

Please refer to paragraph 6.2 in chapter 2 of the prescribed book as well as paragraphs 3.4 and 3.7 of learning unit 3 for a discussion on format and presentation.

SOLUTION 3

BLACKJACK LTD
STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 MARCH 2014

	Share capital – ordinary shares R	Share capital – cumulative preference shares R	Retained earnings R	Revaluation reserve – Property, plant & equipment R	Mark-to-market reserve R
Balance at 1 April 2013	4 800 000	1 400 000*	702 000	–	800 000
Total comprehensive income for the year:					
Profit for the year			780 000		
Other comprehensive income				340 000	200 000
Issue of shares					
– Ordinary shares	2 000 000				
– Preference shares		216 000			
– Capitalisation	640 000		(640 000)		
Dividends					
– Preference shares			(438 900)		
– Ordinary shares			(211 200)		
Share issue expenses			(2 000)		
	7 440 000	1 616 000	189 900	340 000	1 000 000

* (200 000 x R7)

SOLUTION 3 (continued)

Calculations:

1. Issued shares – current financial year

		R
Ordinary shares issued	(200 000 shares x R10)	2 000 000
15% Cumulative preference shares	(24 000 shares x R9)	216 000

2. Capitalisation of shares

Ordinary shares capitalised	(200 000 + 600 000) shares ÷ 10 x R8	640 000

3. Revaluation of land

Revaluation surplus: 990 000 – 650 000	340 000

4. Fair value adjustment

Fair value adjustment of investment [100 000 x (14 – 12)]	200 000

5. Dividends

			R
Preference dividends	Previous year:	(1400 000 x 15%)	210 000
	Current year:	(1400 000 x 15%)	210 000
		(216 000 x 15% x 7/12)	18 900
			438 900
Ordinary dividends [80 000 + (600 000 + 200 000)] x 24 cents			211 200

6. Total comprehensive income for the year:

Comprehensive income (given)	850 000
Depreciation R700 000 x 10%	(70 000)
	780 000

7. Mark-to-market reserve 1 April 2013:

100 000 x (14 – 12)	200 000

LECTURER'S COMMENT

Please refer back to learning unit 1 & 3 to refresh your memory on calculation of capitalisation issues and dividends.

SOLUTION 4

Equalisation of lease payments:

(6 000 x 24) + [(6 000 x 110%) x 12] + (2 400 x 12) / 48
144 000 + 79 200 + 28 800/48
= R5 250 per month

Annual prepayment 1 March 2011 to 28 February 2012 **and**
1 March 2012 to 28 February 2013:

	R
For 12 months (5 250 x 12	63 000
Actually paid (6 000 x 12)	72 000
Prepayment per annum	9 000

Annual prepayment 1 March 2013 to 28 February 2014:

	R
For 12 months (5 250 x 12)	63 000
Actually paid (6 600 x 12)	79 200
Prepayment for the year	16 200

Shortfall 1 March 2014 to 28 February 2015:

	R
For 12 months (5 250 x 12)	63 000
Actually paid (2 400 x 12)	28 800
Shortfall for the year	34 200

LECTURER'S COMMENT

The lease payments of a lease where the recognition exemption in respect of low value assets is applied, are recognised as an expense on a straight-line basis over the lease term. If the cash flows are not equal, the difference between the cash flows and the expense in the statement of profit or loss and other comprehensive income will end up in the statement of financial position as an accrued or prepaid expense.

SOLUTION 4 (continued)

Journal entries:

	Dr R	Cr R
Year ended 28 February 2012		
Lease expense (SPL)	63 000	
Prepayment (SFP)	9 000	
Bank (SFP)		72 000
Year ended 28 February 2013		
Lease expense (SPL)	63 000	
Prepayment (SFP)	9 000	
Bank (SFP)		72 000
Year ended 28 February 2014		
Lease expense (SPL)	63 000	
Prepayment (SFP)	16 200	
Bank (SFP)		79 200
Year ended 28 February 2015		
Lease expense (SPL)	63 000	
Prepayment (SFP)		34 200
Bank (SFP)		28 800